INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-137224-12

Tina Meaux
LB&I:NRC

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Corporation X =

Contract 1 =

Contract 2 =

ISSUES:

(1) Whether the special rule for government contracts under § 199(c)(4)(C) eliminates the requirement otherwise applicable under § 199(c)(4)(A)(i) that domestic production gross receipts (DPGR) must be attributable to the “disposition” of qualifying production

property (QPP) manufactured or produced by Taxpayer in whole or in significant part within the United States?

(2) Whether any of the gross receipts derived by Taxpayer from two contracts are non-DPGR because the gross receipts are attributable to services or non-qualified property?

CONCLUSIONS:

(1) Yes. Taxpayer is treated as making a disposition of QPP under § 199(c)(4)(A)(i) because it meets the requirements of the special rule for government contracts under § 199(c)(4)(C).

(2) Yes. Under each contract part of the gross receipts are attributable to non-qualified property provided to the government and are non-DPGR.

FACTS:

There are two contracts at issue in this technical advice request. Both of which were part of system development and acquisition programs. These types of programs generally progress thru the following types of contracts[1]:

1. Study Contract - A basic or applied research contract for scientific analysis and experimentation directed toward increasing fundamental knowledge and understanding in those fields of the physical, engineering, environmental, and life sciences related to long-term national security needs.

2. Technology Development Contract - A research and development contract for the translation of promising basic research into solutions for broadly defined military needs but short of major development projects.

3. Engineering and Manufacturing Development (EMD) Contract - A research and development contract for the definition of the system functionality and interfaces, complete hardware and software detailed design, and reduce system-level risk. It also includes demonstration of the ability of the system to operate in a useful way consistent with the approved key performance parameters and that system production can be supported by demonstrated manufacturing processes.

4. Low-rate Initial Production Contract (LRIP) - A research and development contract that includes line items for supply of production items for the completion of manufacturing development in order to ensure adequate and efficient manufacturing capability and to produce the minimum quantity necessary to provide production or production-representative articles for Initial Operational Test and Evaluation, establish an initial production base for the system; and

[1] The list is intended to be representative. Not all contracts fit neatly into one of the listed contract types.

permit an orderly increase in the production rate for the system, sufficient to lead to full-rate production upon successful completion of operational (and live-fire, where applicable) testing.

5. Production Contract - A supplies contract for the delivery of the fully funded quantity of systems and supporting material and services for the program or increment to the users.

6. Sustainment Contract - A supplies/services contract for personnel, training, logistics, and other support required to maintain and prolong operations or combat until successful accomplishment or revision of the mission or of the national objective.

Taxpayer entered into a contract with the United States on (Contract 1). Contract 1 was a fixed-price incentive fee full-scale development contract for the development of . The stated purpose of the system development program was "to develop a with as few variants as necessary to meet specific mission requirements. This includes all effort to develop, fabricate, integrate and test prototype ." Contract 1 is most comparable to an EMD contract, and included detailed design, prototype construction, software development, integration and testing .

Contract 1 was preceded by a preliminary design phase contract. Pursuant to the preliminary design phase contract, Taxpayer developed a preliminary design for the .

Taxpayer's activities under Contract 1 included all effort to develop, fabricate, integrate and test prototype and models representative of the proposed production design to demonstrate mission performance during the static and dynamic tests. As part of the design and development work required under the contract, Taxpayer was required to perform a significant amount of computer software development work. The Taxpayer developed software systems for use in the systems. Taxpayer employed computer software programmers and analysts and the services of an additional similar personnel through another company. Taxpayer also developed and produced specified test and support equipment. The contract further included the preparation of a definitive manufacturing plan. The contract did not call for delivery of test or operational to the customer. Delivery of operational would have come under future production contracts if the program continued.

During the time that the contract was in effect, Taxpayer produced a total of prototype test . The prototype were significantly different from one another in order to accommodate the wide range of testing required by the contract.

Of the prototypes built (or at least partially completed), only were planned to be representative of what was envisioned as one version of the production . None of the was completed when the program was terminated for convenience by the government. of the were to be tested to destruction, and the remaining were to be used in other stages of the contract by Taxpayer.

