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subject: Section 199

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Taxable Years at Issue =

Platform A =

Platform B =

Platform C =

Fee X =

Fee Y =

Group L Fees =

Group S Fees =

Application A =

Application B =

Application C =

Application D =

Application E =

Application Grouping A =

ISSUES

(1) Whether any of Taxpayer's gross receipts derived from online and online are gross receipts derived from providing customers access to computer software that was manufactured, produced, grown, or extracted (MPGE) by Taxpayer in whole or in significant part within the United States for the customers' direct use while connected to the Internet or private communications network (online software) under § 1.199-3(i)(6)(iii) of the Income Tax Regulations?

(2) Whether Taxpayer properly applied the "item" rule in § 1.199-3(d)(1)?

CONCLUSIONS

(1) None of Taxpayer's gross receipts derived from online and online are gross receipts derived from providing customers access to computer software that was MPGE by Taxpayer in whole or in significant part within the United States for the customers' direct use while connected to the online software under § 1.199-3(i)(6)(iii).

(2) Taxpayer improperly applied the "item" rule in § 1.199-3(d)(1).

FACTS

Taxpayer operates online for the through an array of websites and also offers online . Taxpayer acts as an to facilitate the

by providing a

.

Generally, Taxpayer's online provide the infrastructure to enable global online on Platforms A and B. Platform C comprises Taxpayer's online . Taxpayer's infrastructure enabling the operation of Platforms A, B, and C includes websites, user interfacing software applications, non-user interface software applications, servers where computer software is hosted (data centers), other hardware, and the computer network. For purposes of this advice, the infrastructure, in the aggregate, is referred to as the respective Platform.

The terms and conditions for customers' use of each Platform are set forth in the User Agreement contracts. Customers must accept the terms and conditions before they may use any Platform. Taxpayer controls all of the terms and conditions and has the right to change them at any time.

Taxpayer charges a variety of fees for the features and functions offered to customers on each Platform. Fee Schedules in the User Agreements identify the fees for each feature and function. Taxpayer does not separately or directly charge for computer software on Platforms A, B, and C or the enabling infrastructure. Depending on a Platform, some features are offered for free. For example, for Platform A, these features and services may be grouped into four main categories: (1) ; (2) ; (3) ; and (4) .

Some features are required for customers' use of a Platform and are subject to mandatory fees. Other features are offered on an optional basis and are subject to various fees that customers may choose to pay.

Before on Platform A, must register. pay no fee to register. pay no fee to access Platform A. Before must register. pay no fee to . Taxpayer does not charge a fee for any made on Platform A.

are offered for free. Taxpayer charges Fee X for on Platform A. The amount of Fee X depends on . Taxpayer also charges Fee Y . Generally, Fee Y is .

Taxpayer also charges for optional features. For a few optional features, Taxpayer charges . For example, Taxpayer charges for features and tools that enable customers to better manage their activities on Platform A. Taxpayer claims that those features and tools are enabled by Applications A and C, and are computer software within the meaning of § 1.199-3(j)(3). Typically, the total cost of on Platform A includes Fee X and Fee Y, plus any fees for optional features chosen by the .

Transactions on Platform B are similar to ones on Platform A. For purposes of simplifying this advice with respect to online , we only specifically describe fees charged on Platform A.

For online , Taxpayer generally charges for completed . Generally, the fee is a . The applicable fee varies depending on a variety of factors. For example, Taxpayer may charge . The applicable fee may also differ based on .

Specific Description of Platform A Fees and Applications

Fee X is charged when a , that is, when some using Platform A. The amount of the fee depends on how the . It also depends on the . The total amount of Fee X also depends on the duration of . Fee X is generally charged every days. Fee X is non-refundable and is charged even if the . The however, may receive a credit if the .

Fee Y is charged when the . The amount charged depends on the , and is usually computed based on . Fee Y is non-refundable. The , however, may receive a credit if .

Generally, Taxpayer charges many different optional fees that, for example, can help increase or a chances for a . This advice analyzes two groups of such fees, Group L Fees and Group S Fees.

