OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT: INQUIRY REGARDING EXISTENCE OF GOODWILL AND VALIDITY OF TREAS. REG. § 1031(a)-2(c)(2)

This Field Service Advice responds to your memorandum dated June 8, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer:
Subsidiary:
A:
B:
C:
Qualified Intermediary:
Relinquished Property 1:
Relinquished Property 2:
Replacement Property 1:
Replacement Property 2:
Appraiser:
Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:
Date 7:

Tax Year:
a:
b:
c:
d:
e:
f:
g:

ISSUE(S):

1. Whether the existence of goodwill was properly determined under I.R.C. § 1060.

2. Whether Treas. Reg. § 1.1031(a)-2(c)(2) is valid.

CONCLUSION(S):

1. The facts of this case indicate that it was reasonable to conclude goodwill was transferred along with the relinquished property. Further, it was appropriate to rely on section 1060 to ascertain the value of the goodwill. However, we do not have sufficient facts to form an opinion as to whether the purchase price was properly allocated to the transferred assets, including goodwill.

2. Treas. Reg. § 1.1031(a)-2(c)(2) provides reasonable guidance on the issue of whether goodwill or going-concern value constitute like-kind property. The determination that goodwill and going-concern value cannot constitute like-kind property does not conflict with the provisions of section 1031 or with the other regulations that provide rules for exchanges of other intangible and nondepreciable personal property. The regulation provides a reasonable interpretation of the term "like-kind property" in view of the unique qualities of goodwill and going-concern value and, accordingly, should be sustained.

FACTS:

We rely on the facts set out in your memorandum and on information derived from the attached documents.

Taxpayer is a corporation in the business of operating facilities. Taxpayer is the parent company of Subsidiary. At the time of the exchange, Subsidiary was, directly or indirectly, the parent of Relinquished Property 1. In addition, although the facts are unclear on this point, we assume that at the time of

the exchange, Taxpayer, either directly or indirectly, owned Relinquished Property 2.

A is the parent corporation of B. A and B are corporations operating facilities.

On Date 2, Taxpayer, Subsidiary, A and B entered into an asset purchase agreement in which A and B agreed to acquire Relinquished Property 1 and Relinquished Property 2 for a purchase price of a. The agreement specified that the purchase price was subject to certain adjustments. Relinquished Property 1 is described as an and Relinquished Property 2 is described as a . Under the agreement, the property subject to transfer included land and improvements; equipment, including computer equipment; ; contracts with ; patents and patent applications associated with the facilities; and names, trade names, trade marks and service marks associated with the facilities. The property excluded from the sale included cash and cash equivalents, receivables, proprietary information contained in employee or operation manuals, certain computer software and equipment and entitlement to reimbursement from that might result from the exchange.

Under the agreement, B agreed to assume certain liabilities for future payments and for performance under existing contracts. In addition, the parties agreed to related to a between the parties. The parties also agreed that closing would take place on or before Date 3 and that the purchase price would be allocated among the various classes of transferred assets in accordance with section 1060. The agreement recited that within 30 days of closing B would engage Appraiser, or a mutually agreeable firm, to appraise the transferred property for tax purposes or for purposes.

Your memorandum indicates that on Date 3, Taxpayer through Subsidiary entered into an exchange agreement with Qualified Intermediary. The copy of the agreement of exchange in our file, dated Date 2, is between C and Qualified Intermediary. We assume for purposes of our analysis that C was a subsidiary of Taxpayer at the time of the transfer and that C was in a position to transfer the assets of Property 1. The copy of the agreement does not reflect the signature of Qualified Intermediary.

The agreement purports to set up a like-kind exchange under section 1031(a). Under the agreement, C agrees to transfer property to Qualified Intermediary and to identify replacement property within 45 days. Qualified Intermediary agrees to use its best efforts to acquire the replacement property and then to transfer it to C. The agreement contains provisions allowing C to transfer and receive property directly,

rather than through Qualified Intermediary. However, C's rights to receive cash from the transaction are restricted for a period of 180 days from the date of transfer of the relinquished property.

Appraiser prepared an valuation of Relinquished Property 1 as of Date 1. The report was submitted on Date 5. According to the report, "[t]he purpose of this valuation is to estimate the fee simple market value of the subject property's land, land improvements and buildings and equipment and then allocate the purchase price to the assets appraised." In the report, Appraiser discussed several valuation approaches, but used the cost and the sales comparison approaches. Under the cost approach, the estimated value of Relinquished Property 1 was c; under the sales comparison approach, the estimated value ranged between d and e. The appraisal concludes that because the parties agreed to a sales price of b, that b reflects the fair market value of the property. The amount of b was then allocated to the hard assets acquired by A and B in the exchange. The appraisal does not make a determination as to the existence of goodwill and does not allocate any part of the purchase price to goodwill.

