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subject: Application of § 1.199-3(i)(6)(iii)(B)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Business A =

U =

V =

W =

X =

Y =

Z =

ISSUES

1) Whether Taxpayer can aggregate computer software programs offered by third parties to customers by tangible medium or download (offline) for purposes of determining if the property Taxpayer offers in the normal course of business meets the exception in § 1.199-3(i)(6)(iii)(B) (the "third-party comparable exception")?

2) Whether Taxpayer can apply the third-party comparable exception to components of the property Taxpayer offers in the normal course of business?

CONCLUSIONS

1) No. Taxpayer cannot aggregate offline third-party computer software programs in order to meet the third-party comparable exception.

2) Yes. Taxpayer can apply the third-party comparable exception to components of the property Taxpayer offers in the normal course of business to determine whether any of the components qualify as an item under § 1.199-3(d)(1)(i).

FACTS

Taxpayer is a limited partnership. For its U taxable year, Taxpayer reported gross receipts of V and domestic production gross receipts (DPGR) of W. Taxpayer's primary product is Business A. Business A includes X different features.

As part of Business A, customers directly use Taxpayer's online computer software (Online Software). The Online Software meets the definition of computer software in § 1.199-3(j)(3). Customers access the Online Software

and download Taxpayer's client application to

access the Online Software. Taxpayer's client application consists of an executable file that allows the client to communicate with Taxpayer's servers over the Internet.[1]

Taxpayer has identified other unrelated third parties that have computer software products that Taxpayer represents are similar to Taxpayer's Online Software. In the aggregate, Taxpayer represents the third-party computer software products are equivalent to Taxpayer's Online Software. The greatest number of features covered by a single third party's computer software is Y, a number less than X. Taxpayer represents that the primary value of the Online Software is the Z feature, but that feature is not the only feature that has value to customers. Taxpayer has not established whether all of these third-party computer software products are provided to customers on a tangible medium or by download. Taxpayer claims its DPGR include gross receipts that are primarily derived from the disposition of the Z feature of Business A.

LAW AND ANALYSIS

Section 199(c)(4)(A)(i) includes as DPGR gross receipts of a taxpayer derived from the lease, rental, license, sale, exchange, or other disposition of computer software which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.

Section 1.199-3(d)(1) provides that a taxpayer determines whether gross receipts qualify as DPGR on an item-by-item basis. Section 1.199-3(d)(1)(i) defines item as the property offered by the taxpayer in the normal course of the taxpayer's business for disposition to customers, if the gross receipts from the disposition of such property qualify as DPGR.

Section 1.199-3(d)(1)(ii) provides if § 1.199-3(d)(1)(i) does not apply to the property, then any component of the property is treated as the item, provided that the gross receipts from the disposition that are attributable to such component are DPGR. Each component that meets the requirements of § 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(i)(6)(i) provides DPGR include gross receipts 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 DPGR does not include gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing

1. This advice only addresses the Taxpayer's Online Software, and does not address Taxpayer's executable file.

access to online electronic books, newspapers, and journals), and other similar services do not constitute the 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 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 from the disposition of computer software if one of two exceptions is met.

Section 1.199-3(i)(6)(iii)(B), commonly called the third-party comparable exception, provides gross receipts are from a disposition if another person derives, on a regular and ongoing basis in its business, gross receipts from the disposition of substantially identical software (as described in § 1.199-3(i)(6)(iv)(A)) (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 such as a disk or DVD or download from the Internet).

Section 1.199-3(i)(6)(iv)(A) provides that substantially identical software is computer software that from a customer's perspective, has the same functional result as the online software, and has a significant overlap of features or purpose with the online software.

Section 1.199-3(j)(3)(i) defines computer software as any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. Thus, for example, an electronic book available online or for download is not computer software. For purposes of §1.199-3(j)(3), computer software also includes the machine-readable code for video games and similar programs, for equipment that is an integral part of other property, and for typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, regardless of whether the code is designed to operate on a computer (as defined in § 168(i)(2)(B)). Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs, as well as application programs, are included. Except as provided in § 1.199-3(j)(5), if the medium in which the software is contained, whether written, magnetic, or otherwise, is tangible, then such medium is considered tangible personal property for purposes of § 1.199-3.

Section 1.199-3(j)(3)(ii) also includes in the definition of computer software any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Such incidental and ancillary rights are not included in the definition of trademark or trade name under § 1.197-2(b)(10)(i). For example, a trademark or trade name that is ancillary to the ownership or use of a

specific computer software program in the taxpayer's trade or business and is not acquired for the purpose of marketing the computer software is included in the definition of computer software and is not included in the definition of trademark or trade name.

Section 1.199-3(j)(3)(iii) provides computer software does not include any data or information base unless the data or information base is in the public domain and is incidental to a computer program. For this purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program. For example, if a dictionary feature that may be used to spell-check a document or any portion thereof, then the entire program (including the dictionary feature) is computer software regardless of the form in which the dictionary feature is maintained or stored.

Issue 1: Taxpayer offers its customers direct use of its Online Software in the normal course of its business. This is not a qualifying disposition under the general rules of §§ 1.199-3(i)(6)(i) and (ii). However, Taxpayer is treated as making a qualifying disposition of the computer software if it can show that it meets the third-party comparable exception.

To meet the third-party comparable exception under § 1.199-3(i)(6)(iii)(B), another person must derive, on a regular and ongoing basis in its business, gross receipts from the offline (affixed to a tangible medium or downloaded from the Internet) disposition of substantially identical software to customers. To be substantially identical, the computer software offered offline must, from a customer's perspective, have the same functional result as the online software, and the offline software must have a significant overlap of features or purpose. The plain language of § 1.199-3(i)(6)(iii)(B) does not contemplate aggregating multiple third-party software programs. This makes sense because integration in software can provide a different customer experience than a disjointed accumulation of software programs. Based on the facts, Taxpayer's Online Software's functionality, features, and purpose are not replicated by a single competitor's offline software (even assuming all third-party computer software was provided offline). Thus, when compared, Taxpayer's Online Software is not substantially identical to the offline software of another person for purposes of the third-party comparable exception.

Issue 2: While the Online Software that Taxpayer offers in the normal course of business for license does not qualify as the item under § 1.199-3(d)(1)(i), Taxpayer can apply § 1.199-3(d)(1)(ii). Section 1.199-3(d)(1)(ii) provides that if § 1.199-3(d)(1)(i) does not apply to the property offered by the taxpayer, then any component of the property is treated as the item, provided that the gross receipts from the disposition of such component are DPGR. To the extent that Taxpayer can show that an individual component of its Online Software has a substantially identical offline counterpart, gross receipts attributable to that component should qualify as DPGR (assuming all other § 199 requirements are met).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call James Holmes (202) 622-3040 if you have any further questions.