Physician Member of Surgery Center LLC Has Passive Income, Not Subject to SECA

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Hardy v. Commissioner1 is a memorandum opinion of the Tax Court with potentially significant implications. The opinion, filed January 17, 2017, deals with a fairly common arrangement in which physicians have both a medical practice and an ownership interest in a separate medical facility. In this case, the taxpayer was a plastic surgeon who held a membership interest in a surgical center limited liability company ("LLC") treated as a partnership for U.S. federal income tax purposes. The Tax Court held that the physician could treat his interest in the surgery center LLC as separate from his medical practice, and that his distributive share of income from the LLC was passive income for purposes of section 4692 and not subject to tax under the Self-Employment Contributions Act ("SECA") because he was properly classified as an investor in the LLC.

Background Facts

Dr. Hardy is a plastic surgeon who, before joining surgery center MBJ LLC, performed most of his surgery in his office or at one of two local hospitals. Because of limited availability of hospital operating rooms, Dr. Hardy had considered building his own surgery center to provide a cost-efficient alternative to hospitals and to allow himself more flexibility in scheduling surgeries. Before beginning construction,

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2 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").
however, Dr. Hardy was approached by MBJ LLC about becoming a member of that surgery center. He determined that it would be wiser to join an already operational surgery center because of the expenses of constructing, staffing, certifying, and operating the center. Dr. Hardy purchased a 12.5 percent interest in MBJ LLC in 2006 to join seven other practicing physicians as owners of the surgery center.

MBJ LLC is professionally managed, hires its own employees and does not share employees with Dr. Hardy. Each member of MBJ LLC receives his or her share of the center's earnings from facility fees, less expenses. MBJ LLC does not pay the physicians for their services; each physician using the facility bills separately for surgical services. Moreover, Dr. Hardy does not pay MBJ LLC for use of its facility; the patients are billed separately and pay the facility fees directly to MBJ LLC. Dr. Hardy attends quarterly meetings with the other owners of MBJ LLC, but generally is not involved in hiring or firing decisions. He has no day-to-day responsibilities or input into management decisions. Dr. Hardy's income from MBJ LLC is not related to the number of surgeries he performs there. In general, Dr. Hardy performs approximately half of his surgeries at his private office, 9-20 percent at MBJ LLC, and the balance at other facilities. Dr. Hardy's patients choose where to have the surgeries performed.

In 2006 and 2007, Dr. Hardy and his wife employed an accountant to prepare their tax returns; the accountant determined the Hardys' distributive share of income from MBJ LLC was non-passive and subject to tax as income from self-employment under SECA. The Hardys reported suspended passive losses from other activities on Form 8582, Passive Activity Loss Limitations, in 2006 and 2007. In 2008, the Hardys' accountant changed his opinion and determined that the income from MBJ was passive under section 469. The Hardys did not amend their tax returns for 2006 and 2007. Rather, they carried their suspended passive losses from those years forward and deducted the losses in 2008 because there was sufficient passive income from MBJ LLC.

Subsequently, the Hardys have reported their returns from MBJ LLC as passive income and used that income to allow use of significant passive losses.

Contrary to the traditional posture of taxpayers and the IRS, the Commissioner took the position in this case that MBJ LLC was non-passive for one of two reasons: Either the grouping of Dr. Hardy's surgical practice with MBJ LLC is required, or the Hardys had grouped the two together in 2007 and 2008 and were required to be consistent with that grouping decision. The Hardys argued that they had not grouped the two activities and were not required to do so under the regulations. In addition, the Hardys argued that they had overpaid their SECA tax for those years because their distributive share of income from MBJ LLC was not subject to SECA.

Passive Loss Rules

Section 469 provides that losses from passive activities are allowed only to the extent of income from passive activities.3 A passive activity is defined as a trade or business activity in which the taxpayer

3 Section 469(a).
does not materially participate and most rental activities. Each trade or business activity can be treated as a separate activity for purposes of section 469 (a “grouping”) or two or more can be grouped together (another possible “grouping”) if the activities form an appropriate economic unit. If a taxpayer appropriately groups two business activities (such as the taxpayer’s surgical practice and the surgical center), the taxpayer’s material participation in his surgical practice is sufficient to establish material participation in both portions of the grouped activity and vice versa.

The rules relating to grouping are relatively flexible, providing that the taxpayer should consider the following when determining an appropriate grouping: common ownership and control, geographical location, similarity and differences in businesses, and interdependencies. There is more than one way to group, and not all factors have to be present to have an appropriate grouping. The primary rule is one of consistency. Once grouped, the taxpayer cannot regroup unless there is a material change in facts and circumstances or the original grouping was clearly inappropriate. In addition, under the regulations, the Commissioner has the authority to regroup a taxpayer’s activities, but only if the grouping is not an appropriate economic unit and a principal purpose of the taxpayer’s grouping is to circumvent the underlying purpose of section 469.

