Dental, dental specialty and veterinary practices have substantial salable goodwill with dental and dental specialty practice goodwill above all others.1 Assuming that goodwill represents approximately 80% of the practice sale and 20% tangible assets2, the deductibility of goodwill is an important issue.

The purpose of our Panel is to examine three recent transactions in dental and dental specialty practices where this author believes that the anti churning rules under Section 197 have not been followed and personal goodwill was inappropriately proposed.

Included in the materials is "Professional Practice Transitions, Section 197, and the Anti-Churning Rules", The Practical Tax Lawyer, Summer, 2018, Mark P. Altieri, William P. Prescott.

The Antichurning Rules

Example 1

Professional practice was formed prior to August 10, 1993. It has been proposed by counsel for the incoming owner that Dr. Junior form an S-corporation which will purchase an undivided interest in the tangible assets of the practice in both the tangible assets and goodwill of the practice. Subsequent with the purchase, the doctors will form a limited liability company which will bill the patients, pay the operating expenses, employee the staff, sponsor the benefits plans, and distribute profits to the respective S corporations, which will then be distributed to Dr. Senior and Dr. Junior.

Dr. Junior's counsel has advised Dr. Junior that the goodwill can be deducted for both the buy-in and later buy-out of Dr. Senior, irrespective that the practice was formed before August 10, 1993.

Example 2

Professional practice has two 50% shareholders who have practiced together for several years. The practice was formed prior to August 10, 1993. For Dr. Senior's buy-out, it has been proposed that Dr. Junior should purchase 30% of the remaining 50% of Dr. Senior's stock. Thereafter, the shareholders will practice as 80%/20% shareholders. Upon the retirement of Dr. Senior, it has been proposed that the corporation purchase the remaining 20% owned by Dr. Senior through the purchase of Dr. Senior's

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personal goodwill. The rationale is that Dr. Senior and Dr. Junior now do not own more than 20% of the stock, although they were previously 50% shareholders. The remaining tangible asset value would be paid through the purchase of Dr. Senior's stock by Dr. Junior.

**Example 3**

The professional practice was formed prior to August 10, 1993. Dr. Senior and Dr. Junior practice through an S-corporation as more than 20% shareholders. Dr. Junior's counsel is proposing that upon the mandatory buy-out of Dr. Senior in roughly 10 years that Dr. Junior purchase a combination of stock at the pro-rata fair market value of tangible assets and the personal goodwill of Dr. Senior. Restrictive Covenants are in place and there has been no appraisal of any personal goodwill.

**Commentary**

**Three-Entity Method**

An increasingly common business and tax structure for partnership is for Dr. Junior to form an S-corporation and purchase a fractional interest in the tangible assets and goodwill from the practice owner or the owner’s practice entity. After the purchase, the senior and junior dentists operate the practice through a newly formed limited liability company or partnership, a third entity, that collects the revenue, pays the operating expenses, including employee benefits, and employs the staff. Profits are distributed to the entities, which are owned by Dr. Senior and Dr. Junior and which pay the direct business expenses of each owner, e.g., Dr. Senior’s S- or C-corporation and Dr. Junior’s newly formed S-corporation. The three-entity method also may include use of a compensation shift, the purchase of the practice owner’s personal goodwill if the practice operates as a C-corporation, questionable S-corporation distributions (because all distributions from limited liability companies and partnerships are earned income), and/or independent contractor relationships. Note that the tangible assets may be owned by the respective corporations because the transfer of equipment to the limited liability company or partnership may create a taxable event. New purchases of equipment and technology, however, can be made by the third entity, the limited liability company, or the partnership.

