

Number: **201850014**  
Release Date: 12/14/2018  
Index Number: 1031.02-00

Date:  
September 13, 2018

Replacement Distribution Rights #3	=
Date <u>1</u>	=
Date <u>2</u>	=
Date <u>3</u>	=
Date <u>4</u>	=
Simultaneous Exchange Transferee	=
Simultaneous Exchange Value	=
Value of Relinquished Property	=
Value of Replacement Property	=
Debt	=
Qualified Intermediary	=

Dear \_\_\_\_\_ :

This is in response to a request for a private letter ruling dated March 23, 2018, and submitted on behalf of Taxpayer by your authorized representative. Specifically, Taxpayer is requesting a ruling on whether the exchange of certain distribution rights to Products A and B for other distribution rights to Products A and B qualifies for the deferral of gain under § 1031 of the Internal Revenue Code.<sup>1</sup>

## FACTS

Taxpayer is a Subchapter S corporation that uses a calendar year taxable year and the accrual method as its overall method of accounting. Taxpayer is incorporated in State C.

Taxpayer is in the business of wholesale distribution of Product A, Product B, and related products. Taxpayer's occupation principally falls under NAICS Code D. To conduct its business activities, Taxpayer is required to hold specific distribution rights (aka "franchise rights") issued by the companies that produce Product A and Product B. These distribution rights allow Taxpayer to distribute the companies' brands of such products according to the companies' guidelines and in a defined geographical area. To maintain a competitive edge, Taxpayer occasionally enters and exits from specific markets, both geographically and with respect to certain brands, which requires the disposition and replacement of their related distribution rights. The transactions at issue in this ruling request primarily involve Products A and B distributed by Taxpayer under E Distribution Agreement and F Distribution Agreement.

During the period between Date 1 and Date 3, the Taxpayer engaged in a series of exchange transactions intended to meet the requirements of § 1031, all of which involved the relinquishment, replacement, or simultaneous exchange of distribution rights addressed under the occupation code in NAICS Code D. Three of the transactions, which are specified in three separate purchase and sale and closing documents (Relinquished Distribution Rights #1, Relinquished Distribution Rights #2, and Relinquished Distribution Rights #3) involve the sale of distribution rights under E Distribution Agreement and F Distribution Agreement used by Taxpayer in its trade or business to three unrelated parties.

Three other transactions also specified in three separate purchase and sale and closing documents (Replacement Distribution Rights #1, Replacement Distribution Rights #2, and Replacement Distribution Rights #3) were purchases by Taxpayer of replacement

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<sup>1</sup> Because Taxpayer's transactions occurred prior to December 31, 2017, all references to § 1031 of the Internal Revenue Code are to that section as it read prior to amendments made to § 1031 by § 13303 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

distribution rights in certain geographic areas to certain brands under E Distribution Agreement and E Distribution Agreement for use by Taxpayer in its trade or business.

One additional transaction was a simultaneous exchange of Taxpayer's distribution rights used in its trade or business for the distribution rights of an unrelated party for use in Taxpayer's trade or business. This exchange occurred on Date 2 and was entered into between Taxpayer and Simultaneous Exchange Transferee. The value of the exchanged property was Simultaneous Exchange Value and there was no boot in that particular exchange.

Taxpayer represents that the distribution rights that have been sold and are subject to this ruling request have been held for at least X years and used in Taxpayer's trade or business, and that all replacement distribution rights have been acquired for use in Taxpayer's trade or business and are intended to be held for multiple years.

E Distribution Agreement is concerned with clarifying the brands and territories covered in addition to specifying the rights and obligations of the parties. The obligations of the producer in that Agreement to Taxpayer ("Distributor") include timely providing a certain quantity of each product to Taxpayer, providing Taxpayer with details of advertising undertaken by the producer regarding products subject to E Distribution Agreement, providing the Taxpayer with written standards for handling and storage of the products and assuring proper labeling of its products according to state and federal law. As wholesale distributor, Taxpayer is obligated to comply with producer's best practices including following concise directions for the storage of its products to assure their freshness, maintenance of a fully staffed sales team trained to producer's standards, retention of sufficient inventories, prompt delivery services to retailers, undergoing steps to maintain the reputation and competitive position of the producer's brands, and providing the regular submission of specific retail sales and retail account documentation to producer.

The purpose of E Distribution Agreement is to expand the geographical territories to which Taxpayer can distribute this producer's products. Taxpayer had previously acquired distribution rights to this producer's products for different geographic territories under a distribution agreement dated Date 4. The Purchase and Sales Agreement for Replacement Distribution Rights #1 incorporated the distribution agreement dated Date 4 to address the rights and obligations of the Taxpayer and the producer under those agreements for the expanded territory. This Distribution Agreement addressed the applicable brands and territories covered by the earlier distribution agreement now supplemented with newly acquired territories. This agreement spells out the obligations of the "Distributor" (Taxpayer) and the producer, such as marketing, quality control, and inventory maintenance.