In this case, the Commissioner argued that the taxpayers had inappropriately treated Dr. Hardy’s surgical practice and his interest in the surgery center as separate activities, thereby generating passive income from the surgery center that was properly part of Dr. Hardy’s surgical practice. The Commissioner pointed to an example in the regulations that illustrates a grouping that is considered abusive and may be challenged. In the example, taxpayers D, E, F, G, and H are doctors who operate separate medical practices. D invested in a tax shelter that generates passive losses and the other doctors also had passive losses from real estate activities. The doctors form a partnership to acquire and operate x-ray equipment. Substantially all of the partnership’s activity is to provide services to the doctors or their patients, roughly in proportion to the doctors’ interests in the partnership. The x-ray partnership is managed by a general partner selected by the doctors. The x-ray partnership generates passive income that the doctors use to offset their passive losses from other investments. The example concludes that the grouping is inappropriate and that the Commissioner can regroup the taxpayer’s activities into a single unit. It explains further that the taxpayers’ medical practice services and the services provided by the partnership are an appropriate economic unit and that the principal purpose of treating the medical practices and the services provided by the partnership as separate activities is to circumvent the underlying purposes of section 469.

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4 Section 469(c)(1).
5 Section 1.469-4.
6 Section 1.469-4(c)(1) and Example 1 of section 1.469-4(c)(3).
7 Section 1.469-4(c)(2).
8 Section 1.469-4(e)(1).
9 Section 1.469-4(f)(1).
10 Section 1.469-4(f)(2).
In contrast to the argument that the Commissioner made in *Hardy* at the Tax Court, the IRS issued a technical advice memorandum (the “TAM”) in the spring of 2016 that took a different position. Dealing with facts that were remarkably similar to those in the *Hardy* case, the TAM concluded that there was more than one reasonable grouping available to the physicians, that it is not clearly inappropriate in the facts presented to treat a surgical center as separate from a medical practice, and that in the case under consideration in the TAM there was no principal purpose of circumventing the purposes of section 469.

Given the Hardys’ facts, the Tax Court agreed with the reasoning of the TAM and held that the Hardys’ grouping (treating each activity as separate) is reasonable, and the Commissioner’s attempt to regroup the Hardys’ activities together is not allowed because the Hardys had good business reasons to invest in the surgery center and not a principal purpose to circumvent the underlying purposes of section 469.

The facts that the Tax Court relied on for its conclusion are significant. First, based upon the facts it appears that the Hardys’ decision to invest in a surgical center was not motivated by an interest in generating passive income. In fact, they reported that income as non-passive in 2006 and 2007. Rather, the court determined that Dr. Hardy was interested in having access to another surgery center for his patients for business reasons. Next, Dr. Hardy’s income from MBJ LLC is not linked to his medical practice. The Hardys did not carve out a portion of the medical practice to generate passive income, as was the case in the regulations’ example of an abusive grouping. Moreover, application of the other relevant factors support treating the activities as separate: Dr. Hardy’s ownership in MBJ LLC is a minority interest and he owns 100 percent of his surgical practice; he has no operational control of MBJ LLC and complete operational control of his surgical practice; his medical practice and MBJ LLC do not share the same building or employees, billing functions, or accounting services, his return from MBJ LLC is not directly tied to his use of the facility, and he continues to perform surgery at his own office and at local hospitals, depending on the patient’s preference.

The Commissioner’s second argument was that the taxpayer had grouped MBJ LLC with his surgical practice when he reported the income as non-passive in 2006 and 2007. The court disagreed, noting that there was no disclosure or other evidence that the two activities had been grouped together, only evidence of error in applying the passive activity loss rules. In addition, however, the court did not allow the passive losses from 2006 and 2007 to be carried to 2008 and used in that year, noting that the losses should have been deducted in the years incurred. Nevertheless, the court found that the Hardys were not liable for any penalties with respect to the position taken on the 2008 return regarding the passive losses because they reasonably relied on their accountant in preparing their returns.

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11 TAM 201634022.
12 Not filing amended returns for 2006 and 2007 was thus a costly error, causing deductions of more than $100,000 to be permanently lost.
SECA and LLCs

Sections 1401(a) and (b) impose a tax on net earnings from self-employment. Net earnings from self-employment is defined as gross income less allowable deductions from a taxpayer’s trade or business plus the “distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade of business carried on from a partnership of which he is a member.”

Generally, partners must include their distributive share of a partnership’s trade or business income in their net earnings from self-employment, but there are a number of exceptions. Section 1402(a)(13) provides an exclusion from SECA for the distributive share of a “limited partner.” The term “limited partner” is not defined for purposes of SECA. The court looked to its discussion of the meaning of that term in Renkemeyer and Campbell & Weaver, LLP v. Commissioner for guidance. In Renkemeyer, the partners were lawyers operating out of a law firm treated as a partnership for tax purposes. The earnings of the law firm (the LLP) were from fees for services, but the firm did not include the partners’ distributive shares of those fees as subject to SECA. The Commissioner disagreed and the Tax Court agreed with the Commissioner, stating:

[T]he intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and were not actively participating in the partnership’s business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.

