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IRS Reverses Position on Like-Kind Exchanges of Certain Intangibles, Creating Opportunities for Business Swaps and Intellectual Property Assets

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Overview

The Internal Revenue Service recently reversed its long-standing position that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles could not qualify as like-

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kind property under Section 1031 of the Internal Revenue Code.

Treasury regulations currently prohibit taxpayers from treating a business's goodwill or going concern value as like-kind property under Section 1031.¹ Prior to the release of Chief Counsel Advice 200911006,² IRS had consistently stated that trademarks, trade names, mastheads, and customer-based intangibles were too closely related to goodwill or going concern value to be treated any differently.³ CCA 200911006, however, reverses that position.

This article will summarize IRS's change in position with respect to these intangibles and briefly discuss some new tax planning opportunities that could be available to taxpayers in light of this change.

Statutory/Regulatory Law

Section 1031 provides that no gain or loss shall be recognized on an exchange of property held for productive use in a trade or business or for investment purposes for other "like kind" property to be held for trade or business or investment purposes.⁴ Long-standing Treasury regulations promulgated under Section 1031 define "like kind" and provide some additional guid-

¹ Treasury Regulations Section 1.1031(a)-2(c)(2).

² March 13, 2009.

³ See, e.g., Technical Advice Memorandum 200602034 (Jan. 13, 2006); Field Attorney Advice 20074401F (Sept. 25, 2007), discussed *infra*.

⁴ I.R.C. Section 1031(a)(1).

ance for determining when property will be considered to meet the “like kind” standard.⁵

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Additional regulations subsequently were issued that provide more detailed rules for exchanges of personal property.⁶ These regulations provide, in part, that tangible personal property is considered to be of like kind to other property if both properties are of “like class” (i.e. within the same general asset class or product class).⁷ In addition, tangible personal property may be like kind to other property regardless whether the properties are also of a like class.⁸

With respect to intangible personal property, however, there are no general asset or product classes.⁹ As a result, for intangible assets to be eligible for tax deferral treatment under Section 1031, they must strictly be of “like kind” to other intangible assets received in an exchange.¹⁰

The regulations state that whether intangible assets will be considered of “like kind” will depend generally on:

- the nature or character of the rights involved (e.g., patent or copyright); and
- the nature or character of the underlying property to which the intangible relates.¹¹

Goodwill and going concern value, however, are strictly prohibited from qualifying as like-kind property because they are viewed as unique and incapable of being of “like kind.”¹²

‘Old’ IRS View

IRS historically had viewed exchanges of certain limited types of intangible assets as qualifying for like-kind exchange treatment under Section 1031, but not others.

⁵ See generally Treas. Reg. Section 1.1031(a)-1(b) and (c).

⁶ Treas. Reg. Section 1.1031(a)-2.

⁷ Treas. Reg. Section 1.1031(a)-2(a) and (b). These regulations were amended in 2005 to replace the use of the Standard Industrial Classification (SIC) system with the North American Industry Classification System (NAICS) for purposes of determining what tangible properties are of a like class. See T.D. 9201, 2005-1 C.B. 1213.

⁸ Treas. Reg. Section 1.1031(a)-2(a).

⁹ Treas. Reg. Section 1.1031(a)-2(c).

¹⁰ Id.

¹¹ Treas. Reg. Section 1.1031(a)-2(c)(1) and (3). For example, a copyright on a novel would be like-kind to a copyright on a different novel but a copyright on a novel would not be like-kind to a copyright on a song.

¹² Treas. Reg. Section 1.1031(a)-2(c)(2). See also T.D. 8343, 1991-1 C.B. 165.

According to IRS in TAM 200602034, both trademarks and trade names were simply components of the taxpayer’s overall business goodwill or going concern value, which are strictly excluded from qualifying as like-kind property.

For example, exchanges of patents covering assets belonging to the same general asset class or NAICS product class had been held to be qualifying Section 1031 like-kind exchanges by IRS.¹³ Some exchanges of Federal Communications Commission licenses had been as well.¹⁴ However, IRS had declined to rule favorably on exchanges of certain other types of intangibles which it viewed as exchanges of assets closely related to goodwill.

