

# 1031 Exchanges of Businesses Clarified

by Robert W. Wood • San Francisco

Exchanges of businesses under Section 1031 would probably not have been discussed ten years ago. But, while such procedures are uncommon, the Internal Revenue Service has ruled that Section 1031 can apply to exchanges of whole businesses. See Revenue Ruling 85-135, 1985-2 C.B. 181, but see Revenue Ruling 89-121, 1989-2 C.B. 203 (rejecting a single business approach and requiring asset-by-asset analysis). In a recent technical advice memorandum, though, No. 9448001, the IRS considered a Section 1031 exchange of two businesses in which a significant portion of the fair market value of the businesses was allocated to intangibles. Noting that an exchange of multiple assets of a business cannot be treated as an exchange of a single asset, the Service analyzed whether Section 1031 applied to the underlying assets that are exchanged.

According to the technical advice memorandum, the proper procedure in applying Section 1031 is to place the assets into groups so that all the assets in that group are of like kind to all the other assets in the group. If the fair market value of the replacement assets in a group exceeds the fair market value of the relinquished assets, that excess must be allocated as boot to other groups in order to make the assets of the relinquished property be of equivalent fair market value to the aggregate fair market value of the replacement like-kind property and boot in the group. Other property received in the transfer that is not of like kind to assets in any group must be allocated as boot to each group, so the fair market values of the assets in each group are equivalent.

While replacement property is of like kind to the extent it is exchanged for an equivalent fair market value of relinquished property of a like kind, it is not of like kind to the extent it is exchanged for property not of like kind. Replacement property is exchanged for property not of like kind to the extent its fair market value exceeds the fair market value of the relinquished property of a like kind. Boot must be taken into account in determining the gain to be recognized for each group.

## Boot Rules

After allocating boot to groups subject to Section 1031, boot must be allocated pro rata in accordance with the fair market value of the relinquished property in groups not subject to Section 1031. Gain with respect to groups not subject to Section 1031 must be determined with that boot treated as the amount realized. After that allocation, if there is boot not yet allocated, that boot must be allocated pro rata in accordance with the fair market value of all the property transferred in the exchange.

## Big Ticket

The main asset of the taxpayer in TAM 9448001 was an intangible of some kind not identified in the ruling. The taxpayer failed to show that this intangible was of like kind to the main asset in the business it was being exchanged for. Accordingly, the IRS ruled that the two businesses involved in the exchange were not of like kind to one another for purposes of Section 1031. Nevertheless, the ruling concludes that Section 1031 could apply to avoid recognition of gain with respect to the non-primary assets of the businesses.

The approach taken in TAM 9448001 is hardly surprising. Indeed, it follows the position taken in Reg. Section 1.1031(j)-1. ■

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