Group L Fees are charged for, among other things,
and
. Various fees are charged for

. Further, various fees are charged for to

.

Group S Fees are a group of fees that includes fees for features enabled by Application A, B, and C. When describing Group S Fees, this advice assumes Applications A, B, and C are discrete computer software applications that Taxpayer separately offers to customers and in that way Applications A, B, and C are not integrated components of computer software on Platform A.

Application A offers a bundle of features and functions that allows to help

, as well as (depending on the version) to

. can
. Application A is accessed by Taxpayer's customers online only and is optional for on its Platform A. Application A enables to manage, interface, and conduct business with Taxpayer. Taxpayer charges to subscribe to Application A.

Application B is a software tool to help

Taxpayer offers this software tool by download only and at no charge.

Application C includes software that is downloaded to subscribers' computers. The software enables to

. Taxpayer charges a monthly fee to subscribe to Application C.

Third-Party Applications Identified by Taxpayer

Application D is a third party building and hosting software. Application E is a software platform to create and host websites. Third parties offer Applications D and E for disposition via tangible medium or download on a regular and ongoing basis in their businesses. Application D and E offer many functions, some of which Taxpayer has identified as substantially identical to Application A. Taxpayer also identified these applications as substantially identical software for many other identified functions that purportedly correspond to separate components of computer software on Platform A. Thus, Taxpayer treated Application A and many other features enabled by separately identified computer software components as substantially identical to Applications D and E.

Overview of Taxpayer's Domestic Production Gross Receipts (DPGR) Determination

To establish that qualified computer software on each of its Platforms was produced in whole or in significant part in the United States, Taxpayer estimated the cumulative number of days that it would take to re-create computer software that enables each identified function (which Taxpayer treated as qualified for § 199 purposes). Based on estimated development days, Taxpayer estimated that roughly percent of the qualified computer software on each Platform was produced outside the United States.[1] Accordingly, Taxpayer concluded that its qualified software was produced in whole or in significant part in the United States for purposes of § 1.199-3(g)(3)(i).

Taxpayer acknowledged that some computer software on each Platform was purchased from third parties. Also, some computer software on each Platform was developed pursuant to contracts, for which Taxpayer claims it had the benefits and burdens of ownership for § 199 purposes. To limit DPGR to computer software that was produced by Taxpayer, Taxpayer excluded a small portion of revenues that it allocated to the third- party purchased computer software. The allocation is similarly based on Taxpayer's estimate of development days needed to re-create the third-party software.

[1] We note that determining whether Taxpayer produced the software in whole or in significant part within the United States is outside the scope of this CCA. Taxpayer must separately show it meets such requirements. Further, including these facts is not intended to imply that we agree that Taxpayer's method of substantiation is reasonable.

Generally, Taxpayer treated its revenues from online (including Fee X, Fee Y, and optional fees (Group L and Group S) and similar fees from Platform B), and online for services and certain other fees as DPGR eligible for the § 199 deduction. Taxpayer treated fees from downloaded computer software as DPGR, but excluded revenues such as advertising and interest from other business operations. Taxpayer assumed that the fees it derived from online and online are gross receipts derived from providing customers access to computer software for the customers' direct use while connected to the Internet for purposes of § 1.199-3(i)(6)(iii)(B) (referred to as the "Third-Party Comparable Exception"). Taxpayer relied on the Third-Party Comparable Exception to establish that these fees are derived from the disposition of computer software.

Taxpayer claims that the item it offers in the normal course of its business to its customers is the access to, and the direct use of, the computer software provided through Platforms A, B, and C. Because no other person derives gross receipts from offering to customers' substantially identical computer software, Taxpayer concluded that it does not satisfy the Third-Party Comparable Exception on the aggregate level. However, Taxpayer identified discrete features and functions enabled by user-interfacing computer software on Platforms A, B, and C that correspond to discrete functions offered by third-party computer software. On a function-by-function basis, Taxpayer identified about two dozen different computer software programs offered for disposition to customers by third parties, which Taxpayer claims as satisfying all of the requirements of the Third-Party Comparable Exception.

