

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **201148006**

Release Date: 12/2/2011

CC:CORP:BO4

POSTS-120417-11

UICL: 1504.01-00

date: August 12, 2011

to:
(Appeals Officer)

from: Marie C. Milnes-Vasquez
(Senior Technician Reviewer)

subject: Affiliation of Medical Practice

You have requested that we review the claim by Hospital Consolidated Group of its affiliation with Medical Practice, and the Field Counsel memorandum of April 2, 2010 (Field Memo), which concludes that no affiliation exists. The facts contained in the Field Memo are incorporated by reference.

Field Arguments

Affiliation is dependent upon satisfaction of the requirements of section 1504(a). As noted in the Field Memo, the following factors are generally key to determining satisfaction of those requirements: right to vote; right to dividends (which the Field Memo refers to as "the right to share in current earnings and cumulative surplus"); and right to liquidation proceeds. The Field Memo concedes that Hospital, as the sole holder of any ownership interest in incorporated Medical Practice, and the party in complete control of the board of directors, holds voting control in Medical Practice.

However, the Field Memo asserts that the right to dividends is not satisfied because, under state law, Medical Practice is prohibited from making dividend distributions. In addition, the Field Memo states that the Hospital "arguably" does not hold the right to liquidating distributions because: (1) Medical Practice is not solvent; and (2) it argues that a transfer of assets to Hospital would not further the enumerated purposes listed in the Articles of Medical Practice, and that such a transfer "would arguably be precluded by the By-laws and [the Articles]."

In summary, the Field Memo argues,

Though [Hospital] passes one and, arguably, two of the three above-described parts of the beneficial ownership test, it does clearly fail to [possess] the right to share in current earnings and cumulative surplus of [Medical Practice]. We conclude that [Hospital] thus did not have beneficial ownership of [Medical Practice] as is required under section 1504.

Analysis

For an includable corporation¹ subsidiary to be affiliated with a group, one or more other group members must directly own stock possessing at least 80 percent of the voting power of all classes of the corporation's stock (vote requirement), and at least 80 percent of the value of each class of the corporation's stock (value requirement). Section 1504(a)(1) and (2). On the facts presented, as the Field Memo concedes, the vote requirement of section 1504(a)(2) is satisfied through Hospital's holding of the sole ownership interest in Medical Practice.

The value requirement is generally treated by analyzing two factors: right to dividends and right to liquidation proceeds. With regard to the value requirement, the Field Memo appears to take the position that the fact that Medical Practice is precluded under state law from distributing dividends prevents the parties from satisfying the value requirement of section 1504(a)(2).

This office disagrees with the conclusion of the Field Memo with regard to the right to dividends. The right to dividends is examined as a part of the value requirement under section 1504(a). Because state law prevents Medical Practice from distributing dividends to any party, no value is transferred from corporate solution to owners until liquidation. Therefore, in cases in which no value can leave the corporation in the form of dividends, the dividend analysis loses its pertinence. The key to the value requirement becomes the examination of liquidation rights in the corporation.

Under the facts presented, it appears that Hospital had rights to the distribution of all assets of Medical Practice on liquidation. The Articles provide that, following settlement of debts, Medical Practice will distribute its remaining assets as the Board of Trustees in its sole discretion will determine. See Articles of Incorporation, Article 10. Further, the bylaws grant Hospital the ability to unseat any Trustee at any time, without cause. In addition, the Hospital had the power to amend both the Bylaws and the Articles at any time. See Bylaws, Article 2.5; Articles of Incorporation, Articles 8 and 9. Because of Hospital's complete control over the Board of Trustees, the Field Memo states that "we believe that [Hospital], at all relevant times did have the power to determine distribution

¹ The facts indicate (and the Field Memo concedes) that Medical Practice is an includable corporation.

of assets upon liquidation, and thus could have distributed any of the remaining assets to [itself].” We agree.

However, the Field Memo goes on to assert that it is “arguable” that Medical Practice would be precluded under its Articles and Bylaws from making liquidating distributions to Hospital. The memo’s only rationale for this position is that:

[The Articles and the Bylaws] specifically provide that [Medical Practice] shall be operated exclusively to carry out several enumerated purposes, none of which would be furthered if the remaining assets, if any, were transferred to [Hospital].

The Field Memo does not list or discuss the corporate purposes that are enumerated in the bylaws, nor does the memo provide any analysis with regard to this argument.

The corporate organizational documents of [Medical Practice] provide that one of the corporate purposes of the entity is to “deliver health care to the public.” See Articles of Incorporation, Article 4(d). The facts presented indicate that Medical Practice was in the business of operating physician clinics, and that the business activities of Hospital involve providing hospital and other health care services to the public. Therefore, the Field Memo’s argument does not appear to be supportable.

The Field Memo also argues that the value test was not satisfied because, “as a practical matter, [Medical Practice’s] liabilities greatly exceeded its ability to pay during each of the periods at issue. Thus, distribution of the remaining assets other than to the creditors of [Medical Practice] would not have occurred.”

The Field Memo is inconsistent with law in the affiliation area. The liquidation value analysis, as acknowledged in the Field Memo, focuses on whether a party holds the benefits and burdens of increase or decrease in the value of the entity. See Miami National Bank v. Comm., 67 T.C. 793, 801 (1977); Rev. Rul. 70-469. It is also important to note that even the bankruptcy of a corporation does not prevent its affiliation with the holders of its stock. See Rev. Rul. 63-104; see also Treas. Reg. § 1.597-4(f)(1) (providing that, unless an election to disaffiliate is made, the fact that an insolvent financial institution is controlled by the FDIC or other agency does not cause the financial institution to cease to be a member of a consolidated group); §1.1502-80(c) (containing rules that require the deferral of a claim of worthlessness on the stock of a group member, beyond the year in which such worthlessness would otherwise be claimed under section 165). Thus, the insolvency or even the bankruptcy of an entity does not prevent its affiliation.

The parties agree and the facts indicate that Hospital holds in Medical Practice the 80 percent vote requirement for affiliation. Although the question is not free from doubt, it

appears that the 80 percent value requirement for affiliation has also been satisfied,² due to Hospital's apparent ability to require that it be the recipient of liquidating distributions from Medical Practice. Therefore, under the facts presented, we conclude that Medical Practice should be includible in the Hospital Consolidated Group for the years at issue.

Please call (202) 622-7530 if you have any further questions.

² Some uncertainty remains, due to possible differences in interpretation of the organizational documents under state law.