



## Tax Reduction Letter

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### TAM 922004

January 8, 1992

#### ISSUE

Whether a taxpayer engaged solely in the business of providing physical therapy services is a qualified personal service corporation under *section 448(d)(2) of the Internal Revenue Code*, and therefore required to use the 34 percent corporate income tax rate pursuant to *section 11(b)(2)*.

#### FACTS

The taxpayer is engaged in the business of solely providing physical therapy services to its clients. These services include the evaluation, treatment, instruction, and administration of physical therapy services for the purpose of assessing, preventing, correcting, or alleviating a client's physical pain through the use of massage, exercise, instruction, and the use of equipment.

According to b state law, the taxpayer may obtain its clients only through a physician's referral or prescription. Ordinarily, a physician makes the initial examination and diagnosis of the client, and the physical therapist provides the physical therapy services prescribed by the physician.

The taxpayer employs c full-time therapists and d assistants. All of the taxpayer's employees' duties are directly related to the provision of physical therapy services. The taxpayer is a calendar year corporation, and its stock is exclusively owned by one shareholder, who is also an employee of the taxpayer.

#### APPLICABLE LAW

*Section 448(d)(2) of the Code* defines the term "qualified personal service corporation" as any corporation: (A) substantially all of the activities of which involve the performance of services within the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; and (B) substantially all of the stock of which (by value) is held directly or indirectly by (i) employees, (ii) retired employees, (iii) the estate of an employee, or (iv) any other party who acquired the stock as a result of the death of an employee.

*Section 11(b)(2) of the Code* provides that the amount of tax imposed on the taxable income of a qualified personal service corporation (as defined in *section 448(d)(2)*) shall be equal to 34 percent of the taxable income.

Section 1.448-1T(e)(3) of the temporary Income Tax Regulations provides that the term qualified personal service corporation means any corporation that meets (i) the function test of paragraph (e)(4) of this section, and (ii) the ownership test of paragraph (e)(5) of this section.

Section 1.448-1T(e)(4)(i) of the temporary regulations provides that substantially all of the activities of a corporation are involved in the performance of services in any qualifying field,

such as health, if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field.

Section 1.448-1T(e)(4)(ii) of the temporary regulations defines services performed within the field of health as the provision of medical services by physicians, nurses, dentists, and other similar health-care professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services within the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

Section 1.448-1T(e)(5)(i) of the temporary regulations provides that a corporation meets the ownership test, if at all times during the taxable year, substantially all of the corporation's stock, by value, is held, directly or indirectly, by (i) employees, (ii) retired employees, (iii) the estate of an employee, or (iv) any other party who acquired the stock as a result of the death of an employee. For purposes of this paragraph (e)(5), the term "substantially all" means an amount equal to or greater than 95 percent.

*Section 1.213-1(e)(1)(i) of the regulations* defines the term "medical care" to include the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for medical care include those expenses paid for the purpose of affecting any structure or function of the body or for transportation primarily for any essential medical care. Furthermore, *section 1.213-1(e)(1)(ii)* provides that amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care.

## **RATIONALE**

The taxpayer contends that it is not a qualified personal service corporation as defined in *section 448(d)(2) of the Code* because it is not within the "field of health" as defined in *section 448(d)(2)(A)*. Specifically, the taxpayer argues that because a client's diagnosis is made by a physician and it is unable to prescribe medication, it does not provide medical services. In contrast, the examining agent contends that the taxpayer is within the "field of health," and thus is a qualified personal service corporation. The examining agent argues that because physical therapy services are prescribed by a physician, the taxpayer does, in fact, provide medical services.

In order to be considered a qualified personal service corporation under *section 448(d)(2) of the Code*, section 1.448-1T(e)(3) of the temporary regulations provides that a taxpayer must meet two tests, the "function test" as set forth in paragraph (e)(4) of section 1.448-1T, and the "ownership test" of paragraph (e)(5) of section 1.448-1T. In the case at hand, the taxpayer argues that it is not a qualified personal service corporation because it has not met the elements of the function test. The taxpayer concedes that the elements of the ownership test have been met.

### **A. Function Test**

The first test, the "function test," requires that substantially all of the corporation's activities must be devoted to the field of health, law, engineering, architecture, accounting, actuarial

science, performing arts, or consulting. See section 1.448-1T(e)(4)(i) of the temporary regulations. In order to meet the function test, the taxpayer must meet three criteria.