For example, in Technical Advice Memorandum 200602034, the taxpayer sold various trademarks, design marks, and trade names pertaining to one product, subsequently acquired trademarks, design marks, and trade names pertaining to another product, and claimed like-kind exchange treatment. While the taxpayer argued the exchanged marks and trade names should be considered “like kind” under Section 1031 because they all served the same marketing function and enjoyed the same legal protections under the Lanham Act, IRS disagreed. According to IRS, both trademarks and trade names were simply components of the taxpayer’s overall business goodwill or going concern value, and since goodwill and going concern value are strictly excluded from qualifying as like-kind property under the Section 1031 Treasury regulations, so too were these intangibles.

Over a year later, IRS published additional guidance adding newspaper mastheads, subscriber accounts, and advertiser accounts to the list of intangibles that were too closely related to goodwill to be eligible for Section 1031 like-kind exchange treatment.¹⁵ In Field Attorney Advice 20074401F, IRS specifically declined to follow the Supreme Court’s analysis in *Newark Morning Ledger Co. v. United States*.¹⁶ In that case, the taxpayer, a newspaper publisher, allocated \$67.8 million to an intangible asset denominated “paid subscribers” after it merged with another newspaper business. That asset represented the expected future profits to be derived from the approximately 460,000 current subscribers of the merged company’s newspapers. The taxpayer hired an expert who determined:

¹³ See, e.g., IRS TAM 200602034 (Jan. 13, 2006) (ruling that certain patents would be considered “like kind” under Section 1031 if the underlying properties were either of the same general asset class or the same product class or otherwise were of “like kind”).

¹⁴ See, e.g., Revenue Ruling 85-135, 1985-2 C.B. 181; Rev. Rul. 57-365, 1957-2 C.B. 521; IRS Private Letter Ruling 200532008 (Aug. 12, 2005).

¹⁵ FAA 20074401F (Sept. 25, 2007).

¹⁶ *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993).

- the estimated life of the asset based on the projected amount of time that the at-will subscribers would likely continue to subscribe, and
- the value of the asset using the income method.

Because the taxpayer was able to calculate both an estimated useful life and a value for the asset, it depreciated the asset for tax purposes over its useful life.

IRS, however, disagreed with the taxpayer's treatment, arguing that the "paid subscribers" asset was indistinguishable from goodwill and, therefore, not depreciable.

In ruling for the taxpayer, the U.S. Supreme Court held that if a taxpayer can prove that an intangible asset has an ascertainable value and a limited useful life, the duration of which can be determined with reasonable accuracy, regardless whether it otherwise could be conceptually characterized as goodwill, such intangible asset will be able to be depreciated over its limited useful life.

While the taxpayer in the 2007 FAA cited to *Newark Morning Ledger* for the proposition that intangible assets should not be treated as goodwill if it can be shown that they have an ascertainable fair market value and limited useful life, IRS found the case to be irrelevant to the question at hand because it was a Section 167 depreciation case and not a Section 1031 like-kind exchange case.

'New' IRS View (CCA 20091006)

In CCA 20091006, IRS reversed its prior position.¹⁷ IRS, in that recent pronouncement, now states that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles (such as subscriber accounts) can, in fact, qualify as like-kind property under Section 1031.

Basically adopting the taxpayer's position in FAA 20074401F,¹⁸ IRS now states that if intangible assets such as the ones mentioned above can be separately described and valued apart from a business's goodwill, they will not be considered goodwill for purposes of Section 1031, and therefore, will not be strictly excluded from Section 1031 treatment. The CCA goes on to state that except in rare or unusual circumstances, these types of intangibles should be able to be described and valued apart from goodwill, creating a presumption in favor of like-kind property eligibility.¹⁹

¹⁷ Although a chief counsel advice generally cannot be cited as precedent, it does indicate the IRS national office's current legal interpretation of an issue. Furthermore, a CCA may be used to support a "substantial authority" tax reporting position. Treas. Reg. Section 1.6662-4(d)(3)(iii).

¹⁸ In effect, IRS has adopted the analysis the Supreme Court used in *Newark Morning Ledger Co.* to determine if an intangible asset was subject to the Section 167 depreciation allowance (under prior law before the enactment of Section 197) to now determine if an intangible asset is eligible for "like kind" exchange treatment.