Contract 1 contained a cross reference to the Federal Acquisition Regulations (FAR) § 52.232-16 Progress Payments (April 1984 version). FAR § 52.232-16(d) generally provides that title to property described vests in the government.

Contract 1 incorporated by reference § 52.227-7013, Rights in Technical Data and Computer Software (October 1988), of the Defense Acquisition Regulations System (DFARS).

On , the government terminated Contract 1 for convenience. On , Taxpayer submitted a claim of $ for reimbursement under the terms of a termination for convenience. That claim was denied, but on , Taxpayer settled its case by agreeing to receive $ in settlement. Taxpayer's position is that the entire settlement amount is DPGR.

In , Corporation X was awarded the prime contract for the development of certain by the United States . On , as part the system development program for the , Corporation X entered into a contract with Taxpayer (Contract 2). Contract 2 is a subcontract to the prime contract between Corporation X and . Contract 2 was an EMD phase contract, and was preceded by a preliminary design phase contract. Taxpayer was to continue the system development and design of the system for the .

Under Contract 2 Taxpayer produced and delivered systems of increasing design maturity with the initial deliveries being concept verification and more current deliveries being full scale, final , operating production hardware that are currently installed in delivered by Corporation X to . Taxpayer was also required to produce computer software under Contract 2. During the audit period timeframe, there were ship sets of integrated hardware, containing modules per ship set, delivered to Corporation X. These hardware modules were integrated with separately provided computer software at a Corporation X facility.

FAR § 52.245-5 (January 1986 version) concerning government property is incorporated in Contract 2. FAR § 52.245-5(c) generally provides that title to property described vests in the government.

Contract 2 incorporates the provisions of DFARS § 252.227-7013, Rights in Technical Data-Non Commercial Items (Nov 1995), and DFARS § 252.227-7014, Rights in Non-

Commercial Computer Software and Non-Commercial Computer Software Documentation (June 1995). In accordance with those rights, Taxpayer agreed to provide unlimited rights to the external shape and/or geometry of the items delivered under the purchase order, subject to claims for less than unlimited rights. Under Contract 2, Taxpayer provided to Corporation X a statement of limited and restricted rights to protect Taxpayer's rights and the rights of Taxpayer's subcontractors in technical data, computer software, and computer software documentation to which the government does not obtain unlimited rights under DFARS § 252.227-7013 and DFARS § 252.227-7014.

LAW AND REGULATORY GUIDANCE:

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 percent for taxable years beginning in 2005 and 2006, 6 percent for taxable years beginning in 2007 through 2009, and 9 percent 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) provides the term DPGR means the gross receipts of the taxpayer which are derived from (i) any lease, rental, license, sale, exchange, or other disposition of (I) QPP which was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States.

Section 199(c)(4)(A)(iii) provides DPGR includes gross receipts derived from, in the case of a taxpayer engaged in the active conduct of an engineering or architectural services trade or business, engineering or architectural services performed in the United States by the taxpayer in the ordinary course of such trade or business with respect to the construction of real property in the United States

Section 199(c)(4)(C) is a special rule for certain government contracts where gross receipts derived from the manufacture or production of any property described in § 199(c)(4)(A)(i)(I) shall be treated as meeting the requirements of § 199(c)(4)(A)(i) if (i) such property is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government, and (ii) the FAR requires that title or risk of loss with respect to such property be transferred to the Federal Government before the manufacture or production of such property is complete.

Section 199(c)(5) defines QPP as including tangible personal property and computer software.

In § 1.199-3(e)(5), Example 5, Z MPGE QPP within the United States. The following activities are performed by Z as part of the MPGE of QPP while Z has the benefits and burdens of ownership under Federal income tax principles: materials analysis and selection, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, diagnosis and correction of system failure, and packaging for shipment to customers. Because Z MPGE the QPP, these activities performed by Z are part of the MPGE of QPP.

Section 1.199-3(f)(1) provides that only one taxpayer may be treated as conducting the qualifying activity with respect to an item of property. If that taxpayer uses a contract manufacturer for its property, then the entity that has the benefits and burdens over the property when the qualifying activity occurs is treated as engaging in the qualifying activity.