Taxpayer traced many functions to the same third-party computer software programs. After comparing functions of its identified user-interfacing computer software components to the identified third party software components' functions, Taxpayer concluded that all of its computer software on Platforms A, B, and C have substantially identical software. Taxpayer concluded that it satisfied the Third-Party Comparable Exception, and treated gross receipts from Platforms A, B, and C as derived from the disposition of computer software.

Taxpayer does not separately offer to its customers for their direct use computer software that enables functions for which Taxpayer identified a third-party comparable. Except for Application A and C, Taxpayer does not separately charge fees for the discrete software components it identified. Instead, Taxpayer charges fees for different features customers may choose, and equates these features to identified groupings of

computer software applications. Taxpayer separately for Applications A and C, but Taxpayer did not determine DPGR based on these separately stated fees.[2]

Taxpayer computed DPGR by allocating the total gross receipts from each Platform that it treated as qualified to each identified grouping of computer software components based on a fraction of estimated development days for each component over the estimated development days for all user-interfacing computer software on the Platform. Thus, Taxpayer allocated gross receipts from each Platform that it treated as qualified for § 199 purposes proportionately to each user-interfacing computer software application for which Taxpayer identified a substantially identical third-party comparable. In the process, Taxpayer allocated gross receipts to many computer software functions that it offers for free. Taxpayer allocated no gross receipts to any non-user interfacing computer software (such as security or encryption software) or enabling infrastructure (such as servers, hardware, and network).

LAW

Section 199(c)(4)(A)(i)(I) defines DPGR as gross receipts of a taxpayer which are derived from the lease, rental, license, sale, exchange, or other disposition (collectively "disposition") of qualifying production property (QPP), which was MPGE by the taxpayer in whole or in significant part within the United States. Section 199(c)(5) defines the term QPP as including computer software.

Section 1.199-3(i)(1)(i) defines the term "derived from the disposition" of QPP as limited to the gross receipts directly derived from the disposition. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a disposition, or whether it is a service, or whether it is some combination thereof.

Section 1.199-3(i)(5)(ii)(B) provides that a taxpayer's gross receipts that are derived from a disposition of computer software that is MPGE in whole or in significant part within the United States include advertising income and product-placement income with respect to that computer software, but only if the gross receipts if any, derived from the disposition of computer software are (or would be) DPGR. For this purpose, advertising

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[2] Applications A and C were included in the Application Grouping A, which also included eight other software components.

income and product-placement income mean compensation for placing or integrating advertising or integrating advertising or a product into the computer software. Section 1.199-3(i)(5)(ii)(B) does not extend to the exceptions provided in § 1.199-3(i)(6)(iii). See also § 1.199-3(i)(6)(iv)(F).

Section 1.199-3(i)(6)(i) provides that DPGR includes gross receipts of the taxpayer that are derived from the disposition of computer software MPGE by the taxpayer in whole or in significant part within the United States.

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 disposition of computer software.

Section 1.199-3(i)(6)(iii) provides that, notwithstanding § 1.199-3(i)(6)(ii), if a taxpayer derives gross receipts from providing customers access to computer software produced in whole or significant part by the taxpayer within the United States for the customers' direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as derived from the disposition of computer software only if § 1.199-3(i)(6)(iii)(A) or (B) is met.

Section 1.199-3(i)(6)(iii)(A) (referred to as the "Self-Comparable Exception"), requires that a taxpayer also derive, on a regular and ongoing basis in the taxpayer's business, gross receipts from the disposition to customers that are unrelated persons of computer software that (1) has only minor or immaterial differences from the online software; (2) was MPGE by the taxpayer in whole or in significant part within the United States; and (3) has been provided to such customers affixed to a tangible medium or by allowing them to download the computer software from the Internet.