**The Anti-Churning Rules**

If the practice was formed prior to August 10, 1993, the buy-in and buy-out under the three-entity method, as well as the purchase of any personal goodwill of the practice owner by the practice upon Dr. Senior’s buy-out, is subject to the IRC Section 197 anti-churning rules. The anti-churning rules deny amortization of the goodwill purchased by Dr. Junior if Dr. Senior and Dr. Junior jointly did or will own 20% or more of the third entity or are family members, e.g., Dr. Senior and his or her son or daughter/dentist, even in a complete sale to a family member. It is the third entity, the limited liability company or partnership that creates the problem for non-related owners because 20% or more

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3 IRC Reg. 1.197-2(h)(6)(i)(A).
common ownership makes the owners related parties. IRC Section 197 does not provide for separation of the pre- and post-August 10, 1993, goodwill.\(^4\) While I have not seen any audits on this point yet, note that the IRS is well aware of this situation and has stated that it can track asset sales through Form 8594, which must be filed by Dr. Senior, his or her corporation, and Dr. Junior.\(^5\) There is direct authority under the IRC Section 197 Regulations for the IRS to recast the transaction to avoid any of the anti-churning rules.\(^6\) Notwithstanding, the IRC Section 197 Regulations do provide guidance to avoid the anti-churning rules in Example 19.\(^7\) Here, Dr. Senior’s S- or C-corporation contributes its tangible assets and Dr. Senior contributes his or her personal goodwill to a newly formed limited liability company in year 1. On the first tax return, the limited liability company makes what is called an IRC Section 754 Election. In year 2, Dr. Junior purchases 50% of Dr. Senior’s membership interest in the limited liability company. However, Example 19 seems to conflict with the authority of the IRS to recast the transaction. As a result, I am not convinced that following Example 19 is a workable solution. In addition, we cannot readily locate dental appraisers to appraise personal versus corporate goodwill, as opposed to the goodwill of the entire practice. If Example 19 is utilized, an appraisal of the personal goodwill is essential.\(^8\)

**Personal Goodwill for the Buy-Out**

Another buy-out structure is where the departing shareholder’s (assuming Dr. Senior) stock is purchased by the practice excluding goodwill, but is coupled with the purchase by the practice of the departing shareholder’s personal goodwill. To the extent that there is personal goodwill,\(^9\) the purchaser, which is the practice and not Dr. Junior, is able to amortize or deduct the personal goodwill over 15 years while the purchase of stock cannot be deducted. Advisors advocating this method are attempting to get the personal goodwill to be taxed at favorable capital gains at one tax level to Dr. Senior and not double taxed.\(^8\)

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\(^4\) *Mergers, Acquisitions, and Buyouts*, Martin D. Ginsburg, Jack S. Levin, Aspen Publications, 4-118, Example 17, Section 403.4.4; December, 2002; Example 20, Section 403.4.1.4, February, 2012.


\(^6\) IRC Reg. 1.197-2(j).

\(^7\) IRC Reg. 1.197-2(k), Example 19.

\(^8\) *Kennedy v. Commissioner*, T.C. Memo. 2010-206.

\(^8\) IRC Section 197(f)(9)(A)(i); IRC Reg. 1.197-2(h)(2)(i).

\(^9\) The following recent cases recognize the existence of personal goodwill: *Muskat v. U.S.*; 554 F.3d 183; *Solomon v. Commissioner*, T.C. Memo. 2008-102, 208 WL 1744406 (U.S. Tax Ct.).
Understand, however, that the purchase and sale of personal goodwill is not without significant problems. First, if personal goodwill is part of the transaction, Dr. Senior cannot be, or have a written agreement that he or she will be, subject to a restrictive covenant with the practice upon the buy-out. This point effectively eliminates this business and tax structure because Dr. Junior will/should require that Dr. Senior be subject to a restrictive covenant and vice-versa.

However, in both Martin Ice Cream and Norwalk, had the shareholders not have had covenants not to compete with the purchaser, there would not have been personal goodwill. Therefore, to use personal goodwill in a shareholder buy-out, the shareholder cannot be subject to a restrictive covenant or a written promise to not enter into a restrictive covenant with a practice; but if there is no restrictive covenant with the purchaser, there is no personal goodwill. As a result, the use of personal goodwill in a shareholder buy-out is inadvisable, at least in my view.

In addition, if the practice was formed prior to August 10, 1993, the goodwill is not deductible. Finally, if personal goodwill for a shareholder buy-out is used, it is important to have an appraisal that distinguishes your personal goodwill from any corporate goodwill.


Summary and Thoughts

Query?: what is the result when the doctors and/or advisors do not follow the rules?

