Goodwill As 1031

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In California where I live, Section 1031 of the Internal Revenue Code is practically a religion. Its observers may not drink Kool-Aid or follow Jim Jones, but at times, they seem almost that fervent. Even clients who know nothing at all about tax law know one Code Section: 1031.

Real estate values may be off-kilter at the moment, but throughout most of California's history, real estate was king. Code Sec. 1031 exchanges were like low-hanging fruit on orange trees that were at one time so plentiful. It is not even cynical to suggest that people frequently do Code Sec. 1031 exchanges because deferring tax is a knee-jerk reaction. There's typically little thought given to crunching the numbers. In some cases taxpayers might conceivably be better off paying a capital gain tax at a historically low rate, and getting a stepped-up basis. Still, deferral being hard to pass up, they do 1031 deals again and again.

Most Code Sec. 1031 exchanges involve real estate. That is the norm, and it is unlikely to change. Nevertheless, I've long noted that Code Sec. 1031 is relatively rarely applied in the business context. Exchanges of business assets do occur, and there is even some history of whole businesses (primarily radio stations) being exchanged under Code Sec. 1031. In large part, though, Code Sec. 1031 is not exactly prominently displayed in the toolkit the average M&A lawyer has at his or her disposal.

Plus, that situation could actually become worse, given several recent letter rulings dealing with exchanges of assets. The big stumbling block one encounters when parties in a business context resort to Code Sec. 1031 is goodwill.

There's Nobody Like You

Goodwill is simply not like-kind to anything. [*See* Reg. §1031(a)-2(c)(2).] It is one of those totally unique (not to mention hard to define) assets. That means a taxpayer cannot exchange goodwill or going concern value and defer recognizing gain.

One key question in this area, of course, is just what constitutes goodwill. Assets such as trademarks and subscriber lists are sometimes considered goodwill, expanding the definition materially. M&A TAX REPORT readers should well remember *Newark Morning Ledger*, SCt, 93-1 USTC ¶50,228, 507 US 546 (1993). In that case, the U.S. Supreme Court held that customer lists were distinct and separate from goodwill. Of course, that case was about Code Sec. 197 and its benefits, not Code Sec. 1031.

Still, having assets treated as other than goodwill for one purpose may well be sufficient for another. At least, that's what I'd argue. Unfortunately, two IRS rulings suggest the IRS thinks otherwise. In TAM 200602034 [Sept. 29, 2005], the IRS addressed a taxpayer that had trademarks and trade names.

The question was whether it could exchange those trademarks and trade names under Code Sec. 1031. The taxpayer argued that the trademarks and trade names were like-kind property, conforming

to regulations under Code Sec. 1031. The taxpayer argued that the nature and character of the rights involved were the same (that is, legal protection under trademark law).

Not only that, the taxpayer argued that the nature and character of the underlying properties were the same (combinations of words, common names, common symbols, and devices that are eligible for registry under trademark law). Nevertheless, the IRS view was that the trademarks and trade names were *not* distinct assets. Instead, the IRS said they were *mere components* of a larger asset (goodwill or going concern value). According to the ruling, that made them *per se* unavailable for like-kind treatment under Code Sec. 1031.

The second ruling, FAA 20074401F, involved the taxpayer's masthead, advertiser accounts and subscriber accounts. Once again, the question was whether these assets could be swapped under Code Sec. 1031. The IRS first concluded that a masthead was a trademark or trade name. Similarly, the IRS concluded that the advertiser accounts and subscriber accounts were closely related to goodwill, and were in effect indistinguishable from the taxpayer's trademarks and trade names. Once again, the IRS said these assets were ineligible for Code Sec. 1031 treatment.

Newark Morning What?

It is hard to read these rulings without conjuring up the history of *Newark Morning Ledger*. That case involved quite similar assets, the question being whether they could be separated from goodwill and going concern value for purposes of Code Sec. 197. Yet, one would think goodwill for purposes of Code Sec. 197 and goodwill for purposes of Code Sec. 1031 would be the same.

Conversely, one would think something ruled *not to be* goodwill under Code Sec. 197 would likewise not be goodwill under Code Sec. 1031. Unfortunately, the IRS apparently doesn't believe in the maxim that what's good for the goose is good for the gander, at least when it comes to goodwill.

In fact, the IRS comes right out and says that Code Sec. 197 and the case law arising under it are simply distinguishable from Code Sec. 1031. It doesn't even appear that the IRS has to get to the classification of goodwill before it applies its negative opinion on the applicability of a transfer of such assets under Code Sec. 1031. In the two rulings mentioned above, the IRS seems careful to say that Code Sec. 1031 doesn't apply because these assets were "closely related to, if not a part, goodwill and going concern value."

In other words, relying on kind of a nexus taint, the IRS seems to admit that the assets in question may not constitute goodwill. That nexus inquiry invites the question of just how close is too close. The assets may simply be "closely related" to goodwill, and that proximity will be enough for the bad goodwill (or is that "good badwill"?) taint. That should make some taxpayers nervous.

Conclusion

There will probably be few tears shed about the ostensible inapplicability of Code Sec. 1031 to a few of these assets. Nevertheless, the IRS's position on it seems hard to justify, if not outright wrong. Any comments out there?