Section 1.199-3(i)(6)(iii)(B) (defined above as the "Third-Party Comparable Exception") requires that another person derives, on a regular and ongoing basis in its business, gross receipts from the disposition of substantially identical software (as compared to taxpayer's online software) to its customers pursuant to an activity described in § 1.199-3(i)(6)(iii)(A)(3) (i.e., by a tangible medium or download from the Internet). Section 1.199-3(i)(6)(iv)(A) defines substantially identical software as computer software that (1) from a customer's perspective, has the same functional result as the online software; and (2) has a significant overlap of features or purpose with the online software.

Section 1.199-3(i)(6)(v), Example 1, provides: 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 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: 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: 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.

Section 1.199-3(i)(6)(v), Example 4, provides: O produces tax preparation computer software within the United States. O derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are unrelated persons of O's computer software that has been affixed to a compact disc as well as from the sale to customers of O's computer software that customers have downloaded from the Internet. O also derives gross receipts from providing customers access to the computer software for the customers' direct use while connected to the Internet. The computer software sold on compact disc or by download has only minor or immaterial differences from the online software, and O does not provide any other goods or services in connection with the online software. Under § 1.199-3(i)(6)(iii)(A), O's gross receipts derived from providing access to the online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

Section 1.199-3(i)(6)(v), Example 5, provides: The facts are the same as in Example 4, except that O does not sell the tax preparation software to customers affixed to a

compact disc or by download. In addition, one of O's competitors, P, derives, on a regular and ongoing basis in its business, gross receipts from the sale to customers of P's substantially identical computer software that has been affixed to a compact disc as well as from the sale to customers of P's substantially identical tax preparation computer software that customers have downloaded from the Internet. Under § 1.199-3(i)(6)(iii)(B), O's gross receipts derived from providing access to its tax preparation online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).

As with other deductions, the § 199 deduction is strictly a matter of legislative grace, and the taxpayer has the burden to prove that it meets all the requirements, as well as the deductible amount. See ADVO, Inc. v. Commissioner, 141 T.C. 298, 322-323 (2013) (*citing* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992)); Gibson & Associates, Inc. v. Commissioner, 136 T.C. 195, 221 (2011).

ISSUE 1 ANALYSIS

Taxpayer asserts that the use of the term "notwithstanding" introducing the Self-comparable and Third-Party Comparable Exceptions in § 1.199-3(i)(6)(iii) converts all gross receipts from providing online services as described in § 1.199-3(i)(6)(ii) to gross receipts from a disposition of computer software if all of the elements described in § 1.199-3(i)(6)(iii)(A) or (B) are met. Our office does not agree with Taxpayer's application of the rules described in § 1.199-3(i)(6)(ii) and (iii). Taxpayer's method overlooks relevant language in § 1.199-3(i)(6)(iii) and is inconsistent with the examples in § 1.199-3(i)(6)(v) that illustrate the rules of § 1.199-3(i)(6).

Section 1.199-3(i)(6)(iii) is a limited exception to § 1.199-3(i)(6)(ii)

The phrase "notwithstanding [§ 1.199-3(i)(6)(ii]," indicates an exception to § 1.199-3(i)(6)(ii). The phrase introduces the exception, but the gross receipts excepted from § 1.199-3(i)(6)(ii) are limited to those described by the clause that follows that phrase:

> if a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer within the United States for the customers' direct use while connected to the Internet or any other public or private communications network…

Section 1.199-3(i)(1) requires determining whether a transaction is, in substance, a disposition, service, or some combination thereof in accordance with Applicable Federal

Income tax principles. The clause in § 1.199-3(i)(6)(iii) limits which gross receipts can meet the exceptions to be treated as from a disposition and requires Taxpayer to establish the necessary link between the customer's payment to Taxpayer (i.e. Taxpayer's gross receipts), and the Taxpayer's online software that customers access and directly use. The regulations illustrate that there are cases in which a taxpayer allows customers access to a taxpayer's online software, but does not derive gross receipts from that access because the online software is only enabling the provision of services. In those cases, the gross receipts are not described by the language in § 1.199-3(i)(6)(iii).