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11 Kennedy v. Commissioner, T.C. Memo. 2010-206.
PROFESSIONAL PRACTICE TRANSITIONS, SECTION 197, AND THE ANTI-CHURNING RULES

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This article is a substantial extension of an earlier iteration that appeared in The Practical Tax Lawyer in its Winter 2011 edition. © 2018 Mark P. Altieri, William P. Prescott, and Wickens Herzer Panza.

One of the new more perplexing mazes for the tax adviser to negotiate involves the anti-churning rules of Section 197. Taxpayers generally can claim an amortization 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. Amortizable Section 197 intangibles most commonly 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 or practice are also amortizable Section 197 intangibles. Self-created intangibles (as opposed to purchased intangibles) are not amortizable Section 197 intangibles.

The concepts analyzed in this article are particularly germane to the complete or fractional purchase and sale of a professional practice. Our examples will illustrate the tax results in that context.

Why is Section 197 relating to the deductibility of goodwill significant? Let's assume that the goodwill represents 80 percent of the practice value and tangible assets 20 percent, typical in a professional practice. The goodwill is treated as favorable capital gains to the seller and the tangible assets, usually fully depreciated, are treated as ordinary income. To the purchaser, the goodwill, if amortizable, is depreciated over 15 years and the tangible assets typically over five or seven years. The result is a win-win for both the seller and purchaser. If the goodwill is not deductible to the purchaser, the purchase price for a complete sale or fractional interest is usually reduced from the practice appraisal, assuming that it was prepared on a tax-neutral basis. The reduction to the purchase price is meant to balance the tax effects to the purchaser and seller. In a complete purchase and sale of a practice, the goodwill is always amortizable except for sales to family members. Not so for co-ownership. We'll start out with a complete purchase and sale in EXAMPLES 1 through 5 and move to fractional purchases and sales or co-ownership beginning with EXAMPLE 6.

EXAMPLE 1: Old Doc began practicing in 1990 and has grown the practice into a very profitable business. Unrelated New Doc purchases all the assets of the practice in 2017, including Old Doc's personal and/or 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 and used in the acquired practice. 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.

If Old Doc's practice is organized as a C corporation, Old Doc should authorize an appraisal of the personal versus corporate goodwill. An appraisal of the personal
versus corporate goodwill should be distinguished from the appraisal of Old Doc's practice that does not consider whether the goodwill is personal or corporate.

**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. 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:** 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 issued and outstanding stock of the corporation. Old Doc, Inc., the new owner of the practice assets, is unable to amortize any of the intangibles contributed to it by Old Doc as they were non-amortizable in his or her hands prior to the capital contribution and were received by the transferee corporation in a tax-free capital contribution under Section 351.8

**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 in order to transform previously non-amortizable intangibles into newly-purchased, amortizable intangibles.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, 199110 and August 10, 1993 (the later day being the day before the general effective date of the Section 197 rules) and that are sold to a related taxpayer after that later date.

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).11 However, the normal more-than 50 percent threshold of ownership between owners and controlled entities is lowered to more-than 20 percent.12 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. Section 707 defines a similar relationship in which the partner owns, directly or indirectly, the required percentage of a capital or profits interest in a partnership entity. 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).13 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 and grandparents.14

As will be illustrated later in this article, partners in a partnership or NOT deemed related to each other by virtue of being partners in the same partnership (e.g., the partners aren't additionally related to each other as family members). This is the basis for the very confusing but all-important Section 754 exceptions to the anti-churning rules that will be detailed below.15

**EXAMPLE 3:** Old Doc from EXAMPLE 1 (who commenced practice in 1990) sells his practice to New Doc, his son, in 2017. 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 as the original owner would indirectly (through attribution) control the purchasing entity.

**EXAMPLE 4:** 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, in 2017. 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 unrelated shareholder in New Doc, Inc., the same result
would occur unless New Doc owned 20 percent or less of New Doc, Inc. Also, the same result would occur if the entity was a limited liability company or other partnership entity as opposed to an S or C corporation.

**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. Perhaps because of the practical difficulty of splitting the baby in two, the Treasury Regulations take the position that any pre-effective date goodwill will taint the whole.

**EXAMPLE 5:** Return to the facts of EXAMPLE 3 where old Doc sells to his son, 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, Old Doc’s son, constitute amortizable intangibles.

