INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-118347-05/CC:ITA:B4

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Tax Year 1 =
Date 1 =
ID-Date 1 =
Date 2 =
ID-Date 2 =
Date 3 =
Sub 1 =
Sub 2 =
Sub 2A =
Sub 2B =
Sub 2C =
Sub 2D =
Sub 2E =

Sub 2F =
Sub 3A =
Sub 3B =
Sub 3C =
Sub 3D =
Sub 3E =
Seller 1 =
Seller 2 =
Buyer 1 =
Buyer 2 =
State A =
State B =
Country C =
State D =
State E =
State F =
State G =
State H =
Country J =
Country K =
AA =
AAAA =
AAAAAA =
B =
BB =
BB1 =
BB2 =
BB3 =
BB4 =
BBBB =
BBBBBB =

CC =

CCCC =

CCCCCC =
DD =

DD1 =
DD2 =
DD3 =
DD4 =
DD5 =

DDDD =

DDDDDD =

Patent X =
Patent Y =

XX =
$A =
$B =
$C =
$D =
$E =

$F =
$G =
$H =
$J =

ISSUE(S):

1. Whether Taxpayer's transfers and acquisitions of intangible property qualify as like-kind exchanges so that gain may be deferred under § 1031 of the Internal Revenue Code.

2. Whether Taxpayer's transfer of intangible property of a domestic entity and the acquisition of intangible property of a foreign entity qualifies as a like-kind exchange under § 1031(h)(2).

3. Whether Taxpayer's exchanges of intangible property complied with the identification requirements of § 1031(a)(3)(A) and § 1.1031(k)-1(c) of the Income Tax Regulations.

CONCLUSION(S):

1. Taxpayer's transfers and acquisitions of intangible property qualify as like-kind exchanges so that gain or loss is deferred only to the extent that the properties exchanged are of like kind and the exchanges otherwise satisfy the requirements of § 1031.

2. The exchange of intangible property by a domestic entity for the intangible property of a foreign entity does not qualify as a like-kind exchange to the extent that the exchange is of property used predominantly within the United States for property used predominantly outside the United States as provided under § 1031(h)(2).

3. With the exception of replacement property acquired before the end of the identification period, Taxpayer did not properly identify replacement property in accordance with the requirements of the § 1031 and the regulations thereunder.

FACTS:

During Tax Year 1, Taxpayer entered into four transactions involving the transfer and acquisition of tangible and intangible business assets. On its corporate income tax return for Tax Year 1, Taxpayer claimed like-kind exchange treatment under § 1031 for transactions (as described below) involving the intangible assets:

On Date 1, Taxpayer, acting through Sub 3A and Sub 3C, transferred the tangible and intangible assets pertaining to the business of Sub 1 to Buyer 1. Buyer 1 paid $A for these intangibles. Sub 1 researched, designed, manufactured, and marketed AA for customers in the United States and around the world. Sub 1 was headquartered in State A and had facilities in State A, State B and Country C. The Standard Industry Classification (SIC) code for Sub 1 was AAAA. The current corresponding North American Industry Classification System (NAICS) code for Sub 1 is AAAAAA. The intangible assets transferred were divided by Taxpayer into five broad categories, including (1) patents; (2) trademarks (including design marks) and trade names; (3) designs and drawings; (4) software; and (5) trade secrets and know-how.

On Date 2, Taxpayer, acting though Sub 3A and Sub 3B, transferred to Buyer 2 substantially all of the assets of the BB and engineering service businesses of Sub 2A, Sub 2B, Sub 2C, Sub 2D, and Sub 2E, as well as certain assets of Sub 3A and Sub 2F. The businesses and assets transferred to Buyer 2 are referred to collectively as “Sub 2.” Buyer 2 paid $C for the intangible assets. Sub 2 designed, manufactured, marketed, tested, and repaired BB used in certain types of industrial operations. Sub 2’s products and manufacturing operations were divided into four divisions: BB1, BB2, BB3, and BB4. Sub 2 operated facilities in State D, State E and State F. The SIC code for Sub 2 was BBBB. The current corresponding NAICS code for Sub 2 is BBBBBB. The intangible assets pertaining to Sub 2 transferred by Taxpayer to Buyer 2 were divided by Taxpayer into the same five broad categories described above, including (1) patents; (2) trademarks and trade names; (3) designs and drawings; (4) software; and (5) trade secrets.

