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Memorandum**

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subject: Section 199 Request for Legal Advice

This General Legal Advice Memorandum (GLAM) addresses your request for advice on § 199 of the Internal Revenue Code¹. This GLAM may not be used or cited as precedent.

ISSUES

1. Whether any of taxpayer's gross receipts from its insurance business described in Situation 1, where customers may interact with taxpayer over the Internet, qualify as domestic production gross receipts (DPGR) for purposes of § 199?
2. Whether any of taxpayer's gross receipts from its shipping business described in Situation 2, where customers may track shipping status online, qualify as DPGR for purposes of § 199?

CONCLUSIONS

1. No. Taxpayer's gross receipts derived from its insurance business in Situation 1 do not qualify as DPGR. Taxpayer's gross receipts are derived from services and none of

¹ Section 199 was repealed for all taxable years beginning after 2017. Public Law 115-97, 131 Stat. 2054, 2126.

the gross receipts are treated as derived from a lease, rental, license, sale, exchange, or other disposition (collectively “disposition”) of computer software.

2 No. Taxpayer’s gross receipts derived from its shipping business in Situation 2 do not qualify as DPGR. Taxpayer’s gross receipts are derived from services and none of the gross receipts are treated as derived from a disposition of computer software.

FACTS

The facts below are the generic fact patterns on which advice is requested. The situations described in these generic fact patterns occurred during a time in which section 199 was in effect.

Situation 1. Insurance

In the normal course of taxpayer’s business, taxpayer offered insurance policies to customers by entering into insurance contracts with the customers over the Internet via taxpayer’s online website. The insurance policies are a contract (generally a standard form contract) between the insurer and the insured, known as the policyholder, which determines the claims which the insurer is legally required to pay. In exchange for an initial or recurring payments, known as the premiums, the insurer promises to pay for loss caused by perils covered under the policy language. Taxpayer produced computer software that enabled customers to select, pay for, and manage their insurance policies through taxpayer’s website accessible over the Internet. All customers had an option to manage their policy online via authorized access to the customer’s web account (to view, update information, submit claims, print a report/policy, and pay bills). Taxpayer did not invoice or charge its customers any fee for access to the web account and the fee paid for the insurance policy did not vary based on the customer’s use or non-use of the web account. Taxpayer did not market or advertise online software for any fee. Taxpayer described, classified, and treated all of the gross receipts as insurance premium revenues for computation of federal tax, state tax, insurance regulatory purposes, and financial reporting purposes.

Situation 2. Logistics

In the normal course of business, taxpayer offered to customers its shipping and transport capabilities, which generally involves the taxpayer transporting shipments of goods by some means (e.g. truck, plane, or combination) to a customer’s desired location. Customers paid shipping fees determined by reference to speed of delivery and the load’s weight, size, and shape. Taxpayer produced computer software that allowed for tracking of customers’ shipments and provided the tracking information to customers (look-up delivery, stage, and status) through taxpayer’s website accessible over the Internet. Taxpayer did not invoice or charge its customers any fee for any computer software and the shipping fee did not vary based on a customer’s use or non-use of its website. Taxpayer did not market or advertise online software for any fee.

Taxpayer described, classified, and treated all of the shipping fees as revenues from the provision of shipping services for computation of federal income and excise tax, state income tax, regulatory and financial reporting purposes.

LAW AND ANALYSIS

LBI asked the National Office to analyze whether the taxpayers in Situations 1 and 2 have any DPGR for purposes of section 199. Generally, Situations 1 and 2 entail the provision of services, which ordinarily do not result in DPGR. Because Situations 1 and 2 both involve customers' interaction with taxpayers' computer software while connected to the Internet, CC:LBI asked the National Office to consider whether taxpayers can treat any of their gross receipts from customers as derived from the disposition of computer software under § 1.199-3(i)(6) so that gross receipts could qualify as DPGR.

Situations 1 and 2 are both situations where, absent a customer's ability to interact with taxpayers' computer software while connected to the Internet, the gross receipts would be considered gross receipts from services for purposes of section 199 and thus not included within DPGR as defined in § 199(c)(4)(A). The issue, however, is whether providing the ability to interact with taxpayers' computer software changes the result for purposes of § 199, because gross receipts from a disposition of computer software to customers can qualify as DPGR under § 199(c)(4)(A)(i)(I), assuming all other § 199 requirements are met. Taxpayers did not derive any gross receipts from a disposition of computer software under the general disposition rule in § 1.199-3(i)(6)(i) as no software was provided to customers affixed to a tangible medium or by download from the Internet. However, because the taxpayers' customers interact with the taxpayers' websites over the Internet, it is necessary to consider the rules in § 1.199-3(i)(6)(ii) and (iii).

