INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-131376-13

RFTH, Industry Director, Field Operations West,

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =

Contracting Parties =

Contracting Party A =

Contracting Party B =

End Users =

Business A =

Results =

Date 1 =

Date 2 =

Date 3 =

Agreement X =

Master Agreement 1 =

Master Agreement 2 =

Master Agreement 3 =

Computer Software =

Year 1 =

Z =

ISSUE:

For purposes of Taxpayer's domestic production activities deduction under § 199 of the Internal Revenue Code, did Taxpayer derive domestic production gross receipts (DPGR) from the license of Computer Software to Contracting Parties, or non-DPGR from providing services to End Users?

CONCLUSION:

Taxpayer derived DPGR from the license of Computer Software to Contracting Parties.

FACTS:

Overview: Our Office was provided with representative agreements between Taxpayer and Contracting Party A and Taxpayer and Contracting Party B. Our Office also received a sample subscriber agreement between Taxpayer, Contracting Party B, and End Users. Taxpayer and LB&I agree that Taxpayer's relationship with each of the Contracting Parties is generally similar. Taxpayer and LB&I also provided Agreement X entered into by Taxpayer and Contracting Party A. This memorandum does not address Agreement X because the gross receipts derived from it were nominal in the years involved. Our Office's analysis is further limited to analyzing the gross receipts Taxpayer receives as a result of its agreements with the Contracting Parties, and does not address any of Taxpayer's other sources of gross receipts, including gross receipts from .

Taxpayer, in Business A, develops and licenses that calculate Results used by End Users to , such as These proprietary are software developed, owned and controlled by Taxpayer.

Many of the Business A products and services are distributed through the Contracting Parties. Under master agreements with each of the Contracting Parties, Taxpayer designs and develops unique Computer Software for each Contracting Party's data, and Taxpayer licenses the Computer Software to the Contracting Parties. An End User subscribes to a product or service by entering into a subscriber agreement with both Taxpayer and the respective Contracting Party. Under the subscriber agreement, the End User submits a service request to the Contracting Party, and the Contracting Party uses the licensed computer software and the Contracting Party's data to perform the service (generation and distribution of the Results) with the Results provided by the Contracting Party to the End User. In some cases, Taxpayer grants the End User a license to use the Results. Under the subscriber agreement, the Contracting Party collects End User fees. The Contracting Party pays Taxpayer an amount as provided under the respective master agreement.

Contracting Party A Master Agreement: Contracting Party A and Taxpayer entered into an agreement (Master Agreement 1) on Date 1.

The recitals to Master Agreement 1 provide that "[Contracting Party A] and [Taxpayer] desire to mutually create and market various products and services. This contract specifies the nature of the overall business relationship…"

provided that "Each product or service to be developed and offered under this Agreement, the responsibilities of [Contracting Party A] and [Taxpayer] with respect thereto, the fees to be charged for the use of such product or service by [Contracting Party A's] subscribers and the allocation of revenue between [Contracting Party A] and [Taxpayer] will be set forth in detail in Addenda to this Master Agreement…"

provided that "It is anticipated that both [Contracting Party A] and [Taxpayer] will generate revenues as a result of this Agreement. It is the intention that such revenues, unless otherwise defined, will be pooled and shared in proportions set forth in this Agreement and its addenda. It is likely that shared proportions will differ by product or service depending on the relative contributions of [Taxpayer] and [Contracting Party A]."

Under of Master Agreement 1, Contracting Party A's monthly payment to Taxpayer was based on End User fees invoiced, with subsequent adjustments for write-offs of uncollected amounts. Taxpayer's compensation under Addendums to Master Agreement 1 is referred to as either "[Taxpayer's] share" or "royalties."

states that "…[Taxpayer] shall use the data provided by [Contracting Party A] to develop [Computer Software], to conduct analyses of Pooled Data Base [Computer Software], to provide performance data for use in marketing the products and services, and for research and development to the end of improving the jointly developed products and services. Such [Computer Software] will be developed for the use of [Contracting Party A] in the Software Facility defined by this Agreement." (added by amendment) of Master Agreement 1 provides that Contracting Party A is responsible for invoicing and collecting fees from End Users, and it is authorized as Taxpayer's agent for purposes of collecting fees.

