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to: , Team Manager

from:

Senior Counsel, LB&I

subject:

Section 199 Software Claim

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This is in response to your request for our opinion as whether the merchant discount fees earned by (the "Taxpayer") in connection with its merchant acquiring services business during the taxable years constitute domestic production gross receipts ("DPGR") eligible for the domestic production activity deduction under I.R.C. § 199. For the reasons set forth below, we are of the view that they are not.

ISSUE

Whether the merchant discount fees earned by the Taxpayer constitute DPGR as defined by I.R.C. § 199(c)(4) and the regulations thereunder?

CONCLUSION

No. The merchant discount fees do not come within the statutory definition of DPGR. The fees were derived from online services under Treas. Reg. § 1.199-3(i)(6)(ii) and therefore do not constitute gross receipts derived from a disposition of computer software unless they come within Treas. Reg. § 1.199-3(i)(6)(iii). Further, the fees do not meet either the self-comparable or third-party exceptions of Treas. Reg. § 1.199-3(i)(6)(iii).

FACTS

The Taxpayer is a company that files consolidated income tax returns as the parent of a consolidated group that includes . The Taxpayer has a taxable year ending .

In , acquired , which was renamed (" ") in . On its and income tax returns, the Taxpayer reported Principal Business Activity (PBA) Code as , " ." According to the Taxpayer, is subject to as it is owned by a , but it is not itself a under , and is not classified as a in its state of incorporation.

As described in greater detail below, processes credit and debit card payment transactions for its customers through various card networks. customers, referred to as "merchants," include retailers, service providers, and other entities that wish to accept payment by credit or debit card. This type of activity, which is generally referred to as merchant acquiring services, involves "gathering sales information from the merchant, obtaining authorization for the transaction, collecting funds from the card-issuing bank, and reimbursing the merchant." Office of the Comptroller of the Currency, Comptroller's Handbook, O-MP, p. 1 (hereafter "OCC Handbook"). performs merchant acquiring services for a merchant only after approval of the merchant's application and subject to the terms and conditions of various agreements between the merchant and .[1] develops, maintains, and operates specialized software and to facilitate its processing and settlement of card transactions. In some cases, also sells and leases point of sale data processing equipment and software to merchants.

Payment Card Transactions - Overview

A typical card transaction involves five parties: (1) the card issuer, which is a bank or other financial institution that is a member of a card network, (2) the cardholder, who uses the card to make payments; (3) the merchant, which accepts the card in payment for goods or services; (4) the merchant acquirer ( ), which

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[1] The defines the " " between and the merchant as "

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processes and settles the transactions for the merchant; and (5) the card network, which intermediates the authorization and settlement of the transaction.[2]

A payment card transaction involves authentication, authorization, clearance, and settlement. See generally Capital One v. Commissioner, 133 T.C. 136, 141-156 (2009), aff'd 659 F.3d 316 (4th Cir. 2011). Authentication is the process of verifying that the person presenting the card for payment is authorized to use the card. Authorization is the process of approving or declining a transaction before a purchase is finalized. Clearing is the process of delivering final transaction data from the acquirer to the issuer for posting to the cardholder's account. Clearing also includes the calculation of certain fees and charges that apply to the issuer and acquirer. Settlement is the process of transmitting sales information to the issuer for collection and of reimbursing the merchant. It also includes the process of calculating, determining, and reporting the net financial position of the issuer and acquirer for all transactions that are cleared.

Payment Card Transactions - Authentication and Authorization

uses the following diagram to show the steps of the authentication and authorization process:

. The steps in the authentication and authorization process are as follows:

1. Cardholder Initiates Transaction. A transaction starts when a cardholder presents a card to a merchant for payment. Before completing the sale, the merchant must receive approval from the card issuer. In most instances, approval is requested and the transaction data (cardholder's name, card number, amount of the transaction) is captured electronically by a point of sale device ("POS device"), either by swiping the card through the POS device or manually entering the transaction data into the POS device. If a merchant does not have a working POS device, the merchant can

[2] The transaction described is one involving the use of a branded card issued by a bank belonging to one of the bank card associations (*i.e.*,). Certain other companies (*e.g.*,) issue their own cards. A transaction using a card issued by one of these card companies differs somewhat from those using association branded cards, principally in that the card issuer and the card network are the same entity. The discussion herein focuses on transactions using branded cards issued by members of one of the bank card associations as

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alternatively request authorization by calling the [redacted].[3] For online transactions where no POS device is present, authorization can be requested and transaction data can be transmitted via a gateway program such as [redacted], a computer software program accessed through an internet browser ([redacted] is discussed below). Authorization is required for every transaction to determine if the card number is valid, if the card has been reported lost or stolen, and if the cardholder has sufficient credit or funds available.

