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subject: Domestic Production Gross Receipts and § 199

This Chief Counsel Advice responds to your request for advice regarding § 199 of the Internal Revenue Code. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

W =

X =

Y =

Z =

Product =

ISSUES

Whether domestic production gross receipts (DPGR), as defined in § 199(c)(4)(A)(i)(I), includes gross receipts derived by Taxpayer in the 3 scenarios described below.

CONCLUSIONS

The gross receipts derived from the sale of Taxpayer's tangible personal property in scenario 1 qualify as DPGR under § 199(c)(4)(A)(i)(I). Taxpayer's gross receipts in scenarios 2 and 3 must be allocated between the gross receipts derived from the disposition of Taxpayer's tangible personal property, which qualify as DPGR, and gross receipts derived from the license of Taxpayer's intangible property, which are non-DPGR.

FACTS

Taxpayer is a world-wide corporation. Within the United States, Taxpayer developed X using specific scientific processes. X produces desirable characteristics/traits in a Y, such as resistance to Z, and is created by inserting a specific segment of DNA into specific locations within a Y's chromosomal structure until the desired characteristics occur. Taxpayer uses the Product containing X to produce a variety of streams of income. Your request for advice asks us to review three scenarios.

In scenario 1, Taxpayer produces the Product containing X in commercial quantities (i.e. mass quantities) within the United States. Taxpayer sells the Product containing X to customers (i.e. distributors/wholesalers) in commercial quantities. Taxpayer's customers then offer the Product containing X for sale to end-users ( ). Taxpayer maintains all rights with respect to reproduction of the Product containing X. Taxpayer's customers have no right to reproduce the Product containing X, but sell and distribute Taxpayer's Product containing X to end-users. The end-users also have no right to reproduce Taxpayer's Product containing X.

In scenario 2, Taxpayer enters into a licensing agreement. The license grants the licensee the right to reproduce the Product containing X in commercial quantities (subject to various quality control restrictions). The licensee reproduces the Product containing X in commercial quantities and that Product containing X is then sold and distributed under Taxpayer's brand-name to end-users. The end-users have no right to reproduce Taxpayer's Product containing X. Taxpayer receives royalty and/or technology fees from the companies or distributors licensed to sell Taxpayer's branded Product containing X.

In scenario 3, the arrangement between Taxpayer and the licensee is similar to scenario 2. The difference is that the licensee's final Product containing X is sold and distributed under a non-Taxpayer brand-name. Taxpayer receives royalty and/or

technology fees from companies or distributors licensed to sell non-branded Product containing X.

In both scenario 2 and 3, the licensee is provided with the Product containing X (in the same or in a substantially similar form as Taxpayer's Product containing X) that is sold to customers in scenario 1, but not in commercial quantities. For purposes of our analysis, we assume Taxpayer's Product containing X is provided to the licensee. Taxpayer's Product containing X is provided because the process creating X is so random that a licensee effectively could not exercise the licensed right to reproduce the Product containing X if only provided with a set of specific instructions as the W, and X cannot be transferred without being incorporated into a tangible medium such as the Product.

LAW AND ANALYSIS

Under § 199(a), the § 199 deduction is determined by applying a percentage to the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 3% for taxable years beginning in 2005 and 2006, 6% for taxable years beginning in 2007 through 2009, and 9% for taxable years beginning after 2009.

Under § 199(c)(1), QPAI is determined by taking DPGR for the taxable year less cost of goods sold (CGS) allocable to such DPGR, less other expenses, losses, or deductions, which are properly allocable to such DPGR.

Section 199(c)(4)(A)(i) provides that DPGR means the gross receipts of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition of: (I) qualifying production property (QPP), which was manufactured, produced, grown or extracted (MPGE) by the taxpayer in whole or significant part within the United States.; (II) any qualifying film produced by the taxpayer; or (III) electricity, natural gas, or potable water produced by the taxpayer in the United States.

