Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date: March 6, 2009

Legend:

Taxpayer =

Parent =

Group =

State Z =

X =

Date 1 =

Date 2 =

Dear

This responds to your letter dated , requesting a ruling that Taxpayer's gross receipts from License Fees are excluded from the definition of "royalties" within the meaning of section 165(g)(3)(B).

FACTS

Parent, a State Z corporation, is the common parent of a group of affiliated corporations that files a consolidated federal income tax return. Parent or other members of the Group owned 100% of the issued and outstanding stock of Taxpayer, a State Z corporation and member of the Group, from Date 1 through Date 2.

Description of Taxpayer's Business Operations

Taxpayer is a software development company engaged in building software applications for mobile phones and other embedded devices. Taxpayer has developed a proprietary software technology called "X," which is a "middleware" that allows companies to distribute software applications on a multitude of mobile devices regardless of the device type or operating system. In order for Taxpayer to translate the software applications to accommodate the various devices and operating environments, the software applications must be written in Taxpayer's proprietary language. The majority of Taxpayer's business activities consist of developing custom applications for its customers using its proprietary language and deploying such applications across devices and networks using the X platform.

Taxpayer has entered into numerous contracts with customers. For each customer, Taxpayer (1) develops a customized application to perform the features and functionality as set forth by the customer ("Development Requirement"); (ii) grants the right to use the X, which is necessary to operate the custom application (together with the Development Requirement, the "Development Function"); and (iii) provides ongoing software maintenance and support, including back-end support for program errors ("Maintenance & Support Function").

Development Function

As part of its Development Function, Taxpayer designates software developers to work with the customer to ascertain the design specifications for the application to be developed. Once the design specifications are established, Taxpayer works collaboratively with the customer to agree upon a delivery schedule based on milestones. This schedule sets forth the sequence in which the tasks associated with the development, completion, and release of the customized application are to be undertaken by Taxpayer and accepted by customer. Thereafter, Taxpayer tests the application to ensure that its meets the design specifications and functions properly.

Once the testing is complete, the customized application, including application concepts, formatted text files, graphics, data files, source code, and all computer software (except the X), is delivered to the customer. Upon receipt of the custom application, the customer either: (i) provides Taxpayer with a written approval, in which case the custom application may become the exclusive property of the customer (i.e., all intellectual property rights in the customized application are transferred to the

customer), or (ii) provides Taxpayer with a list of changes needed to meet the design specifications.

Under each contract, Taxpayer is paid a fixed fee for development of the software application. This fee is payable either upon the customer's acceptance of the product, upon various milestones (including commercial release of the application) or on a regular basis over the course of the developmental period.

The customer application is written in the Taxpayer's proprietary language and therefore cannot operate independently of the X middleware. Taxpayer grants the customer a non-exclusive, non-assignable, non-transferable right to use, reproduce, distribute, or transmit the X solely in connection with the customized software application developed by Taxpayer for the customer. In addition, Taxpayer grants the customer the right to sublicense to the end-user who purchases the customer application the X, which is necessary for the operation of the customer application. Taxpayer is paid a license fee that is either fixed over a period of time and may also be based on a percentage of the customer's revenue from end-user subscriptions or based on a per-unit shipped basis (the "License Fees"). This fee arrangement is consistent with industry practices.

Maintenance and Support Function

Taxpayer provides each customer with updates and enhancements to the X. In addition, Taxpayer provides each customer with ongoing telephone and email support. These support functions include training the customer's staff in operating and maintaining the custom application. In addition, Taxpayer provides certain back-end technical support services, including expanding the application to support additional end-users, identifying defective source code, and providing corrections, workarounds and/or patches to correct program errors. For its maintenance and support services, Taxpayer earns a maintenance fee that is usually a percentage of any negotiated License Fees. At the option of each customer, the maintenance and support services provided by Taxpayer may be extended beyond the term originally specified in each contract.

Law and Analysis

Section 165(a) of the Internal Revenue Code allows a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(g)(1) of the Code provides the general rule that if any security which is a capital asset becomes worthless during the tax year, the resulting loss is treated as a loss from the sale or exchange of a capital asset. Section 165(g)(2) defines a security to include stock in a corporation.

