Part I

Section 199.—Income attributable to domestic production activities

26 CFR 1.199-3: Domestic production gross receipts
(Also: § 7701)

Rev. Rul. 2011-24

ISSUE

In the situations described below, does a taxpayer that provides telecommunication services derive gross receipts from services to customers, leasing or renting property to customers, or some combination thereof for purposes of the domestic production activities deduction under § 199 of the Internal Revenue Code?

FACTS

Situation 1. Z corporation is in the business of providing telecommunication services, including the transmission of voice, data, and video communications. Z contracts with A, a corporation that is not in the telecommunications industry, to transmit A's telecommunications. A has multiple business locations. The contract requires Z to transmit A's telecommunications at A's desired times, to A's desired destinations, and at a certain speed. If Z cannot transmit A's telecommunications according to the terms of the contract, then the contract requires Z to provide A with a service credit. The contract requires A to make payments to Z for transmitting A's telecommunications.

Z's optical and digital transmission equipment, usually a Synchronous Optical Network (SONET) ring, and the associated Public Switched Telephone Network (PSTN) are used to transmit A's telecommunications. Z's SONET ring is deployed in a ring topology and interconnects multiple business locations designated by A so that telecommunications can be transmitted between A's business locations without being transmitted to Z's PSTN. The SONET ring also connects with Z's central office, switching center, or remote terminal so that telecommunications can be transmitted to and from Z's PSTN.

The PSTN is comprised primarily of fiber optic cable and copper cable that connects switching centers with each other and connects switching centers to remote terminals. The PSTN is owned by Z and is not dedicated to A or to any of Z's other customers. Z's PSTN provides a multitude of different pathways to transmit telecommunications to and from A's business locations. The SONET ring and PSTN assets used to transmit A's telecommunications include: (1) network electronics, such as multiplexers, switches, routers, digital cross connects, optical and digital transmission equipment; (2) fiber optic cable and/or copper cable; (3) network facilities such as a central office; and (4) software.

A owns some telecommunications equipment that connects with the SONET ring to allow transmission of A's telecommunications between A's business locations or to the PSTN, and transmission of others' telecommunications to A from the PSTN. A's telecommunications equipment is located solely on A's side of the demarcation point (point of interconnection) as that term is used in 47 C.F.R. Part 68. A's telecommunications equipment typically includes a router, a channel service unit/data service unit, and diagnostics modem (collectively the "customer premises equipment"). The contract does not require Z to provide any services related to A's customer premises equipment.

Z owns, installs, operates, and maintains the SONET ring and PSTN. Z will replace any SONET ring and PSTN assets when repairs or upgrades are required. The contract requires that A grant Z reasonable access to A's premises for the purpose of installing, inspecting, testing, rearranging, maintaining, repairing, or removing any of the SONET ring assets located on A's premises. Z maintains and repairs the SONET ring and PSTN at no additional charge to A. A is prohibited from installing, inspecting, testing, rearranging, maintaining, repairing, or removing any component of the SONET ring and/or PSTN.

Situation 2. The facts and circumstances are the same as in Situation 1, except A does not have multiple business locations and Z's dedicated circuit, instead of a SONET ring, is used to transmit A's telecommunications to the PSTN and others' telecommunications from the PSTN. All telecommunications transmitted to or from A must be transmitted using the PSTN. Z's dedicated circuit, also referred to as the "local loop" or "last mile," is comprised of Z's equipment (copper or fiber optic cable, point of presence equipment, and dedicated or shared equipment).

Z generally does not notify A if Z repairs the dedicated circuit or PSTN. Z may notify A if Z upgrades the dedicated circuit or PSTN. A cannot stop Z from making any necessary repairs or upgrades to the dedicated circuit or PSTN.

Situation 3. The facts are the same as Situation 2 except that A does not own the customer premises equipment required to connect with the dedicated circuit to allow transmission of A's telecommunications. As part of the contract for Z to transmit A's telecommunications, Z also provides the customer premises equipment, and provides support services to A in relation to managing the customer premises equipment. The contract provides that it is a lease of the customer premises equipment to A, but does not separately state the lease amount.