In addition to other amendments, amendment to Master Agreement 1 (Master Agreement 2) was entered into with Contracting Party A, and was effective as of Date 2.

The recitals to Master Agreement 2 states "WHEREAS, the Parties desire to establish a relationship that involves, among other things, each Party treating the other Party as a with respect to the activities contemplated by this Agreement and the other agreements referenced below…" The next recital provides "WHEREAS, under this [Master Agreement 2], the Parties are amending [Master Agreement 1] for the purpose of modifying certain terms applicable to [Computer Software]."

Under of Master Agreement 2, of Master Agreement 1 was replaced. The second agreement provides that "all fees, charges, royalties, rebates, revenue shares and prices payable by [Contracting Party A] to [Taxpayer] for [Computer Software] shall be replaced by the royalty payments set forth in this . Taxpayer is entitled to receive payment each month based on End User fees invoiced, regardless of whether Contracting Party A collected the fees.

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Contracting Party B Master Agreement: Contracting Party B and Taxpayer entered into an agreement (Master Agreement 3) on Date 3.

provides that "[Contracting Party B] is in the business, having a of information ."

provides that "[Taxpayer] is in the , having the capability to develop from data."

provides that [Contracting Party B] and [Taxpayer] desire to jointly develop, produce, market, service and maintain services described herein, utilizing [Contracting Party B's] proprietary information database and its data base processing facilities and Taxpayer's proprietary technology and its expertise in design software. These services will be offered to and other businesses (the "Subscribers") within the United States to provide them with ("[Results]") of the information in the [Contracting Party B] data base…The services to be jointly developed and produced pursuant to this Agreement are referred herein as the "Services" or [Contracting Party B]/[Taxpayer] Services" or "Joint Services."

(added by addendum) provides that Contracting Party B is generally responsible for collecting fees from End Users, and it is authorized as Taxpayer's agent for purposes of collecting fees.

provides that "The initial schedule of fees and charges to [End Users], and the allocations of such fees and charges between [Contracting Party B] and [Taxpayer] are set forth in attached hereto…There shall be no fee for the development of the [Computer Software] by Taxpayer or for the information provided by [Contracting Party B], or for any other service provided hereunder, except as expressly stated herein. In all other respects, each party shall bear it [sic] own costs and expenses." , Taxpayer's compensation was either a fixed amount per Result provided to End User, or a percentage if there was a fixed fee arrangement with the End User.

provides that any collection action against an End User is taken on behalf of both Taxpayer and Contracting Party B if the parties subsequently agree to take action. Taxpayer has never been a party to any collection action, and is unaware that any such action has occurred.

provides that "Both parties shall provide adequate staffing and resources to facilitate the marketing and sale of the Joint Services covered by this Agreement. [Taxpayer] shall provide said resources under the direction of a project director who

shall aggressively pursue all mutually agreed upon marketing and publicity activities. [Contracting Party B] shall name a lead marketing individual who shall have final authority to coordinate the combined efforts.

provides that "[Contracting Party B] shall have primary responsibility for sales. [Taxpayer] shall make good faith efforts to participate in joint sales calls, when potential billings to the customer are large, and when technical expertise is needed to close the sale."

provides that "Marketing material shall from time to time be prepared by [Taxpayer] and/or [Contracting Party B]…Any marketing materials, literature, or media releases pertaining to products or services covered by this Agreement shall be prepared jointly by]Taxpayer] and [Contracting Party B] and shall not be disseminated without the approval of both parties…."

Under Master Agreement 3, Taxpayer's compensation is generally referred to as "[Taxpayer's] share," although Year 1 amendments (after the years involved) use the term "royalties" to refer to Taxpayer's compensation. Under of Master Agreement 3, Contracting Party B's monthly payment to Taxpayer was contingent upon receipt of payment from End Users. Under three Year 1 amendments (after the tax years covered by this technical advice), Contracting Party B pays Taxpayer compensation based on user fees invoiced, with subsequent adjustments for write-offs of uncollected amounts.