First, the taxpayer must provide medical services. Specifically, section 1.448-1T(e)(4)(ii) of the temporary regulations provides that services within the field of health includes the provision of medical services. Although the Code and temporary regulations do not provide a definition of those services which are included within the provision of medical services, *section 213* provides some guidance.

*Section 1.213-1(e)(1)(i) of the regulations* defines medical care as the diagnosis, cure, mitigation, treatment, or prevention of disease. Similarly, state b defines "physical therapy" as the evaluation, treatment, instruction, and administration of services to assess, prevent, correct, or alleviate the signs and symptoms of physical disability and pain. Although state b requires that the initial diagnosis be performed by a physician, a physical therapist is still responsible for the cure, mitigation, treatment, and prevention of its clients' pain and disabilities.

Furthermore, *section 1.213-1(e)(1)(ii) of the regulations* provides that amounts paid for therapy are deemed to be for the purpose of medical care. Thus, because therapy services are medical care under *section 1.213-1(e)(1)(i)*, the physical therapy services provided by the taxpayer to its clients are medical services under section 1.448-1T(e)(4)(ii) of the temporary regulations.

The second criteria of the function test requires that the taxpayer must be a health-care professional. Specifically, section 1.448-1T(e)(4)(ii) of the temporary regulations requires that the medical services are provided by physicians, nurses, dentists, or other "similar health-care professionals." The Code and regulation do not define the term "similar health-care professionals." Nonetheless, the taxpayer is "similar" to other health-care professionals listed in section 1.448-1T(e)(4)(ii) in education, training, and the very nature of its services.

For example, to practice physical therapy services in state b, a physical therapist must be licensed. In order to become licensed, a physical therapist must be a graduate of a board certified school of physical therapy. The physical therapist must also pass an examination given by e to determine the fitness of the applicant. This process is similar to the certification requirements of a nurse, dentist, or physician in state b.

Furthermore, the very nature of a physical therapist's services is to provide evaluation, treatment, instruction, and administration of physical therapy services for the purpose of assessing, preventing, correcting, or alleviating physical disability or pain. Unlike a health spa or a health club that provides physical exercise or conditioning to its customers, physical therapy services are more than merely related to the health of the service recipient. In fact, physical therapy services are for the specific treatment of a physical ailment. Thus, the very nature of the taxpayer's services are similar to the services provided by other health-care professionals such as physicians, nurses, and dentists.

The third criteria of the function test requires that substantially all of the taxpayer's activities must be devoted to the field of health. Specifically, section 1.448-1T(e)(4)(i) of the temporary regulations requires that substantially all of the activities of a corporation are devoted to the field of health, which means that 95 percent or more of the employees' time must be devoted to the performance of services within the field of health. In this case, the taxpayer states that all of its employees' duties are directly related to the provision of physical therapy services. Accordingly, the taxpayer's employees devote substantially all of their time to the performance of physical therapy services.

Nowhere in *section 448 of the Code* and the temporary regulations thereunder does the definition of the "field of health" require that a health-care professional be able to prescribe medication, or that a health-care professional make the client's initial diagnosis. In fact, *section 448* and the temporary regulations thereunder directly suggests the opposite. For example, nurses are generally unable to provide medication. Furthermore, a nurse does not make a client's initial diagnosis. A physical therapist, much like a nurse, uses technical services to execute medical orders prescribed by a physician or dentist. Thus, because the taxpayer is unable to prescribe medication or make a client's initial diagnosis, does not preclude the taxpayer from being within the field of health.

#### B. Ownership Test

The second test for determining whether a taxpayer is a qualified personal service corporation under *section 448(d)(2) of the Code* is the "ownership test." The ownership test provides that at all times during the taxable year substantially all of the corporation's stock must be owned by (1) employees, (2) retired employees, (3) the estate of an employee, or (4) any other party who acquired stock by way of the death of an employee. Section 1.448-1T(e)(5)(i) of the temporary regulations provide that the term "substantially" means an amount equal to or greater than 95 percent. In the case at hand, 100 percent of the corporation's stock is owned by an employee during the taxable years in question. Thus, as conceded by the taxpayer, the taxpayer has met the ownership test.

#### CONCLUSION

A taxpayer engaged solely in the business of providing physical therapy services is a qualified personal service corporation under *section 448(d)(2) of the Code*. Consequently, the taxpayer must use the 34 percent corporate income tax rate pursuant to *section 11(b)(2)*.

A copy of this technical advice memorandum is to be given to the taxpayer. *Section 6110(j)(3) of the Code* provides that it may not be cited as precedent.