Section 1.199-3(f)(2) provides a special rule for government contracts where gross receipts derived from the MPGE of QPP in whole or in significant part within the United States will be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the taxpayer in whole or in significant part within the United States notwithstanding the requirements of § 1.199-3(f)(1) if (i) the QPP is MPGE by the taxpayer within the United States pursuant to a contract with the Federal government; and (ii) the FAR (Title 48, Code of Federal Regulations) requires that title or risk of loss with respect to the QPP be transferred to the Federal government before the MPGE of the QPP is completed.

Section 1.199-3(f)(3) provides if a taxpayer (subcontractor) enters into a contract or agreement to MPGE QPP on behalf of a taxpayer to which § 1.199-3(f)(2) applies, and the QPP under the contract or agreement is subject to § 1.199-3(f)(2)(ii), then, notwithstanding the requirements of § 1.199-3(f)(1), the subcontractor's gross receipts derived from the MPGE of the QPP in whole or in significant part within the United States will be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP MPGE by the subcontractor in whole or in significant part within the United States.

In § 1.199-3(g)(5), Example 9, X designs shirts within the United States, but cuts and sews the shirts outside of the United States. Because X’s design activity is the creation of an intangible its design activity is not taken into account in determining whether the manufacture of the shirts is substantial in nature under § 1.199-3(g)(2), and the costs X incurs in creating the design of the shirts are not direct labor or overhead under § 1.199-3(g)(3). Therefore, X has not MPGE the shirts in significant part within the United States.

Section 1.199-3(i)(4)(i) provides that generally gross receipts from services do not qualify as DPGR. In addition, DPGR does not include the gross receipts from the

disposition of non-qualified property. The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed reasonable if the allocation reflects the fair market value of the embedded services or non-qualified property.

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

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(j)(3).

Section 1.199-3(j)(3)(ii) provides computer software also includes 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) is an exception to the definition of computer software and 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 word-processing program includes 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.

FAR § 52.245-5(c) (January 1986 version) provides that the government shall retain title to (1) all government-furnished property, (2) all property purchased by the Contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under the contract shall pass to and vest in the Government upon the vendor's delivery of such property, (3) all other property the costs of which is reimbursable to the Contractor shall pass to the government upon (i) issuance of the property for use in contract performance; (ii) commencement of processing of the property or use in contract performance; or (iii) reimbursement of the cost of the property by the government, whichever occurs first. FAR § 52.245-5(c)(4) provides title to all government-furnished property and all property acquired by the Contractor, title to which vests in the Government, shall not be affected by its incorporation into or attachment to any property not owned by the government, nor shall government property become a fixture or lose its identity as personal property by being attached to any real property.

FAR § 52.232-16(d)(1) (April 1984 version), under Progress Payments, provides generally that title to property (defined in § 52.232-16(d)(2)) shall vest in the government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.

DFARS § 252.227-7013 (October 1988 version) describes the rights in technical data and computer software. DFARS § 252.227-7013 (November 1995 version) describes the rights in technical data—noncommercial items. DFARS § 252.227-7014 (June 1995 version) describes rights in noncommercial computer software and noncommercial computer software documentation.

ANALYSIS:

Issue (1): Contract 1 is the only contract relevant to this issue because a disposition under § 199(c)(4)(A)(i) occurs in Contract 2. LB&I asserts that none of the gross receipts Taxpayer derived from Contract 1 qualify as DPGR because Taxpayer did not deliver any property produced to the government. In Contract 1 delivery of the tangible personal property produced was not required and title to the property produced reverted from the government back to Taxpayer after production and testing of the property. LB&I believes the purpose of the rule in § 199(c)(4)(C) is to allow for a disposition in cases where title or risk of loss to property produced for the government was never held by the manufacturer because of FAR requirements. LB&I argues that property must be delivered and title should remain with the government after the property is manufactured rather than revert directly to Taxpayer. Taxpayer argues that § 199(c)(4)(C) only applies to the tangible personal property produced under Contract 1. Taxpayer admits it does not satisfy § 199(c)(4)(C) with respect to computer software because title or risk of

loss is not transferred under FAR § 52.232-16(d)(1) (April 1984 version). Taxpayer claims that it licensed the computer software in a disposition that qualifies under § 199(c)(4)(A)(i).

