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Supreme Court Declines to Review Appellate Decision Denying Deductibility of Payments under Management Services Agreement

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Elick Case Provides Several Cautionary Rules for Structuring Agreements

In action taken on May 19, 2016, the Supreme Court declined to review a decision of the Ninth Circuit Court of Appeals that had upheld the Tax Court's denial of a deduction claimed by a dental practice organized as a "C" corporation for payments made to a management company that was owned by an employee stock ownership plan of which the dental practice group's employees were beneficiaries. In a previously published article in the *Journal of Health Care Compliance*, the author reviewed the 2013 decision by the Tax Court, *Wiley M. Elick v. Comm'n,* TC Memo 2013-139 (June 3, 2013).[1]

As described in the prior article, the Tax Court had cited several factors in its denial of the deduction of significant management fees. For example, even after entering into the management agreement, the dental practice continued to employ a bookkeeper to handle billing, collection, and accounting services. Moreover, the management company had no paid employees, and it was unclear to the Tax Court that the management company actually conducted any activities.

In upholding the decision of the Tax Court, the Ninth Circuit Court of Appeals[2] found that the management fees paid by the dental practice were nondeductible by the dental practice since they were not ordinary and necessary. The appellate court agreed with the Tax Court's finding that based on the record, the management fees were not necessary to the practice's ongoing business and that the evidence "amply support[ed]" the Tax Court

finding that the management company did not actually provide services to the dental practice.

With the Supreme Court's denial of certiorari, the Ninth Circuit's decision is now final, and physicians and other health care providers should take heed of the lessons learned from the *Elick* case in structuring management services agreements, particularly those with an entity that is commonly controlled with the practice entity or health care provider.

Lesson No. 1

The management services agreement should require that the management company provide the practice entity or other health care provider with evidence of the services performed by the management company.

Lesson No. 2

The compensation paid to the management company should be "reasonable" based on the services to be provided (and actually provided). For example, the compensation paid to the management company should be in the range of that which would be payable if a third-party owned management company had provided comparable services.

Lesson No. 3

The management company should employ or pay to obtain the services of billing, bookkeeping, or comparable personnel so that the management company incurs a cost and financial risk in performing services under the management agreement.

In summary, the *Elick* case does not invalidate in all situations the tax deductibility of management fees paid by a practice entity or health care provider. However, it provides several cautionary "rules of the road" in structuring management services agreements, particularly those with related management services organizations.

Endnotes:

1. *See* "Tax Court Decision Addresses Tax Deductibility of Payments under Management Services Agreement," *Journal of Health Compliance*, November – December 2013, p. 65.
2. 117 AFTR 2d 2016-457, Ninth Cir. Ct. of App. 2016.

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