**SECTION 197 ISSUES FOR NEW INCOMING PROFESSIONAL OWNER WHERE OLD OWNER REMAINS IN PRACTICE**

We will analyze the Section 197 issues where the older owner retires in a moment. Now we will examine more precisely acquisition and post-acquisition practice formats and how Section 197 relates to them where there is a new incoming professional and the old owner remains in that practice. An increasingly common method of accommodating the incoming unrelated owner in a professional practice (New Doc in our previous EXAMPLES), where Old Doc will remain in the practice for a future period of time, 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 if not an already existing S corporation. Thereafter, Old Doc and New Doc will operate the actual practice through a newly-formed limited liability company, owned by the two S corporations, (the “Three Entity Method”) that collects practice revenues, pays the operating expenses (including employee benefits) and employs the general staff. Occupancy expenses are usually allocated pro rata, e.g., 50 percent/50 percent in a two doctor practice. Net profits are passed-through (Schedule K’1d) to the S corporations owned by the respective Docs. 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.

Provided that Old Doc’s practice was formed after August 10, 1993, the goodwill is amortizable to New Doc’s practice for both New Doc’s buy-in and Old Doc’s buy-out. In addition, Old Doc can be bought out for cash in a two owner practice. However, a drawback is yearly preparation of three tax returns and other complexities of the operation of these entities. Two alternatives are as follows.

Old Doc can sell some percentage (e.g., 50 percent) of his or her stock to New Doc inclusive of goodwill without an appraised break-down of personal or professional goodwill (“Stock Including Goodwill”). Old Doc receives all capital gains, there is one entity, it’s easy to
utilize term cross insurance for the triggering event of death. Thereafter, when Old Doc retires in a two owner practice, New Doc, as sole remaining shareholder, can grant the practice to a lender as security and Old Doc gets bought-out for cash. For Stock Including Goodwill, the tax neutral practice valuation is adjusted downward to reflect the fact that New Doc cannot deduct the purchase price for either New Doc’s buy-in or Old Doc’s buy-out, although New Doc gets “basis” in the purchase price for the stock and pays capital gains only above the purchase price when the stock is later sold. Unfortunately, that does not help New Doc for some time. And what we’re seeing in the marketplace is that Old Doc is unwilling to reduce the buy-in purchase price and buy-out formula for it to be tax balanced.

A second alternative is for Old Doc to sell 50 percent or some percentage of the stock excluding goodwill (“Stock Excluding Goodwill”). The stock is usually the fair market value of tangible assets of the practice or some mutually agreed stock value, e.g., $100,000.00. The goodwill for the buy-in is paid by way of a compensation shift whereby New Doc takes less compensation than New Doc would otherwise be entitled to and Old Doc receives more for some period of time, e.g., five or seven years, until 50 percent of the goodwill is paid. While Stock Excluding Goodwill for the buy-in has not posed problems for S corporations, there can be unreasonable compensation issues for C corporations.18

For the buy-out, the stock remains the value of the tangible assets of the practice or an agreed upon value contained in a share redemption agreement where the corporation purchases the departing shareholder’s stock. The goodwill is paid through continued or deferred compensation over some period of time, e.g., five or seven years. The disadvantage of Stock Excluding Goodwill is that Old Doc is paid over time and not in cash.

Under the Stock Excluding Goodwill method, the tax-neutral valuation is not reduced as in Stock Including Goodwill, but is increased to reflect that Old Doc is taxed at ordinary income rates for the goodwill piece of both the buy-in and the deferred compensation and again for an interest component.

Under Stock Excluding Goodwill, some advisors advocate using personal goodwill for both the buy-in and buy-out. However, for the buy-in, New Doc is not a separate trade or business.19 For the buy-out, if Old Doc has a restrictive covenant with Old Doc, Inc., there would be no personal goodwill.20 However, if Old Doc has no employment or consulting agreement with New Doc, Inc., there would be no sale of personal goodwill.21 Because Old Doc, Inc. and New Doc, Inc. are the same entity or related (if more than 20 percent common ownership) in co-ownership, use of personal goodwill outside of a complete purchase and sale is not advisable, at least in the authors’ view.

