

INTERNAL REVENUE SERVICE

Number: **200139005**

Release Date: 9/28/2001

Index Nos.: 162.02-00, 761.01-01

CC:PSI:2 - PLR-106317-01

June 27, 2001

Clinic =

University =

Health System =

Medical School =

Billing =

Hospital =

State =

City =

D1 =

D2 =

D3 =

D4 =

Dear :

This is in reply to your letter dated January 26, 2001, and subsequent correspondence requesting a ruling on behalf of Clinic regarding whether the contract between Clinic and Billing will be classified as a partnership for federal income tax purposes and whether the fees paid by Clinic to Billing for billing and collection services will be deductible by Clinic as ordinary and necessary business expenses under § 162 of the Internal Revenue Code.

The information provided states that Clinic is a State professional limited liability company composed of members of the clinical faculty of the Medical School.

The Clinic operates primarily within space leased from

University in medical center facilities (the Medical Center) and uses the equipment, facilities, and other assets of the Medical Center and the Hospital to provide medical services, all in return for an amount determined annually by the Clinic and University to represent the value of the facilities, nonprofessional services, goodwill, and other valuable consideration made available to the Clinic by University.

The Clinic has been recognized by the State courts and by the Internal Revenue Service as an independent entity separate from University and the Health System. The Health System is a State non-profit corporation qualified as an exempt organization under § 501(c)(3). The Health System operates Hospital, an operating division of the Health System.

The Clinic's clinical practice operations began in D1, shortly after the Hospital opened. Until D2, the arrangement between the members of the Clinic consisted of only unwritten understandings. In D2, the members of the Clinic formalized the terms of the partnership under the State version of the Uniform Partnership Act.

In D3, the Clinic converted from a general partnership to a professional limited liability company in order to gain the benefits of limited liability and improve the management of the organization.

Most of the Clinic's clinical practice is carried on in space specifically designated for the Clinic in the Medical Center and in the Hospital. Virtually all of the Clinic departments, however, also engage in practice at clinics or hospitals off-campus, several of which are outside of the City community.

From the opening of the Hospital in D1 until D2, the relationship between the Clinic and University consisted of only an unwritten understanding. In D2, the Clinic and University entered into a formal contract to govern the terms of their relationship (the D2 Agreement). Pursuant to the D2 Agreement, the Clinic pays annually to University an amount determined by the Clinic and University to represent the value of the facilities, nonprofessional services, goodwill, and other valuable consideration made available to the Clinic by University.

Many Clinic patients are also patients of the Health System. However, the Health System and the Clinic have historically maintained separate billing systems and departments that duplicate many of the costs associated with the collection of patient accounts and the management of patient financial records.

In D4, University and the Clinic agreed to cooperate in seeking to improve the coordination of admissions as well as billings, and a computer and software system were acquired to develop an admission system that avoided duplication of effort, and that system is still being operated today by the Clinic for the benefit of both the Clinic and the Health System. Nevertheless, significant portions of both the Clinic's and the Health System's billing and collection process continues in a separate and uncoordinated system.

On the recommendation of independent consultants, the Clinic and the Health System have agreed to coordinate their billing and collections activities with a single billing and collections agent so as to achieve greater efficiencies in the billing and collection process. To accomplish this goal, the Health System has created a new limited liability company (Billing), which will perform billing and collection services for the Health System. Billing is a single member limited liability company, with the Health System as the sole member. Pursuant to § 301.7701-3(b) of the Procedure and Administration Regulations Billing is disregarded as a separate entity from its owner, Health System. The Health System will appoint all managers and hire all employees of Billing.

The Clinic has agreed to purchase billing and collection services from Billing and to appoint Billing as the Clinic's agent to collect its account receivables pursuant to certain guidelines. The guidelines and other terms of the relationship between the Clinic and Billing are set forth in the Services Agreement, being entered into by and between the Clinic and Billing. The Clinic will remit to Billing a fixed annual fee in exchange for the services performed by Billing as an agent to collect the Clinic's receivables.

Pursuant to the terms of the Services Agreement, the Clinic and Billing will negotiate each year the fee to be charged by Billing for the billing and collection of the Clinic's accounts receivables. In the event they cannot agree on a mutually acceptable fee, the prior year's fee for services will remain in effect.

The Services Agreement also provides that either party can cancel the agreement on 60 days' notice. If the Services Agreement is cancelled, Billing will continue to provide services for a ten-month period during which time the Clinic will pay fees equal to the greater of Billing's cost of providing such services or the fair market value of such services.