Taxpayer's submission includes documentation regarding the transactions including purchase agreements, assignments to Qualified Intermediary of the purchase agreements, brand and territory specifications and the closing statements.

Upon completing the final steps of the transactions, Taxpayer had relinquished a total investment in the distribution rights which it had previously held approximately equal to the Value of Relinquished Property, including the Simultaneous Exchange Value, which is reflected in the selling prices of the relinquished distribution rights. Taxpayer received in exchange a total investment in replacement distribution rights of approximately Value of Replacement Property, including the Simultaneous Exchange Value, which difference between the purchase price of the relinquished and replacement properties was paid with a combination of the sales proceeds from the relinquished distribution rights plus loans incurred from banks equal to Debt to pay the additional purchase price for the replacement distribution rights.

In all cases where the subject exchanges of relinquished and replacement distribution rights were deferred, the purchases and sales were accomplished by Taxpayer's assignment of all purchase agreements, both for the relinquished and replacement distribution rights, to Qualified Intermediary, a qualified intermediary, which conducted the purchase and sales transactions for these exchanges.

Taxpayer represents that all exchanges were completed within 180 days and with the relinquished and replacement distribution rights, where applicable, properly identified within 45 days of Taxpayer's initial sale or purchase, whichever came first, of the exchanged property.

Further, according to the submission, all the transactions occurred between Taxpayer and various unrelated parties who acquired the distribution rights to be used in their occupation likewise covered by NAICS Code D.

Taxpayer has requested a ruling that the relinquished distribution rights transferred by Taxpayer in these transactions are like kind, within the meaning of § 1031 and the regulations thereunder, including § 1.1031(a)-2(c)(1), to the replacement distribution rights.<sup>2</sup>

#### LAW AND ANALYSIS

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<sup>2</sup> To the extent that the agreements involving the Relinquished Distribution Rights #1, #2, #3, the Simultaneous Exchange, and the Replacement Distribution Rights #1, #2, #3 also involve the sale or purchase of customer lists, goodwill, inventory and other property that is either excepted out from § 1031(a)(1) by § 1031(a)(2) (such as stock in trade or other property held primarily for sale) or by § 1.1031(a)-2(c)(2) (such as goodwill), Taxpayer will have to recognize gain or loss. This ruling is limited to the distribution rights at issue in this request and does not purport to address the taxation of other property covered by these agreements.

Section 1031(a)(1) provides generally 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 a like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(2)(A) provides that § 1031(a) nonrecognition does not apply to any exchange of stock in trade or any other property held primarily for sale.

Section 1.1031(a)-1(b) of the Income Tax Regulations provides, in part, that as used in § 1031(a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality, and that an exchange of one kind or class of property for a different kind or class is not a like-kind exchange.

Section 1.1031(a)-2(a) provides, in part, that personal properties of a like class are considered to be of a "like kind" for purposes of § 1031, and an exchange of properties of a like kind may qualify under § 1031 regardless of whether the properties are also of a like class. In determining whether exchanged properties are of a like kind, no inference is to be drawn from the fact that the properties are not of a like class. Further, under § 1.1031(a)-2(b), depreciable tangible personal property is of a like class if they are either within the same General Asset Class (as defined in § 1.1031(a)-2(b)(2)) or within the same Product Class (as defined in § 1.1031(a)-2(b)(3)).

Section 1.1031(a)-2(c)(1) provides that an exchange of intangible personal property qualifies for nonrecognition of gain or loss under § 1031 only if the exchanged intangible properties are of a like kind. No like classes are provided for intangible properties. Whether intangible personal property is of a like kind to other intangible personal property generally depends on (i) the nature or character of the rights involved (e.g., a patent or a copyright) and (ii) the nature or character of the underlying property to which the intangible personal property relates.

Section 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.

Section 1.1031(a)-2(c)(3) illustrates the application of this paragraph (c) with the following examples:

Example (1). Taxpayer K exchanges a copyright on a novel for a copyright on a different novel. The properties exchanged are of a like kind.

Example (2). Taxpayer J exchanges a copyright on a novel for a copyright on a song. The properties exchanged are not of a like kind.

Section 1.1031(j)-1(b) provides the rules for computing gain with respect to exchanges of multiple properties qualifying for nonrecognition of gain or loss under § 1031. Section 1.1031(j)-1(b)(2) provides that to the extent possible the properties transferred and the

properties received by the taxpayer in the exchange are separated into exchange groups and a residual group. Each exchange group consists of the properties transferred and received in the exchange, all of which are of a like kind or a like class. A residual group is created if the aggregate fair market value of the properties transferred in all of the exchange groups differs from the aggregate fair market value of the properties received in all of the exchange groups. Section 1.1031(j)-1(b)(2)(iii).

Section 1.1031(j)-1(b)(3) provides that the amount of gain or loss realized with respect of each exchange group and the residual group is the difference between the aggregate fair market value of the properties transferred in that exchange group or residual group and the properties' aggregate adjusted basis. The gain realized with respect to each exchange group is recognized to the extent of the lesser of the gain realized and the amount of the exchange group deficiency, if any. An exchange group deficiency is the excess aggregate fair market value of the properties transferred in an exchange group over the aggregate fair market value of the properties received (less the amount of any excess assumed liabilities). The amount of gain or loss realized and recognized with respect to property not within any exchange group or the residual group is determined under § 1001 and other applicable provisions of the Code.

