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Multi-Asset Exchanges

By Anna Gregory Wagoner, Title and Regulatory Attorney/Exchange Counsel

Most taxpayers are aware that they can effect a § 1031 exchange on the sale of a rental home or commercial building, as that sale involves only real property. But what if the sale involves multiple types of property, as in the sale of a business, hotel, or restaurant? Such a sale may include up to three types of properties: real property, such as the land or building; personal property, such as furniture, fixtures and equipment; and intangible property, such as goodwill. Many taxpayers are unaware that these multi-asset properties may also qualify for § 1031 exchange treatment, but careful planning and execution are necessary to successfully complete such a complex exchange. The following is a discussion of the important considerations for a multi-asset exchange.

The Like-Kind Requirement

One of the requirements for any successful exchange is that the relinquished property and the replacement property are of like-kind with each other. This is not an issue when exchanging real property, as the like-kind definition for real property is very broad: all real property is like-kind with any other kind of real property. This is not the case with the exchange of personal property, however, as the like-kind definition of personal property is much more restrictive. It is also important to remember that real property is **not** of like-kind with personal property.

Depreciable Tangible Personal Property

Treasury Regulation § 1.1031(a)-2(b) offers a “like-class” safe harbor for depreciable tangible personal property, including office furniture, computers, airplanes, automobiles, and construction equipment. This like-class safe harbor says that if both relinquished and replacement properties are in the same General Asset Class or the same Product Class, they can be presumed to be like-kind. There are 13 General Asset Classes set out in Treasury Regulation § 1.1031(a)-2(b)(2)(I) to (xiii). The Product Classes are set out in Sectors 31, 32, and 33 of the North American Industry Classification System (“NAICS”). Pursuant to Treasury Regulation § 1.1031(a)-2(b), if a property is within a General Asset Class, it may not be classified within a Product Class. A copy of the NAICS manual may be accessed at www.census.gov/naics.

Treasury Regulation § 1.1031(a)-2(b)(5) sets out the following exchange examples:

A personal computer may be exchanged for a printer because they are both in the same General Asset Class and are of like-class;

An airplane may not be exchanged for a heavy general-purpose truck because they are each within different General Asset Classes and are not of like-class or like-kind;

A grader may be exchanged for a scraper because neither is within a General Asset Class and they are both within the same Product Class and are of like-class.

If the depreciable tangible personal property does not qualify under the like-class safe harbor, it may still qualify for non-recognition treatment under the like-kind standard.

Unfortunately, there is little guidance for what constitutes like-kind for personal property, but the rulings appear to follow a narrower standard than that of real property. According to Jeremiah Long & Mary Foster in their treatise *Tax-Free Exchanges Under Sec. 1031*, the regulations seem to imply that a similar use requirement exists for personal property exchanges.

Following are examples of properties that have been held to be of like-kind:

Gold bullion for Canadian maple leaf coins (Rev Ruling 82-96);

SUVs and passenger automobiles (PLR 200550005);

Fishing permits, regardless of species or fishery location or type of fishery gear (IRS Market Segment Specialization Program, Alaska Commercial Fishing: Catcher Vessels, Part I, Released July 1995).

Recent Public Letter Rulings have allowed the following exchanges:

Nitrous oxide emission reduction credits for volatile organic chemical compounds credits (PLR 201024036);

www.1031itec.com

121 North Columbia St.
Chapel Hill, NC 27514
exchanges@invtitle.com

Phone: 800.724.8791
Fax: 800.653.9811

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Automobiles for light-duty trucks - even though they are not within the same General Asset Class, they are of like-kind to each other (PLR 200912004).

It is interesting to note that it is possible for properties to be considered of like-class and therefore within the safe-harbor because they fall within the same General Asset Class, even though they would not be considered like-kind because they do not have similar uses.

Intangible and Non-depreciable Personal Property

Pursuant to Treasury Regulation § 1.1031(a)-2(c)(1), there is no like-class designation for intangible and non-depreciable personal property, so these types of properties must be like-kind in order to qualify for non-recognition treatment. With regard to these types of properties, the IRS has stated: "Whether intangible personal property is of a like-kind to other intangible personal property generally depends on the nature or character of the rights involved (e.g. a patent or copyright) and also on the nature or character of the underlying property to which the intangible personal property relates." Treas. Reg. § 1.1031(a)-2(c)(1).

The IRS has permitted the following types of intangible exchanges:

A copyright on a novel for a copyright on a different novel (Treas. Reg. § 1.1031(a)-2(c)(3);

Airport take-off and landing rights (General Counsel Memorandum 39606).

Goodwill

Goodwill is defined as the value of a trade or business attributable to the expectancy of continued customer patronage. Treas. Reg. § 1.1060-1(b)(2)(ii). Goodwill is never exchangeable because the goodwill of one business is so unique to that business that it can never be like-kind to the goodwill of another business. Treas. Reg. § 1.1031(a)-2(c)(2), T.D. 8343, 1991-1 C.B. Therefore, most tax professionals recommend that the smallest amount of the purchase price possible be allocated to goodwill and that if it is possible to re-categorize an asset into something that is like-kind, it should be done. Any allocation must be reasonable, and, if agreed upon in writing, will be binding upon the parties unless the IRS determines that it is not appropriate. *Tax-Free Exch Under § 1031 § 5:8 (2010)*. In Field Attorney Advice 20074401F, the IRS ruled that newspaper mastheads, advertiser accounts, and subscriber accounts could not be exchanged for other newspaper mastheads, advertiser accounts, and subscriber accounts because they are so closely related to the goodwill of the newspapers. In 2009, the IRS reversed its position in a Chief Counsel Advice Memorandum 200911006 and stated that, except in rare and unusual situations, intangibles such as trademarks, trade names, mastheads, and customer-based intangibles can be valued separately and apart from goodwill.

Business Swaps

Taxpayers will sometimes sell one business and buy a similar business, such as a restaurant for a restaurant. This type of transaction will have both real property assets and personal property assets. Can the taxpayer just exchange the old business for the new business, each as one single asset, or must he match up the different types of assets and exchange on an asset-for-asset basis? The answer to this question was unclear prior to the issuance of the personal property regulations, but rulings subsequent to the issuance of the regulations make it clear that the IRS will require a business swap to be effected on an asset-by-asset basis. In Revenue Ruling 89-121, the IRS ruled that the exchange of the assets of two television stations should not be treated as a disposition of a single property and requires an analysis of the underlying assets involved in the exchange. It is important to note that in a business swap, even incidental property, such as dishes and utensils, must be put into like classes and valued, as there is no *de minimis* rule in these situations.

According to Treasury Regulation § 1.1031(a)-2(a), if the taxpayer is unable to match up the assets using the like-class safe harbor, he may still apply the like-kind standard and classify the assets into broader groups. The risk with using the like-kind standard is that the taxpayer will not have the benefit of the safe harbor and will not, therefore, have any guarantee that the exchange will be successful.

Conclusion

In a multi-asset exchange, it will be very helpful to the qualified intermediary and to the tax professional who is preparing the tax return, if the values of each of the different types of property are set out in the contract. This practice will also help the taxpayer to determine the type and value of replacement property he needs to purchase. The taxpayer and his tax advisor should then be able to match up like-kind real property, like-class or like-kind personal property, and determine if there is any intangible personal property that will not qualify for § 1031 exchange treatment. Because of the complexity of the multi-asset exchange, advanced planning and consultation with a tax advisor are imperative in order to avoid unintended negative tax consequences.

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