Our Office acknowledges that a disposition normally involves a customer taking possession of property for at least some period of time (e.g., a lease allows a customer use of property for an agreed period of time). Further, in addition to the other requirements of § 199, we agree that a taxpayer must show under § 199(c)(4)(A)(i) that it is deriving gross receipts from a lease, rental, license, sale, exchange, or other disposition of property described in § 199(c)(4)(A)(i)(I). However, § 199(c)(4)(C) may apply to Contract 1 because the contract is between Taxpayer and the Federal Government. Section 199(c)(4)(C) is a special rule for certain government contracts, which provides to the extent its requirements are met a taxpayer is treated as meeting § 199(c)(4)(A)(i) (i.e., the disposition requirement of § 199).

Section 199(c)(4)(C) provides that gross receipts from the manufacture or production of any property described in § 199(c)(4)(A)(i)(I) shall be treated as meeting the requirements of § 199(c)(4)(A)(i) if (i) such property is manufactured or produced by the taxpayer pursuant to a contract with the Federal Government, and (ii) the Federal Acquisition Regulation (FAR) requires that title or risk of loss with respect to such property be transferred to the Federal Government before the manufacture or production of such property is complete. Thus, there are three requirements outlined in § 199(c)(4)(C) that a Taxpayer must meet to be treated as making a disposition.

When applying the requirements to Contract 1, Taxpayer should be treated as making a disposition of QPP under § 199(c)(4)(A)(i). First, Taxpayer produced tangible personal property, QPP. The QPP also appears to meet the other requirements of §199(c)(4)(A)(i)(I), meaning Taxpayer MPGE the QPP in whole or in significant part within the United States. Thus, Taxpayer produced property described in § 199(c)(4)(A)(i)(I). Second, Contract 1 was with the Federal Government and expressly required Taxpayer to produce several variant prototypes and certain other tangible personal property. For example, Taxpayer was required to produce prototype and did actually produce prototype . Thus, Taxpayer met the requirement of § 199(c)(4)(C)(i). Third, the contract also contained the FAR title vesting requirement, which meant the Federal Government held title to the tangible personal property before the production of such property was complete. FAR § 52.232-16(d)(1)(title vesting). Thus, Taxpayer met the requirement of § 199(c)(4)(C)(ii). Taken together, Taxpayer satisfied the requirements of § 199(c)(4)(C) and should be treated as making a disposition under § 199(c)(4)(A)(i).

Based on the conclusions that Taxpayer is treated as making a disposition of property under § 199(c)(4)(A)(i), and the property disposed of was that described in § 199(c)(4)(A)(i)(I), Taxpayer should treat gross receipts derived from the QPP as DPGR.

LB&I's position primarily focuses on the policy behind § 199(c)(4)(C). LB&I believes Congress did not intend to allow gross receipts derived from a contract like Contract 1 to qualify as DPGR when enacting § 199(c)(4)(C). Our Office cannot adopt LB&I's position for several reasons. The plain language of § 199(c)(4)(C) does not include the requirements that LB&I seeks to impose. The plain language treats a taxpayer that meets the requirements of § 199(c)(4)(C) as having derived gross receipts from a disposition under § 199(c)(4)(A)(i). Delivery, to the extent required, would be an element of a disposition under § 199(c)(4)(A)(i). Because Taxpayer is treated as having made a disposition it seems inconsistent to apply a delivery requirement in this case. Section 199(c)(4)(C) requires that FAR require title (or risk of loss) be transferred to the Federal Government before the manufacture or production process is complete. It does not address whether title can or cannot revert back to Taxpayer at any point in the future. Further, to qualify under § 199(c)(4)(C) a Taxpayer must have manufactured or produced property described in § 199(c)(4)(A)(i)(I). By meeting the requirements of § 199(c)(4)(C), Taxpayer has met all of the requirements to treat gross receipts derived from the QPP as DPGR.