Section 1.199-3(i)(6)(ii) provides, in relevant part, that gross receipts derived from 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 (i.e. the gross receipts are from a service). Section 1.199-3(i)(6)(ii) is broad enough to describe gross receipts from: (1) services that are enabled and/or facilitated by online software; and (2) a customer's access and direct use of online software.

Section 1.199-3(i)(6)(iii) describes exceptions to § 1.199-3(i)(6)(ii) and allows for gross receipts from a customer's access and direct use of online software to be treated as from a disposition of computer software (i.e. the gross receipts are not from a service). Specifically, § 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 in 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 those gross receipts will be treated as

from a disposition of computer software for purposes of section 199 if the requirements under § 1.199-3(i)(6)(iii)(A) (known as the self-comparable exception) or § 1.199-3(i)(6)(iii)(B) (known as the third-party comparable exception) are met.

In considering how § 1.199-3(i)(6)(ii) and (iii) interact, it is important to understand that gross receipts from services that are enabled or facilitated by online software are not described in § 1.199-3(i)(6)(iii), and therefore, maintain their characterization as from a service under § 1.199-3(i)(6)(ii). Only gross receipts from a customer's access and direct use of software may be excepted from § 1.199-3(i)(6)(ii) under the exceptions in § 1.199-3(i)(6)(iii). Section 1.199-3(i)(6)(v) includes nine examples that illustrate the rules in § 1.199-3(i)(6). In *Examples 1 through 3*, the taxpayers produced computer software that enabled or facilitated the provision of a service to their customers for a fee (banking, Internet auction, and telecommunications services, respectively). *Examples 1 through 3* each conclude that, under § 1.199-3(i)(6)(ii), the respective taxpayer is providing its customers with a service and the gross receipts are non-DPGR. In *Examples 1 through 3*, the produced software enabled the respective taxpayers' customers to "receive online banking services," "participate in Internet auctions for a fee," and "obtain telecommunication services." It is implicit in the facts of *Examples 1 through 3* that the respective taxpayer's gross receipts are not derived from providing its customers access to online software for the customers' direct use. *Examples 1 through 3* provide no further analysis under § 1.199-3(i)(6)(iii) because further analysis is not relevant or appropriate under the facts of the examples.

In applying § 1.199-3(i)(6)(ii) and (iii) to particular situations, and as required by § 1.199-3(i)(1) when determining whether gross receipts are directly derived from services, a disposition, or a combination of both, the substance of the transactions must be considered and there should be a direct link between a customer's payment to the taxpayer and the online software that a customer accesses and directly uses (i.e. a taxpayer must have gross receipts directly derived from the software). The direct link does not exist when a customer's online use of software (via interaction with the taxpayer's website) only facilitates or enables taxpayer's provision of services or sale of a product to its customers. For example, gross receipts from buying a product or engaging a service provider using online software are not linked to the software that enabled the purchase/transaction, but to the particular product or service. See § 1.199-3(i)(6)(v), *Examples 1 through 3*. In contrast, when the substance of a customer's transaction/payment is to directly use the online software, such a link does exist. See § 1.199-3(i)(6)(v), *Examples 4 through 7*. The ability to show independent functionality of the computer software to the customer supports such a link. For example, a link exists for gross receipts from a customer to access an online software tax preparation program, where the customer is allowed discretion and control over how to use the tax preparation functions of the program, such as creating a tax return for the customer's own purposes (and not just interacting with the taxpayer to receive services from the taxpayer). See § 1.199-3(i)(6)(v), *Examples 4 and 5*. It is only after determining that a link between the customer's payment and the online software exists that the self-

comparable and third-party comparable exceptions in § 1.199-3(i)(6)(iii)(A) and (B) become relevant.