Z delivers and installs the customer premises equipment on A's premises. Z, if necessary, helps maintain the customer premises equipment by providing telephone support services to A's designated employees related to diagnosing problems and repairing and replacing the customer premises equipment. Z can also remotely perform certain maintenance or diagnostic tasks. A's designated employees complete any required repair or replacement. A is liable for any repair charges or the replacement cost of the customer premises equipment if it is damaged or lost. A can relocate or modify the customer premises equipment, and may attach it to non-Z equipment with Z's written authorization, which may not be unreasonably withheld. When the contract terminates, if A does not return the customer premises equipment or make it available for removal by Z, then A is liable to Z for the customer premises equipment's then current market value. A is liable for costs of any restoration of the customer premises equipment beyond ordinary wear and tear.

LAW AND ANALYSIS

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to § 199) for the taxable year (or, in the case of an individual, adjusted gross income).

Sections 199(b)(1) and (b)(2) limit the amount of the deduction allowable under § 199(a) to 50 percent of the W-2 wages of the taxpayer for the taxable year that are allocable to domestic production gross receipts (DPGR).

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's DPGR for such taxable year, over (B) the sum of (i) the cost of goods sold that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under § 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i)(I) provides that the term DPGR means the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.

Section 1.199-3(i)(1) of the Income Tax Regulations provides that applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof. Section 1.199-3(i)(4)(i)(A) provides that gross receipts derived from the performance of services generally do not qualify as DPGR.

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 lease, rental, license, sale, exchange, or other disposition of computer software. Example 3 of § 1.199-3(i)(6)(v) concludes that gross receipts derived from telephone and related telecommunication services run by computer software produced by the taxpayer 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.

Rev. Rul. 68-109, 1968-1 C.B. 10, holds that switchboards or dial switching apparatus installed by the taxpayer, a regulated communications utility, at a customer location and used to furnish communications services to tax-exempt organizations or governmental units were eligible for the investment tax credit because the equipment installed was not owned or leased by the tax-exempt organizations or governmental units. The taxpayer retained all ownership in, and possession and control over, the equipment. The agreement entered into between the taxpayer and the customer was not a sale or lease but a service contract. The services furnished by the taxpayer and the manner in which they must be furnished were described in tariffs (which did not include provisions that authorized the taxpayer to sell or lease any of the property in question) on file with the Federal Communications Commission, and with the pertinent state public utility regulatory agencies.

Rev. Rul. 72-407, 1972-2 C.B. 10, holds that fully serviced vehicles that were furnished on a daily basis to a department of the United States Government were ineligible property for purposes of the investment tax credit because the vehicles were provided under a lease arrangement rather than a service contract. The ruling reasons that the provision of vehicles was more analogous to the facts under Rev. Rul. 71-397, 1971-2 C.B. 63 (in which an owner-manufacturer's machines placed with and for the use of tax-exempt organizations and governmental units were not eligible for the investment tax credit because the manufacturer did not have possession and use of the machines), than to the facts under Rev. Rul. 68-109. The ruling reasons that, because the vehicles were not part of an integrated network and no government regulations prohibited a lease of the vehicles, provision of the vehicles was fundamentally different from the provision of communications services considered in Rev. Rul. 68-109. The vehicles were provided to the governmental unit by the taxpayer; however, the taxpayer did not use them to render services to the governmental unit. Instead, the placement of the vehicles with the governmental unit allowed the governmental unit to provide services to itself.

In addition, case law addresses whether a contract is a lease or a service contract. For example, in Xerox Corporation v. United States, 656 F.2d 659 (Ct. Cl. 1981), the court held that machines were eligible for the investment tax credit because the machines were not leased but supplied as an integral part of service. The court, after citing Rev. Rul. 68-109 and other rulings, focused the service-versus-lease analysis on the possessory interest a taxpayer retains in the property and whether the property is part of an integrated operation. The court described four factors to use when analyzing the possessory interest: (1) retention of property ownership by taxpayer (see Rev. Rul. 68-109); (2) retention of possession and control of the property by taxpayer (see Rev. Rul. 68-109 and Rev. Rul. 71-397); (3) retention of risk of loss by the taxpayer (see Rev. Rul. 68-109); and (4) reservation of the right to remove the property, and replace it with comparable property.

In Smith v. Commissioner, T.C. Memo. 1989-318, in determining whether the taxpayer was eligible for the investment tax credit, the court listed four factors for distinguishing leases from service contracts: (1) which party has the use and possession or control of the equipment; (2) which party operates the machine; (3) whether the tax-exempt organization pays for the use of the machine for some duration, or, instead pays based upon the number of procedures executed; and (4) whether the equipment is part of a broader, integrated system of equipment and services.