Royalty Waivers: From time to time, a Contracting Party asks Taxpayer to waive its fees relating to the Contracting Party's services for certain End User projects. Taxpayer's agreement to waive its fees is documented in the form of a letter addressed to the Contracting Party and is described as a "royalty waiver."

Subscriber agreements: An End User subscribes to a product or service by entering into a subscriber agreement. Master Agreement 3 imposes a number of requirements and restrictions on the subscriber agreements. For example, of Master Agreement 3 provides "Neither party shall provide any of the Joint Services to any third party unless such third party has executed a Subscriber Contract therefor in a form approved by both [Contracting Party B] and [Taxpayer]. Such contacts shall be in the joint names of [Contracting Party B] and [Taxpayer] on one hand, and the Subscriber on the other. [Contracting Party B] is authorized to execute such contracts in an approved form on behalf of [Taxpayer]." Master Agreement 1 with Contracting Party A does not require Taxpayer's prior approval of the subscriber agreement.

In the representative subscriber agreement between Taxpayer, Contracting Party B, and End User, Contracting Party B is solely responsible for distributing the products and services to End Users. The subscriber agreement provides that Taxpayer owns the Results, the End User places a request for services with Contracting Party B, and

Contracting Party B delivers the services to the End User, with Taxpayer licensing the right to use the Results of Contracting Party B's services to End Users.

The subscriber agreement recitals state:

"WHEREAS, [Contracting Party B] is in the business of providing Services to clients…who have entered into one or more separate agreements with [Contracting Party B] for such Services;

WHEREAS, [Taxpayer] is in the business with expertise in developing …which are used to calculate…; and

WHEREAS, Client…desires to license the [Results]…in connection with it is purchasing from [Contracting Party B], for the purposes permitted by the agreement."

. provides that "From time to time, Client may request that [Contracting Party B] deliver the [Results] to Client…[Contracting Party B] agrees to perform the Services as reasonably practicable."

of the subscriber agreement includes "a personal, non-exclusive, non-transferrable, non-sublicensable, limited license to use, internally the [Results] solely for the particular purpose…for which the [Results] were obtained, subject to the limitations set forth in this Agreement…"

provides that "Under no circumstances will Client…(a) attempt in any manner, directly or indirectly, to discover or reverse engineer any confidential and proprietary information,…(b) alter, change, modify, adapt, translate or make derivative works of the [Results]; (c) sublicense or request the [Result] Services or [Results] for timesharing, rental, outsourcing, or service bureau operations, or to create or maintain a database for itself or otherwise; (d) use the [Results] in any manner not permitted under this Agreement, including, without limitation, for or any other purpose that may result [Results]…"

In , both Contracting Party B and Taxpayer provide limited warranties under the subscriber agreements. In , Contracting Party B represents and warrants that the services will be provided in a professional and workmanlike manner consistent with industry standards. In , Taxpayer warrants the software's that it delivers to Contracting Party B. serves to limit the parties' warranties.

Under , Taxpayer and Contracting Party B have the power to terminate the subscriber agreement, both must consent to any assignments or

transfers of the agreement by the End User, and they must both consent to any amendments of the agreement.

LAW:

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.

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 CGS 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) defines DPGR to mean the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (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)(5) defines QPP as including computer software.

Section 1.199-3(i)(1)(i) of the Income Tax Regulations defines the term "derived from the lease, rental, license, sale, exchange, or other disposition" as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of QPP. 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, except as provided in § 1.199-3(i)(4)(i)(B), gross receipts derived from the performance of services do not qualify as DPGR.

Section 1.199-3(i)(6)(i) provides that DPGR includes the gross receipts of the taxpayer that are derived from the lease, rental, license, sale, exchange, or other disposition of computer software MPGE by the taxpayer in whole or in significant part within the United States. Such gross receipts qualify as DPGR even if the customer provides the computer software to its employees or others over the Internet.

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.

Section 1.199-3(i)(6)(v), Example 1, provides that L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under § 1.199-3(i)(6)(ii), gross receipts derived from online banking services 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. Therefore, L's gross receipts derived from the online banking services are non-DPGR.