Our Office finds other support for allowing Taxpayer to treat gross receipts derived from the QPP in Contract 1 as DPGR. Based on documents submitted with the advice request, of the prototypes produced under the contract were to be tested to destruction and the rest were to be used within the context of the contract. Thus, title reversion and delivery to Taxpayer would have no value as the property produced was used under the contract. Effectively, the government exhausted the value of the tangible personal property. Also, § 199 is not an "all-or-nothing" statute, meaning gross receipts derived from activities under a contract can be allocated between DPGR and non-DPGR where appropriate. Thus, our Office believes it is consistent with the purpose of § 199 to allow gross receipts to qualify as DPGR in contracts with the Federal Government when the gross receipts are allocable to property described in § 199(c)(4)(A)(i)(I) and a taxpayer meets the requirements of § 199(c)(4)(C).

Issue (2): LB&I and Taxpayer agree that part of the gross receipts derived from Contract 2 qualify as DPGR because Taxpayer disposed of QPP that it MGPE in whole or in significant part within the United States. Based on our Office's conclusion in Issue (1), LB&I and Taxpayer should treat at least part of the gross receipts derived from Contract 1 as DGPR. However, LB&I and Taxpayer disagree as to the amount of gross receipts qualifying as DPGR under both contracts. LB&I maintains that an allocation of gross receipts between DPGR and non-DPGR is necessary because Taxpayer is also deriving gross receipts from non-qualifying property and/or services. Taxpayer's position is that all of its gross receipts from both contracts qualify as DPGR.

Section 1.199-3(i)(4)(i) provides that generally gross receipts from services do not qualify as DPGR. In addition, DPGR does not include the gross receipts from the disposition of non-qualified property. Intangible property generally is non-qualified

property for purposes of § 199, with certain exceptions for computer software, sound recordings, and qualified films. Thus, to the extent we find that Taxpayer is deriving gross receipts from embedded services or non-qualifying property, then an allocation should be made between the gross receipts that are DPGR (from the production and disposition of QPP that meets the requirements of § 199) and non-DPGR (embedded services or non-qualified property).

Services

Under both contracts the Taxpayer clearly engages in design and development activities. Our Office's position is that design and development activities alone are activities that create intangible property (rather than being the MPGE of QPP). However, when a taxpayer designs, develops, and produces tangible personal property for disposition we believe that a taxpayer can treat what would be "non-MPGE" activities as part of the MPGE of QPP. The result is when a taxpayer engages in the MPGE of QPP and disposes of the QPP to customers, the taxpayer does not have to allocate gross receipts to potentially non-qualifying activities or services it engaged in as part of the MPGE of QPP. Our office believes Example 5 of § 1.199-3(e)(5) (Example 5) supports this interpretation.

LB&I believes that design and development cannot be treated as part of the MPGE of QPP. LB&I's position is that gross receipts from design and development are derived from non-qualifying services and are always non-DPGR. LB&I relies on the fact that design and development are not activities listed in Example 5. LB&I also relies on Example 9 of § 1.199-3(g)(5) (Example 9) that addresses the in whole or in significant part requirement of § 199, and LB&I asserts that gross receipts derived from architecture and engineering services only qualify to the extent the services relate to the construction of real property.

Our Office, however, does not believe Example 5 is an exclusive list of non-MPGE activities that can be treated as part of the MPGE of QPP when a taxpayer MPGE that QPP. Design and development activities are similar to the other activities in Example 5 because design and development can relate to the MPGE of QPP by the taxpayer, while still not qualifying alone as the MPGE of QPP. Example 5 demonstrates that, if a taxpayer engages in the MPGE of QPP, then activities or services that alone would not be considered MPGE activities are treated as MPGE activities. Our Office thinks Example 9, while addressing a separate requirement of § 199, indirectly supports our interpretation. In Example 9, the taxpayer is treated as having not made shirts that it designed in the United States and produced abroad. To the extent LB&I's interpretation is correct, if the taxpayer did produce the shirts in the United States, then upon the sale, it should be required to allocate between its design activities and production activities. Our Office does not believe that is an appropriate result. Our Office acknowledges it is easier to see the design services in Taxpayer's case. However, the reason it is easier is because Taxpayer is recouping its design and development costs in a single