For those practices that were originally formed pre-August 11, 1993, the anti-churning rules will be applicable even if New Doc is not a related party and will deny amortization of the goodwill purchased by the incoming owner if Old Doc, directly or indirectly, owns more than twenty percent of the practice entity (the limited liability company).

EXAMPLE 6: Return to the facts of EXAMPLE 3 where Old Doc commenced practice in 1990, except that New Doc is unrelated and Old Doc sells one-half of his practice assets and goodwill to SCorp 1, wholly owned by New Doc. Thereafter, Old Doc (who previously practiced as a sole proprietor or a single member LLC) contributes his unsold practice assets to newly-formed SCorp 2, wholly-owned by Old Doc. SCorp 1 and SCorp 2 then 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 SCorp 1 and SCorp 2.

The LLC will be unable to amortize any part of the acquired goodwill. The unsold intangibles that have been contributed successively to SCorp 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.22 With regard to the goodwill and other intangibles bought and then contributed by SCorp 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. SCorp 2 owns more than 20 percent of LLC and Old Doc is deemed to own the entire membership interest in LLC owned by his or her controlled corporation, SCorp 2. SCorp 2 is a 50 percent member of LLC and as Old Doc is deemed to
own indirectly what his or her 100 percent owned SCorp 2 owns. Through attribution, Old Doc is a 50 percent member of LLC and is well within the more than 20 percent ownership threshold of Section 197(f)(9)(C). In establishing the time to test for a prohibited relationship, the Regulations on these facts (where there is a series of related transactions) will check immediately before the earliest such transaction or immediately after the last such transaction for such a relationship.23 Except for the exceptions noted below, the only way to amortize the goodwill and other intangibles purchased from Old Doc by New Doc in this scenario would be if Old Doc owned, directly or indirectly, 20 percent or less of LLC.24

A solo group arrangement can be a good alternative to the Three Entity Method because there is no common ownership of a third entity.25 New Doc purchases an undivided interest in the tangible assets and goodwill of Old Doc, Inc. and amortizes it. Thereafter, Old Doc and New Doc operate Old Doc, Inc. and New Doc, Inc. under an office sharing arrangement and bill patients separately, pay their share of operating expenses either equally or by a percentage of respective collections. There are separate retirement and health insurance plans and each practice employs its own staff, although staff members can be shared. What is significant about a solo group is that absent death or disability, there is usually no mandatory buy-out of Old Doc, Inc. by New Doc, Inc., which is not the case in any business and tax structure for co-ownership. While New Doc, Inc. usually has an option to purchase Old Doc, Inc.'s assets, the practices remain separate and if New Doc, Inc. is sufficiently busy not to buy-out Old Doc, Inc., Old Doc, Inc. can find a third-party professional to buy the practices because they remain separate.

EXCEPTIONS TO THE ANTI-CHURNING 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 as 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.26 Under this exception, anti-churning rules do not apply if: (i) 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 (ii) 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 Section 1.

A second exception to the anti-churning rules is that they are inapplicable to acquisitions of intangibles by reason of death where the new owner obtains a Section 1014(a) step-up in basis.27

EXAMPLE 7: 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.

The last exception to the anti-churning rules, and the one that will be thoroughly explored in this article, poses a much greater possibility in practice transitions. This involves a partnership entity that has made the "Section 754" election. General partnerships, limited partnerships, limited liability companies and limited liability partnerships, 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.28

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 individual partners.

The Section 754 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 partner to have housed their professional practice (including non-amortizable professional goodwill) in a partnership entity. The fact that the practice is fully within a pre-existing partnership that has made the Section
754 election causes a markedly different result than those that we have looked at earlier. 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 Section 754 election, when New Doc becomes a new partner, New Doc would assume his nonamortizable share of the practice intangibles. The results are very different if the Section 754 election is in effect where we see the aggregate theory in play.

**EXAMPLE 8:** We will presume that Old Doc and his older partner have conducted their practice through their equally owned partnership entity (“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. Prior to New Doc’s entry into the practice, presume for simplicity sake that PS’s assets consisted of the following:

<table>
<thead>
<tr>
<th>AB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
</tr>
</tbody>
</table>

New Doc pays the existing partners $330,000.00 for his or her new one-third interest in 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), Section 743(b) is invoked. The 754/743 effect is that New Doc is deemed to have purchased one-third of the goodwill and can amortize over 15 years the $300,000.00 he or she paid for his or her share of it.\(^{26}\)

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.\(^{30}\)

**EXAMPLE 9:** Old Doc alone 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 assets, including half of Old Doc’s practice goodwill, and to subsequently practice with him or her through a partnership entity. The parties are ready to consummate the transaction when their advisors determine that the anti-churning rules illustrated as **EXAMPLE 6** will come into play.