In Hardy, the court held that Dr. Hardy is an investor in MBJ LLC, which is distinguishable from the LLP formed by the lawyers in Renkemeyer. The court listed the following distinguishing factors:

- MBJ LLC owns and operates a surgical center that is equipped for doctors to perform surgeries that require local and general anesthesia.
- MBJ LLC bills patients for the use of the facility.
- Although Dr. Hardy performs surgeries at the facility, he is not involved in the operations of MBJ LLC as a business.
- Patients separately pay Dr. Hardy for his services as a surgeon and then separately pay MBJ LLC for the use of the facility and use the facility in the same manner as a hospital.

The court’s conclusion was that Dr. Hardy’s distributive share of MBJ LLC’s income is not subject to SECA because “he received the income in his capacity as an investor.”

13 Section 1402(a).
15 Id. at 146.
Analysis

The *Hardy* case is interesting in a number of respects. First, the failure to consider whether any of the recharacterization rules under section 469 apply to recharacterize Dr. Hardy’s net income from MBJ LLC as non-passive is surprising. Generally, the section 469 rules are crafted to eliminate what are colloquially known as “PIGS,” passive income generators. The reason is that an increase in passive income allows use of more passive losses—thereby reducing the effectiveness of the purpose of section 469: the suspension of passive losses from purely investment activities. One of the recharacterization rules that could have been applied in this case is the recharacterization of net income from significant participation passive activities (“SPPAs”). Very generally, a SPPA is a trade or business activity in which the taxpayer significantly participates (for more than 100 hours) but does not materially participate. Because Dr. Hardy attended quarterly meetings of members and, while not involved in day-to-day management, was likely somewhat involved in maintaining the quality of both the facility and its employees, it is surprising that no mention was made of this possibility.

Second, it is interesting to note that the Hardys’ reporting the income from his interest in the surgical center as non-passive was not assumed to be a grouping of Dr. Hardy’s medical practice and his interest in the surgical center. While taxpayers are sometimes concerned that failing to identify income and loss as allocable to different business activities is a de facto grouping, this case suggests some latitude with respect to groupings, even when reporting the activities as separate would have affected the taxpayers’ income tax liability. Revenue Procedure 2010-13 now requires disclosure of new groupings, however, thus reducing the prevalence of this issue.

Third, the conclusion that a member of an LLC who receives income from the LLC as an investor is not subject to SECA is a novel one. The regulations under section 1402(a)(13) that were proposed in 1997 tried to define a “limited partner” for SECA purposes as only income of a limited partner is excluded by statute from SECA; all other partnership income from a partnership trade or business is subject to SECA. These regulations made a distinction between a regular investor who is only minimally involved in a partnership and a service partner in a service partnership, requiring all of a service partner’s income to be treated as subject to SECA. However, those regulations were never finalized.

In contrast to the opinion in *Renkeymeyer*, the proposed regulations are neither cited nor discussed in *Hardy*. Rather, the court simply looked to the legislative history of section 1402(a)(13), as discussed in *Renkeymeyer*, and drew a conclusion that relies on the legal form of the arrangement to determine whether SECA applies. In this case, the court drew a legal distinction between fees paid by a patient to Dr. Hardy and fees paid by his patients when Dr. Hardy used the facility to provide his services. The court did not consider the fact that the services provided by Dr. Hardy and the other physician members

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16 Section 1.469-2T(f)(2).
17 Note that in this case, the failure to report the income from the surgical center as passive caused the taxpayers’ passive losses to be suspended and ultimately lost when the court accepted the characterization of the activity in 2008 as passive.
18 2010-4 I.R.B. 329.
19 Proposed section 1.1402(a)-2(h).
enhance MBJ LLC’s ability to earn income and does not attribute any of Dr. Hardy’s medical service hours to MBJ LLC’s business activities. Rather, the court seemed to find it sufficient to distinguish the holding in *Renkemeyer* (in which the lawyers who were members of the LLP provided the services producing the fee income) rather than analyzing why Dr. Hardy should be considered a limited partner under section 1402(a)(13). Unlike the court in *Renkemeyer* (in which the court discussed the state law form of the entity, an LLP), the *Hardy* court did not address the fact that the entity is an LLC rather than an LP.

Under the court’s analysis, income of a partner in an LLC holding in the capacity as an investor seems to be a new category of exception from SECA.20

**Conclusion**

The *Hardy* case is somewhat lacking in its analysis of both section 469 and section 1402(a)(13), but may provide an indication of the way certain courts are tending to examine these provisions. The SECA portion of the opinion appears to rely on the legal forms adopted by the taxpayers to segregate portions of their business activities and investments (so long as the division has a business purpose and not an abusive motive) while the passive activity analysis seems to allow reasonable groupings and not hold taxpayers to their past reporting if they did not make a formal grouping election. Nevertheless, the facts in *Hardy* may be unique and under different facts other courts may come to different conclusions. Despite the fact that *Hardy* may still be appealed, taxpayers have reason to be optimistic about this court’s approach to both SECA and the passive loss rules.

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20 The IRS has stated informally that it will allow a partner to be exempt from SECA if the partner meets the definition of a limited partner in the proposed regulations. Since the court decided that Dr. Hardy had two distinct activities, he could have qualified as a limited partner in the LLC within those rules.