Assuming the relinquished property was transferred on Date 3, Taxpayer timely identified Replacement Property 1 and Replacement Property 2 within the identification period. The exchange was completed on Date 6, within the 180-day exchange period. Taxpayer reported the transaction as a like-kind exchange on its income tax return for Tax Year. The computations relating to the exchange relied on the valuation and allocation of purchase price prepared by Appraiser. The return reflected net gain on the transaction in the amount of f. On Date 7, Taxpayer filed an informal claim requesting a favorable adjustment to reflect a different configuration for the exchange groups and to reflect a claim for additional assumed liabilities. The claim was allowed in part.

During the audit, the exam team requested information and workpapers to support Appraiser's valuation. Taxpayer did not respond. The Service determined that in addition to the hard assets, Taxpayer's transfer of Relinquished Property 1 included a transfer of goodwill. The property's fair market value was reallocated based on an internal appraisal and the amount of g was assigned to the value of goodwill transferred in the exchange. In accordance with the Service's position that the goodwill or going-concern value of one business is not of a like kind to the goodwill or going-concern value of another business, an adjustment was made to Taxpayer's like-kind exchange computations. This resulted in the recognition by Taxpayer of substantial gain on the exchange in Tax Year.

LAW AND ANALYSIS

Issue 1

Goodwill represents an expectancy that old customers will resort to the old place of business. International Multifoods Corp. v. Commissioner, 108 T.C. 25, 36-37 (1997). Goodwill is the value of a preexisting business relationship founded upon a continuous course of dealing that can be expected to continue indefinitely. Canterbury v. Commissioner, 99 T.C. 223, 247 (1992). Goodwill has been described as an advantage or benefit that is acquired by an establishment beyond the value of the capital, stock, or property that an establishment receives because of business from regular customers on account of location, celebrity or reputation. See Newark Morning Ledger Co. v. United States, 507 U.S. 546, 557 (1993). The existence of goodwill and other intangible assets related to a going-concern are questions of fact. Ithaca Indus. v. Commissioner, 97 T.C. 253 (1991), aff'd, 17 F.3d 684 (4th Cir. 1994).

In this case, the terms of the asset purchase agreement suggest that the sale of Relinquished Property 1 was intended to be a sale of a ongoing business. , contracts with staff, rights to patents and patent applications and rights to trade names, trademarks and service marks were all transferred to A and B along with the land and improvements. In addition, the asset purchase agreement contained a series of covenants providing that Taxpayer would use its best efforts to cause the smooth, efficient and successful transition of the business operations of Relinquished Property 1 to B. (Section 6 of the Asset Purchase Agreement). Under these circumstances, it is reasonable to conclude that the parties contemplated the transfer of goodwill, or going concern value as part of the exchange.

Section 1060[1] provides that in the case of an applicable asset acquisition, for purposes of determining the transferee's basis in the assets and for determining the gain or loss of the transferor, the consideration received for the assets must be allocated to the assets in the same manner as amounts are allocated to assets under section 338(b)(5). Accordingly, the selling price must be allocated among transferred assets, including goodwill, to determine the amount and type of gain or loss separately for each asset. Section 1060 requires both a buyer and seller of a trade or business to allocate the consideration paid or received to the assets under the residual method as prescribed by the regulations under section 338.

The residual method requires that the purchase price be allocated as follows[2]:

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[1]I.R.C. section 1060 was added by section 641 of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2282).

[2]The regulations in existence at the time the transaction was consummated provided for four types of asset allocation classifications.

1. to Class I assets (cash, demand deposits, and other similar items);

2. to Class II assets (certificates of deposit, U.S. Government backed securities, readily marketable stock or securities, foreign currency, and other similar items);

3. to Class III assets (all assets, other than Class I, II and IV assets), both tangible and intangible (whether or not depreciable, depletable or amortizable); and

4. to Class IV assets (intangible assets in the nature of goodwill and going concern value). See Temp. Treas. Reg. §§ 1.338(b)-2T and 1.1060-1T(d).