If gross receipts are described by the clause, § 1.199-3(i)(6)(iii) provides, "*then* such gross receipts will be treated as derived from the [disposition] of computer software," but "only if" the additional requirements described in § 1.199-3(i)(6)(iii)(A) or (B) are also met. Any other gross receipts continue to maintain their characterization as gross receipts from online services under § 1.199-3(i)(6)(ii).

Taxpayer's method of applying the Third-Party Comparable Exception in § 1.199-3(i)(6)(iii)(B) did not analyze whether its gross receipts were described by the limitation in § 1.199-3(i)(6)(iii). This limiting language must be read as part of the Third-Party Comparable Exception and the Self-Comparable Exception (which is not at issue in this case). Therefore, we analyze whether any of Taxpayer's gross receipts are derived from providing customers access to computer software for the customers' direct use while connected to the Internet or any other public or private communications network. As necessary, we will also comment on the other requirements of the Third-Party Comparable Exception.

Taxpayer's gross receipts were not derived from providing customers access to computer software for the customers' direct use based on Examples 1 and 2 in § 1.199-3(i)(6)(v)

Providing an online is the provision of an online service under § 1.199-3(i)(6)(ii). Taxpayer acts as an with respect to the and Platforms A and B enable Taxpayer to provide different types of . For purposes of this advice, we analyzed fees charged with respect to the online accessed via Platform A. Fees charged on the online accessed via Platform B are similar, and are similarly treated for purposes of § 199.

Fees X, Y, and Group L Fees from Platform A: Taxpayer charged its customers, , each of these fees separately. Therefore, we evaluated them separately for purposes of § 199 under the rules of § 1.199-3(d)(1). We find that Taxpayer charged

none of these fees for customers' direct use of computer software as described in § 1.199-3(i)(6)(iii). Rather, Taxpayer provided access to the computer software needed for its customers to participate in the online , and not for the direct use of computer software.

Fee X is charged to to on Platform A, which means it becomes accessible to looking to on Platform A. The amount of the fee depends on the . Fee X is non-refundable and charged even if .

The , however, may receive a credit if . Fee X is a charge that could be avoided by a if it chose to available through alternative means, . Instead, pay Fee X to with Platform A. The fee, in substance, relates to

with Platform A, and use the computer software to provide the necessary information ( ).

Fee Y is charged when the on Platform A. The amount charged depends on , and is usually . Fee Y is non-refundable. The however, may receive a credit . agree to Fee Y before , but the fee is only finalized . It is consistent to treat this similarly to Fee X because it must be agreed to when Like Fee X, this fee is necessary to participate in the online Fee Y is not connected to any particular computer software directly used by

Group L gross receipts are fees charged for . These fees generally relate to how a will be featured, and are designed to pay Fee X and Fee Y as part of making on Platform A, and pay the Group L fees to further on Platform A. These fees represent additional service fees relating to participating in the online on Platform A.

Alternatively, if not considered as additional fees to participate in the online the rule in § 1.199-3(i)(5)(ii)(B), related to advertising income, should be considered. While Fee X and Fee Y also share some of the characteristics of income described in § 1.199-3(i)(5)(ii)(B), these Group L fees are even more analogous to classic advertising gross receipts that newspapers, or other print advertisers of products generate. Section 1.199-3(i)(5)(ii)(B) provides gross receipts from integrating advertising into online software dispositions are non-DPGR. This section would apply if you view the as paying the Group L fees for Taxpayer to integrate the the computer software the on Platform A use. This appears relevant because the Group L fees are paid for the purpose of on Platform A will see the —i.e. it is advertising within the entire online on Platform A. If the gross receipts are treated as advertising income, then § 1.199-3(i)(5)(ii)(B) applies, and the gross receipts are non-DPGR.

