Professional Practice Transitions, Section 197, And The Anti-Churning Rules

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Intangibles can have great value--if they are handled correctly when transferred.

TAXPAYERS GENERALLY CAN CLAIM an amortization (straight-line) deduction over a 15-year period on purchased intangible assets defined as "amortizable Section 197 intangibles" to the extent they are acquired after August 10, 1993, and held in connection with the conduct of an active trade or business or for the production of income. §197(a). (All section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.) An alternative possibility would apply to intangible assets acquired after July 25, 1991, which was an earlier effective date for taxpayers who elected early application of the §197 rules. This second possibility would be of unlikely relevance to the professional practice scenarios addressed in this article. Amortizable section 197 intangibles include goodwill and going-concern value as well as intellectual property such as franchises, trademarks, trade names, copyrights, and patents purchased in connection with the acquisition of a business. Covenants not to compete provided by the seller to the buyer incident to the acquisition of a business are also amortizable section 197 intangibles. §197(d). Self-created intangibles (as opposed to purchased intangibles) are not amortizable section 197 intangibles. §197(c)(2).

The concepts analyzed in this article are particularly germane to the taxable acquisition of a professional practice. Our examples will illustrate the tax results in that context.

Example 1: Amortization Of Goodwill

Old Doc began practicing in 1990 and has grown the business into a very profitable practice. Unrelated New Doc purchases all the assets of the practice in 2010, including Old Doc's personal practice goodwill. New Doc will be able to amortize the purchased goodwill (as well as other amortizable section 197 intangibles such as a covenant not to compete) over a 15-year period beginning in the month in which the intangibles are acquired. The 15-year amortization period applies regardless of the actual useful life of the amortizable section 197 intangible such as a five-year covenant not to compete given to New Doc by Old Doc.

CAPITAL CONTRIBUTIONS OF INTANGIBLES DO NOT MAKE THEM AMORTIZABLE • The owner of a non-amortizable, pre-August 11, 1993, intangible cannot convert it into an amortizable intangible by contributing it to the capital of a controlled corporation or partnership on a tax-free basis under sections 351 or 721. §197(f)(2). Despite the fact that there is a new legal owner of the intangible, because the entity takes a carry-over tax basis in that asset by virtue of sections 362 or 723, the entity is deemed to have "stepped into the shoes" of the transferor's non-amortizable status.

Example 2: Transferred Goodwill Remains Unamortizable

Old Doc creates a wholly-owned C or S corporation, Old Doc Professional Corporation, Inc. ("Old Doc, Inc."). Old Doc contributes all assets associated with his professional practice, including his personal goodwill, to his wholly-owned corporation on a tax-free basis in return for all of the issues and outstanding stock of the corporation. §351(a). Old Doc, Inc., the new owner of the practice assets, is unable to amortize any of the intangibles contributed to it by Old Doc because they were non-amortizable in his hands prior to the capital contribution.

THE ANTI-CHURNING RULES • Conceptually similar to the restriction just illustrated, section 197 also has so-called anti-churning rules that are meant to prevent "related" taxpayers from buying and selling intangibles amongst themselves to transform previously non-amortizable intangibles into newly-purchased, amortizable intangibles. §197(f)(9). The anti-churning rules apply only to intangible assets that were used by the seller (or a person related to the seller) between July 25, 1991, and August 10, 1993, which was the date before the general effective date of the section 197 rules, and that are sold to a related taxpayer after that later date.

Related Parties

When is there a sale to a related party that would trigger the anti-churning rules? Related parties are defined under the wide-ranging section 267(b) and the similar definition for partners and partnerships under section 707(b). (Section707(b) incorporates section 267 by reference.) However, the normal more-than-50-percent threshold of ownership between owners and controlled entities is lowered to more-than-20 percent. §197(f)(9)(C). The most common relationships under section 267(b) involve members of a family and an individual as well as a corporation in which the individual owns, directly or indirectly, the requisite percentage of the corporation's outstanding stock. Section707 defines a similar relationship in which the partner owns, directly or indirectly, the required percentage of a capital or profits interest in a partnership. With regard to indirect, or constructive, ownership in the corporation or partnership, the family attribution rules under section 267(b)(1) are much broader than the similar family attribution rules governing stock redemptions under section 318(a)(1). §267(c)(4). For example, section 267 includes siblings and all ancestors and lineal descendants as related parties, whereas section 318 includes only children, grandchildren, and parents and excludes siblings. §318(a)(1)(A).