¹⁹ In comments to the District of Columbia Bar Association, Stephen Toomey, Branch 4 Senior Counsel in the IRS Office of Associate Chief Counsel, summarized IRS's new position as follows: "We saw the light. Except in rare or unusual circumstances, those items can be valued apart from goodwill, and therefore are subject to the two-part test [limited useful life and ascertainable value] . . . Unless it's goodwill as defined by the Supreme Court in *Newark Morning Ledger* . . . then it will

It is important to note, however, that this CCA does not hold that all trademarks, trade names, and mastheads, for example, are automatically considered like-kind property to all other trademarks, trade names, and mastheads. The "nature and character" requirements of the regulations must still be met.

However, this recent IRS pronouncement is significant in that it indicates that the IRS national office no longer interprets Section 1031 as virtually prohibiting these types of intangibles from being characterized as "like kind" to any other intangible because of their similarity to goodwill and/or going concern value.

Potential New Tax Deferral Opportunities

Business Swaps

In light of this new IRS pronouncement, both buyers and sellers of businesses may wish to consider whether an allocation of residual purchase price to intangible assets other than goodwill could create an opportunity for them to defer taxes in a like-kind exchange.

Prior to the enactment of Section 197 in 1993, buyers often engaged in a similar exercise to try and increase their amortization deductions. Before Section 197, purchase price that was properly allocable to intangibles with ascertainable useful lives and capable of separate valuation could be amortized over those useful lives, while purchase price allocated to intangible assets like goodwill and going concern value were required to be permanently capitalized. As a result, buyers of businesses generally tried to allocate as much of their purchase price to separately identifiable intangible assets and away from goodwill and going concern value as possible. (This also was the taxpayer's goal in *Newark Morning Ledger Co. v. United States*.)

After the enactment of Section 197, however, this planning technique was largely mooted because Section 197 now requires 15-year amortization for all purchased Section 197 intangibles used in a trade or business. Section 197 intangibles include such items as patents, trademarks, covenants-not-to-compete, customer and subscription lists, goodwill, going concern value, and other similar items. As a result, following the enactment of Section 197, regardless of how residual purchase price is allocated, it generally is amortizable over 15 years for tax purposes.

Though the allocation of residual purchase price may no longer be a significant issue for tax amortization purposes, it now may present an opportunity for tax savings in the like-kind exchange arena in light of the recent issuance of CCA 20091006.

not be subject to the per se rule that an intangible cannot be of like kind." Stephen Toomey, Remarks at the April 8, 2009, Meeting of the District of Columbia Bar Association, Doc. 2009-8073, 2009 TNT 66-2 (April 9, 2009). See also Lauren Gardner, *Like-Kind Exchanges: IRS Official Discusses Future Section 1031 Guidance, Reversal on Trademark Treatment*, Daily Tax Report (BNA) No. 66, at G-2 (April 9, 2009).

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CCA 200911006.**

First, business owners looking to swap similar businesses or business lines now can potentially defer the gain associated with not only the like-kind or like-class tangible assets associated with their businesses, but also the like-kind non-goodwill intangibles that they dispose of in an “exchange.”

Furthermore, due to the development of the rules for nonsimultaneous, deferred exchanges and so-called reverse exchange parking transactions, taxpayers engaging in “cash” sales or purchases (rather than direct, simultaneous swaps) also now may be able to defer otherwise taxable gain with respect to substantially all of the assets being disposed of in the transaction,²⁰ including intangibles that can be separated from goodwill or going concern value, in a Section 1031 exchange.

While the rules for deferred exchanges involving all of the assets of a business can be fairly complicated,²¹ sellers generally can enter into appropriate deferred exchange documents with a Section 1031 qualified intermediary (QI),²² close on a “sale” of a business with the

²⁰ Section 1031 specifically excludes the following types of property from being eligible for “like-kind exchange” treatment: property primarily held for sale; stocks, bonds, or notes; other evidences of indebtedness; partnership interests; certificates of trust or beneficial interests; and choses in action. In addition, as discussed previously herein, the Treasury regulations provide that goodwill and going concern value can never be like-kind property.

²¹ See Treas. Reg. Section 1.1031(j)-1 for rules addressing exchanges of multiple properties.