Fee X, Fee Y, and the fees in Group L present an analogous situation to M in Example 2 of § 1.199-3(i)(6)(v) (referred to as "Example 2"). As stated earlier, Taxpayer derived similar fees from transactions on Platform B. This analysis considers how the rules apply to Platforms and to the components of Platforms. Example 2 provides:

> 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 paragraph (i)(6)(ii) of this section, gross receipts derived from online auction services are attributable to a service and do not constitute gross receipts derived from [the disposition] of computer software. M's activities constitute the provision of online services. Therefore, M's gross receipts from the Internet auction services are non-DPGR.

Taxpayer's computer software allows customers to which is similar to the Internet auctions described in Example 2. Customers pay fees to do this, and at different levels depending on the fees they choose to pay ( ). These fees are analogous to the fees that M would charge to participate in Internet auctions. Similar to what M's customers would need to provide to participate in Internet auctions in Example 2, Taxpayer's customers need to provide the information on

, and must also communicate to Taxpayer

. Taxpayer's computer software enables these things. Thus, as

Example 2 illustrates, when computer software enables a customer to participate in a taxpayer's service, those gross receipts are considered derived from an online service.

Following the example, Taxpayer's gross receipts from customers' use of Platform A are not gross receipts from providing customers' access to online computer software for the customers' direct use as described in § 1.199-3(i)(6)(iii). Instead, the customers are paying to participate in Taxpayer's online , meaning that the fees are for an online service. Because the gross receipts from Fee X, Fee Y, and the fees in Group L are not described in § 1.199-3(i)(6)(iii), the gross receipts cannot be treated as from the disposition of computer software.

Moreover, this example shows that when it relates to provision of online , a taxpayer's transactions with its customers may be characterized only as a service. This is important, as once characterized as a service, there are also no gross receipts attributable to any computer software that enables participation in the service. Taken a step further, there should also be no gross receipts attributable to any components of the computer software that enables participation in the service. Thus, because gross receipts from online are derived from a service, and Platform A only enabled participation in such service, there are no gross receipts attributable to any of the components of the Platform.

Online Fees: Taxpayer generally charges for completed Generally, the fee is a .

Taxpayer's activities are analogous to activities of L in Example 1 of § 1.199-3(i)(6)(v), which produces computer software that enables its customers to receive online banking services for a fee. The example concludes that gross receipts derived from online banking services are attributable to a service and do not constitute DPGR. Again, this illustrates that Taxpayer does not meet the requirements of § 1.199-3(i)(6)(iii) because there are no gross receipts from providing customers' access to computer software for a customer's direct use while connected to the Internet. Customers in Example 1 are paying, in substance, for an online service enabled by computer software. Platform C, in this case, is the computer software that enables customers to receive the service. We conclude the same characterization should result for the fees Taxpayer charges its customers as the fees described in Example 1. Therefore, Taxpayer's fees from online are non-DPGR.

Taxpayer's position is a misreading of the examples in § 1.199-3(i)(6)(v)

Taxpayer's position essentially disregards Examples 1, 2, and 3. Taxpayer suggests that these examples do not apply because they do not expressly address the exceptions in § 1.199-3(i)(6)(iii)(A) and (B). However, the flush language preceding the nine examples which states, "the following examples illustrate the application of this paragraph (i)(6)," makes it clear that the nine examples illustrate the application of all rules in § 1.199-3(i)(6) to the facts in each example. Because the rules under § 1.199-3(i)(6) include the rule in § 1.199-3(i)(6)(ii) and the exceptions in § 1.199-3(i)(6)(iii), these examples cannot be construed as applying only one of these rules and excluding another. Substantively, Examples 1, 2, and 3 illustrate circumstances in which a customer is paying for services and is not paying to use computer software.