Example 3: Related Parties Rule Prevents Amortization

Old Doc from Example 1 (who commenced practice in 1990) sells his practice to New Doc, his son, in 2010. Because the two doctors are related to each other as parent and child, New Doc is unable to amortize any of the purchased intangibles.

Having a related party purchase the intangibles through a controlled entity would not change this result, because the original owner would indirectly (through attribution) control the purchasing entity.

Example 4: Constructive Ownership Prevents Amortization

Old Doc sells all the assets of his practice (again, founded in 1990) to New Doc Professional Corporation, Inc. ("New Doc, Inc."), a corporation wholly-owned by his son, New Doc. Under the constructive ownership provisions just noted, Old Doc is deemed to own the stock actually owned by New Doc, so he is considered the 100 percent owner of New Doc, Inc. and amortization of the purchased intangibles would be prohibited. If there was another actual and unrelated shareholder in New Doc, Inc., the same result would pertain, unless New Doc owned 20 percent or less of New Doc, Inc.

BIFURCATING INTANGIBLES • Recall that the anti-churning rules apply to the sale of intangibles between related parties that were in existence between July 25, 1991, and August 10, 1993 (the "Transition Period"). Professor Eustice used to have fun with the tax students at New York University by questioning them as to how little an amount of prohibited boot was necessary to blow-up a Type B reorganization (a tax-free voting stock for voting stock swap). The answer is, with very few exceptions (e.g., cash for fractional shares) any other consideration flowing to the target shareholders will do so. There is an analogous issue under the anti-churning rules.

An intangible asset in the form of goodwill and going-concern value is an ever-evolving asset. What if in the prior examples the business commenced shortly before the general effective date of section 197 such that a small, even *de minimis*, portion of the current goodwill accrued before August 11, 1993? Can pre- and post-effective date goodwill be bifurcated so that post-August 10, 1993, goodwill can be sold to a related party without invoking the anti-churning rules?

The legislative history is not particularly clear on this issue. Conference Report, p. 234, Revenue Reconciliation Act of 1993 (P.L. 103-66). Perhaps because of the practical difficulty of exactly splitting the baby in two, the Treasury Regulations take the position that any pre-effective date goodwill will taint the whole. Treas. Reg. §1.197-2(k), Example 18.

Example 5: Pre-August 10, 1993 Goodwill Prevents Amortization

Return to the facts of Example 3, except that Old Doc commenced his practice in July 1993 rather than in 1990. A few of his original 1993 patients are still with him and his practice has grown steadily thanks to favorable referrals from his original patients.

Even though the vast majority of goodwill and going-concern value related to Old Doc's practice accrued after August 10, 1993, some of it was in existence during the Transition Period. None of the intangibles purchased by New Doc constitute amortizable intangibles.

COMMON PRACTICE ACQUISITION FORMATS • Now we will examine more precisely acquisition and post-acquisition practice formats and how section 197 relates to them. An increasingly common method of accommodating the incoming owner in a professional practice (New Doc in our previous examples) is for New Doc to form an S corporation and have it purchase some (but not all) of the assets from the existing practice owner (Old Doc) who also drops his or her unsold assets into a second newly-formed S corporation. Thereafter, the new owner and old owner will operate the actual practice through a newly-formed limited liability company or partnership (owned by the S corporations) that collects practice revenues, pays the operating expenses (including employee benefits), and employs the staff. (General operating, staff, and occupancy expenses are usually allocated pro rata, *e.g.*, 50%/50% in a two-doctor practice). Net profits are passed-through ("Schedule K-1'd") to the S corporations owned by the respective owners. Each of those doctor-owned entities pays the direct business expenses of each owner that may include liability insurance, continuing education, business travel, automobile and possibly lab and/or any other expenses which may be disproportionate between the doctors. The intermediary S corporation format is generally implemented to obtain payroll tax benefits, something the authors will analyze (and question) in a subsequent article in The Practical Tax Lawyer.