2. Transmittal of Data to [redacted].[4] Once the transaction is authorized, the transaction data is sent to the [redacted], a central server used by [redacted] to store merchant information and to route information between merchants and the issuers. The [redacted] verifies the [redacted] ("[redacted]"), reads the card number, and routes transaction data to the appropriate issuer.

3. Transmittal of Data to Card Issuer. The [redacted] sends the transaction data to the card issuer through the appropriate card network. The card issuer determines whether to approve or decline the transaction and sends its response back to the [redacted] through the card network.

4. Transmittal of Response to [redacted]. The [redacted] receives the response from the card issuer through the card network and sends it to the merchant.

5. Transmittal of Response to Merchant. The merchant receives the card issuer's response from the [redacted] via the same means it transmitted the data (POS device, phone, [redacted]) and completes the sale if approved.

Payment Card Transactions - Clearance and Settlement

The [redacted] uses the following diagram to show the steps of the clearance and settlement process:

[redacted]

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[3] The [redacted] defines "[redacted]" as "[redacted]." [redacted].

[4] The [redacted] defines the "[redacted]" as "[redacted]." [redacted].

. The steps in the clearance and settlement process are as follows:

1. Generally the merchant's POS device sends the merchant's approved, unsettled transactions (referred to as a "batch") to the . If the merchant is not using a POS device or an alternative channel such as , the merchant sends hard copy transaction receipts to the processing center.

2. The sends the transactions in the batch to Interchange, the clearing and settlement system used by .

3. Interchange sends the transactions to the appropriate card issuer.

4. The card issuer posts the transactions to the cardholder's account and sends the transaction amount less the card issuer's interchange fee (discussed below) to Interchange.

5. Interchange sends the transaction amount less the interchange fees to the .

6. The sends a message to the Automated Clearing House ("ACH") to pay the merchant for the transaction amount.

7. The ACH sends the transaction amount from to the merchant's (" ")[5] via electronic transfer. fees (discussed below) are debited from the merchant's on a monthly or daily basis.

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[5] The is a "

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To process and settle card transactions for its merchant clients, utilizes what it describes as an " " consisting of proprietary software hosted on the company's servers (the "Platform"). . The Taxpayer describes the Platform as:

. This Platform, consisting principally of two software systems, known as " " and " ," provides the basic mechanical functions of merchant acquiring services: capturing transactions from merchants, routing those transactions for approval, and clearing and settling approved transactions. and are custom designed to comply the varying requirements of the card networks and financial institutions with which does business. The and designations are used internally by , but are not marketed externally to customers and there is no mention of them on website or in customer agreements.

is the software that facilitates the authentication and authorization of card transactions. That is, it receives and captures transaction data submitted electronically by merchants and routes that data to the appropriate card issuer through the card network for authorization and relays the issuer's response back to the merchant. can interface directly with merchants using POS devices or indirectly with merchants using a standard internet browser through software or through third-party software such as .

is the software that facilitates the clearance and settlement of card transactions. That is, it converts transaction data into the appropriate format for remission, posting transactions, and initiating the transfer of funds. computes amounts due to each party to a payment card transaction and executes the transfer of the correct amount of funds to each party. functions automatically, performing "auto settlement" runs .

servers also host the software system. The Taxpayer characterizes as a " ." . allows a merchant to use a standard internet browser on their computer to interface with and in order to process card transactions.[6] is an app that can be downloaded onto a mobile device through the . The app allows merchants to conduct card transactions from a mobile device. Merchants desiring to use must also be registered to use , which acts as an interface between and .

According to the Taxpayer, , , and are " ." . , , and are only hosted on servers. does not provide customers with a manual or instructions for the use of this software, nor does it provide the merchants with copies of the software in any form. Customers can only connect to and through an online connection with . By contrast, is downloaded by customers onto their mobile devices and allows merchants to interface with and through . claims that it produced the , , and software in whole or in significant part in the United States.[7] did not manufacture the servers or other computer hardware that host , , and .

The entered into between and its merchant clients expressly provides that customers acquire no rights in software:

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[6] The defines " " as " ."

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[7] It is our understanding that the exam team is not challenging the assertion that , , and software were produced in whole or in significant part in the United States.

Bank Card Associations / Acquiring Banks

A card transaction can only be cleared and settled through a bank that is a member of the card network, and a merchant that wishes to accept credit card payments must be sponsored by such a bank (known as the acquiring bank). The acquiring bank owns the Bank Identification Number ("BIN") or Interbank Card Association ("ICA") number through which settlement takes place.[8] A BIN/ICA number is a bank's unique identification number that is used to facilitate the clearing and settlement of transactions through the card network. A card transaction cannot be cleared and settled without an acquiring bank and the use of its BIN/ICA.

. is also a registered service provider in each of the card networks. These affiliations, which the merchants themselves lack, are necessary to process card transactions.