Also on Date 2, Taxpayer, acting through Sub 3A and Sub 3C, acquired the assets and business operations of Seller 1, a firm engaged in the research, design, manufacture and marketing of highly-engineered CC in the United States. The intangible assets of Seller 1 were acquired for the total sum of $F. Seller 1 was headquartered in State G and had manufacturing plants in State G and State H. The SIC code for Seller 1 was CCCC. The current corresponding NAICS code for Seller 1 is CCCCCC. The intangible assets acquired were divided by Taxpayer into four broad categories, including (1) trademarks and trade names; (2) designs and drawings; (3) software; and (4) trade secrets and know-how.

On Date 3, Taxpayer, acting through Sub 3A, Sub 3D and Sub 3E, acquired the assets of Seller 2, a manufacturer of DD. The intangible assets of Seller 2 were acquired for the total sum of $E. Seller 2's products and manufacturing operations were split into two divisions. One division was a leading producer of DD1 with manufacturing plants in Country J and Country K. The other division was a leading producer of DD2 with facilities in Country J and the United States. Seller 2 had a reputation for innovative engineering and manufacturing skills and was regarded as the industry's technology leader in DD3. The SIC code for Seller 2 was DDDD. The current corresponding NAICS code for Seller 2 is DDDDDD. The intangible assets acquired were divided by Taxpayer into four broad categories, including (1) patents; (2) designs and drawings; (3) software; and (4) trade secrets and know-how.

Taxpayer claimed like-kind exchange treatment on the disposition of the intangibles pertaining to Sub 1 and Sub 2 and the acquisition of the intangibles of Seller 1 and Seller 2 on its corporate income tax return for Tax Year 1. Taxpayer did not claim like-kind exchange treatment with respect to any of the tangible assets involved in the above-described transactions.[1] For the Date 1 transfer of Sub 1 intangible assets for $A and the Date 2 acquisition of Seller 1 intangible assets for $B, Taxpayer claimed deferral of taxable gain based upon the exchange of two categories of intangible property: (1) trademarks and trade names, and (2) trade secrets and know-how.

For the Date 2 transfer of Sub 2 intangible assets for $C and the same-day (Date 2) acquisition of Seller 1 intangible assets for $D, Taxpayer claimed deferral of taxable gain based upon the exchange of four categories of intangible property: (1) trademarks and trade names; (2) designs and drawings; (3) trade secrets and know-how; and (4) Software.

For the Date 2 transfer of Sub 2 intangible assets for $C and the Date 3 acquisition of Seller 2 intangible assets for $E, Taxpayer claimed deferral of taxable gain based upon the exchange of four categories of intangible property: (1) patents; (2) designs and drawings; (3) trade secrets and know-how; and (4) software.

APPLICABLE LAW AND ANALYSIS:

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 like kind which is to be held either for productive use in a trade or business or for investment.

[1] In the transactions described here, the intangible assets disposed of by Taxpayer and replaced by Taxpayer, were held and are now held by Sub 3A. Thus for these transactions, there is no question or concern about whether the entity that held the relinquished intangible property is the same entity that is receiving the replacement intangibles.

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 and 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 “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 properties are 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(b)(1) provides, in part, that a single property may not be classified within more than one General Asset Class or within more than one Product Class. In addition, property classified within any General Asset Class may not be classified within a Product Class. A property's General Asset Class or Product Class is determined as of the date of the exchange.

Section 1.1031(a)-2(b)(2) generally provides that property within a General Asset Class consists of depreciable tangible personal property described in one of asset classes 00.11 through 00.28 and 00.4 of Rev. Proc. 87-56, 1987-2 C.B. 674. These General Asset Classes describe types of depreciable tangible personal property used in many businesses.

Section 1.1031(a)-2(b)(3) generally provides that property within a Product Class consists of depreciable tangible personal property that is described in a 6-digit Product Class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System (NAICS), set forth in Executive Office of the President, Office of Management and Budget, North American Industry Classification System, United States, 2002 (NAICS Manual), as periodically updated. Sectors 31 through 33 of the NAICS Manual contain listings of specialized industries for the manufacture of described products and equipment. For this purpose, any 6-digit NAICS Product Class with a last digit of 9 (a miscellaneous category) is not a Product Class for purposes of this section. If a property is listed in more than one Product Class, the property is treated as listed in any one of those Product Classes. A property's 6-digit Product Class is referred to as the property's NAICS code.

