



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

CC:DOM:FS:IT&A  
STMosley

**ACTION ON DECISION**

SUBJECT: Osteopathic Medical Oncology and Hematology, P.C.  
v. Commissioner  
113 T.C. No. 26  
T.C. Dkt. No. 11551-98

**Issue:**

Whether the administration of chemotherapy drugs arising from the provision of medical services constitutes the sale of merchandise within the meaning of Treas. Reg. § 1.471-1. Further, whether Treas. Reg. § 1.446-1(c)(2)(i) requires the use of an accrual method of accounting with respect to the purchase and administration of such chemotherapy drugs.

**Discussion:**

The taxpayer is a qualified personal service corporation (within the meaning of I.R.C. § 448(d)(2)) specializing in the treatment of cancer through chemotherapy. During the year in dispute, the taxpayer operated three offices at which chemotherapy treatments were administered. From the time it was formed through 1995, the taxpayer used the cash receipts and disbursements method of accounting (the cash method) for tax purposes.

The physicians employed by the taxpayer prescribe a regimen of chemotherapy for the patients that are referred to the taxpayer. The taxpayer's employees are responsible for mixing, preparing and administering the prescribed chemotherapy drugs to patients on the taxpayer's premises; the drugs cannot be self-administered. The taxpayer is precluded by law from selling the chemotherapy drugs without providing the medical service. Thus, the taxpayer furnishes pharmaceutical drugs in the course of providing diagnostic and other medical services.

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The Commissioner determined the chemotherapy drugs constituted merchandise which was an income-producing factor in the taxpayer's business. Accordingly, the Commissioner argued that Code section 471 and Treas. Reg. § 1.471-1 required the taxpayer to use inventories. Further, because the taxpayer was required to use inventories, the Commissioner argued that Treas. Reg. § 1.446-1(c)(2)(i) required the use of an accrual method of accounting for that portion of the taxpayer's business that involved the purchase and administration of chemotherapy drugs. The taxpayer argued that it was not a merchandising business and that, therefore, it need not maintain inventories for the chemotherapy drugs or use an accrual method of accounting.

In a court reviewed opinion, the Tax Court held that the taxpayer was not required to account for inventories or to use an accrual method of accounting based on its determination that the furnishing of chemotherapy drugs was not a sale of merchandise within the meaning of Treas. Reg. § 1.471-1. Osteopathic Medical Oncology and Hematology, P.C. v. Commissioner, 113 T.C. No. 26 (No. 11551-98 Nov. 22, 1999). In reaching this conclusion, the court determined that furnishing chemotherapy drugs in this setting was "subordinate to the provision of the medical services" and was an "integral, indispensable and inseparable part of the rendering of medical services." The court gave weight to a number of factual points, including that "[t]he patient does not select the type or quantity of drugs used in the treatments," Slip Opinion at page 4, "the chemotherapy drugs cannot be self-administered," Id., and the taxpayer was "precluded by law from selling the chemotherapy drugs to any person without providing the medical service," Id. at page 15. The court thought it "critical that a person is unable to obtain the chemotherapy drugs without purchasing petitioner's service." Id. at pages 19-20. The court distinguished the seminal case of Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 (1st Cir. 1970), affg. T.C. Memo. 1969-79, by finding that the taxpayer in Wilkinson-Beane, sold funeral services and caskets together as a package by choice rather than legal compulsion. Slip Opinion at pages 19-20. Based on these factors, the court concluded that the drugs administered in connection with providing medical services were supplies rather than merchandise. Slip Opinion at page 16.

The Commissioner acquiesces in the result reached by the Tax Court in this case. Further the Commissioner agrees that, under circumstances comparable to those presented in this case, prescription drugs or similar items administered by healthcare providers are not merchandise within the meaning of Treas. Reg. § 1.471-1. Under Treas. Reg. § 1.162-3, however, a similarly situated health care provider may be required to treat the cost of such property as deferred expenses that are deductible only in the year used or consumed.

**Recommendation:**

Acquiescence in result only.

**Reviewers:**

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Approved:

STUART L. BROWN  
Chief Counsel

By:

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