If a direct link is determined between the payment and the online software accessed and directly used by a customer as described in § 1.199-3(i)(6)(iii), then taxpayer can treat those gross receipts as being derived from a disposition of computer software provided the taxpayer satisfies one of the exceptions described in § 1.199-3(i)(6)(iii)(A) or (B). To satisfy the self-comparable exception under § 1.199-3(i)(6)(iii)(A) the following requirements must be met: (1) the taxpayer must derive gross receipts from a disposition of computer software that has only minor or immaterial differences from the online software; (2) the computer software must have been MPGE by the taxpayer in whole or in significant part in the United States; and (3) the computer software must have been provided to its customers either affixed to a tangible medium or by allowing them to download it from the Internet. To satisfy the third-party comparable exception under § 1.199-3(i)(6)(iii)(B), the taxpayer must show that another person, on a regular and ongoing basis in its business, derives gross receipts from a disposition of substantially identical software (as compared to the taxpayer's online software). The third party is required to provide its software to customers either affixed to a tangible medium or by allowing them to download it from the Internet. Substantially identical software is defined in § 1.199-3(i)(6)(iv) as software that: (1) from a customer's perspective has the same functional result as the online software described in § 1.199-3(i)(6)(iii); and (2) has a significant overlap of features or purpose with the online software described in § 1.199-3(i)(6)(iii). The online software described in § 1.199-3(i)(6)(iii) is the software that customers access and directly use over the Internet or any other public or private communications network from which the taxpayer derives gross receipts. Thus, for determining a customer's perspective, the relevant customer's perspective is the taxpayer's customer that uses the online software as opposed to any generic customer. Reading the term "customer" this way prevents redundancy between the first and second requirements in § 1.199-3(i)(6)(iv)(A). This also makes sense because the taxpayer is seeking to qualify the gross receipts as from the provision of online software to its customers and so it is important for those customers to have the option of obtaining the comparable software affixed to a tangible medium or by download from the Internet. If a comparable under § 1.199-3(i)(6)(iii)(A) or (B) is substantiated, then the gross receipts from the online software are treated as from a disposition of computer software. To the extent a comparable under § 1.199-3(i)(6)(iii)(A) or (B) is not substantiated, the gross receipts are considered as from a service under § 1.199-3(i)(6)(ii) (See *Example 7* of § 1.199-3(i)(6)(v) for an illustration of when gross receipts from access and direct use of computer software as described in § 1.199-3(i)(6)(iii) are considered not derived from a disposition of computer software under § 1.199-3(i)(6)(ii) when no comparable is found).

As described in § 1.199-1(d)(1)(relating to allocating gross receipts) and § 1.199-3(i)(1)(i) (relating to when gross receipts are derived from a disposition), based on the substance of a transaction, gross receipts can be derived from a service, a disposition of property, or a combination of both. See, e.g., § 1.199-3(i)(6)(v), *Example 6*

(illustrating a situation involving online computer software where a transaction involved a combination). In the situation where gross receipts from a transaction consist of both gross receipts from a service and disposition of property, it is necessary to make an allocation of gross receipts between the non-qualifying service (non-DPGR) and the property (DPGR, assuming all other § 199 requirements are met). However, it is not appropriate to make an allocation before establishing that the transaction consists of both elements. For example, if gross receipts are entirely attributed to a service enabled or facilitated by online software under § 1.199-3(i)(6)(ii), then no portion of the fees may be reasonably allocated under § 1.199-1(d) to online software using § 482 principles or any other methodology. In the context of software this means the taxpayer must show that there has been a disposition under § 1.199-3(i)(6)(i) or a deemed disposition under § 1.199-3(i)(6)(iii).

In Situation 1, taxpayer is in the business of providing insurance to customers. If taxpayer solely entered into contracts and processed claims with customers in person, over the phone, or by mail, it would be clear that taxpayer's gross receipts from premiums would be from a service and not DPGR for purposes of § 199. The results are no different just because taxpayer allows access to online computer software for a customer to select, pay, and manage their insurance policy online via authorized access to the customer's account. Based on § 1.199-3(i)(1)(i) and § 1.199-3(i)(6)(ii) and (iii), it is necessary to evaluate whether customers are paying, in substance, for insurance services that are facilitated or enabled by online software or for the access and direct use of computer software as part of their transactions. In this situation the actions that a customer can complete all directly relate to the taxpayer's provision of insurance. Taxpayer needs customers to enter into insurance contracts and pay their premiums. Modifications of a policy would result in changes to the underlying contract/coverage and potentially changes in premiums (up or down depending on the modification). Allowing customers to submit claims online allows customers a way to provide taxpayer the information needed for taxpayer to evaluate a claim in an efficient manner. These actions are all facilitative of the service in the same way that alternatives of completing these actions in person, over the phone, or by mail would be facilitative. In reviewing the examples in § 1.199-3(i)(6)(v) that illustrate the computer software rules in § 1.199-3(i)(6), taxpayer's fact pattern appears most analogous to *Example 1* where bank L's computer software enables its customers to receive L's online banking services for a fee and the gross receipts are determined to be non-DPGR, as no gross receipts are derived from a disposition of computer software.