The parties restructure the format so as to shoehorn into the **EXAMPLE 8** results. Old Doc and his or her 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. The LLC makes a Section 754 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.\(^{31}\)

**SECTION 197 ISSUES WHERE OLD OWNER RETIRES FROM PRACTICING IN A PARTNERSHIP ENTITY**

Now we will look at Section 197 implications where Old Doc is retiring from the practice. If Old Doc is selling a partnership interest to unrelated New Doc, the same tax result occurs as in **EXAMPLE 8**.

**EXAMPLE 10:** Again, Old Doc and his older partner have conducted their practice through the equally owned PS since 1990. Prior to New Doc’s entry into the practice, PS’s assets consisted of the following:

<table>
<thead>
<tr>
<th>AB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
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<tr>
<td>Goodwill</td>
<td>0</td>
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</tbody>
</table>

New Doc pays Old Doc $495,000.00 for his or her one-half interest in the PS. Because PS has made the Section 754 election, Section 743(b) is invoked. The 754/743 effect is that New Doc can amortize over 15 years the $450,000.00 he or she paid for his or her share of the goodwill.\(^{32}\) The analysis is technically more complicated than this simple explanation as selling a 50 percent or more interest in the partnership triggers a Section 708(b)(1)(B) termination of the partnership (as will be more
thoroughly detailed below), but the net result will be as just stated.

Here is another fascinating aspect of the Section 754 election and a partnership entity. Now we will change the facts and presume a three-person partnership entity with a significant amount of previously non-amortizable practice goodwill as the doctors are all older practitioners. Old Doc is again retiring from the practice but is selling to his other two partners, not to a new incoming doctor. This transition can be formatted one of two ways, either as a direct sale of Old Doc’s partnership interest to the other two partners or as liquidating payments from the partnership to the retiring partner under Section 736.

Let’s first examine the direct sale of the partnership interest to the two remaining partners.

**EXAMPLE 11:** Old Doc and his older partners have conducted their practice through the equally owned PS since 1990. The PS’s assets consist of the following:

<table>
<thead>
<tr>
<th>AB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
</tr>
</tbody>
</table>

Old Doc sells his or her one-third interest in the partnership entity directly to the continuing partners. Old Doc’s gain will be a long-term capital gain and if the PS has made the Section 754 election, Section 743(b) is invoked. The 754/743 effect is that the continuing partners can step up their 15-year amortizable basis in the goodwill by $150,000 each.

The regulations again emphasize the aggregate theory on these facts treating the transaction as if Old Doc directly sold his share of the goodwill to the two remaining partners. The regulatory prohibitions in this situation are invoked only if the continuing partners are related to Old Doc under Section 267 or if Old Doc remains a direct user of his goodwill sold to the continuing partners (e.g., Old Doc continues to work in the practice as a non-partner associate). As noted earlier, partners in a partnership or NOT deemed related to each other by virtue of being partners in the same partnership (e.g., the partners aren’t additionally family members).

The Section 736 retiring partner scenario involving a general partner in a service intensive (as opposed to a capital intensive) partnership, like the professional practice situations we have been examining, presents major and additional planning opportunities.

**EXAMPLE 12:** Again, Old Doc and his older partners have conducted their practice through the equally owned PS since 1990. Again, the PS’s assets consist of the following:

<table>
<thead>
<tr>
<th>AB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
</tr>
</tbody>
</table>

Now the documentation clearly indicates Old Doc is retiring from the partnership entity and payments from the partnership will be governed by Section 736. The famous Foxman case emphasizes the importance of properly documenting a Section 736 retirement from a direct sale to the continuing partners so as to properly encompass the intentions of all the parties. Whether the partnership pays Old Doc $330,000 in a lump-sum or in a series of payments over time, the character of Old Doc’s gain will depend on whether the retirement payments are stated in the partnership or liquidating agreement to be for his share of goodwill. If they are, the entirety of Old Doc’s gain will again be long-term capital gain. As to the continuing partners, if again the Section 754 election is in effect, Section 734 (not 743) will be invoked giving each of the continuing partners the same $150,000 basis in their share of the goodwill deemed purchased from Old Doc as in Ex 11. The continuing partners (unless related to Old Doc) are considered to be “eligible partners” under the regulations and are therefore entitled to amortize their share of the goodwill basis increase under Section 734.