²² The Treasury regulations establish a safe harbor for deferred exchange transactions utilizing a Section 1031 QI. Treas. Reg. Section 1.1031(k)-1(g)(4). The documents typically entered into with a QI to consummate a qualifying deferred exchange under the QI safe harbor will include at least an exchange agreement and also typically will provide for an assignment of the taxpayer’s rights in both the relinquished property sale agreement and the replacement property purchase agreement to the QI. The regulations also require that written notice of these assignments be provided to all parties to the respective agreement on or before the date the property subject to such agreement is transferred. See Treas. Reg. Section 1.1031(k)-1(g)(4)(v). Under the agreement with the QI, the taxpayer cannot be permitted to receive, pledge, borrow, or otherwise obtain the benefits of the money or other property held by the QI before the end of the exchange period, with few exceptions, under the so-called (g)(6) limitations of the regulations. See Treas. Reg. Section 1.1031(k)-1(g)(4)(ii) and (6). Often a separate escrow or trust agreement also is entered into in order to provide for the handling of the taxpayer’s proceeds from the sale that meets the requirements of the qualified escrow or qualified trust safe harbor. See Treas. Reg. Section 1.1031(k)-1(g)(3).

net proceeds being transmitted directly to the QI, and potentially defer the otherwise taxable gain associated with those assets by timely identifying like-kind replacement property within 45 days, and then receiving the identified replacement property before the end of the exchange period.²³

Similarly, taxpayers may be able to utilize the so-called reverse exchange structure that IRS has approved²⁴ to “park” additional types of intangible assets in light of the recent CCA.

For example, buyers may be able to “park” non-goodwill intangibles and other assets that they are acquiring with an exchange accommodation titleholder (EAT) for up to 180 days in a “reverse exchange” (while maintaining control of the assets by entering into a simultaneous lease and/or other agreements with the EAT). If properly structured on the front end, such a buyer ultimately may utilize the parked property as its replacement property in a subsequent 1031 deferred exchange.

In light of the flexibility afforded under the deferred exchange and reverse exchange rules, the recent CCA could provide additional tax savings opportunities for both buyers and sellers of businesses that have intangible assets with built-in-gains.

IP Assets

In addition to the context of “business swaps,” this new CCA also could provide an opportunity for some taxpayers who are either buying or selling intellectual property (IP) assets. These taxpayers now may be able to dispose of their IP assets more readily in a Section 1031 exchange without triggering taxable gain.

While Section 1031 has always contemplated patents and copyrights being eligible for like-kind exchange treatment, this CCA specifically mentions trademarks, trade names, and mastheads as also being eligible. Furthermore, the CCA suggests that other types of intangibles (especially customer-based intangibles) that can be separately identified and valued apart from goodwill should be similarly eligible for Section 1031 exchanges.

Although many of these types of intangibles most often can be expected to be part of, and to exist in the context of, a broader sale of assets of an ongoing business, IRS’s expanded view of “like kind” property in the area of intangibles as expressed in the recent CCA is not limited to only sales of entire businesses. As a result, taxpayers with IP assets should be aware of this seemingly expanded tax deferral opportunity.

Conclusion

CCA 200911006 increases the types of intangible assets that IRS now agrees may be eligible for like-kind exchange treatment. In light of this, taxpayers may

²³ See I.R.C. Section 1031(a)(3); Treas. Reg. Section 1.1031(k)-1(b), (c), and (d). The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter. Treas. Reg. Section 1.1031(k)-1(b)(2)(i). The exchange period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the earlier of the 180th day thereafter or the due date (including extensions) for the taxpayer’s return for the tax year in which the relinquished property transfer occurs. Treas. Reg. Section 1.1031(k)-1(b)(2)(ii).

²⁴ See Revenue Procedure 2000-37, 2000-2 C.B. 308.

wish to consider advance planning and analysis of the intangible assets involved in a purchase or sale so as to be able to try and demonstrate the existence of certain intangible assets separate and apart from goodwill and going concern value, and thereby to try and establish the eligibility of such assets for Section 1031 tax deferred exchange treatment.

Furthermore, as a result of this expansion in potentially qualifying intangible assets and the development of the 1031 rules for deferred exchanges (including “reverse” exchanges as described above), taxpayers planning to buy or sell entire businesses (or business lines), or IP assets in general, should carefully consider whether a Section 1031 exchange could provide valuable tax deferral benefits.