Section 1.199-3(i)(6)(v), Example 2, provides that M is an Internet auction company that produces computer software within the United States that enables its customers to participate in Internet auctions for a fee. Under § 1.199-3(i)(6)(ii), gross receipts derived from online auction services 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. M's activities constitute the provision of online services. Therefore, M's gross receipts derived from the Internet auction services are non-DPGR.

Section 1.199-3(i)(6)(v), Example 3, provides that N provides telephone services, voicemail services, and e-mail services. N produces computer software within the United States that runs all of these services. Under § 1.199-3(i)(6)(ii), gross receipts derived from telephone and related telecommunication services 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. Therefore, N's gross receipts derived from the telephone and other telecommunication services are non-DPGR.

ANALYSIS:

The issue in this technical advice is whether Taxpayer derived DPGR from the license of Computer Software to Contracting Parties, or non-DPGR from providing services to End Users. Section 1.199-3(i)(1)(i) defines the term "derived from the lease, rental, license, sale, exchange, or other disposition" as, and limited to, the gross receipts directly derived from the disposition of QPP. In this case, Taxpayer produced Computer Software that qualifies as QPP (and satisfies the other requirements of § 199). Taxpayer also made a qualifying disposition by licensing Computer Software to each of the Contracting Parties. However, there is a question of whether Taxpayer derived gross receipts from the license of Computer Software to the Contracting Parties. LB&I maintains that Taxpayer derives its gross receipts directly from End Users as a result of services provided by Taxpayer, and received no compensation from the Contracting Parties for the license of Computer Software. Taxpayer's position is that it derives gross receipts directly from the license of Computer Software to the Contracting Parties.

In reviewing the agreements provided, our Office considered both the substance of the Taxpayer's relationships with the Contracting Parties and the End Users, and the form of the agreements. Our Office concludes that Taxpayer derived DPGR from the license

of Computer Software to the Contracting Parties in the years involved. Our conclusion with respect to all Contracting Parties relies on LB&I's agreement with Taxpayer that Taxpayer's relationship with other Contracting Parties is generally similar to the relationship Taxpayer has with Contracting Party A and Contracting Party B.

LB&I and Taxpayer both agree a joint venture or partnership was not formed between Taxpayer and any of the Contracting Parties. Our Office reviewed the agreements to determine if we agreed because the provided agreements described the services as "Joint Services," and contained references to the relationship between Taxpayer and Contracting Party B as Characterizing the relationships as a joint venture or partnership could change the analysis and results for purposes of § 199. Our Office concludes that Taxpayer's relationships with Contracting Party A and Contracting Party B were not joint ventures or partnerships. Based on LB&I's agreement with Taxpayer that the relationships between Taxpayer and the Contracting Parties are generally similar, our Office concludes Taxpayer did not form a joint venture or partnership with any of the Contracting Parties in the years involved.

Rather than viewing these agreements as joint ventures or partnerships, our Office views them as transactions generally occurring in two steps, with each party performing discrete activities. First, Taxpayer produces Computer Software for a Contracting Party followed by a license of the Computer Software to the Contracting Party. Second, the Contracting Parties use the Computer Software when providing services to End Users. Our Office finds the agreed facts support this characterization.

The agreed facts support that the first step is Taxpayer producing the Computer Software for a Contracting Party followed by a license to the Contracting Party. It is agreed Taxpayer produces unique Computer Software for a Contracting Party. The Contracting Party provides sample data in order for Taxpayer to develop appropriate Computer Software. It is also agreed Taxpayer licenses the Computer Software to the Contracting Parties.

The agreed facts support that the second step is the Contracting Parties using the Computer Software to provide a service to End Users. It is agreed the Contracting Parties license the Computer Software from Taxpayer. The facts show the Contracting Parties then use the Computer Software to provide services (generation and distribution of the Results) to End Users. A Contracting Party uses its own data in conjunction with the licensed Computer Software to perform the service for End Users. This is important as it shows the services to End Users require both Taxpayer's Computer Software and a Contracting Party's data. Taxpayer only has access to the Computer Software, whereas the Contracting Parties have access to both as a result of the license of the Computer Software. The services that a Contracting Party performs also may be included within a Contracting Party's larger service contract with an End User.