If the $300,000 of payments are not stated to be for Old Doc’s share of the goodwill, the $300,000 will be a guaranteed payment constituting ordinary income to Old Doc and deductible to the continuing partners. In this latter unstated goodwill scenario it appears that the continuing partners would take a current deduction for the guaranteed payment to Old Doc even if they were related to Old Doc as family members. The authors
have found no authority either affirming or denying this treatment to continuing related partners.

Return to the facts in **EXAMPLE 10.** As noted, the sale of 50 percent or more interest in a partnership entity results in a termination of the partnership under Section 708(a)(1)(B). What technically happens on the sale by Old Doc of his 50 percent interest to New Doc is that PS is deemed to contribute all of its assets (including the goodwill) to new PS in return for ownership interests in new PS and then distributing the new PS interests to the old partners and New Doc in liquidation of the original PS. To the extent that the old partnership has a Section 754 election in effect, Section 743 is invoked and apportions the basis increase in the goodwill entirely to New Doc.

Now change the facts in **EXAMPLE 10.** Again, we have two 50 percent owners of a partnership entity in which there is a significant amount of pre-1993 unamortizable goodwill as Old Doc and his partner are older practitioners. Now, however, Old Doc is ceasing practice and transitioning his 50 percent interest to his old partner (Continuing Owner). In this situation, unlike in **EXAMPLE 10** where there was a continuing partnership entity and a termination of the old partnership under Section 708(a)(1)(B), the business now ceases to be conducted as a partnership as there is only one owner and the partnership terminates under Section 708(a)(1)(A). In both case authority (McCaulsen v. Comm., 45 TC 588 (1966)) and Revenue Ruling 99-6, the transition of Old Doc’s 50 percent interest to Continuing Owner terminates the entity as a partnership as there is now only one owner. The cited authority deems this situation to involve a distribution of half of the prior partnership’s assets (including the goodwill) to Old Doc and Continuing Owner. Continuing Owner would then be deemed to have bought Old Doc’s goodwill directly from him, Section 754 is inapplicable as there is no longer a partnership. Recall that in a series of transactions as here, Section 197(f)(9)(c) and the Regulations will mandate examining the first and last step in that series as being the critical ones. On these facts, Continuing Owner would be unable to amortize that purchased goodwill as it was bought from a related party (the partnership entity in which Continuing Owner owned a more than 20 percent or more interest).

The planning technique here is to not terminate the partnership entity under Section 708(a)(1)(A) because of only one ongoing owner, but to continue the practice as a partnership even though there is a termination under Section 708(a)(1)(B).

**EXAMPLE 13:** Again, Old Doc and his partner, Continuing Owner, have conducted their practice through the equally owned PS since 1990. PS’s assets consist of the following:

<table>
<thead>
<tr>
<th>AB</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$90,000.00</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
</tr>
</tbody>
</table>

Continuing Owner’s 100 percent owned Corporation, Continuing Owner, Inc., buys Old Doc’s 50 percent partnership interest for $495,000.00. Even though there is a partnership termination under Section 708(a)(1)(B), we are in the **EXAMPLE 10** scenario where the partnership business of the old partnership is continued in a new partnership entity equally owned by Continuing Owner and Continuing Owner, Inc. If old PS had made the Section 754 election, Section 743(b) is invoked. The 754/743 effect is that Continuing Owner, Inc., can amortize over 15 years the $450,000.00 it paid for Old Doc’s share of the goodwill.

Recall the logic behind the Section 754 exceptions. It is based on the aggregate theory of Subchapter K and is expressed directly in the statute at Section 197(f)(9)(E): “determinations under [the Section 754 exceptions] shall be made at the partner level and each partner shall be treated as having owned and used such partner’s proportionate share of the partnership assets.”