For those practices that were originally formed pre-August 11, 1993, the anti-churning rules will apply and deny amortization of the goodwill purchased by the incoming owner if Old Doc, directly or indirectly, owns at least 20 percent of the practice entity (the limited liability company or partnership).

Example 6: Sub S/LLC Structure Still Cannot Amortize Contributed Goodwill

Return to the facts of Example 3, except that New Doc is unrelated and Old Doc sells one-half of his practice assets and goodwill to S-Corp 1, wholly owned by New Doc. Thereafter, Old Doc (who previously practiced as a sole proprietor) contributes his unsold practice assets to newly formed S-Corp 2, wholly owned by Old Doc. S-Corp 1 and S-Corp 2 contribute all tangible property and goodwill owned by them as capital contributions to a newly formed limited liability company ("LLC"), which is owned 50 percent each by S-Corp 1 and S-Corp 2.

The LLC will be unable to amortize any part of the acquired goodwill. The unsold intangibles that have been contributed successively to S-Corp 2 and LLC by Old Doc were contributed as tax-free capital contributions under sections 351 and 721. As to that portion of the practice intangibles, the LLC has "stepped into the shoes" of Old Doc and is prohibited from amortizing them. §197(f)(2). With regard to the goodwill and other intangibles bought and then contributed by S-Corp 1 to the LLC by New Doc, that portion would be non-amortizable to the extent that LLC is a related party to Old Doc. It is: S-Corp 2 owns more than 20 percent of LLC and Old Doc is deemed to own the entire membership interest in LLC owned by his controlled corporation, S-Corp 2. S-Corp 2 is a 50 percent member of LLC and because Old Doc is deemed to own indirectly what his 100-percent-owned S-Corp 2 owns, he is deemed to be a 50 percent member of LLC and is well within the more-than-20-percent ownership threshold of section 197(f)(9)(C). Except for the exceptions noted below, the only way to amortize the goodwill and other intangibles purchased from Old Doc by New Doc would be if Old Doc owned, directly or indirectly, 20 percent or less of LLC.

EXCEPTIONS TO THE RULES • There are exceptions to the application of the anti-churning rules. The first of these exceptions would be of little practical use in most professional practice transitions, because it requires the recognition of significantly greater amounts of tax liability by the seller (Old Doc in our previous examples). This first exception is the so-called gain recognition exception to the anti-churning rules. §197(f)(9)(B) and Treas. Reg. §1.197-2(h)(9). Under this exception, anti-churning rules do not apply if:

- The practice entity in the Examples would not be related to Old Doc but for the substitution of more than 20 percent (as opposed to more than 50 percent in the previously discussed section 267 related party rules applicable to an entity and its controlling owner); and
- Old Doc actually pays federal income tax on the resulting sale to New Doc (or New Doc's S corporation) at the highest ordinary income tax rate imposed on non-corporate taxpayers under section1.

This result would be disturbing to Old Doc. As has been alluded to in the previous Examples, the popular approach to a sale by Old Doc of his or her practice assets is to have the significant amount of the practice embodied in Old Doc's personal professional goodwill. The concept here is that even if Old Doc previously practiced through a regular C corporation, there would only be one level of tax, and that at capital gains rates, on the sale of the personal goodwill.

The second exception to the anti-churning rules poses a greater possibility in practice transitions. This involves a sale of a partnership interest where the partnership has made the "section754" election. General partnerships, limited partnerships, LLCs and LLPs, although all different forms of business entities under applicable state law, are all taxed as "partnerships" under Subchapter K of the Internal Revenue Code. Any of these entities, therefore, has the ability to make the section 754 election. A single-member LLC, taxable as a sole proprietorship, could not make the section 754 election.

