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subject: Treatment of Computer Software Applications Used to Access Online Services under § 199

This Generic Legal Advice Memorandum (GLAM) responds to your request for assistance dated August 12, 2014. This GLAM should not be used or cited as precedent.

ISSUE

Whether, for purposes of § 199 of the Internal Revenue Code, a taxpayer derives domestic production gross receipts (DPGR) from the disposition of computer software when a taxpayer allows customers to download its computer software application (App) free of charge, and the App allows customers to access taxpayer's online fee-based services (such as online banking services).

CONCLUSION

No. A taxpayer derives no DPGR from the disposition of computer software when a taxpayer allows its customers to download its App free of charge when the App only enables the customers to access taxpayer's online fee-based services. Taxpayer does not make a qualifying disposition of computer software because its App is considered online software for purposes of § 199. Even if the download of the taxpayer's App is a disposition, the gross receipts taxpayer derives are entirely from the provision of online fee-based services and not from a disposition of computer software. Taxpayer does not

meet the exceptions under § 1.199-3(i)(6)(iii) of the Income Tax Regulations with respect to its online software.

FACTS

The facts below are based on the generic fact pattern presented by CC:LBI in its Memorandum dated August 12, 2014 requesting advice from the National Office.

Taxpayer, A, is a bank that offers banking services to its customers through a variety of means, including through bank branches, texting, automated teller machines (ATMs), and over the Internet via A's App, A's traditional website, and A's mobile website. A's online platforms allow its customers to: (1) access their bank accounts, (2) check balances, (3) make deposits, (4) view account activity, (5) transfer funds, (6) wire funds, and (7) deposit checks.

Regardless of whether customers use A's individual tellers, A's websites, or A's App to receive banking services, any banking transaction is executed in essentially the same way. In all cases, A's internal computer systems (computer hardware, software, equipment, and data), which A does not license to its customers or allow them to download, complete any banking transaction. Thus, A's customers must be connected to the Internet (including connecting through a cellular network) for any of A's online platforms, including its App, to function.

From A's customers' perspective, the main difference in conducting banking via A's website, mobile website, or A's App is the appearance of the web-screens on A's customers' electronic devices. A's customers can initiate most of the same functions with any of A's online platforms, although A's customers initiate some functions differently depending on the platform they use.[1] No functions are only available through A's App.

Before A allows its customers to use any of its online platforms to initiate banking transactions, A discloses and requires its customers to accept the terms and conditions for its online platform's use, including its policy on privacy and information gathering in its Online Banking Agreement. With respect to A's App, A's customers download the App free of charge after accepting A's terms and conditions. A grants a non-exclusive, non-sub-licensable, non-transferable, personal, limited license to install and use the App on mobile devices that are owned and controlled by A's customers, solely for personal use as A permits. A also requires its customers to acknowledge and agree that A may collect, transmit, store, and use technical, location, and login or other personal data; including technical information about customers' mobile devices, systems and application software, and peripherals, and information regarding customers' locations. A can terminate, suspend, or limit any customer's access to the App in whole or in part,

[1] For example, using A's App and their mobile devices' built-in camera, A's customers can deposit checks using a single electronic device. However, A's customers can initiate this same function using A's traditional website. A's customers can deposit checks by using a scanner or all-in-one printer (because a computer may not have a built-in camera).

at any time for any reason without prior notice, including if a customer does not use the App for a specified period.

Although A does not charge its customers a fee to download or access its App, customers may incur fees for receiving some banking services provided via A's App that are equal to the fees A's customers incur for receiving banking services via A's website. These fees may vary from the fees A charges to provide banking services at A's banking facility. For example, A charges customers $25 per wire transfer and $1 per check deposit initiated via its App or its website, and $40 per wire transfer and no charge per check deposit initiated at its banking facility. Alternatively, A may charge a $5 monthly banking fee for banking services and not distinguish between services provided to customers through its branches, websites, or App. For financial purposes, A recognizes these revenues as from the provision of banking services.