transaction as opposed to multiple transactions. Lastly, to the extent that architecture and engineering services produce a design or process that is disposed of to a customer the gross receipts are non-DPGR (outside of the real property construction context described in § 199(c)(4)(A)(iii)). However, if the activities also result in the MPGE of QPP, and that QPP is disposed of to the customer, then gross receipts from the disposition of QPP may be DPGR. Thus, gross receipts from an architecture and/or engineering services contract may be DPGR in certain situations.

Based on the above, our Office does not believe Taxpayer must treat gross receipts related to design and development as non-DPGR from services.

Non-qualified property

LB&I asserts Taxpayer also transferred non-qualified property, and Taxpayer must treat gross receipts from that transfer as non-DPGR. Our Office agrees. Our Office believes the technical data and rights to the technical data that Taxpayer transferred under both contracts represented intangibles that are non-qualified property. Gross receipts which are attributable to this non-qualified property are non-DPGR.

In analyzing these contracts our Office considered a general spectrum of commercial transactions involving sales of tangible personal property.

At one end of the spectrum a manufacturer could produce equipment for the purpose of marketing that equipment to customers, i.e. a basic sale of tangible personal property. A customer that purchases a piece of equipment obtains certain rights of ownership in the specific equipment purchased. For example, Taxpayer can use it for the intended purpose, resell it, and/or have it repaired or modified by the person of its choosing. The manufacturer would retain the rights to the design of the property (including the right to reproduce the property for internal use or sale), the data and other information necessary to manufacture the equipment, and any other intellectual property rights. In that case, our Office would view the manufacturer as transferring tangible personal property, and, assuming all other requirements of § 199 are met, the manufacturer's gross receipts would all qualify as DPGR.

On the other end of the spectrum is the situation where a customer enters into a contract with a party to design a piece of equipment that the customer desires to manufacture. In that case, a customer could contract for the equipment and for all of the intellectual property rights with respect to the equipment. For example, the customer could receive rights related to the design of the equipment, data and other information necessary to produce the property, exclusive production rights, and exclusive rights to use any other technology created in the course of developing the equipment. Among other things, these rights and information would allow the customer to manufacture and sell the equipment, and prevent the designing party from using the design at all. In this situation under § 199 an allocation should be made between DPGR

related to the tangible equipment produced and sold to the customer and non-DPGR related to the intangible property produced and transferred to the customer.

Our Office thinks Contracts 1 and 2 are different from the situations at either end of the spectrum. While both contracts transfer less than "all" intellectual property associated with the tangible personal property produced, the intangible property is clearly distinguishable from the very limited transfer of intangible rights in a basic sale of tangible personal property. After analyzing the technical data and the rights to the technical data that are transferred in Contracts 1 and 2, our Office believes gross receipts are allocable to non-qualified property under both contracts.

While the government is able to separately contract for rights, most of the rights transferred in these contracts are the result of incorporating requirements of DFARS. These rights appear valuable to our Office. Under DFARS § 252.227-7013(b) a contractor grants the government royalty free, world-wide, non-exclusive, irrevocable license rights in technical data. With respect to Contract 2, and the tangible personal property produced, the government received varying levels of license rights to technical data based on the level of government funding under DFARS § 252.227-7013, Rights in Technical Data—Noncommercial items (November 1995 version). Contract 1 was subject to DFARS § 252.227-7013 (October 1988 version), which provided similar rights to those described in the later version of DFARS that Contract 2 is subject. For purposes of the analysis below the citations are to the November 1995 version of DFARS. DFARS § 252.227-7013(a)(14) defines technical data as recorded information, regardless of the form or method of the recording, of a scientific or technical nature. Under DFARS § 252.227-7013(a)(5) detailed manufacturing or process data is technical data that describe the steps, sequences, and conditions of manufacturing, processing or assembly used by the manufacturer to produce an item or to perform a process.