Although our office is unable to verify the correctness of the representations made by Taxpayer concerning identification and receipt of the subject properties, we note that §1.1031(k)-1(b)(2)(iii) provides that if, as part of the same deferred exchange, the taxpayer transfers more than one relinquished property and the relinquished properties are transferred on different dates, the identification period and the exchange period are determined by reference to the earliest date on which any of the properties are transferred. Section 1.1031(k)-1(c)(1) provides, in part, that any replacement property that is received by the taxpayer before the end of the identification period will in all events be treated as identified before the end of the identification period.

Here, Relinquished Distribution Rights #1, #2, and #3, and the Simultaneous Exchange transaction were all completed within a couple of days of each other. Similarly, Replacement Distribution Rights #1 and #3 were received by Taxpayer within a few days of the relinquishment of the Relinquished Distribution Rights and within 45 days of the earliest date on which any distribution rights were transferred. Pursuant to § 1.1031(k)-1(c)(1), the distribution rights under Replacement Distribution Rights #1 and #3 received by Taxpayer before the end of the identification period will be treated as identified before the end of the identification period.

The distribution rights provided for under E Distribution Agreement and E Distribution Agreement, which are the subject of the agreements in Relinquished Distribution Rights #1, #2, and #3 and the agreements in Replacement Distribution Rights #1, #2, and #3 are intangible property that grant rights to the distribution of Product A or Product B and related products. Because Taxpayer has entered into a series of purchase and sales agreements with counterparties pursuant to which Taxpayer relinquished or acquired

certain distribution rights to Product A, Product B, and related products pursuant to E Distribution Agreement and E Distribution Agreement, the only issue is whether the agreements for Relinquished Distribution Rights #1, #2, and #3 and the agreements for Replacement Distribution Rights #1, #2, and #3 are of a like kind. This depends on (i) the nature or character of the rights involved and (ii) the nature or character of the underlying property to which the agreements relate. Section 1.1031(a)-2(c)(1).

The agreements for Relinquished Distribution Rights #1, #2, and #3 and the agreements for Replacement Distribution Rights #1, #2, and #3 are all in the nature of Product A and Product B and related product distribution agreements. Distribution of Product A and Product B is a single business activity. The terms of the agreements are substantially similar, and any difference among them is a difference in grade or quality (such as different brands or geographic localities). Accordingly, the nature or character of the agreements for Relinquished Distribution Rights #1, #2, and #3 and the agreements for Replacement Distribution Rights #1, #2, and #3 are of a like kind.

The second requirement for the agreements to be of a like kind under § 1.1031(a)-2(c)(1) is that the underlying properties subject to these agreements must itself be of a like kind. The underlying properties to which the intangible rights relate are Product A, Product B, and related products, which are covered by NAICS Code D. Product A and Product B and related products may be of different grade or quality, with different brand names, appearances, ingredients, packaging, manufacturing processes, marketing strategies, and sold in potentially different geographic areas. However, Product A and Product B, and related products share a substantially similar distribution process to a largely common set of customers (retailers of Product A, Product B and related products) and which the retailers resell to their end customers who consume Product A, Product B, and related products for a substantially similar purpose. Any differences among Product A or Product B or the related products that are relevant to distribution are differences in grade or quality, and not differences in nature or character. Accordingly, the underlying property subject to the agreements for Relinquished Distribution Rights #1, #2, and #3 and the agreements for Replacement Distribution Rights #1, #2, and #3 is of a like kind.

## RULING

The distribution rights transferred by Taxpayer in the agreements for Relinquished Distribution Rights #1, #2, and #3 are of a like kind, within the meaning of § 1031, to the distribution rights received by the Taxpayer under the agreements for Replacement Distribution Rights #1, #2, and #3, and no gain or loss will be recognized by Taxpayer on the exchange of rights under the agreements for Relinquished Distribution #1, #2, and #3, and Replacement Distribution Rights #1, #2, and #3, except to the extent of any gain required to be recognized under § 1.1031(j)-1(b)(3)(i).

## CAVEATS

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Taxpayer should apply and the examiner should verify the correct application of § 1031(a)(2) and § 1.1031(a)-2(c)(2) concerning property that is excluded from the like-kind property rules of § 1031. In addition, Taxpayer should apply and the examiner should verify the matching of replacement property distribution rights with relinquished property distribution rights for each transaction as well as the correct application of the gain recognition provisions of § 1031(b) and § 1.1031(j)-1, and especially the extent of any gain required to be recognized under § 1.1031(j)-1(b)(3)(i). This ruling will not prevent assessments based on the taxability of boot received by Taxpayer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

Sincerely,

Shareen S. Pflanz  
Senior Technician Reviewer, Branch 5  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure (1)