Section 199(c)(5) provides that QPP includes tangible personal property, any computer software, and any property described in § 168(f)(4) (qualified sound recordings).

Section 1.199-3(a)(1)(i) of the Income Tax Regulations provides, in part, that DPGR are the gross receipts (as defined in § 1.199-3(c)) of the taxpayer that are derived from any lease, rental, license, sale, exchange, or other disposition (as defined in § 1.199-3(i)) of QPP (as defined in § 1.199-3(j)(1)) that is manufactured, produced, grown, or extracted (MPGE) (as defined in § 1.199-3(e)) by the taxpayer (as defined in § 1.199-3(f)) in whole or in significant part (as defined in § 1.199-3(g)) within the United States (as defined in § 1.199-3(h)).

Section 1.199-3(d)(1) provides, in part, that whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-

product line, or transaction-by-transaction basis). Section 1.199-3(d)(1)(i) further provides that the term "item" means the property offered by the taxpayer in the normal course of the taxpayer's business for lease, rental, license, sale, exchange, or other disposition (collectively referred to as disposition) to customers, if the gross receipts from the disposition of such property qualify as DPGR.

Section 1.199-3(d)(1)(ii) provides that, if § 1.199-3(d)(1)(i) does not apply to the property, then any component of the property described in § 1.199-3(d)(1)(i) is treated as the item, provided that the gross receipts from the disposition of the property described in § 1.199-3(d)(1)(i) that are attributable to such component qualify as DPGR. Each component that meets the requirements under § 1.199-3(d)(1)(ii) must be treated as a separate item and a component that meets the requirements under § 1.199-3(d)(1)(ii) may not be combined with a component that does not meet these requirements.

Section 1.199-3(j)(2)(i) defines "tangible personal property" as any tangible property other than land, real property described in § 1.199-3(m)(3), and any property described in § 1.199-3(j)(3), (j)(4), (k)(1), or (l), and further provides that, except as provided in § 1.199-3(j)(5)(ii) and (k)(2)(i), computer software, sound recordings, and qualified films are not treated as tangible personal property regardless of whether they are affixed to a tangible medium. However, the tangible medium to which such property may be affixed (for example, a videocassette, a computer diskette, or other similar tangible item) is tangible personal property.

Section 1.199-3(j)(2)(iii) provides that tangible personal property does not include property in a form other than in a tangible medium. For example, mass-produced books are tangible personal property, but neither the rights to the underlying manuscript nor the online version on the book is tangible personal property.

Section 1.199-3(e)(1) provides, in part, that the term MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP. The term MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with or incorporated into the MPGE of QPP, whether or not by the taxpayer.

<u>First Approach: Scenarios 1, 2, and 3</u>

<u>Scenario 1 Analysis</u>

Taxpayer's gross receipts derived from the sale of the Product containing X in scenario 1 qualify as DPGR under § 199(c)(4)(A)(i)(I). The property Taxpayer offers for sale to customers (i.e. distributors/wholesalers) in the normal course of business is Taxpayer's Product containing X. This property that Taxpayer offers for sale qualifies as the item

under § 1.199-3(d)(1)(i) because the gross receipts from the sale of such property qualify as DPGR.

The gross receipts derived from the sale of the Product containing X qualify as DPGR because the gross receipts are derived from the sale of tangible personal property (as defined in § 1.199-3 (j)(1)) that was MPGE (as defined in § 1.199-3(e)(1)) by Taxpayer (as defined in § 1.199-3(f)) in whole or significant part (as defined in § 1.199-3(g)(1)) within the United States (as defined in § 1.199-3(h)).

Scenarios 2 and 3 Analysis

Our Office analyzed scenarios 2 and 3 together because the difference between the scenarios does not affect whether the gross receipts qualify as DPGR for purposes of § 199(c)(4)(A)(i)(I). The difference only affects the amount of gross receipts that Taxpayer receives from the license agreements.

