Medical Practice Scores Victory in Inventory/Correct Accounting Method Case

Reed Tinsley, CPA
Director of Physician Services
Horne CPA Group
Houston, Texas

In a noteworthy victory for medical practices with significant drugs and supplies on hand, the U.S. Tax Court recently held that chemotherapy drugs that a professional medical corporation administered to its patients were not merchandise under Treas. Reg. § 1.471-1 and the taxpayer could therefore account for such drugs on a cash basis. *Osteopathic Medical Oncology and Hematology PC. v. Commissioner,* 113 TC. No. 26; No. 11551-98 (Nov. 22, 1999)

The taxpayer in the case, a professional service corporation, was a hematology/oncology practice specializing in the treatment of cancer. This included treatment protocols utilizing chemotherapy, which require the use of drugs and other pharmaceuticals as part of the treatment plan. The practice used the cash method of accounting to expense the cost of the drugs when they were acquired. The IRS on examination determined that the drugs were “merchandise” (i.e., inventory) under Treas. Reg. § 1.471-1, and that the practice therefore was required to use the accrual method of accounting to report all related revenues and drug purchases.

The Tax Court rejected the IRS’ characterization of the drugs as inventory, ruling that the intrinsic nature of the practice was as a service provider. The court found that the practice’s use of the chemotherapy drugs was secondary to the delivery of its services, and that the practice used the drugs as an indispensable and inseparable part of the rendering of its services. The court accordingly concluded that the chemotherapy and other drugs were not “merchandise” under Treas. Reg. § 1.471-1, and that the practice had properly used the cash method of accounting to expense the cost of the drugs it purchased.

Background and Facts

The chemotherapy drugs in question were pharmaceutical drugs. Under the applicable state law (Michigan), such drugs must be prescribed by a doctor and may he sold only by a licensed pharmacist. Neither the practice nor any of its doctor-owners was a licensed pharmacist, and it was unlawful for the practice to sell the drugs. However, the practice could lawfully use the drugs in the performance of its chemotherapy services.

Chemotherapy drugs generally come in ready-to-use form or as powders or liquids that require mixing. The practice usually maintained about a two-week supply of chemotherapy drugs, and it regularly purchased chemotherapy drugs from suppliers to insure that it had enough on hand to administer its prearranged treatments to patients. Chemotherapy drugs, in an unmixed form, have a shelf life varying from about six months to one year.

The practice’s procedures were similar to those of most oncology practices. A patient was first evaluated, and a physician then sometimes prescribed a chemotherapy regimen. The patient then began regular, periodic treatments. The patient did not select the type or quantity of drugs used in the treatments: this selection was within the sole discretion of practice’s professional staff. The practices personnel mixed and prepared the chemotherapy drugs that were administered to patients, and one of the practice’s oncology nurses usually performed the administration, with a physician always on site to respond to emergencies.

The dollar amount reimbursed to the practice for a drug administered to a patient was ascertained by reference to the average wholesale price (“AWP”) of the units in which the drug was packaged and sold wholesale, with the AWP published annually with quarterly updates. Generally, the reimbursement amount for drugs equals the AWP times the units used, with rounding up to the next whole unit of a drug when billing for administration of a partial unit. The standard total charge nationally for chemotherapy drugs is usually 1.5 to 2.0 times the AWP and the practice billed its patients for the drugs at this rate with the expectation that the patient would pay the excess over the contracted rate or the usual, customary, or reasonable rate, depending on the payor.

The practice consistently had used the cash method for purposes of both financial and tax accounting,
and it never maintained an inventory of any of the items used in its practice. The actual cost of chemotherapy drugs that it had on hand at the end of 1995 was $31,887. On its 1995 tax return, it deducted $772,522 for “medical supplies” for the actual cost of the chemotherapy drugs, and $66,305 for “laboratory supplies” for the actual cost of miscellaneous nonpharmaceutical items. The practice reported $2,938,726 in gross receipts on its 1995 tax return, and no cost of goods sold. Upon examination, the IRS determined that the practice was required to account for its chemotherapy drugs as inventory, and thus asserted that the practice’s use of the cash method did not clearly reflect its income. The IRS then changed the practice’s method of accounting to a hybrid method that accounted for the chemotherapy drugs on an accrual method and the balance of practice’s business on the cash method.