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 and going concern value of a business is not of a like kind to the goodwill and going concern value of another business.

Section 1.1031(a)-2(c)(3) illustrates the application of this paragraph (c) with only the two 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.

Thus, as demonstrated by these examples, both the nature or character of the rights involved and the nature or character of the underlying property must be of like kind.

The Service has long rejected any notion that taxpayers may treat the multiple assets of a business as a single property for like-kind exchange purposes. Rather, the determination of whether (or the extent to which) § 1031 applies to an exchange of the assets of one business for the assets of another business requires an analysis of the underlying assets exchanged. Rev. Rul. 89-121, 1989-2 C.B. 203. See also Rev. Rul. 55-79, 1955-1C.B. 370 (requiring separate computations to determine gain or loss of each asset constituting the sole proprietorship sold by a taxpayer). The asset- by-asset analysis is required to verify that the properties exchanged are of like kind.

Even small differences between similar properties are relevant in determining whether two properties are like kind. For example, compare Rev. Rul. 79-143, 1979-1 C.B. 264 (U.S. $20 gold coins, which are numismatic-type coins, are not like kind to South African Krugerrand gold coins, which are bullion-type coins), with Rev. Rul. 76-214, 1976-1 C.B. 218 (Mexican 50-peso gold coins and Austrian 100-corona gold coins, both of which are official government restrikes and noncurrency bullion-type coins, are like-kind). *See also California Federal Life Insurance Co., v. Commissioner*, 680 F.2d 85, 87 (9th Cir. 1982), *aff'g* 76 T.C. 107 (1981), which held that U.S. Double Eagle $20 gold coins and Swiss francs are not property of "like kind" because the latter were still currency representing an investment in the Swiss economy while the former were numismatic-type coins. When personal property is concerned, the Service has been stricter in its determinations of what constitutes like-kind property than for exchanges of real property. This position has withstood judicial scrutiny. *California Federal Life Insurance Co.* at 87.

This strict approach to like-kind personal property determinations also seems consistent with longstanding legislative policy. For example, in 1969 Congress amended § 1031 by adding subsection (e) which provides that, for purposes of § 1031, livestock of

different sexes is not property of a like kind. The legislative history of this provision suggests that Congress intended that like-kind interpretations be strict insofar as personal property is concerned. *See* S. Rep. No. 91-552, 91st Cong., 1st Sess. 102 (1969); 1969-3 C.B. 488-489.

In the case of exchanges of intangible property, the standard for determining if intangible property is of like-kind to other intangible property is, if anything, still more rigorous than the standard for matching tangible personal property. For example, as noted above, exchanged tangible personal properties are matched for § 1031 purposes if they are at least of a like class, while for intangible property, like classes are not provided. Rather, a two-pronged analysis is required under § 1.1031(a)-2(c)(1), which requires a matching of both (i) the nature or character of the rights involved and (ii) the nature or character of the underlying property to which the intangible personal property relates. The fact that like classes are not provided for intangible properties does not mean that the General Asset Classes under §1.1031(a)-2(b)(2) and the Product Classes of § 1.1031(a)-2(b)(3) are ignored. Whenever possible, the underlying tangible personal properties to which the intangible asset relates should be compared using the same General Asset Classes and Product Classes already afforded for testing whether personal properties are of like class. However, as indicated in the regulations, even if such a match is made, the properties are not of like kind unless the nature and character of the rights involved are also of the same nature or character.

Patents

Under this methodology of using the General Asset and Product Classes, the task of determining whether patents are of like-kind becomes relatively straightforward. Section 1.1031(a)-2(c)(1) indicates that for purposes of § 1031 the nature or character of rights under one patent are the same as the nature or character of rights under a different patent, even if the underlying property may differ. Thus, the first prong of the test under § 1.1031(a)-2(c)(1) is satisfied if a patent exists on both sides of the exchange. In testing whether there is a match of the underlying property for purposes of satisfying the second prong of the like-kind test set forth in § 1.1031(a)-2(c)(1), matching by General Asset Class under §1.1031(a)-2(b)(2) and the Product Classes of § 1.1031(a)-2(b)(3) is both reasonable and consistent with the Income Tax Regulations.