In a basic sale of tangible personal property a manufacturer would not grant a customer the same rights the government receives in Contracts 1 and 2. Our Office believes a simple outline of the rights in technical data received is sufficient to see these rights are different. For purposes of the analysis, it is also important to note that almost all of the government's rights in technical data produced pursuant to the contract vary depending on the funds used in developing the technical data.

To the extent a development was or will be developed exclusively with government funds, the government receives unlimited rights. Under DFARS § 252.227-7013(b)(1), among other unlimited rights,[2] the government has unlimited rights in technical data that are data pertaining to an item, component, or process which has been or will be developed exclusively with government funds. Unlimited rights, defined in DFARS

[2] Under DFARS § 252.227-7013(b)(1)(ii), (iv), (v), (vi), (vii), (viii), and (ix) the government also receives unlimited rights regardless of what type of funding occurred. For example (b)(1)(ii) gives the government unlimited rights in technical data that are studies, analyses, test data, or similar data produced under a contract, when the study, analysis, test data, or similar work was specified as an element of performance.

§ 252.227-7013(a)(15), means rights to use, modify, reproduce, perform, display, release, or disclose technical data in whole or in part, in any manner, and for any purpose whatsoever, and to have or authorize others to do so (Unlimited Rights).

To the extent a development was or will be developed with "mixed funding," which means the development was accomplished partially with costs charged to indirect cost pools and/or costs not allocated to a government contract, and partially with costs charged directly to a government contract, the government receives government purpose rights. Under § 252.227-7013(b)(2), the government has government purpose rights for a five-year period in technical data that pertain to items, components, or processes developed with mixed funding. According to § 252.227-7013(b)(2)(ii), upon expiration of the five-year period the government shall have unlimited rights in technical data. Government purpose rights, defined in § 252.227-7013(a)(12), means the rights to (i) use, modify, reproduce, release, perform, display, or disclose technical data within the Government without restriction, and (ii) release or disclose technical data outside the government and authorize persons to whom release or disclosure has been made to use, modify, reproduce, release, perform, display, or disclose that data for the United States government purposes (Government Purpose Rights).

To the extent a development was accomplished entirely with costs charged to indirect cost pools, costs not allocated to a government contract, or any combination thereof, the government receives limited rights in technical data. Under DFARS § 252.227-7013(a)(13) limited rights means the rights to use, modify, reproduce, release, perform, display, or disclose technical data, in whole or in part, within the Government. The Government may not, without the written permission of the party asserting limited rights, release or disclose the technical data outside the Government, use the technical data for manufacture, or authorize the technical data to be used by another party, except that the Government may reproduce, release or disclose such data or authorize the use or reproduction of the data by persons outside the Government if reproduction, release, disclosure, or use is (i) necessary for emergency repair and overhaul; or (ii) a release or disclosure of technical data (other than detailed manufacturing or process data) to, or use of such data by, a foreign government that is in the interest of the Government and is required for evaluational or informational purposes; (iii) subject to a prohibition on the further reproduction, release, disclosure, or use of technical data; and (iv) the contractor or subcontractor is notified of such reproduction, release, disclosure, or use (Limited Rights).

Taxpayer's position, while acknowledging the situation presented by both contracts does not fall at either of the extremes of the spectrum, is that no allocation is necessary and all gross receipts in both contracts should be treated as DPGR. Taxpayer believes to have a separate intangible a customer must receive, at a minimum, the right to reproduce the entire property. Taxpayer believes the Unlimited Rights and Government Purpose Rights received have no value because the Limited Rights prevent the government (without authorization) from having the ability to hire another contractor to

reproduce the properties that are the subjects of each contract. Taxpayer believes the Limited Rights do not provide the government any more rights than a customer in a basic sale contract for custom-designed property would otherwise obtain, and thus, Taxpayer argues there are no gross receipts allocable to non-qualified property.