Applicable Federal income tax principles relevant to determining whether a taxpayer's gross receipts are derived from providing telecommunication services or from a lease or rental of property include the factors described in § 7701(e)(1). Section

7701(e)(1) provides that for purposes of chapter 1, of which § 199 is a part, a contract that purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property taking into account all relevant factors, including whether or not (A) the service recipient is in physical possession of the property, (B) the service recipient controls the property, (C) the service recipient has a significant economic or possessory interest in the property, (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Although authorities on Federal income tax principles such as those summarized above demonstrate that Federal income tax principles are generally used to determine a single character for a given transaction, § 1.199-3(i)(1) provides that, solely for purposes of § 199, a single transaction may, depending on applicable Federal income tax principles, have both a services element and a lease element. Accordingly, the application of Federal income tax principles described in § 1.199-3(i)(1) requires an analysis of relevant factors taken from Federal income tax principles, but does not require a determination of a single character. However, analysis of the relevant factors may lead to a determination that the transaction has only a single character element for purposes of § 199.

In Situation 1, under the applicable Federal income tax principles described above, Z is using its SONET ring and PSTN to provide telecommunication services to A, not providing a combination of telecommunication services with a lease or rental of Z's SONET ring or PSTN to A. Although a determination for § 199 purposes that a transaction constitutes exclusively the provision of services requires thorough consideration of all relevant facts and circumstances, several significant factors in Situation 1 support this conclusion.

For instance, Z maintains control of the SONET ring and PSTN that are necessary for Z to fulfill the conditions of its contract with A. To fulfill the contract terms, Z must transmit A's telecommunications at A's desired times, to A's desired destinations, and at a certain speed. A contracts with Z for the quantity and quality of telecommunication services, but does not control how Z uses the SONET ring and PSTN to provide the services.

Further, A does not have a possessory interest in the SONET ring and PSTN that Z uses to complete the transmissions. Z must operate the SONET ring and PSTN because, if A makes the payments due under the contract to Z, Z is required to transmit A's telecommunications. A does not operate, maintain, repair or upgrade the SONET ring and PSTN. A grants Z reasonable access to A's premises for the purpose of installing, inspecting, testing, rearranging, maintaining, repairing, or removing any of the SONET ring assets located on A's premises. Z operates, maintains, repairs, and upgrades the SONET ring and PSTN at no additional charge to A. A is prohibited from installing, inspecting, testing, rearranging, maintaining, repairing, or removing any component of the SONET ring or PSTN. Z is the party with a possessory interest in the SONET ring and PSTN. Z must be able to operate the SONET ring and PSTN because, if Z cannot transmit A's telecommunications according to the terms of the contract (i.e., A's desired times, destinations, and speed), then Z is required to provide a service credit.

In addition, the SONET ring and PSTN are part of Z's broader integrated operation of transmitting telecommunications. While the SONET ring allows Z to transmit A's telecommunications between A's designated business locations without accessing Z's PSTN, the SONET ring also connects with Z's central office, switching center, or remote terminal so that telecommunications can be transmitted to and from Z's PSTN. The PSTN is owned by Z and is not dedicated to A or to any of Z's other customers. The PSTN provides a multitude of different pathways to transmit telecommunications to and from A's business locations.

In this situation, A contracts with Z for reliable telecommunication services and Z provides those services using its SONET ring and PSTN subject to the contract terms governing the quantity and quality of services that Z must provide. Accordingly, Z's gross receipts derived from transmitting A's telecommunications are derived from the performance of services without the lease or rental of Z's SONET ring and PSTN to A for purposes of § 199.

In Situation 2, under the applicable Federal income tax principles described above, Z is using the dedicated circuit and PSTN to provide telecommunication services to A, not providing a combination of telecommunication services with a lease or rental of

Z's dedicated circuit or PSTN to A. Although a determination for § 199 purposes that a transaction constitutes exclusively the provision of services requires thorough consideration of all relevant facts and circumstances, several significant factors in Situation 2 support this conclusion.