Taxpayer, however, suggests a matching scheme that would group all patents into four broad classes of underlying property: (1) Process, (2) Machine, (3) Manufacture, and (4) Composition of Matter. These are the same categories used in United States patent law for classifying intellectual property that may be patented. 35 U.S.C. § 101. According to Taxpayer, a machine patent should be of like-kind to any other machine patent, a patent on a process should be of like-kind to any other patent on any other process, and so forth. Thus, for example, a patent for any machine or part of a machine, such as for a new kind of an electronic component for a computer would be of like kind to a patent for a hedge trimmer, or a hair dryer or a helicopter rotor blade.

However, we find no authority to support Taxpayer's method of matching of patents for § 1031 purposes, nor does Taxpayer cite any. In fact, it would be inconsistent to require matching of tangible personal property by its NAICS code while ignoring NAICS when comparing underlying property for patents on the same item. Moreover, the tax law with respect to like-kind exchanges generally mandates specificity and the analysis of exchanges on an item-by-item basis rather than on a global basis. Rev. Rul. 89 -121. The requirement of specificity is also demonstrated in the identification rules provided in § 1.1031(k)-1, which are addressed later in this document.

Therefore, in determining which patents are of like kind, assuming that all patents involved in an exchange are either used predominantly in the United States (domestic patents) or all used predominantly outside the United States (foreign patents), the underlying property must be either of the same General Asset Class or the same Product Class or otherwise of like kind. Thus, for example, patents for BB1, BB2, BB3 and BB4 (described within the BBBBBB NAICS code) are not of like kind to patents for DD1, DD2 and DD3 (described within the DDDDDD NAICS code) because the underlying property is not of like class or of like kind. In contrast Taxpayer proposed a match of relinquished Patent X for replacement Patent Y. The underlying properties on both patents have for their NAICS code DDDDDD, and each was a component of a larger machine having a NAICS code of BBBBBB. Assuming that both the relinquished and the replacement properties at issue are either used predominantly within the United States or used predominantly outside the United States, then Patent X is of like kind to Patent Y.

Trademarks and Trade Names

In its own submission, Taxpayer states that any "trademark, trade name or design mark [or, presumably, any service mark] serves the same marketing function, which is to identify the 'source of origin.'" (Bracketed language added.) Thus, it is Taxpayer's position that all marks and trade names exchanged in these transactions should be considered of like-kind for § 1031 purposes.

In support of this contention Taxpayer first argues that intangible assets properly registered with the United States Trademark Office under the Lanham Act[2] enjoy essentially the same legal protections. Therefore, the nature and character of such rights are of a like kind. For example, an owner of a federally registered design mark has the same legal right of recourse as an owner of a federally registered trade name. Under the Lanham Act, eligible design marks and eligible trade names both enjoy the same rights and privileges of federal trademark protection.

In addition, Taxpayer asserts that the second prong of the like-kind test for intangible property in § 1.1031(a)-2(c)(1), which relates to the underlying property, is also satisfied. The Lanham Act applies to a "word, name, symbol, or device or any

[2] The Lanham Act is codified as 15 U.S.C. at §§ 1051 – 1126.

combination thereof." Thus a registered trademark may refer to any item that is within one of those categories. In this case, all of the exchanged trademarks at issue were in the last category, i.e., a combination of words, names, symbols, or devices.

Under Taxpayer's analysis any mark or trade name is of like-kind regardless of use, appearance, form or origin. We disagree. The term "trademark" has been generally defined as "a device used by a merchant to identify its goods or services and to distinguish them from those of others." ROGER E. SCHECHTER & JOHN R. THOMAS, INTELLECTUAL PROPERTY: THE LAW OF COPYRIGHTS, PATENTS AND TRADEMARKS, 539 (Hornbook Series, WESTLAW and West Group, 2003). Similarly, the term "trade name" is generally understood to mean a "name, word, or phrase employed by one engaged in business, as a means of identifying its products, business, or services, and of establishing good will." BALLENTINE'S LAW DICTIONARY 1289 (3d ed. 1969).

Trademarks and trade names are, we believe, a component of a larger asset, either of goodwill, or of going concern or both. Section 1.1060-1(b)(2)(B)(ii) provides that goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a business or any other factor. Section 1.1060-1(b)(2)(B)(ii) also defines "going concern value" as the additional value that attaches to property because its existence is an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership.

In view of the volume of litigation concerning the infringement of registered marks and trade names (all based on the fundamental premise that each mark or trade name is unique and of importance to the promotion of the goods, services or enterprises they may represent), it seems disingenuous for anyone to assert that all marks and trade names are alike. Clearly they are not. Since they are so closely related to (if not a part of) the goodwill and going concern value of a business, it is our view that trademarks and trade names should not be considered of like-kind under § 1031.