Our view of the facts supports the conclusion Taxpayer derived gross receipts from the license of Computer Software to the Contracting Parties, and not from providing

services to End Users. In our view, the substance of Taxpayer's relationship with the Contracting Parties is that Taxpayer produces the Computer Software used by the Contracting Parties to provide services to End Users. However, even though LB&I and Taxpayer agree on the facts described above, the parties reach a different conclusion as to which party is paying Taxpayer.

Our Office reviewed the language in the agreements and found some support for LB&I's position, but overall we find the language primarily supports concluding that Taxpayer received royalty payments for licensing Computer Software to the Contracting Parties. The clearest example of this is in the Master Agreement 2 between Taxpayer and Contracting Party B, which is effective for the majority of the years involved. , provides that any and all payments (however previously described) are now covered by the royalty payment language. The agreement also includes . Beyond this example, our Office does not agree that any of the other payment terms or the structure of the payments prevent characterizing the payments as royalties from the license of Computer Software. Thus, our Office finds Taxpayer is directly paid by the Contracting Parties for the license of Computer Software.

Our Office disagrees that Taxpayer's license to End Users in the representative subscriber agreement between Contracting Party B, Taxpayer, and the End User means Taxpayer is providing services to the End Users.[1] Instead, this license indicates the limits of the license provided by Taxpayer to the Contracting Parties. Essentially, the master agreements allow the Contracting Parties to use the Computer Software to provide the services to End Users only so as long as Taxpayer is able to restrict an End Users rights with respect to the Results. For example, of Master Agreement 3 with Contracting Party B contains language allowing Taxpayer to approve the "Subscriber Contract" before the services are provided. Taxpayer's reason for this license is protecting its intellectual property

. This is consistent with our view that Taxpayer placed limits on the Contracting Parties rights with respect to Taxpayer's intellectual property, which limits are included in the subscriber agreement. It also helps explain why Taxpayer is a party to the subscriber agreement. Therefore, we conclude the license to End Users is not an indication of Taxpayer providing services to End Users.

LB&I compared Taxpayer's situation with those of the taxpayers described in Examples 1, 2, and 3 in § 1.199-3(i)(6)(v). These examples illustrate the rule in § 1.199-3(i)(6)(ii) and describe situations where a taxpayer producing computer software does not lease, rent, license, sell, exchange, or otherwise dispose of such computer software, but instead uses the computer software to provide online services to customers. The gross receipts are determined to be non-DPGR because the taxpayers are deriving gross

1. The facts indicate the license to End Users is only in "some" of the subscriber agreements, so the argument that the license represents Taxpayer services to End Users would not apply to all transactions.

receipts from providing services, not from the license of computer software. Taxpayer's facts are different from these examples. Here, Taxpayer licenses (disposes of) the Computer Software to the Contracting Parties, and the Contracting Parties (not Taxpayer) use the Computer Software to provide services to End Users. Thus, the examples do not support the conclusion that Taxpayer's gross receipts are derived from services.

Our Office acknowledges the language discussing the Contracting Parties serving as the collection agent for Taxpayer with respect to fees from End Users. While we think this could serve to support a different characterization, our Office concludes it does not necessarily, and even so, would not change our view in this context.

CAVEAT(S):

Our Office does not address whether or not Taxpayer meets any of the embedded service exceptions in § 1.199-3(i)(4)(i)(B), particularly the computer software maintenance agreement exception (§ 1.199-3(i)(4)(i)(B)(5)) and the de minimis exception (§ 1.199-3(i)(4)(i)(B)(6)). LB&I states that Taxpayer did not include in DPGR its revenue from ancillary services, and that the Service has not proposed that an additional portion of Taxpayer's revenue under the master agreements should be allocated to embedded services. Further, to the extent our technical advice makes these questions relevant, LB&I did not request legal advice as to these issues.

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