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Memorandum

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from: Paul Colleran
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subject:

Section 199 Domestic Production Activities Deduction

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

ISSUE

CONCLUSION

FACTS

LAW

The domestic production activities deduction (DPAD) is determined under § 199(a) by applying a percentage to the lesser of a taxpayer's qualified production activities income (QPAI) or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 9 percent for taxable years beginning after 2009.

Section 199(b)(1) limits the deduction for a taxable year to 50 percent of the W-2 wages paid by the taxpayer during the calendar year that ends in such taxable year. Section 199(b)(2) provides that W-2 wages does not include any amount which is not properly allocable to domestic production gross receipts (DPGR).

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 manufactured,

produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States.

Section 199(d)(10) provides the Secretary shall prescribe such regulations as are necessary to carry out the purposes of § 199.

Under Treas. Reg. § 1.199-3(d)(1) a taxpayer may use any reasonable method satisfactory to the Secretary based on all facts and circumstances to determine whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis).

Treas. Reg. § 1.199-3(d)(1)(i) defines the term "item" as meaning the property offered by the taxpayer in the normal course of business of taxpayer's business for lease, rental, license, sale, exchange, or other disposition (collectively referred to as disposition) to customers, if the gross receipts from such property qualify as DPGR.

Gross receipts derived from the performance of services generally do not qualify as DPGR. The exception to this general rule in Treas. Reg. § 1.199-3(i)(4)(i)(B) for construction and engineering or architectural services is not applicable here.

Section 199(c)(5) defines the term QPP as including computer software.

Treas. Reg. § 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. 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.

Treas. Reg. § 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 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. Treas. Reg. § 1.199-3(i)(1)(i).

Treas. Reg. § 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.

Treas. Reg. § 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.

Treas. Reg. § 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 if one of two exceptions is met.

ANALYSIS

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (617) 788-0804 if you have any further questions.

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