Unregistered Intellectual Property

In the case of unregistered intellectual property, Taxpayer claimed like-kind exchange treatment by matching exchanged properties by the following categories: (1) designs and drawings, (2) trade secrets and secret know how, and (3) software. These categories of property are not protected through registration in the manner of patents or trademarks. However, this genre of intangible property embodies various rights and privileges of a proprietary nature to a trade or business and is protected from unauthorized disclosure under state enactments of the Uniform Trade Secrets Act, the federal enactment of the Economic Espionage Act of 1996, 18 U.S.C. §§ 1831-39, (making misappropriation of trade secrets a federal crime), and the common law.

The nature or character of the proprietary rights associated with a particular type of unregistered intellectual property is similar to those of any other type of unregistered intellectual property. Unregistered intellectual property is generally protected if it satisfies two criteria: (1) secrecy maintained through the reasonable diligence of the holder of the information; and (2) commercial value derived from not being generally known. *See* SCHECTER, *supra, at* 531, *citing* RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 (1995).

There is no limit to the number or variety of forms of proprietary information that may be protected as trade secrets under this body of law. The case law in this area describes many of the known forms, including customer lists, marketing data, bid price information, technical designs, manufacturing know-how, computer programs, and chemical formulae. *Id.* at 531, *citing* RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 cmt. d (1995). Federal law lists additional forms of unregistered intangible properties as included within the meaning of the term 'trade secret,' i.e., financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether stored, compiled or memorialized physically, electronically, graphically, photographically, or in writing. 18 U.S.C. § 1839(3).

In view of the commonality of legal protections afforded to unregistered intangible property generally, it is apparent that the proprietary information exchanged by Taxpayer (designs and drawings, trade secrets and secret know-how, and software) satisfy the first prong of the test set forth in § 1.1031(a)-2(c)(1) for determining if intangible properties exchanged are of like kind. The rights of Taxpayer to the proprietary information at issue are of the same nature and character, provided that they are "trade secrets" within the meaning of the law.

Taxpayer urges that the second prong of the test, that the underlying property be of the same nature or character, should be treated as satisfied if the proprietary information is grouped in the same general categories suggested in the Uniform Trade Secrets Act, namely, "a formula, pattern, compilation, program, device, method, technique or process." In support of its argument, Taxpayer suggests the following as "specific examples" of matches of relinquished and replacement unregistered intellectual property in the transactions at issue:

Example One:

Relinquished Unregistered Intellectual Property:

> Process - B Selection Programs: Property is engineering calculations software, which consists of various spreadsheets, and other programs designed to reduce the time required to perform complicated engineering calculations.

Replacement Unregistered Intellectual Property:

> Process - General Design Formula and Programs: Property is engineering calculations software, which consists of various spreadsheets and other programs designed to reduce the time required to perform complicated engineering calculations.

Example Two:

Relinquished Unregistered Intellectual Property:

> Manufacture – Drawings/Information Stored in Print Room and Warehouse & XX Drawing Vault Information: Properties are examples of unregistered manufacturing innovations that are maintained (either electronically or in hard copy) in design libraries. The libraries are either physically locked or protected through the use of an electronic password.

Replacement Unregistered Intellectual Property:

> Manufacture – DD4 Design & DD5 Design: Properties are examples of unregistered manufacturing innovations that are maintained (either electronically or in hard copy) in design libraries. The libraries are either physically locked or protected through the use of an electronic password.

Taxpayer's argument that unregistered intangibles satisfies the second part of the intangible like-kind property test in § 1.1031(a)-2(c)(1) if the exchanged properties are in the same broad category corresponds almost precisely with Taxpayer's approach for matching patents within the four groups of machine, process, manufacture and composition of matter. For the same reasons that we rejected Taxpayer's theory with respect to patents, we must also reject the same theory as applied to unregistered intangible properties.