In scenarios 2 and 3, Taxpayer's gross receipts that are derived from the license agreements must be allocated between receipts qualifying as DPGR and receipts that are non-DPGR. Gross receipts derived from the licensing of the right to reproduce the Product containing X are non-DPGR because those gross receipts are derived from the license of an intangible, the right to reproduce the Product containing X. Taxpayer does not transfer X without Taxpayer's Product. Taxpayer's gross receipts derived from the value of Taxpayer's Product containing X provided to a licensee without the right to reproduce the Product containing X are DPGR under § 199(c)(4)(A)(i)(I).

In your request for advice you question whether Taxpayer's X constitutes tangible personal property under § 199(c)(5)(A) and § 1.199-3(j)(2) and, thus, constitutes QPP. After review, we believe this issue is not determinative in scenarios 2 and 3 under this approach because Taxpayer's X is not the property offered for license by Taxpayer to customers in its normal course of business. The property Taxpayer offers to customers is the intangible right to reproduce the Product containing X. As part of this licensed right, Taxpayer also provides non-commercial quantities of Taxpayer's Product containing X so that the licensee can exercise the intangible right to reproduce the Product containing X.

In scenarios 2 and 3, Taxpayer licenses to customers in the normal course of business the right to reproduce the Product containing X. A licensee uses this right to produce the Product containing X in commercial quantities. The resulting commercial product, which is the same as Taxpayer's Product (or nearly identical) offered in scenario 1, is sold to end-users under Taxpayer's brand-name (scenario 2) or a non-Taxpayer brand-name (scenario 3).

The licensing of an intangible right is not a disposition that gives rise to DPGR under § 199(c)(4) because intangibles are not QPP under § 199(c)(5). Therefore, Taxpayer's gross receipts derived from the license of the intangible right to reproduce the Product

containing X do not qualify as DPGR and § 1.199-3(d)(1)(i) does not apply to the property offered for license by Taxpayer.

Because § 1.199-3(d)(1)(i) does not apply to the property offered for license by Taxpayer, under § 1.199-3(d)(1)(ii) any component of the property offered for license by Taxpayer is treated as the item, provided the gross receipts attributable to the component qualify as DPGR. The gross receipts derived from the disposition of Taxpayer's Product containing X qualify as DPGR under § 199(c)(4)(A)(i)(I) for the same reasons as established in scenario 1. The amount of gross receipts attributable to Taxpayer's Product containing X in scenarios 2 and 3 that qualify as DPGR should equal the amount that a licensee would pay for Taxpayer's Product containing X, without the intangible right to reproduce the Product containing X. In scenarios 2 and 3, Taxpayer's item under § 1.199-3(d)(1)(ii) is the Product containing X without the right to reproduce the Product containing X.

Taxpayer's situation is unusual because, for a licensee to exercise the licensed intangible right to reproduce the Product containing X, Taxpayer must transfer X with Taxpayer's Product. The fact that Taxpayer's Product containing X is provided to the licensee does not change the fact that the gross receipts in scenarios 2 and 3 primarily relate to the licensed intangible right to reproduce property, rather than to Taxpayer's sale of property as in scenario 1.

The dichotomy of what Taxpayer is offering in the normal course of business is clear between scenario 1 and scenarios 2 and 3. In scenario 1 Taxpayer offers for sale the Product containing X. In scenarios 2 and 3 Taxpayer offers for license the right to reproduce the Product containing X and provides non-commercial quantities so that the licensee can exercise that right.

The difference in the amount of Taxpayer's Product provided to customers accentuates the difference in what Taxpayer offers for sale or license. In scenario 1, Taxpayer sells commercial quantities of Taxpayer's Product containing X. In scenarios 2 and 3, Taxpayer only provides non-commercial quantities because Taxpayer has licensed the right to reproduce the Product containing X (either Taxpayer branded or non-Taxpayer branded depending on whether scenario 2 or scenario 3). Further, as the typical license agreement involves the license intangible property rights, we question whether tangible personal property can be licensed rather than leased, rented, sold, exchanged, or otherwise disposed of.