Most practitioners have heard of the "aggregate" and "entity" approach of Subchapter K. Partnership entities, being the purer form of tax-conduit entities as opposed to S Corporations, normally follow the aggregate theory. This theory takes the position that the partnership is not an entity separate from the partners but rather is the partners.

The section754 election provides one of the better examples of the aggregate theory. In the context of the professional practice transitions we are describing, we would need Old Doc and at least one other older doctor to have housed their professional practice (including professional goodwill) in a partnership entity. The fact that the practice is fully within a pre-existing partnership that has made the section754 election causes a markedly different result than those that we have explored above. Old Doc's share of professional goodwill that has been grown within the partnership may be of significant value but will have little or no "inside" tax basis in the hands of the partnership. Absent any section754 election, when Old Doc sells his partnership interest to New Doc (the primary value of which involves Old Doc's share of the practice goodwill and going concern value), New Doc would step into Old Doc's shoes, taking over his low or nonexistent (and non-amortizable) share of the practice intangibles. The results are very different if the section754 election is in effect.

Example 7: Goodwill Amortizable With Section 754 Election

We will assume that Old Doc and his older partner have conducted their practice through their equally owned partnership ("PS") since 1990. They are interested in bringing in New Doc (unrelated to either of the older partners) as a new one-third partner and to eventually transition the entire practice to him. Before New Doc's entry into the practice, assume for the sake of simplicity that PS's assets consisted of the following:

	AB	FMV
Cash	$90,000	$90,000
Goodwill	0	$900,000

New Doc pays $330,000 for his new one-third interest to PS. Because PS has made the section 754 election (which could have been previously made or made in the year of New Doc's entry into PS), section743(b) is invoked. The 754/743 effect is that New Doc can amortize over 15 years the

$300,000.00 he paid for his share of the goodwill. Treas. Reg. §1.197-2(k), Example 19.

The authors are aware that the IRS is looking for abuse of the section 754 exception. The section 197 Treasury Regulations elsewhere empower the government to disregard the amortizable nature of an intangible if one of the principal purposes of the transaction is to avoid the anti-churning rules. Treas. Reg. §1.197-2(h)(11).

Example 8: Section 754 Election As Avoidance Of Anti-Churning Rules

Old Doc has practiced since 1990 through a corporation that owns all the tangible assets of the practice. Old Doc has negotiated with New Doc to purchase one-half of his practice and to subsequently practice with him through a partnership entity. The parties are ready to consummate the deal when their advisors determine that the anti-churning rules illustrated in Example 6 will come into play.

The parties restructure the format so as to shoehorn into the Example 7 results. Old Doc and his corporation become members of a newly-formed LLC. The corporation transfers its tangible assets to the LLC and Old Doc transfers his personal goodwill to the LLC. New Doc is employed by the LLC. The LLC makes a section754 election on its first tax return. Thereafter, Old Doc and his corporation sell New Doc 50 percent of the membership interests in the LLC. If detected on audit, the Service will attempt to recast the transaction as having a principal purpose of avoiding the anti-churning rules. The Service would likely be able to recast the transaction unless the LLC was "old and cold" and not formed incident to the transition of part of the practice to New Doc.

Lastly, the anti-churning rules are inapplicable to acquisitions of intangibles by reason of death when the new owner obtains a section1014(a) step-up in basis. §197(f)(9)(D) and Treas. Reg. §1.197-2(h)(5)(i).

Example 9: Amortization Allowed After Section 1014(a) Basis Step-Up

The facts are the same as in Example 3 except that Old Doc's practice is bequeathed to his son, New Doc, on Old Doc's death. The adjusted bases in the practice assets, including Old Doc's practice goodwill, are stepped-up to fair market value on the date of death. New Doc can amortize the goodwill as if he were unrelated to Old Doc and had purchased that asset for fair market value.

CONCLUSION • As has been noted, we have seen a growing interest by the IRS in the section 197 anti-churning rules, particularly in the context of acquisitions of professional practices. Therefore, it would behoove the tax adviser to be aware of this risk, to make the client aware of it, and to make appropriate contingencies in pricing and formatting the sale and purchase of the professional practice.