In addition, Z, an unrelated third party, produces a mobile banking software App "Z App." Z offers Z App to its customers, A's competitor banks, by download over the Internet. Z licenses Z App to A's competitor banks and derives gross receipts from those licenses on a regular and ongoing basis. A's competitor banks then use Z App to provide banking services to multiple account holders. A's competitor banks' account holders use Z App in the same manner as A's account holders use A's App.

LAW

Section 199(c)(4)(A)(i)(I) defines DPGR as gross receipts of a taxpayer which are derived from the lease, rental, license, sale, exchange, or other disposition (collectively "disposition") of qualifying production property (QPP), which was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States. Section 199(c)(5) defines the term QPP as including computer software.

Section 1.199-3(i)(1)(i) defines the term "derived from the disposition" of QPP as limited to the gross receipts directly derived from the disposition. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a disposition, or whether it is a service, or whether it is some combination thereof.

Section 1.199-3(i)(6)(i) provides that DPGR includes gross receipts of the taxpayer that are derived from the disposition of computer software MPGE by the taxpayer in whole or in significant part within the United States.

Section 1.199-3(i)(6)(ii) provides that gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services do not constitute gross receipts derived from a disposition of computer software.

Section 1.199-3(i)(6)(iii) provides that, notwithstanding § 1.199-3(i)(6)(ii), if a taxpayer derives gross receipts from providing customers access to computer software produced in whole or significant part by the taxpayer within the United States for the customers' direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as derived from the disposition of computer software if one of two exceptions is met.

The first exception (the self-comparable exception), in § 1.199-3(i)(6)(iii)(A), applies to a taxpayer that derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the disposition to customers that are unrelated persons of computer software that (1) has only minor or immaterial differences from the online software; (2) was MPGE by the taxpayer in whole or in significant part within the United States; and (3) has been provided to such customers affixed to a tangible medium or by allowing them to download the computer software from the Internet.

The second exception (the third-party comparable exception), in § 1.199-3(i)(6)(iii)(B), applies if another person derives, on a regular and ongoing basis in its business, gross receipts from the disposition of substantially identical software (as compared to taxpayer's online software) to its customers pursuant to an activity described in § 1.199-3(i)(6)(iii)(A)(3) (i.e., by a tangible medium or download from the Internet). Section 1.199-3(i)(6)(iv)(A) defines substantially identical software as computer software that (1) from a customer's perspective, has the same functional result as the online software; and (2) has a significant overlap of features or purpose with the online software.

Section 1.199-3(i)(6)(v), Example 1, provides: L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under paragraph (i)(6)(ii) of this section, gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non–DPGR.

Section 1.199-3(i)(6)(v), Example 2, provides: M is an Internet auction company that produces computer software within the United States that enables its customers to participate in Internet auctions for a fee. Under paragraph (i)(6)(ii) of this section, gross receipts derived from online auction services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. M's activities constitute the provision of online services. Therefore, M's gross receipts derived from the Internet auction services are non–DPGR.

Section 1.199-3(i)(6)(v), Example 3, provides: N provides telephone services, voicemail services, and e-mail services. N produces computer software within the United States that runs all of these services. Under paragraph (i)(6)(ii) of this section, gross receipts derived from telephone and related telecommunication services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale,

exchange, or other disposition of computer software. Therefore, N's gross receipts derived from the telephone and other telecommunication services are non–DPGR.

Section 1.199-3(i)(6)(v), Example 4, provides: O produces tax preparation computer software within the United States. O derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are unrelated persons of O's computer software that has been affixed to a compact disc as well as from the sale to customers of O's computer software that customers have downloaded from the Internet. O also derives gross receipts from providing customers access to the computer software for the customers' direct use while connected to the Internet. The computer software sold on compact disc or by download has only minor or immaterial differences from the online software, and O does not provide any other goods or services in connection with the online software. Under paragraph (i)(6)(iii)(A) of this section, O's gross receipts derived from providing access to the online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

ANALYSIS

A taxpayer's gross receipts qualify as DPGR under § 199(c)(4)(A)(i)(I) if the taxpayer derives the gross receipts from a disposition of computer software that was MPGE by the taxpayer in whole or in significant part within the United States. Under § 199(c)(4)(A)(i)(I), a taxpayer must dispose of computer software and derive gross receipts from that disposition. The analysis in this GLAM focuses on whether the download of A's App by A's customers is a disposition for purposes of § 199, whether A derives gross receipts from the App, and whether A meets either of the two exceptions for online software in § 1.199-3(i)(6)(iii). The analysis assumes that A has MPGE the App in whole or in significant part within the United States.