Under Temp. Treas. Reg. § 1.1060-1T(e)(4), the Service is given express authority to challenge a taxpayer's determination of the value of any asset by any appropriate method, taking into account all factors, including any lack of adverse tax interests between the parties.

Section 1031 allows a taxpayer to exchange certain property held for productive use in a trade or business or for investment for like-kind property to be held for productive use in a trade or business or for investment without recognition of gain or loss. Generally, the rules require the recognition of gain to the extent that cash or property which does not meet the requirements of section 1031(a) is received by the taxpayer. However, section 1060(c) provides that a transaction shall not fail to be treated as an applicable asset acquisition merely because section 1031 applies to a portion of the assets transferred. This provision forecloses actions by a taxpayer who may, when acquiring a trade or business, attempt to avoid the residual method by exchanging only a small like-kind business together with substantial amounts of cash for the acquired business. The determination of whether the assets transferred constitute a trade or business is made by taking into account all the assets transferred including the like-kind property. Treas. Reg. § 1.1060-1T(b)(4). If an applicable asset acquisition includes like-kind property, the like-kind property involved in the exchange, and any other property or money which is treated as transferred in exchange for the like-kind property, are excluded for purposes of allocating consideration among the assets under the residual method. Treas. Reg. § 1.1060-1T(b)(4).

According to Temp. Treas. Reg. § 1.1060-1T(e)(4)[3], the Service is authorized to use any appropriate method to challenge the parties' valuation of any asset. Thus,

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[3]See also, the committee reports for Public Law 99-514 (Tax Reform Act of 1986), section 641, H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, section 632; S. Rep. 99-313, pp. 251-255, at 255,

particularly in the absence of cooperation from Taxpayer, the Service was entitled to rely on its engineer to reallocate the purchase price under the asset purchase agreement in this case. However, the question as to whether the amount allocated to goodwill accurately reflects its value is inherently factual. We have not been provided a copy of the engineer's report and, consequently, do not have sufficient facts before us to form an opinion as to its accuracy or thoroughness. Accordingly, we have not addressed the propriety of the allocation of the purchase price to the transferred assets, including goodwill.

Issue 2

Section 1031(a)(1) provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held for productive use in a trade or business or for investment.

Section 1031(a)(2) provides that section 1031(a) is not applicable to any exchange of (a) stock in trade or other property held primarily for sale; (b) stocks, bonds, or notes; (c) other securities or evidences of indebtedness or interest; (d) interests in a partnership; (e) certificates or trust or beneficial interests; or (f) choses in action.

Treas. Reg. § 1.1031(a)-1(b) defines the words "like kind" as having reference to the nature or character of the property and not to its grade or quality. Further, the regulation provides that one kind or class of property may not, under the nonrecognition provisions of section 1031(a), be exchanged for property of a different kind or class.

Treas. Reg. § 1.1031(a)-2 provides rules for exchanges of personal property and is effective for exchanges occurring on or after April 11, 1991.

Treas. Reg. § 1.1031(a)-2(c) provides rules for exchanges of intangible personal property and nondepreciable personal property. Under Treas. Reg. § 1.1031(a)-2(c)(1), an exchange of intangible personal property or nondepreciable personal property qualifies for nonrecognition of gain or loss under section 1031 only if the exchanged properties are of a like-kind. No like classes are provided for these properties.

Treas. Reg. § 1.1031(a)-2(c)(2) provides that the goodwill or going concern value of a business is not of a like kind to the goodwill or going concern value of another business.

Treas. Reg. § 1.1031(j)-1 provides for exchanges of multiple properties. The regulation provides an exception to the general rule under section 1031 that requires a property-by-property comparison for computing the gain recognized and

the basis of property received in a like-kind exchange. Treas. Reg. § 1.1031(j)-1 is effective for exchanges occurring on or after April 11, 1991.

Treas. Reg. § 1.1031(j)-1(a)(2) provides for the separation of the properties transferred and received in the exchange into exchange groups. The separation of properties into exchange groups involves, to the extent possible, the matching up of properties of a like kind or like class.

Treas. Reg. § 1.1031(j)-1(b)(2)(i) indicates that each exchange group should consist of the properties transferred and received in the exchange all of which are of a like kind or like class. Each exchange group must consist of at least one property transferred and at least one property received in the exchange.