To insure quality standards and to protect the interest of the physician/patient relationship, Billing must perform the

billing and collection services in accordance with the written standards set forth in the Services Agreement. All of the Clinic accounts will be collected by Billing as an agent and solely in the name of the Clinic. The Services Agreement affirms that the Clinic patient accounts receivable and medical records remain at all times property of the Clinic, and in no way are being transferred, assigned or factored to Billing. Furthermore, Billing has no authority to "exercise control or negotiate any funds" of the Clinic, and has no financial interest in the accounts collected on behalf of the Clinic. The proceeds collected by Billing for the Clinic's accounts must be remitted to the Clinic, except for the fee due Billing for its services.

In order to maintain a consistently high level of customer service, Billing has created a committee (the Council) with client representation to monitor the quality of its services and business operations. Pursuant to the terms of the Services Agreement and in recognition of the primary importance of the physician/patient relationship, the Health System agreed that at least half of the members of the Council will be representatives from the Clinic. The Council will approve the annual operating plan and proposed budget, and will monitor Billing's operations to ensure Billing complies with the Services Agreement guidelines. The Council will have the right to inspect the books and records of Billing to monitor financial stability. However, except for the approval of an operating plan and budget, the Council will have no legal authority and will serve primarily as an advisory committee.

Section 761 provides that the term partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by mean of which any business, financial operation or venture is carried on, and which is not a corporation, trust or estate.

Section 1.761-1(a) of the Income Tax Regulations provides that the term partnership means a partnership as determined under §§ 301.7701-1, 301.7701-2, and 301.7701-3.

In order for a joint venture or other contractual arrangement to be classified as a partnership for federal tax purposes it must first be determined that the joint venture or other contractual arrangement gives rise to a separate entity for federal tax purposes. See § 301.7701-2(a). Section 301.7701-1 provides that a joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom. Nevertheless, a joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more

persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. For example, if an individual owner or tenants in common of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes.

The Service Agreement expressly states that the parties intend to create an independent contractor relationship. There is no reference to a partnership relationship in the Service Agreement. Under the Service Agreement, Clinic will pay Billing a predetermined fee. Neither Billing nor Health System will share in the profits of Clinic and the fee charged by Billing for services rendered will be determined on an arms' length basis in advance without regard to Clinic's profits. The Service Agreement does not provide for the sharing of profits or losses between Clinic and Health System or Billing. It is represented that the parties will not hold themselves out as partners. Further it is represented that the parties do not contemplate or expect that under the current federal tax laws that a partnership tax return will be required to be filed by the Internal Revenue Service.

Accordingly, based on the information provided and the representations made, we conclude that the contractual relationship, as set forth in the Services Agreement, between Clinic and Billing will not give rise to a separate entity for federal tax purposes between Clinic, Billing, Health System and University. Therefore, this relationship will not be a partnership for federal tax purposes.

Section 162 provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-1 provides, in part, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than § 162.

An expense is "ordinary" if, according to time, place, and circumstance, it is normal, usual, or customary to the taxpayer in the taxpayer's course of business. Welch v. Helvering, 290 U.S. 111, 113 (1933); Deputy v. Du Pont, 308 U.S. 488, 495 (1940). An expense may be ordinary even if it is only made once in the taxpayer's lifetime, as long as the transaction out of which the obligation arose is common and accepted in the

taxpayer's particular business. Welch at 113.

A "necessary" expense is one that is appropriate and helpful to the development of the taxpayer's business. Welch at 113. When determining whether an amount is ordinary and necessary, the reasonableness of the amount is called into question. Ciaravella v. Commissioner, T.C. Memo 1998-31. An amount is considered unreasonable if it is greater than the amount that would have been negotiated between parties dealing at arms' length. Gill v. Commissioner, T.C. Memo 1994-92.

In the present case, Clinic represents that medical practices frequently contract with third parties for the billing and collection of patient accounts, and such services are typical business services that are incurred by many organizations, including medical practices. Thus, the fees charged by Billing are ordinary expenses in the Clinic's business. The Clinic represents that the collection and billing of patient accounts by Billing will result in the Clinic's business becoming more efficient, with more collections on accounts, and less wasted resources. This would certainly be appropriate and helpful to Clinic's business, making the fees necessary to Clinic's business. Finally, the Clinic represents that the fees and expenses charged by Billing are the result of an arm's length negotiation between the Clinic and Billing, making the fees and expenses reasonable in amount.

Accordingly, the Clinic may deduct as ordinary and necessary expenses under § 162 the fees and expenses charged by Billing under the Services Agreement for the processing and collection of the Clinic's accounts.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k) of the Code provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, a copy of this letter is being sent to the Clinic.

Sincerely yours,
J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for section 6110 purposes