There is no basis in law for adopting broad categories for purposes of satisfying the like-kind test under § 1.1031(a)-2(c), and Taxpayer does not cite any such authorities. Also, such broad categories would permit the matching of very different kinds of property interests beyond the scope and intendment of § 1031. For example, the drawing or unpatented design for a coated gas welding rod is not similar to the drawing or unpatented design for a wind turbine. The underlying property for the former is a coated gas welding rod, and of the latter, a wind turbine. The NAICS code for a coated gas welding rod is 333992. The NAICS code for a wind turbine is 333611. If the difference in NAICS codes for objects whose designs are patented is sufficient to prevent two patents from being of like kind, the result should not differ just because the designs are neither patented nor registered. Accordingly, it is our conclusion that the unregistered intellectual property exchanged by Taxpayer is not of like kind unless the specific

underlying properties to which the unregistered intangibles relate are within the same General Asset Class or the same Product Class.[3]

Foreign Intangibles

Section 1031(h)(2)(A) provides that personal property used predominantly within the United States and personal property used predominantly outside the United States are not property of a like kind. Section 1031(h)(2)(B)(i) provides that in the case of personal property relinquished in the exchange, predominant use is determined by its use in the two-year period ending on the date of the relinquishment. Section 1031(h)(2)(B)(ii) provides that in the case of property acquired in the exchange, predominant use is determined by its use during the two-year period beginning on the date of acquisition.

In the present case, through Sub 3A, Taxpayer exchanged part of the intangibles of Sub 2, a company based in the United States, for the intangibles of Seller 2, a Country J-based company.

Taxpayer argues that § 1031(h)(2) is inapplicable to exchanges of intangible personal property because such property lacks a physical or geographical location. Therefore, it is not confined to any one location at any given time. Given this quality, Taxpayer asserts that intangible property is not capable of being used predominantly in one location, in or out of the United States.

However, the physical location of intangible personal property is not necessarily relevant to the question of where it is used. Under § 1031(h)(1), real property located in the United States is not of like kind to real property located outside the United States. Thus location is relevant as to real estate, but not as to personal property. Accordingly, even if an intangible has no definite location, it does not follow that the situs of predominant use cannot be determined.

Taxpayer also notes that, according to the legislative history underlying § 1031(h)(2), the provision was added because "Congress believed that the depreciation and other rules applicable to foreign- and domestic-use property are sufficiently dissimilar so as to treat such property as not 'like-kind' property for purposes of section 1031." H.R. Rep. No. 105-148, at 544 (1997). Taxpayer argues that since foreign intangibles are not depreciated by any different mode than domestic intangibles under § 197, there is no basis for denying like-kind treatment for exchanges of domestic for foreign intangibles.

However, §1031(h)(2) makes no distinction between tangible and intangible personal property. The plain language of the statute must be followed unless some obvious and relevant circumstance exists that plainly demonstrates that such construction and

[3] We recognize that this rationale will not apply to unregistered intangible property or trade secrets for which the underlying property is something other than manufactured goods or other tangible personal property within a general asset or product class. For purposes of making those determinations, an item by item comparison is required.

application of the statute would violate the intent of Congress. We do not see any such circumstance in this case.

Next, Taxpayer argues that the term "use" is ambiguous since it is not defined in § 1031. Therefore, Taxpayer suggests references to other Code provisions and law sources to determine its meaning in the context of § 1031(h). One source suggested is § 865(a), which sources income from the sale of personal property asset to the residence of its owner. Another source urged is § 1033, which defers gain or loss by election of a taxpayer whose property is involuntarily converted.

Taxpayer observes that the term "use" as applied in § 1033(a) (which applies when involuntarily converted property is replaced with other property similar or related in service or use) may supply an acceptable construction of the term in the §1031(h)(2) context. Taxpayer argues that in applying § 1033 in the case of an owner-user, courts developed the "functional test" in which the actual physical uses of the converted property and the replacement property were compared. *See, e.g., Lynchburg National Bank &Trust Co. v. Commissioner,* 208 F.2d 757 (4th Cir. 1953), which held that when an owner of property replaced property held for rent to others with rental property, the owner's relationship to the properties rather than the tenant's use determines the outcome; *Liant Records, Inc. v. Commissioner,* 303 F.2d 326 (2d Cir. 1962); and Rev. Rul. 64 -237, 1964-2 C.B. 319. In *Liant Records,* the Second Circuit suggested that a court should compare the extent and type of the lessor's management activity, the amount and kind of services rendered to the lessees with respect to the property, and the nature of the business risks connected with the properties. 306 F.2d at 329.

Taxpayer thus argues that the same principles applied under § 1033 should be applied under § 1031(h)(2) to determine the predominant use of the intangible because –

(1) Sub 3A has been the active manager of the intangible property licensed to others, and it has managed these intangibles in the United States,

(2) Licensing of intangibles is analogous to leasing tangible property, and

(3) Sections 1031 and 1033 are similar in purpose and their application hinges on an interpretation of the term "use."