The standard for judging the validity of a regulation is well settled. If the regulation implements the congressional mandate in some reasonable manner, it must be upheld. National Muffler Dealers Ass'n v. United States, 440 U.S. 472, 476 (1979). The reasoning behind this principle has been stated as follows:

> "Congress has delegated to the [Secretary of the Treasury and his delegate, the] Commissioner [of Internal Revenue], not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code....That delegation helps ensure that in "this area of limitless factual variations,"... like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject,"... who will be responsible for putting the rules into effect.

Id., at 477 (citations omitted). Thus, courts have deferred to the Commissioner's regulatory interpretations of the Code as long as they are reasonable. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 560-561 (1991). In determining whether a particular regulation properly carries out the congressional mandate, the regulation is examined to see whether it harmonizes with the plain language of the statute and harmonizes with its origin and purpose. National Muffler, 440 U.S. at 477.

Section 1031(a) provides generally for nonrecognition of gain or loss on the exchange of like-kind property held for productive use in a trade or business or for investment. As originally enacted, the only property that was not qualified for nonrecognition treatment in a like-kind exchange was stock-in-trade or property held primarily for sale. I.R.C. § 202(c)(1) (1921). The statute was amended on March 4, 1923 to except certain other property as follows:

> (c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized . . . (1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale, and in the case of property held for investment not including stock, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest), is exchanged for property of a like kind or use.

I.R.C. § 202(c) (amending I.R.C. § 202(c) (1921). The legislative history of the amendment indicates that it was enacted to limit the cases where securities could be exchanged for other securities without the realization of taxable income. H.R. Rep. No. 67-1432 (1923), *reprinted in* SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938 - 1861, at 798 (J.S. Seidman ed., Prentice-Hall, Inc.1939). Congress was addressing a perceived abuse by brokers, investment houses and bond houses. These institutions were structuring exchanges in securities so that their clients could avoid recognition of taxable gain despite the fact that they were disposing of appreciated property and, in essence, cashing out of their investment. Id.

In 1984, section 1031(a) was amended again to exclude exchanges of partnership interests from nonrecognition treatment. This change was intended to address court decisions that had held that certain exchanges of partnership interests would qualify for tax-free treatment as like-kind exchanges if the underlying assets of the partnerships were substantially similar in nature. The legislative history of the Deficit Reduction Act of 1984 indicates that Congress believed that partnership interests typically represented investment interests that were similar to those items already excluded from like-kind treatment under section 1031 (a)(2). In addition, Congress was concerned that investors were using the like-kind exchange rules to facilitate the exchange of interests in tax shelter investments for interests in other partnerships. Under these arrangements, taxpayers were able to take deductions for nonrecourse liabilities without actually paying the liabilities and avoid gain when the used tax shelter was discarded. Congress was concerned that the judicial rule, which allowed like-kind exchange treatment to partnerships holding similar underlying assets, was inadequate to prevent this type of abuse. Consequently, the statute was amended to expressly exclude partnership interests from like-kind treatment. H.R. REP. NO. 98-432, at 1233 (1984), *reprinted in* 1984 U.S.C.C.A.N. 897-898.

The legislative history related to the two amendments to what is now section 1031(a) indicate that the amendments were not enacted to address the requirement under the statute that the property be of a like kind. Instead, the amendments were

intended to insure that certain property be excluded from like-kind treatment regardless of whether it was of a like kind to any exchanged property.

The final regulations covering like-kind exchanges of personal property and multiple properties were promulgated in 1991 and were effective for exchanges occurring on or after April 11, 1991. These regulations include the provision that neither the goodwill, nor the going-concern value of one business is of a like kind to the goodwill or going-concern value of another business. The preamble to the regulations indicates that, in promulgating the final regulation, the Service considered and rejected the possibility of allowing goodwill and going-concern value to be treated as like-kind property under certain limited circumstances. T.D. 8343, 1991-1 C.B. 165, 167. In providing a rationale for rejecting this proposal, the preamble states that the final regulation was based on the conclusion that the nature and character of goodwill and going-concern value were so inherently unique and inseparable from the individual business to which they related, that the goodwill or going-concern value of one business could never be of a like kind to the goodwill or going-concern value of another. Id.

The preamble also addressed the fact that goodwill and going-concern value were not specifically listed as excluded from like-kind treatment under section 1031(a)(2). Citing the legislative history of section 1031(a)(2), the preamble explains that the reasons for providing exceptions under section 1031(a)(2) were unrelated to the reasons for the determination that the goodwill or going-concern value of one business could not be of a like kind to the goodwill or going-concern value of another. Unlike the exceptions under section 1031(a)(2), the determination as to goodwill and going-concern value was made to address the question of whether certain property could be of a like kind to other property. Consequently, the fact that neither goodwill, nor going-concern value were included in the exceptions under section 1031(a)(2) did not preclude the determination that these items could not be of a like kind to other goodwill or going-concern value.