Our Office disagrees. First, our Office does not believe no value exists in the Unlimited and Government Purpose Rights because the government receives Limited Rights as to part of the property produced. The properties produced under both contracts are complex and comprised of many components. For the government to have Unlimited and Government Purpose Rights to parts of the property could be very valuable. Taxpayer has not illustrated, beyond stating that the Limited Rights prevent reproduction of the entire property, that the Unlimited Rights and Government Purpose rights have no other value. For example, having Unlimited Rights means the government would not "start from scratch" if it needed to produce similar property. Unlimited Rights to components also are valuable to the extent the components can be used in other contexts. The Government Purpose Rights, which provide seemingly valuable rights during the non-unlimited rights five-year period become Unlimited Rights after five years. At a minimum, the Government Purpose Rights have the same value as the Unlimited Rights discounted for the five-year Government Purpose period.

Our Office also is not convinced the Limited Rights lack value. The Limited Rights received under both contracts are distinguishable from the rights a manufacturer would transfer in a typical sale, even if it involves custom designed property. Taxpayer compares a normal commercial customer's right to repair property to the government's rights under the Limited Rights emergency repair provision. Our Office agrees with Taxpayer that both the normal commercial customer and government obtain the right to have purchased property repaired by a third party. In our view, however, that comparison is not helpful. In the contracts at issue, the government receives the technical data necessary to help produce the property, and with the Limited Rights received has the ability to give that information to a third party to reproduce the property (or components of the property) for it with some limitations. In essence a commercial customer would have the right to repair property; however, the customer would not necessarily have the information as to "how" to repair the property or the right to give that information to third parties that the government receives under the contracts at issue. Thus, even the Limited Rights are distinguishable from those received by a customer in a normal commercial setting.

Taxpayer's analysis is not consistent with the example in the definition of intangible property in § 1.199-3(j)(2)(iii). The example provides the rights to the underlying manuscript of a book are not tangible personal property. Taxpayer's position suggests if a customer received less than all rights to the underlying manuscript (e.g., only the rights to chapter one through chapter five in a ten chapter book), then those rights would not be capable of separate valuation because the customer would not be able to reproduce the book in its entirety. In our view, these rights likely are not as valuable as

rights to the entire manuscript, but clearly the rights can have value. In this case, the government receives technical data and many rights allowing it to use that technical data under both contracts. Even the Limited Rights allow for third party reproduction of the property in emergency situations, and Unlimited and Government Purpose Rights allow the government use of the other technical data.

The purpose of both of these contracts also appears to be a mix of production of property and production of information. Our Office makes this observation by first pointing out that both of these contracts most closely fall within the general category of EMD contracts. EMD contracts are for both creating designs and data related to how those designs perform as well as producing property that shows the designs can be created in working form. These contracts occur after the pure design phases of systems development programs, but before the low-rate production and full-scale production phases. Thus, the purpose of the contract seems generally consistent with our conclusion that both tangible and intangible properties are transferred.

Taxpayer also cites to DFARS § 252.227-7013(7)(i), which states private expense determinations are made at the lowest practicable level. Taxpayer argues because of this provision many rights developed under a contract become Limited Rights. Taxpayer also cites to their list that provides the components that are the subject of Limited Rights in Contract 2. Our Office believes these arguments are more relevant to the value of the non-qualified property transferred and not to the determination of whether or not there is non-qualified property to which gross receipts are allocable.

Computer Software and Computer Software Documentation

While the analysis to this point has focused on the tangible personal property, technical data, and the associated rights to the technical data that Taxpayer produced under the contracts, both contracts also called for the production of computer software and computer software documentation. Computer software is QPP under § 199(c)(5) Computer software is defined in § 1.199-3(j)(3), and gross receipts derived from the disposition of computer software that a taxpayer produced in whole or significant part within the United States are DPGR under § 199(c)(4)(A)(i)(I). Computer software under § 1.199-3(j)(3)(i) includes the documentation required to describe and maintain the program or routine. For both contracts, Taxpayer asserts that it made a disposition of the computer software under § 199(c)(4)(A)(i), and meets the other requirements of § 199(c)(4)(A)(i)(I). Our Office agrees to the extent the property Taxpayer transferred is computer software that meets the requirements of § 199(c)(4)(A)(i)(I), then Taxpayer's gross receipts allocable to that property are DPGR.

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.