A Does Not Dispose of Computer Software When Customers Download the App

Pursuant to the general rules of §§ 1.199-3(i)(6)(i) and (ii), offering customers access to online software is not a qualifying disposition of computer software. Section 1.199-3(i)(6)(ii), as well as Examples 1, 2, and 3 in § 1.199-3(i)(6)(v), describe service activities that are conducted online, which do not involve a disposition of computer software. Included in that list are online banking services, of which A is a provider. The clearest example of A providing online banking services is when customers use A's website to access A's computer software (internal banking software) to order banking services. The gross receipts derived when customers use A's website are non-DPGR because A is providing banking services via the website and is not disposing of computer software.

A's App is used by customers in a similar manner to A's website. For purposes of our analysis, the potential relevant difference between A's website and A's App is that A's customers download the App. Thus, the question is whether allowing customers to

download the App means that A is disposing of computer software. The answer to this question turns on whether the App falls into the definition of "online software," which is defined in § 1.199-3(i)(6)(iii).

We find that the App fits within the definition of online software in § 1.199-3(i)(6)(iii). Section 1.199-3(i)(6)(iii) defines "online software," in significant part as "providing customers access to computer software . . . for the customers' direct use while connected to the Internet or any other public or private communications network." A's App provides customers access to A's computer software (internal banking software) for the customers' direct use while connected to the Internet. A's App serves the same function as A's website by providing access to the bank's internal computer software, and allowing customers to order various banking services. Like A's website, A's App does not function unless A's customers are connected to the Internet. A's App is useful to customers only while connected to the Internet, and provides no benefits outside of providing another platform to receive A's online banking services. A's App is included in the definition of "online software," and, therefore, A is not disposing of computer software when it allows customers to download its App.

While the § 199 regulations contain references to computer software downloads as dispositions, the intent is to include downloaded software that has independent functionality after customers have downloaded it and are no longer connected to the Internet. *See, e.g.*, Treas. Reg. §§ 1.199-3(i)(6)(iii) and (v), Example 4. This makes sense because if customers can only use downloaded computer software while connected to the Internet, the software cannot be materially distinguished from other software that customers access and directly use while connected to the Internet that is not downloaded (i.e., it is equivalent to online software).

Section 1.199-3(i)(6)(v), Example 4, related to the self-comparable exception, is illustrative of a computer software download that results in a qualifying disposition of computer software. In Example 4, a taxpayer, O, produces tax-preparation computer software that it provides to customers on either a compact disc, by allowing them to download it, or by allowing them to access it while they are connected to the Internet. The regulations treat the downloaded software as a qualifying disposition that O can use as a self-comparable under § 1.199-3(i)(6)(iii)(A) to qualify gross receipts from its online software. However, O's tax preparation software is distinguishable from A's App because the tax preparation software will function and O's customers can use it to perform the desired service (preparing a tax return) even if O's customers are not connected to the Internet. A's App does not function in a similar manner to the downloaded tax-preparation software, but instead functions like a website, and thus, A is not treated as disposing of computer software merely because customers download its App.

A Derives No Gross Receipts From Its App

Even if A is treated as disposing of computer software when customers download the App, in this case, A derives no gross receipts from the disposition of computer software

for purposes of § 199(c)(4)(A)(i)(I). Pursuant to § 1.199-3(i)(1)(i) the term "derived from the disposition" of QPP is limited to the gross receipts directly derived from the disposition. Under the facts presented above, in both form and in substance, A does not directly derive any gross receipts from allowing its customers to download or use its App, as the App only enables customers to receive online banking services.