For instance, A does not control the dedicated circuit or PSTN as Z maintains the same control as Z has over the SONET ring and PSTN in Situation 1. Further, A does not have a possessory interest in the dedicated circuit and PSTN that Z uses to complete the transmissions. Z, in fact, has broader access to a dedicated circuit than a SONET ring. Also, the dedicated circuit is part of Z's broader integrated operation. The dedicated circuit must connect with Z's PSTN to transmit telecommunications to and from A's business location.

In this situation A contracts with Z for reliable telecommunication services and Z provides those services using its dedicated circuit and PSTN subject to the contract terms governing the quantity and quality of services that Z must provide. Accordingly, Z's gross receipts derived from transmitting A's telecommunications are derived from the performance of services without the lease or rental of Z's dedicated circuit or PSTN to A for purposes of § 199.

In Situation 3, under the applicable Federal income tax principles described above, Z is providing a combination of telecommunication services using its dedicated circuit and PSTN and a lease or rental of Z's customer premises equipment to A. Although a determination for § 199 purposes that a transaction constitutes a combination of services and a lease or rental requires thorough consideration of all relevant facts and circumstances, several significant factors in Situation 3 support this conclusion.

With respect to the dedicated circuit and PSTN, the same analysis applies to Situation 3 as applied in Situation 2. In this situation, A's contract with Z also includes the provision of customer premises equipment. The customer premises equipment is necessary to allow A to connect with the dedicated circuit so that Z can transmit telecommunications to and from A's business location.

A controls the customer premises equipment in generally the same manner as in Situation 2 where A owns the customer premises equipment. However, in this case, Z owns, provides necessary telephone support services for, and can perform certain remote maintenance and diagnostic tasks on the customer premises equipment. Nevertheless, A has a possessory interest in the customer premises equipment. Z must operate the dedicated circuit and PSTN, but just as in Situation 2, A operates the customer premises equipment. A designates employees to perform equipment replacement and repair of the customer premises equipment. Z provides telephone assistance, but only if necessary. A can relocate or modify the customer premises equipment, and may attach it to non-Z equipment with Z's written authorization, which may not be unreasonably withheld. A is liable for any repair charges or the replacement cost of the equipment if it is damaged or lost. When the contract terminates, if A does not return the customer premises equipment or make it available for removal by Z, then A is liable to Z for the customer premises equipment's then current market value. If A does return it and the customer premises equipment has more than ordinary wear and tear, then A is liable for those restoration costs. The facts demonstrate in this situation that A has a possessory interest in the customer premises equipment.

Because A is ultimately the party responsible for ensuring that the customer premises equipment is available to connect with the dedicated circuit to allow Z to transmit telecommunications to and from A's business location using Z's dedicated circuit and PSTN, the customer premises equipment should not be considered part of Z's broader integrated network.

In this situation A contracts with Z for reliable telecommunication services and Z provides those services using its dedicated circuit and PSTN subject to the contract terms governing the quantity and quality of services that Z must provide, but A also contracts for the lease or rental of customer premises equipment. Accordingly, Z's gross receipts derived from transmitting A's telecommunications are derived from a combination of services using its dedicated circuit and PSTN and a lease or rental of the customer premises equipment to A.

The terms "lease" and "rent" are used interchangeably throughout the Code, and for purposes of this analysis a distinction is unnecessary. The characterization of a transaction as a combination of services and a lease as opposed to a combination of services and a rental has no effect under § 199.

HOLDINGS

In Situation 1, Z's gross receipts are derived from the performance of telecommunication services without the lease or rental of Z's SONET ring and PSTN to A for purposes of § 199 and do not constitute DPGR.

In Situation 2, Z's gross receipts are derived from the performance of telecommunication services without the lease or rental of Z's dedicated circuit and PSTN to A for purposes of § 199 and do not constitute DPGR.

In Situation 3, Z's gross receipts are derived from a combination of the performance of telecommunication services using its dedicated circuit and PSTN and a lease or rental of the customer premises equipment described above to A for purposes of § 199. Z's gross receipts derived from the performance of services do not constitute DPGR and Z's gross receipts derived from the lease or rental of the customer premises equipment only qualify as DPGR if Z meets the other requirements of § 199 with respect to the customer premises equipment.

DRAFTING INFORMATION

The principal author of this revenue ruling is James A. Holmes of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Mr. Holmes at (202) 622-3040 (not a toll-free call).