

On The Legal Side

A Churning Question – Section 197 and Dental Transactions

William Barrett, Esq. & Co Author, Philip Mackson, Counsel
CEO, Mandelbaum Barrett PC



Bill Barrett is the CEO of the full-service law firm Mandelbaum Barrett PC, co-chair of the firm's National Dental Law Group, and dental dealmaker who has successfully closed hundreds of transactions nationwide. He has co-authored two best-selling books on dental industry transactions, showcasing his expertise. Bill is also a nationally recognized speaker at industry events across the country. Mandelbaum Barrett PC is a Corporate Friend of NYCDS.

Philip Mackson is Counsel in the firm's corporate and dental law practice group, where he focuses on corporate governance matters, corporate formations, financings, M&A and private equity transactions, and commercial licensing transactions.



When selling your practice, you may come across an odd diligence question:

“Was the seller (or any predecessor entity) in operation between July 25, 1991 and August 10, 1993?”

This vestigial query is meant to determine whether the Internal Revenue Code's “anti-churning” rules might apply to the sale of your practice. Understanding the application of these rules can be crucial in structuring your practice sale properly.

Goodwill, Intangibles, and the IRS Rule that Can Complicate Dental Deals

Under Section 197 of the IRS Code, there is favorable tax treatment (in the form of amortized deductions) that is typically available to the owner of an intangible asset. Intangible assets include goodwill, as well as the value of non-competes and intellectual property. This list is not exhaustive, but intangible assets (e.g., goodwill) are often the primary value of a professional practice.

Along with the beneficial deductions, Section 197 implemented “anti-churning” rules that preclude this favorable tax treatment in cases where two related persons transfer an intangible asset between themselves. In dental practice sales, a buyer and a seller can become “related” (according to the IRS) in transactions with sufficient rollover equity.

Two Key Triggers: Timing and Relationship

If the anti-churning rules apply, the buyer of a dental practice may not be able to receive the advantage of the tax deduction associated with amortizing the value of seller's goodwill. This can substantially alter the overall economics of the deal from the buyer's perspective and reduce the price they are willing to pay.

Transactions that involve (a) a business that was in operation prior to August 11, 1993, and (b) a seller and a buyer that are “related persons” under IRS rules (usually caused by a seller receiving rollover equity), may trigger the anti-churning rules and require an analysis. We turn to a more detailed discussion of these two components.

Deduct Like It's 1993

The anti-churning rules apply where an intangible (e.g., goodwill) was “held or used at any time” between July 25, 1991 and August 10, 1993, or “acquired from a person who held such intangible,” and is subsequently transferred to a “related person.” For example, word-of-mouth referrals from patients (or referrals from/to specialists) taking place during the time period may fall within the umbrella of goodwill “held or used” during that time.

It is important to note that the anti-churning rules may apply to a practice even if the current legal entity was formed after 1993, since the rules can be carried over with the intangibles that were in use by a predecessor business.

A Common Structure with Uncommon Consequences: Rollover Equity

Rollover equity (where the seller receives an ownership interest in the buyer's business in a sale), is a frequent component of dental transactions that continues to grow in popularity, particularly in private equity backed transactions. In deals with significant rollover equity, the buyer and seller can inadvertently become "related persons".

Normally, fifty percent or more common ownership is required, however the definition adopted by Section 197 reduces the threshold to twenty percent. Therefore, there is a potential anti-churning issue in any transaction where a seller will own approximately twenty percent or more of the buyer's business (a detailed analysis may be necessary if the ownership is close to the threshold).

The Bottom Line: Don't Let This Slip Past Your Team

If you are a potential buyer or seller, be sure to confirm the ownership and operational history of any practice where rollover equity may be a significant component, as triggering the Section 197 anti-churning rules may impact the expected value of the practice.

The rules are complex (and applicable in a small, but not insignificant, portion of sales of professional practices). If there is any concern these rules may apply, you should ask an attorney or certified public accountant with experience in sophisticated dental transactions for guidance on this issue.

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