Thus, the essence of Taxpayer's argument is that Sub 3A used all relinquished intangible properties in the United States by managing the licensing of such property from the United States. So too, Sub 3A will manage (or "use") all replacement intangible assets in the United States by managing the licensing from the United States.

However, we do not agree with Taxpayer's underlying premise that it is necessary to resort to §§ 865, 1033 or any other law source to construe the meaning of the term "use." Although § 1031(h) does not define the word "use", the language of the statute is not ambiguous. It is well settled that the legislature's failure to define commonly-used

words does not create ambiguity because the words in the statute "are deemed to have their ordinary understood meaning." *Koyo Seiko Co. v. United States,* 36 F.3d 1565, 1571 (Fed. Cir. 1994); *see also Carlson v. Commissioner,* 116 T.C. 87, 93 (2001) (word not defined by statute construed in accord with ordinary common meaning). One common definition of "use" which is consistent with its context in § 1031(h)(2) is the "legal enjoyment of property that consists of its employment, occupation, exercise or practice." WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 1299 (1984). In the present case, the intangible assets are used where they are enjoyed. That is, the location of the use of the intangible asset can be determined by where the property is licensed to be enjoyed.

In this case, with respect to the intangible assets of Seller 2 acquired by Sub 3A, Sub 3A granted Sub 3D, a Country J company, a worldwide license to (i) use the technical information and to practice inventions referenced by the patents, in furtherance of the manufacture of the products at the facilities of the company and (ii) to use the trademarks and copyrights in furtherance of the marketing and sale of the products. Since the agreement grants a license to be used in furtherance of the manufacture of the products at the facilities in furtherance of the marketing and sale of products, and since the facilities are located in Country J, we believe that the intangibles are being used predominantly in Country J. Taxpayer has not established that the intangibles in question are being used predominantly in the United States. Accordingly, for this particular exchange, the properties received are not like-kind to the property transferred.[4]

Deficiencies in Compliance with the Identification Requirements

The final issue for our consideration involves whether Taxpayer properly identified replacement property in the exchanges described in this case. As stated above, on Date 1, Taxpayer transferred the intangible assets pertaining to Sub 1 to Buyer 1 for $A. On ID-Date 1, Taxpayer identified the intangible assets of seven companies as prospective replacement properties for the intangible assets sold on Date 1, having a total estimated value of $G, which is an amount well in excess of 200 percent of the value of $A. Taxpayer ultimately acquired only the intangible assets of Seller 1 (within the categories trademarks and trade names, and trade secrets and know-how) valued at $B, which is an amount that is less than 95 percent of $G.

Also as stated above, on Date 2, Taxpayer transferred the intangible assets pertaining to Sub 2 to Buyer 2 for $C. Also on Date 2, Taxpayer acquired certain intangible assets from Seller 1 worth $D, and those assets were designated as part of the replacement property for the intangible assets pertaining to Sub 2 within the four categories of (1) trademarks and trade names; (2) designs and drawings; (3) trade secrets and know-

[4] We note, however, that one of the subsidiaries of Sub 2, Sub 2B specifically, is also a Country J company. Thus to the extent, if any, that Sub 2 used both the relinquished intangible property and the replacement intangible property predominantly in Country J for the requisite periods, § 1031(h)(2) will not prevent the characterization of the replacement property as of like kind to the relinquished property.

how; and (4) software. On ID-Date 2, Taxpayer identified the intangible assets of 19 more companies as prospective replacement properties for the intangible assets sold on Date 2, having a total estimated value of $H, which is an amount that is more than 200 percent of the value of $C. On Date 3, Taxpayer acquired certain intangible assets of Seller 2 (one of the identified companies) for $E, which Taxpayer designated as replacement property for the intangible assets pertaining to Sub 2 within the four categories of (1) patents; (2) designs and drawings; (3) trade secrets and know-how; and (4) software. The total value of the property acquired by Taxpayer and designated to replace the intangible assets pertaining to Sub 2 is $J, which is an amount less than 95 percent of $H.

Section 1031(a)(3)(A) provides that any property received by the taxpayer shall be treated as property which is not like-kind property if such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange (the identification period).

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. In all other cases, replacement property is identified before the end of the identification period only if the requirements of § 1.1031(k)-1(c)(2)-(6) are satisfied.