Section 165(g)(3) of the Code provides an exception to the general capital loss rule and allows a taxpayer that is a domestic corporation to claim an ordinary loss for worthless securities of an "affiliated" corporation. *See also* section 1.165-5(d) of the Income Tax Regulations. Under section 165(g)(3), a corporation is treated as "affiliated with the taxpayer" only if--

> (A) the taxpayer owns directly stock in the corporation meeting the requirements of section 1504(a)(2) (i.e., at least 80 percent of the voting power and value of the corporation's stock) ["ownership test"], and
>
> (B) more than 90 percent of the aggregate of the corporation's gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities ["gross receipts test"]. *See also* section 1.165-5(d)(2)(iii), which provides that the gross receipts test applies for all the taxable years during which the subsidiary has been in existence.

The gross receipts test was designed to determine whether a subsidiary is an operating company (for which an ordinary loss is allowed) or a holding or investment company (for which an ordinary loss is not allowed). The Revenue Act of 1942, Pub. L. No. 754, section 123(a)(1), 56 Stat. 798, 820 (1942), added section 23(g)(4) (the predecessor to section 165(g)(3)), to provide for an ordinary loss for worthless stock instead of capital loss treatment of certain affiliated corporations. The legislative history indicates the purpose of section 23(g)(4) was to allow a parent corporation to claim an ordinary loss deduction for the stock of its subsidiary if it becomes worthless, regardless of whether the parent and subsidiary file a consolidated return or not. S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B. 504, 543. Section 23(g)(4) included an ownership test and a gross income (changed in 1954 to gross receipts) test.

Shortly after its enactment, section 23(g)(4) was amended by Congress to provide that certain rents and interest earned by an operating company were to be treated as operating income, rather than passive income, in applying the gross income test. *See* Pub. L. No. 235, section 112(a), 58 Stat. 21, 35 (1944); S. Rep. No. 91-1530, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 617, 618; S. Rep. No. 77-1631, 77th Cong., 2d Sess. 46 (1942), 1942-2 C.B 504, 543; 90 Cong. Rec. S121-122 (daily ed. Jan. 12, 1944) (statement of Sen. Davis). In introducing the amendment, Senator Davis noted that Congress' intent in enacting the gross income test was to permit the loss as an ordinary loss only when the subsidiary was an operating company as opposed to an investment or holding company. The intent of the change, as explained by Senator Davis, was to exclude certain rents and interest derived by a company that was solely an operating company from the scope of passive income in accordance with the intent

of Congress. The rent and interest from the sources described were viewed as "incidental to the operating activities of the company" and as arising from a "direct result of its activities as an operating company." 90 Cong. Rec. S at 122.

The legislative history suggests that Congress intended to permit ordinary loss treatment where the subsidiary is an operating company rather than an investment or holding company.

Taxpayer represents at all times during the period Date 1 through Date 2, Parent or other members of the Group owned 100% of the issued and outstanding stock of Taxpayer as described in section 1.1502-34 of the Income Tax Regulations.

Taxpayer represents that Taxpayer's stock is wholly worthless within the meaning of section 165(g) and the additional requirements of section 1502-80(c) of the Regulations were satisfied as of Date 2.

Taxpayer represents that it is engaged in the active conduct of a trade or business of developing, manufacturing, or producing computer software tailored to the needs of specific customers. This is evidenced by the fact that each of Taxpayer's contracts contains a software development component. In addition, Taxpayer provides several services to each of its customers. For example, Taxpayer works collaboratively with each customer to develop a customized software application. This process requires: (i) Taxpayer to write the code for the customized application using its proprietary language; (ii) Taxpayer to test the developed application for application defects and to make any necessary corrections; and (iii) Taxpayer to deliver the customized application to the customer for acceptance. Following the customer's acceptance, Taxpayer continues to service the customer by providing: (i) updates and enhancements to the X; (ii) ongoing telephone and email support; (iii) training in operating and maintaining the custom application; and (iv) back-end technical support, including expanding the application to support additional end-users, identifying defective source code, and providing corrections, workarounds and/or patches to correct program errors.

Taxpayer represents that its License Fees are attributed to computer software which are developed, manufactured, or produced by Taxpayer for specific customers in connection with its trade or business.

Taxpayer represents that if the requested ruling is granted, more than 90% of Taxpayer's aggregate gross receipts for all taxable years have been from sources other than dividends, interest, rents, royalties, annuities, and gains from dispositions of securities.

Based on the facts submitted and the representations made in the ruling request, we conclude that the License Fees earned by Taxpayer are fees arising from sources

that are integral to the development, manufacture, production or support of customized software applications. Therefore, Taxpayer should be treated as an operating company with active gross receipts. As a result, Taxpayer's gross receipts from License Fees should be excluded from the definition of "royalties" within the meaning of section 165(g)(3)(B) of the Code.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Robert M. Casey
Senior Technical Reviewer, Branch 3
(Income Tax & Accounting)