In Situation 1, even though the online activities facilitate the taxpayer's insurance business, the connection between the customers' premiums and the computer software is absent. Taxpayer did not invoice or charge its customers any direct fee for access to the web account and the fee paid for the insurance policy did not vary based on the customer's use or non-use of the web account. Taxpayer did not market or advertise online software for any fee. Other than for § 199, taxpayer described, classified, and treated all of the gross receipts as insurance premium revenues for computation of federal tax, state tax, insurance regulatory purposes, and financial reporting purposes.

While none of these facts alone are determinative, none of these facts support determining that taxpayer was charging customers to directly use this computer software. Further, the computer software offers no independent functionality to taxpayer's customers, as the actions completed are needed for customers to receive insurance services from the taxpayer.

In Situation 1, based on a consideration of the substance of the transactions, including the surrounding facts and circumstances, all of the taxpayer's gross receipts from transactions with customers are derived from services, and taxpayer did not derive any gross receipts by providing customers access to computer software for customers' direct use. Thus, taxpayer's gross receipts do not qualify as DPGR for purposes of § 199.

In Situation 2, taxpayer is in the shipping business. If taxpayer solely entered into agreements to move customers' goods from one location to another, it would be clear that taxpayer's gross receipts from shipping fees would be from a service and not DPGR for purposes of § 199. The results are no different just because taxpayer gives customers access to computer software that allows customers the option of viewing tracking information (look-up delivery, stage, and status) through taxpayer's website accessible over the Internet. Based on § 1.199-3(i)(1)(i) and § 1.199-3(i)(6)(ii) and (iii), it is necessary to evaluate whether customers are paying, in substance, for shipping services that are facilitated or enabled by online software or for the access and direct use of computer software as part of their transactions. In this situation, the action that customers can complete on the taxpayer's website directly relates to the taxpayer's shipping service. It updates customers as to the status of the goods that taxpayer is in the process of shipping. The interaction between taxpayer's customers and taxpayer's software is more attenuated than the examples in § 1.199-3(i)(6)(v) that are illustrating computer software that is enabling or facilitating a service (*Examples 1 through 3*). The taxpayer's situation is not comparable to any examples in § 1.199-3(i)(6)(v) illustrating situations where customers paid at least part of their payments for access and direct use of online software (*Examples 4 through 7*). Providing this information via the website is also facilitative of the service in the same way as if done over the phone.

In Situation 2, even though the online activities inform customers as to the status of taxpayer's shipping services, the connection between the customers' shipping fees and the computer software is absent. Customers paid shipping fees determined by reference to speed of delivery and the load's weight, size, and shape, but taxpayer did not invoice or charge its customers any fee for any computer software and the shipping fees did not vary based on customers' use or non-use of its website. Taxpayer did not market or advertise online software for any fee. Taxpayer described, classified, and treated all of the shipping fees as revenues from the provision of shipping services for computation of federal income and excise tax, state income tax, regulatory and financial reporting purposes. Further, the computer software itself offers no independent functionality to customers as it only allows customers to find out tracking information on already made orders with taxpayer.

In Situation 2, based on a consideration of the substance of the transactions, including the surrounding facts and circumstances, it is our conclusion that all of the taxpayer's gross receipts from transactions with customers are derived from services, and taxpayer did not derive any gross receipts by providing customers access to computer software for customers' direct use. Thus, taxpayer's gross receipts do not qualify as DPGR for purposes of § 199.

Even if the taxpayer in Situation 2 could demonstrate gross receipts directly related to the tracking information, the tracking information itself is not computer software. Any gross receipts attributable to the tracking information would not qualify as DPGR because the tracking information is intangible property, but not computer software, and so it is not qualifying production property as defined in § 199(c)(5). The definition of computer software is in § 1.199-3(j)(3). In defining computer software, § 1.199-3(j)(3)(iii) provides that 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. In this case, because the tracking information (not the software) is the reason for customers to visit the website it would be considered separately from the computer software. In other words, in the interaction with taxpayer's website, customers receive data, which itself is not computer software. Under this analysis, the computer software is still being used to facilitate the delivery of the tracking information, and so there would still be no gross receipts attributable to the access and direct use of the online software as described in § 1.199-3(i)(6)(iii).

Please call Barbara J. Campbell (202) 317-4137 if you have any further questions.