Section 1.1031(k)-1(c)(2) provides generally that replacement property is identified only if it is designated as replacement property in a written document signed by the taxpayer and hand delivered, mailed, telecopied, or otherwise sent before the end of the identification period to either the person obligated to transfer the replacement property to the taxpayer or any other person involved in the exchange other than the taxpayer or a disqualified person (such as a qualified intermediary).

Section 1.1031(k)-1(c)(3) provides that replacement property is identified only if it is unambiguously described in the written document or agreement. Real property generally is unambiguously described by a legal description, street address, or distinguishable name (e.g., Mayfair Apartment Building). Personal property generally is unambiguously described if it is described by a specific description of the particular type of property. For example, a truck generally is unambiguously described if it is described by a specific make, model and year.

Section 1.1031(k)-1(c)(4)(i) provides that the taxpayer may identify more than one replacement property. However, regardless of the number of relinquished properties transferred by the taxpayer as part of the same deferred exchange, the maximum number of replacement properties that the taxpayer may identify is –

(A) Three properties without regard to the fair market values of the properties (the "3-property rule"), or

(B) Any number of properties as long as their aggregate fair market value as of the end of the identification period does not exceed 200 percent of the aggregate fair market value of all the relinquished properties as of the date the relinquished properties were transferred by the taxpayer (the “200-percent rule”).

Section 1.1031(k)-1(c)(4)(ii) provides, in part, that if, as of the end of the identification period, the taxpayer has identified more properties as replacement properties than permitted by § 1.1031(k)-1(c)(4)(i), the taxpayer is treated as if no replacement property had been identified. The preceding sentence shall not apply, however, and an identification satisfying the requirements of § 1.1031(k)-1(c)(4)(i) will be considered made, with respect to –

(A) Any replacement property received by the taxpayer before the end of the identification period, and

(B) Any replacement property identified before the end of the identification period and received before the end of the exchange, but only if the taxpayer receives before the end of the exchange period identified replacement property the fair market value of which is at least 95 percent of the aggregate fair market value of all identified replacement properties (the “95-percent rule”).

Section 1.1031(k)-1(c)(4)(iii) provides that for purposes of applying the 3-property rule, the 200-percent rule, and the 95-percent rule, all identifications of replacement property, other than identifications or replacement property that have been revoked in the manner provided in § 1.1031(k)-1(c)(6), are taken into account. For example, if, in a deferred exchange, B transfers property X with a fair market value of $100,000 to C and B receives like-kind property Y with a fair market value of $50,000 before the end of the identification period, under § 1.1031(k)-1(c)(4)(i), Property Y is treated as identified by reason of being received before the end of the identification period. With respect to additional replacement properties, B will meet the identification requirements for such properties if B (i) identifies two additional replacement properties of any fair market value, (ii) identifies any number of replacement properties with an aggregate fair market value of $150,000,or less, of (iii) identifies any number of replacement properties at any fair market value as long as at least 95 percent of the value of all identified replacement properties is acquired before the end of the exchange period.

In accordance with § 1.1031(k)-1(c), Taxpayer has complied with the requirements for identification only for its acquisition of the intangible assets of Seller 1 for $D within the four categories of (1) trademarks and trade names; (2) designs and drawings; (3) trade secrets and know-how; and (4) software. All of Taxpayer’s other identifications fail to comply with the regulatory requirements for identification of replacement property. Taxpayer identified as replacement property the intangible assets of more than three companies (violating the “three property rule”), identified replacement property having a fair market value in excess of 200 percent of the value of the relinquished property

(violating the “200-percent rule”), and acquired less than 95 percent of the aggregate fair market value of all the identified replacement property (violating the “95-percent rule”).

In addition, in each instance, the written identifications were not specific as is required by § 1.1031(k)-1(c)(3). Each identification only included the following: (1) the name of the seller; (2) a very general description of the property (i.e. “Intellectual Property, including but not limited to patents, trademarks, copyrights, software, know-how, designs and other intellectual property assets as may be owned, licensed by or leased by the seller”); and (3) the estimated value. There are no descriptions of the underlying property pertaining to any of these intangible assets. In view of these deficiencies, no proper identification occurred except as to the replacement property received within the identification period. Under § 1031(a)(3)(A) and § 1.1031(k)-1(c)(4)(ii) replacement property that is not otherwise timely and specifically identified is not of like kind, regardless of any similarity of its nature or character to the property relinquished in the exchange.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.