There appears to us to be another major formatting difference in analyzing a sale of personal goodwill by Old Doc to the continuing practitioner(s). What if Old Doc’s practice goodwill is personal goodwill owned by Old Doc and not of the PS. If sold directly to Continuing Owner, Continuing Owner would now be purchasing Old Doc’s personal goodwill in one step outside the partnership and Continuing Owner would not be purchasing the goodwill from a related party.

If, however, Old Doc sells his personal goodwill to a continuing partnership in which Old Doc is a retiring partner more analysis appears to yield a different result. In establishing the time for testing for a prohibited relationship where there is a single transaction,
the Code and Regulations will check immediately before or immediately after the transaction for such a relationship. Immediately before the sale, Old Doc, if a more than 20 percent partner at that time, would be a related party to the partnership. The purchasing partnership, being a related party to Old Doc, would be prohibited from amortizing the purchased goodwill.

**CONCLUSION**

We earlier made reference to the Foxman case, which is the leading authority in distinguishing between a sale between partners and a Section 736 retirement from the partnership. Foxman has been made more famous by the excerpted quote from it used in the preface of the McKee, Nelson and Whitmire treatise on partnership taxation:

> “The distressingly complex and confusing nature of the provisions of Subchapter K present a formidable obstacle...even by one who is sophisticated in tax matters with many years of experience in the tax field...when its complex provisions may confidently be dealt with by at most only a small number of specialists who have been initiated into its mysteries.”

Could there be a better illustration of the Court’s point then what we have just explored in this article, a snake dancing through some of the tentacles of a Section 754 election? We hope this publication will assist practitioners in that effort.

**Notes**

1. Section 197(a). All Section references are to the Internal Revenue Code of 1986, as amended, unless otherwise noted.
2. 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 Section 197 rules. This second possibility would be of unlikely relevance to the professional practice scenarios addressed in this article.
3. Section 197(d).
4. Section 197(c)(2).
7. Section 197(f)(2).
8. Section 351(a).
9. Section 197(f)(9).
10. See Footnote 2.
11. Section 707(b) incorporates Section 267 by reference.
13. Section 267(c)(4).
15. Sections 707 (b) (1) and (3).
17. Treasury Regulation Section 1.197-2(k), Example 18.
18. Brinks Gilson & Lione, A Professional Corporation v. Commissioner. T.C. Memo. 2016-20; Pediatric Surgical Associates, P.C. v. Commissioner, T.C. Memo. 2001-82; Mulcahy Paulaitsch Salvador & Co. v. Commissioner, 680 F.3d 867 (7th Cir. 2012), Aff’d D.C. Memo. 2011-74; Elements common to the cases were that no meaningful dividends were paid and that all were accessed a 20 percent accuracy related penalty.
19. IRC Reg. 1.1212-1; Harry R. Haury v. Commisioner, T.C. Memo 2012-215; Code Sec(s) 72; 408; 166; 6651; 6654; 7491.
21. Id.
22. Section 197(f)(2).
24. 1.197-2 (k), Example 18.
26. Section 197(f)(9)(B) and Treasury Reg. Section 1.197-2(h)(9).
27. Section 197(f)(9)(D) and Treasury Reg. Section 1.197-2(h)(5)(i).
28. A single member LLC, taxable as a sole proprietorship, could not make the Section 754 election.
29. Treasury Regulation Section 1.197-2(k), Example 19.
30. Treasury Regulation Section 1.197-2(h)(11).
31. Treasury Regulation Section 1.197-2(f).
32. Treasury Regulation Section 1.197-2(k), Example 19.
33. Treasury Regulation Section 1.197-2(h)(12)(v).
34. 41T.C. 535 (1964).
35. Section 736 (b)(2)(B).
36. Treasury Regulation Section 1.197-2 (h)(12)(iv).
37. Section 736 (a)(2).
38. Treasury Regulation Section 1.708-1(b).
39. Treasury Regulation Section 1.197-2 (k), Ex. 16 (ii).
40. Treasury Regulation Section 1.197-2 (h)(6)(i).
41. Treasury Regulation Section 1.197-2(k), Example 19.