The Tax Court’s Analysis

The Tax Court noted that this was the first time the question had been presented as to whether the furnishing of pharmaceuticals by a medical treatment facility was as an integral, indispensable, and inseparable part of the rendering of medical services, rather than the sale of “merchandise” for purposes of Treas. Reg. § 1.471-1. In Hospital Corp. of Am v. Commissioner, 107 T.C. 116 (1996) (“HCA”), the court had addressed a similar question in the context of hospital services. In that case, it held that medical supplies and pharmaceuticals used by the hospital were so vital to the furnishing of medical services that income earned from them constituted income from the performance of services. As a result, the hospital was allowed to use the nonaccrual-experience method under Internal Revenue Code § 448(d)(5). In HCA, the court explicitly reserved for another day the question of whether those supplies and pharmaceuticals were merchandise that had to be treated as inventory under Treas. Reg. § 1.471-1.

The Osteopathic Medical Oncology and Hematology case squarely raised the inventory issue. The IRS argued that the practice’s chemotherapy drugs were merchandise that were an income-producing factor, that the practice was therefore required to treat the drugs as inventory, and that the practice was required to use an accrual method to account for this inventory in order to reflect its income clearly. The practice asserted that it is not a merchandising business but rather a provider of services, specifically chemotherapy treatments for patients stricken with cancer. As such, the practice argued that it did not need to maintain inventories for the chemotherapy drugs used in the treatments. The court agreed with the practice.

The court considered whether the chemotherapy drugs were supplies, and therefore deductible under Code § 162, or inventory under Code § 471. Section 162(a) allows a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business”. Under the Treasury Regulations, taxpayers carrying materials and supplies on hand can include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year.

Code § 471 provides that the Secretary of the Treasury may determine when the use of inventories is necessary in order clearly to determine the income of any taxpayer. The relevant Treasury Regulations state that “inventories at the beginning and the end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income producing factor (emphasis added).” Treas. Reg. § 1.471-1. A taxpayer that keeps inventories should therefore use the accrual method of tax accounting. The question raised was accordingly whether the chemotherapy drugs constituted “merchandise” for purposes of the inventory rules.

The court found that while the practice furnished chemotherapy drugs to its patients as part of its services, (1) a person could not obtain the drugs except for his or her chemotherapy treatments; (2) the treatments required the extensive and specialized service of the practice’s professional staff; (3) the practice’s professional staff, as an integral and indispensable part of furnishing chemotherapy drugs to a patient, must examine the patient and prescribe a treatment regime, monitor the length, kind, quantity, and frequency of the treatments, and reevaluate the patient on an ongoing basis; and (4) the services were critical and essential to the furnishing of the chemotherapy drugs by the practice’s staff.

The court concluded that the practice was not a merchandiser. While it may be true that the practice transferred the tangible quality of the chemotherapy drugs to its patients when it administered the drugs to them, the court noted, the practice did so only as an integral and inseparable part of its services. State law precluded the practice from selling the chemotherapy drugs to any person without providing the medical service, and the drugs could not be self-administered. Therefore, a medical practice such as the
oncology practice in question is inherently a service business, and the drugs administered in the practice are subordinate to the provision of the medical services. In other words, according to the court, the chemotherapy drugs, when administered, were not "goods [that were] purchased in condition for sale," or "articles of commerce held for sale." Simply put, the practice was not peddling products. The practice kept no more than a two-week supply of chemotherapy drugs on hand and used virtually all of the drugs during the taxable year. The drugs were not displayed to patients for selection, patients played no role in determining the type or amount of drugs used on them, and the type of chemotherapy drugs played no role in whether patients chose to purchase the practice’s services.

**Why This Case Is Important**

The timing of the decision is important because the IRS has recently completed a Market Segment Specialization Program audit of physician practices in the Northeast aimed at developing a new audit manual on physician practices. These inventory questions were a significant issue in the audits of medical practices such as radiology. In addition, the IRS office in Nashville, Tennessee, has stated that it would like to see any medical practice that has “supplies on hand” at the end of the year in excess of 15% of collected revenues to use the accrual basis of accounting for the entire practice revenue and expense operation. The issue of whether a medical practice uses a cash or an accrual method of accounting has a substantial revenue impact. so practitioners can expect future controversy in this area.