As the preamble indicates, we do not view section 1031(a)(2) as providing an exclusive list of property that will not be entitled to like-kind treatment. Rather, we believe that before the exclusions under section 1031(a)(2) are taken into account, any exchanged property must first be tested section 1031(a)(1). This includes meeting the requirement that the property be of like kind.

The regulations at § 1.1031(a)-(2) provide rules for determining whether personal property has been exchanged for property of a like kind or like class. Section 1031 is silent on the issue of what constitutes like-kind property. Thus, under its general rule making authority, the Service was justified in providing guidance on the meaning of the term “like-kind property” and on a methodology for determining whether intangible personal property is of a like kind to other intangible personal property. I.R.C. § 7805.

The general rule under Treas. Reg. § 1.1031(a)-2(c)(1) is that the determination of whether intangible personal property is of a like kind to other intangible personal property depends on the nature and character of the rights involved and on the nature and character of the underlying property to which the intangible personal property relates. Thus, the examples illustrate that under certain circumstances, if the underlying property to which the intangible property relates is sufficiently similar, an intangible asset, like a copyright or patent, may be exchanged for a similar intangible asset. However, a copyright cannot be exchanged for a patent, and a copyright on a novel cannot be exchanged for a copyright on a musical composition. Treas. Reg. § 1.1031(a)-2(c)(3).

With copyrights and patents, the nature and character of the rights associated with the intangibles are well defined. Further, while no two books or musical compositions are exactly alike, the nature and character of the underlying types of property to which the copyright or patent relates is capable of being classified. On the other hand, the nature and character of goodwill and going concern value are far less defined than copyrights or patents. In addition, goodwill or going concern value are generated through the operations of businesses each of which is a distinct entity, comprised of various factors. The distinct and unique nature and character of the underlying property generating the goodwill or going-concern value distinguish goodwill and going-concern value from other intangibles.

We believe that Treas. Reg. § 1.1031(a)-2(c)(2) properly recognizes the distinctions between other intangible personal property, on the one hand, and goodwill and going-concern value, on the other. Further, we believe Treas. Reg. § 1.1031(a)-2(c)(2) provides a reasonable interpretation of the term "like-kind property" as that term is applied in the context of determining whether goodwill or going concern value may be considered like-kind property for purposes of section 1031. Accordingly, we conclude the regulation is a valid exercise of agency discretion that should be sustained.

With respect to Taxpayer's arguments, we note that Treas. Reg. § 1.1031(a)-2 was subject to notice and comment procedures. Thus, we disagree with Taxpayer's assertion that the Service did not engage in reasoned decision making. Bankers Life & Cas. Co. v. United States, 142 F.3d 973, 980-981 (7th Cir. 1998). In addition, we note that the revenue rulings that are cited in support of the contention that the Service's position in the regulation is inconsistent with prior rulings do not indicate whether goodwill or going-concern value were among the assets exchanged. Certainly none of the rulings directly address this issue. Further, the determinations in Rev. Rul. 71-137 and Rev. Rul. 67-380, that individual player contracts for athletes may qualify for like-kind treatment, are not inconsistent with the regulation because, while the individual players may be unique, the nature and character of the rights of the team under the contracts were sufficiently standard to allow like-kind treatment. Accordingly, the cited rulings do not support the

argument that the position taken in Treas. Reg. § 1.1031(a)-2(c)(2) is inconsistent with prior determinations.

As a final matter, we believe that Taxpayer's argument that the regulation conflicts with the purpose of section 1031, as outlined in the legislative history, ignores the statute's express requirement that property be of a like kind to qualify for nonrecognition treatment. Although the policy behind the statute is an important consideration, it cannot control whether Taxpayer is qualified to avail itself of the statute's benefits in the first instance. To accept this proposition would effectively eliminate the requirement that the property be of a like-kind.

The regulation in question provides guidance on what constitutes like-kind property for purposes of determining whether an exchange qualifies for nonrecognition under section 1031(a). It stands to reason that this results in the exclusion of certain property. The fact that the regulation may disqualify certain taxpayers from the benefits of nonrecognition does not mean that it is at odds with the statute's policy. It merely means that the disqualified taxpayer is not entitled to the policy considerations embodied in the statute.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

[redacted]

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