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Subject: [redacted]

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[redacted] In addition to the specific comments marked in the draft, I think the following analysis of the regulations and how they evolved should be helpful in responding to your taxpayer's interpretation of the relevant regulations under -3(i)(6).

Let's discuss when you have a moment after your trial.

First, Notice 2005-14 and the first proposed regulations, the Treasury took a position that the disposition requirement for computer software is met only when computer software is provided to customers on a tangible medium (disk or CD) or by download over the Internet. See T.D. 9262 at 3 and 4. All software accessed over the Internet only was treated as a service (non-qualifying for 199). This different treatment of computer software based on the method of its delivery was criticized in the public comments and in a letter to Treasury some members

of Congress asked the Treasury to reconsider the different treatment of computer software that is solely accessed on the Internet v. downloaded or sold in a box. "[O]n July 21, 2005, the Chairman and Ranking Member of the Senate Finance Committee and the Chairman of the House Ways and means Committee sent a letter to the Treasury Department suggesting that the Treasury Department consider further the treatment of online access to computer software and, in particular, whether such treatment should be similar to the treatment of computer software distributed by other means, such as by physical delivery or delivery via Internet download. The letter notes that gross receipts from the provision of services are not treated as DPGR, regardless of the fact that computer software may be used to facilitate such service transactions." See T.D. 9262.

Next, the Treasury issued temporary regulations (T.D. 9262) providing for the first time "two exceptions under which gross receipts derived by a taxpayer from providing computer software to customers for the customers' direct use while connected to the Internet will be treated as being derived from the [disposition] of such computer software." The published preamble explains that the exceptions were made "**as a matter of administrative convenience**." At the same time, the temporary regulations did not modify the rule that the gross receipts from the provision of online services do not qualify. This rule was retained in Treas. Reg. § 1.199-3(i)(6)(ii) and it provides that gross receipts derived from services – Gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Intent 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 the disposition of computer software.

The final regulations adopted the temporary regulations and added nine examples illustrating the rules. T.D. 9317 The preamble to the final regulations provides:
[t]o give meaning to the statutory language requiring [disposition], the online software exceptions have been **narrowly tailored** and are intended to apply only to gross receipts derived from providing customers access to computer software for the customers' direct use while connected to the Internet and only when the taxpayer(or another person) also derives gross receipts from the [disposition] of the computer software (or substantially identical software) affixed to a tangible medium or by download." The "narrowly tailored" exceptions are now known as the "self-comparable exception" (in A) and the "third party comparable exception" (in B) of Treas. Reg. § 1.199-3(i)(6)(iii) (collectively, Exceptions).

Although this taxpayer appears to take a position that the Exceptions override exclusion of online services income, there is no objective evidence that this is the case. As a general matter, all service gross receipts are treated as non-DPGR. The Exceptions apply "notwithstanding" the online services exclusion because all online access to software was treated as a service in the Notice and proposed regulations. The Exceptions apply only **if** a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer within US for the customer's direct use while connected to the Internet. See the

introductory language in Treas. Reg. § 1.199-3(i)(6)(iii). In taxpayer's presentation, this threshold requirement is entirely ignored.

Examples that follow -3(i)(6) rules demonstrate how all of the rules in that section apply, including when the Exceptions are relevant. Example 1 through 3 hold that a taxpayer that produces computer software to enable online banking, participation in online auction, or provision of telecommunication services generates fees that are entirely "attributable to services" and such gross receipts do not constitute as DPGR. Treas. Reg. § 1.199-3(i)(6)(v) Examples 1, 2, 3. The analysis contained in these examples demonstrates that the Exceptions are irrelevant under those facts. The facts in this case appears to be closely aligned with the online banking example. In substance, unless there are facts that are not presented in the write up,

It is not the case that the taxpayer simply licenses software under SaaS model, the taxpayer appear to in fact facilitate transaction processing using data etc.

Other examples illustrate when the exceptions are relevant. The examples include: (1) fees from providing tax preparation computer software for the customers' direct use over the Internet when the taxpayer does not provide any other goods or service in connection with the online software, (2) fees from providing access to payroll management computer software for the customers' direct use over the Internet when the taxpayer does not provide any other goods or service in connection with the online software, and (3) fees from providing customers access to the computer software games for the customers direct use while connected to the Internet when the taxpayer does not provide any other goods or services in connection with the online software games. Treas. Reg. § 1.199-3(i)(6)(v) Examples 4, 5, 6, 7, 8.

[redacted] I am not convinced that actually falls within the SaaS model. SaaS truly contemplates provision of computing capabilities that a customer can unilaterally execute. Here, the taxpayer's customers are not getting access to computer application that they self-use. [redacted]

[redacted]

Thank you!