Examples 4 and 5 in § 1.199-3(i)(6)(v) also support our interpretation of the regulations. Examples 4 and 5 discuss fees from providing tax preparation computer software for customers' direct use over the Internet, and meeting the Self- and Third-Party Comparable Exceptions. The gross receipts derived in these examples are distinguishable from Taxpayer's gross receipts because the online tax preparation computer software is not enabling the taxpayer to provide a service to its customers. Customers are paying for the computer software to complete their tax return. If, in the examples, customers were only using the online software to enter Form W-2 information, which a tax-return preparer was using to complete the customers' tax returns, then the computer software would only be enabling the provision of a service by the tax-return preparer. None of the other examples in § 1.199-3(i)(6)(v) support Taxpayer's reading of the rules.

In summary, after considering the substance of the transactions between Taxpayer and its customers (including the language in relevant customer user agreements and schedule of fees), and the rules described in § 1.199-3(i)(6), we conclude that Taxpayer's gross receipts from online (including Fee X, Fee Y, Group L Fees and fees from Platform B), and fees in connection with online are for services enabled in part by computer software, rather than from providing customers access to computer software for their direct use. Taxpayer cannot treat any of these fees as from the disposition of computer software under § 1.199-3(i)(6)(iii). They remain gross receipts derived from online services under § 1.199-3(i)(6)(ii).

Group S Fees from Platform A

We analyze the Group S fees separately because, unlike Fee X, Fee Y, and the Group L fees, Taxpayer attributes certain Group S Fees specifically to Applications A, B, and C. Taxpayer separately charges for only a few features that are enabled by Application A and C (and Taxpayer does not charge for Application B). However, Taxpayer did not determine DPGR based on these separately stated fees. Instead,

Taxpayer allocated all gross receipts proportionately to each user-interfacing computer software application based on estimated development days. In the process, Taxpayer allocated gross receipts to Application B, which it offers for free; and, potentially more gross receipts to Applications A and C than the features performed by these applications. This allocation is inconsistent with the rule under § 1.199-3(d)(1) that gross receipts qualify as DPGR on an item-by-item basis (and not, for example on a division-by-division basis, product-line-by-product line (such as Application Grouping A), or transaction-by-transaction basis). We find that Taxpayer must first make an allocation of gross receipts to these applications in accordance with § 1.199-3(d)(1) before applying other rules of § 199.

Beyond that, as we note above, Applications B and C are downloaded, and outside the scope of this CCA.

For Application A, LBI has indicated that even if the Taxpayer can substantiate that it derived gross receipts from customers' direct use of Application A online, Taxpayer did not provide an example of computer software that is substantially identical for purposes of the Third-Party Comparable Exception. Our office is not in a position to evaluate whether Application D or E is substantially identical within the meaning of § 1.199-3(i)(6)(iv) due to the factual nature of the inquiry, and we rely on LBI's determination.

ISSUE 2 ANALYSIS

In addition to the problems identifying gross receipts relating to Group S fees, Taxpayer misapplied the "item" rules in § 1.199-3(d)(1) by applying the rules of § 1.199-3(d)(1)(ii) to Platforms A, B, and C with respect to Fee X, Fee Y, Group L fees (and fees from transactions on Platform B), and the online fees. With respect to these fees, Platforms A, B, and C were used to enable customers' participation in online and online , and we determined that all of such gross receipts were from online services. Our analysis also applies for purposes of any computer software components that are integrated into Platforms A, B, and C and are not separately offered to customers for customers' direct use. Customers were not paying to directly use such computer software. The components, similar to the entire respective platform, only enabled participation.

Application of the rules described in § 1.199-3(d)(1)(ii) is inappropriate in this case with respect to fees charged for the use of Platforms A, B, and C because all of the gross receipts are derived from services. The rules of § 1.199-3(d)(1)(ii) only apply in cases in which a taxpayer derives gross receipts from property offered in the normal course of business, but the gross receipts from the entire property did not qualify as DPGR. In those cases, a taxpayer can look to components of the property under § 1.199-

3(d)(1)(ii). In this case, however, Taxpayer only derived gross receipts from services when it charged fees for the use of Platforms A, B, and C, and therefore, there are no components of property from which Taxpayer derived gross receipts that could qualify as DPGR.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

Please call James Holmes at 202-317-4137 if you have any further questions.