Second Approach to Scenarios 1, 2, and 3

Your request for advice focuses on whether X without the Product in scenarios 2 and 3 is the intangible licensed to customers, rather than the right to reproduce the Product containing X. While we believe that the first approach above analyzing scenarios 1, 2, and 3 is the better approach, we do believe that your approach has merit if X is treated as the licensed property. Both approaches should reach the same results.

Section 1.199-3(j)(2)(iii) provides that tangible personal property does not include property other than in a tangible medium. Taxpayer's X is not transferred to customers without a tangible medium, which arguably indicates that X itself is not tangible personal property for purposes of § 199(c)(5)(A).

The example of intangible property in § 1.199-3(j)(2)(iii) arguably supports the conclusion that X licensed in scenarios 2 and 3 is intangible property, even though Taxpayer's Product containing X sold in scenario 1 is entirely tangible personal property under § 199(c)(5)(A). To reach this conclusion an evaluation must be made as to whether the property licensed or sold by Taxpayer in each scenario is closer to the examples of tangible property or intangible property in § 1.199-3(j)(2)(iii).

The example in § 1.199-3(j)(2)(iii) provides that "mass-produced books are tangible personal property, but neither the rights to the underlying manuscript nor an online version of the book is tangible personal property." In scenario 1 it appears that Taxpayer is selling property that is more similar to the tangible mass-produced books as it is selling commercial quantities of Taxpayer's Product containing X. Therefore, in scenario 1 it appears that the gross receipts derived from the sale of Taxpayer's Product containing X to customers should qualify as DPGR under § 199(c)(4)(A)(i)(I). In the context of Taxpayer's industry, in scenarios 2 and 3, it appears that Taxpayer is licensing property that is more similar to the rights to the underlying manuscript, as opposed to tangible mass-produced books, because it is providing the Product containing X in non-commercial quantities so that it can be produced in mass quantities.

A line of cases exists that analyzes property for purposes of former § 48 and § 1.48-1(c) and considers film, sound recordings, and computer software to be tangible personal property. See e.g., Comshare, Inc. v. United States, 27 F.3d 1142 (6th Cir. 1994) (master source code computer discs and tapes); EMI North American Holdings, Inc. v. United States, 675 F.2d 1068 (9th Cir. 1982) (master sound recording); and Walt Disney Productions v. United States, 549 F.2d 576 (9th Cir. 1976) (master film negatives). The line of cases stands for the proposition that, if an intangible is useless without a tangible medium, then the intangible property and tangible property are inextricably connected, and together constitute tangible personal property.

Section 3.04(8)(b) of Notice 2005-14, 2005-2 C.B. 498, states that the definition of tangible personal property is derived primarily from, and is generally consistent with, the definition of that term under § 1.48-1(c). However, tangible personal property "excludes any property that falls within the definition of computer software, a sound recording, or a qualified film," which constitute a majority of the former § 48 cases. Reliance on the above line of cases for the determining tangible personal property under § 199(c)(5)(A) is inconsistent with treating computer software, sound recordings, and qualified films as intangibles.

Section 1.199-3(j)(2)(i) provides that the tangible medium to which certain intangibles are affixed, like a videocassette, computer diskette, or other tangible item, is tangible personal property. Therefore, in scenarios 2 and 3, Taxpayer's Product to which X is affixed should likewise be considered tangible personal property, and because Taxpayer meets the other requirements under § 199(c)(4)(A)(i)(I) with respect to Taxpayer's Product, the gross receipts derived from the disposition of the Taxpayer's Product qualify as DPGR in scenarios 2 and 3. However, as discussed above, the gross receipts derived from the license of X are non-DPGR because intangibles do not qualify as tangible personal property under § 199(c)(5)(A).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call if you have any further questions.