In this case, A does not charge its customers a fee to download its App. Instead, A charges fees only for completed banking transactions, e.g., check deposits or wire transfers (or A may charge a flat monthly fee for all banking services). A's App serves as an alternative means for A to connect with its customers (just like A's website, mobile website, and the tellers employed at A's bank) and solely functions to enable A's customers to receive A's banking services. A's internal banking software and systems perform the service, but are not disposed of by A. Examples 1, 2, and 3 of § 1.199-3(i)(6)(v) show that computer software produced to enable customers to receive and/or participate in online services is part of the online service, and gross receipts are not separately allocable to such computer software. A, therefore, derives gross receipts from the provision of banking services and not from allowing its customers to download its App.

In all material respects, A's facts are the same as the bank's facts in Example 1 of § 1.199-3(i)(6)(v). In Example 1, L, a bank, produced computer software that enabled its customers to receive online banking services. Example 1 concludes that gross receipts derived from online banking services are attributable to a service and are non-DPGR. Although Example 1 is silent as to whether L allowed its customers to download any portion of its computer software, like L's software in Example 1, A's App is part of the computer software that enables its customers to receive online banking services for a fee and serves no other purpose. Consequently, A should be treated similarly to the bank in Example 1, and its gross receipts are attributable to online banking services and are non-DPGR.

A Does Not Meet the § 1.199-3(i)(6)(iii) Exceptions

A is treated as making a qualifying disposition of computer software with respect to its online software (i.e. its App or websites) if it meets either the self-comparable or the third-party comparable exceptions under § 1.199-3(i)(6)(iii). However, A also does not meet either of these exceptions, and so no portion of its gross receipts should be treated as derived from the disposition of computer software.

To satisfy the self-comparable exception under § 1.199-3(i)(6)(iii)(A), A must derive gross receipts from providing customers access to A's computer software for its customers' direct use while connected to the Internet and must also derive gross receipts, on a regular and ongoing basis in its business, from the disposition of computer software that has only minor or immaterial differences from the online software, and which is provided to customers either affixed to a tangible medium or by allowing them to download it. As discussed above, A's App and its websites qualify as online software. A does not meet the self-comparable exception with respect to any of

its online software (i.e. its App and websites) because A does not dispose of any computer software that meets the requirements of § 1.199-3(i)(6)(iii)(A) to serve as a self-comparable to A's online software. Further, even if the download of A's App is considered a disposition of computer software, and thus not online software, A cannot use its App as a self-comparable to qualify any of its online software (i.e. its websites) because A does not directly derive gross receipts from allowing customers to download its App.

To satisfy the third-party comparable exception under § 1.199-3(i)(6)(iii)(B), A must derive gross receipts from providing customers access to A's computer software for its customers' direct use while connected to the Internet and a third party must derive gross receipts, on a regular and ongoing basis in its business, from the disposition of the third party's computer software that is substantially identical to A's online software. The third party must provide its software to customers either affixed to a tangible medium or by allowing them to download it. Section 1.199-3(i)(6)(iv)(A) defines substantially identical software as computer software that (1) from a customer's perspective, has the same functional result as the online software; and (2) has a significant overlap of features or purpose with the online software. Under the facts described above, Z's disposition of computer software to A's competitor banks, Z's customers, is not a disposition of substantially identical computer software as compared to A's online software, including A's App. From A's and Z's customers' perspective, the computer software provides a different functional result and does not have a significant overlap of purpose. A's customers, who are account holders, use A's online software to order individual banking services, while Z's customers, A's competitor banks, use Z's App to provide banking services to multiple account holders. The fact that the competitor banks' account holders use the Z app in the same manner as A's account holders does not affect the analysis because the competitor banks' account holders are not the relevant customers for purposes of the third-party comparable exception. Thus, while Z derives gross receipts on a regular and ongoing basis in Z's business from the disposition of Z App to its customers, Z App is not substantially identical to A's online software for purposes of the third-party comparable exception in § 1.199-3(i)(6)(iii)(B).

Please call Jennifer Records at (202) 317-6853 if you have any further questions.