Interchange, Merchant Discount, and Other Fees

When a card issuer settles a transaction with , its pays the face amount of the transaction less what is referred to in the industry as an interchange fee. The interchange fee is a percentage of the face amount of the transaction being processed.[10] For example, if a cardholder makes $100 purchase from a merchant who is customer, the card issuer will pay the face amount of the transaction less the interchange fee. If the interchange fee is 2 percent, will receive $98 ($100 - ($100 x .02)) from the card issuer.

in turn charges the merchants with whom it contracts a merchant discount fee.[11] Like the interchange fee, the merchant discount fee is a percentage of the face amount of the transaction being processed. It usually also includes a small per transaction charge. assigns a merchant discount rate to each merchant based on various factors such as the merchant's transaction volume and risk profile. The merchant's risk profile is based on factors such as the nature of the merchant's business (*e.g.*, grocery store, gas station, etc.), whether the merchant conducts card-

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9 The defines " " as a " ." .

10 In some cases, the interchange fee may also include a small per transaction charge.

11 The merchant discount fee is commonly referred to as the "merchant discount" or simply the "discount" both within the industry and by the Taxpayer. The defines the " " as " ."

not-present transactions (*i.e.*, phone and mail orders), the merchant's chargeback risk (higher with longer sales-to-delivery time), and the fraud risk associated with the merchant's business. The primary factors considers when setting the merchant discount rate are consistent with role as an intermediary in a financial transaction. The characterizes the merchant discount fee as an amount charged " ." .

The difference between the merchant discount fee and the interchange fee is referred to as the net merchant discount. For example, suppose a cardholder makes a $100 purchase from a merchant who is customer. In the settlement process, the card issuer will pay the face amount of the transaction less the interchange fee. If the interchange fee is 2 percent, will receive $98 ($100 - ($100 x .02)) from the issuer. will in turn pay the merchant (by deposit into the merchant's) the face amount of the transaction less the merchant discount fee.[12] If the merchant discount fee is 2.5%, will pay the merchant $97.50 ($100 - ($100 x .025)), thus netting 50 cents on the transaction. The net merchant discount (50 cents in this example) is primary source of income[13] and claimed DPGR.

In some instances, payment to the merchant may precede the card issuer's payment to . Because of this, agreements with its merchants provide that all amounts credited to a merchant's are "

." . is also at risk for

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[12] It is unclear from the whether (1) deposits the full face amount of the transaction ($100 in the example) to the merchant's and then debits the separately for the merchant discount fee ($2.50 in the example), (2) deposits the face amount of the transaction net of the interchange fee ($98.00 in the example) to the merchant's and then debits the separately for the net merchant discount fee ($.50),or (3) deposits the face amount of the transaction net of the merchant discount fee ($97.50 in the example). The provide that "

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. It also provides that "

." . For purposes of this advice, we have assumed that deposits only the net merchant discount fee ($97.50 in the example) to the merchant's , and that it is the other fees charged by (*e.g.*, any per transaction fee) that are debited from the merchant's account. If in fact what deposits in the merchant's is the full face amount of the transaction or the face amount of the transaction less the interchange fee, is assuming even more risk than we assume to be the case.

[13] The Taxpayer's describes the Taxpayer's revenue for its merchant acquiring services business as consisting "

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charge-back losses should a merchant declare bankruptcy or otherwise become unable to pay.[14]

In addition to the merchant discount fees, merchants may pay any of a number of other fees to . Separate fees are charged for use of the software (which includes the right to use the app), and for third-party gateway software if obtained through .[15] Merchants that lease POS devices from pay rent on these devices. Depending on the terms of their agreement with , merchants may pay additional transaction fees, authorization fees, and other fees as specified in the merchant's agreement with .

DPAD Claims

The Taxpayer claimed no DPAD on its or returns. On , however, the Taxpayer submitted an informal claim for and seeking DPAD of $ and $, respectively. The DPADs were claimed with respect to DPGRs of $ and $ purportedly derived in the Taxpayer's card processing business. Of the DPAD claimed for , $, or percent was attributable to net merchant discount fees earned in the card processing business. Of the DPAD claimed for , $, or percent was attributable to net merchant discount fees earned in the card processing business. The remaining DPAD claimed for and was attributable to other fees or rentals earned in the card processing business. The claim was subsequently denied in full by , Notice of Proposed Adjustment.

Taxpayer's Position

The Taxpayer asserts that the revenue generated in its merchant acquiring activity (including, but not limited to, the net merchant discount) is received from its merchants in exchange for use of an " " composed of , , and . . It further asserts that "

," and that the amounts paid are "

." Id. The Taxpayer characterizes no part of its transactions with the merchants as the provision of services.

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[14] A charge back can arises when a cardholder disputes a transaction or when the merchant fails to follow required procedures. Per the OCC, "[c]redit risk from charge-backs is a significant risk to an acquirer's earnings and capital." OCC Handbook, p. 14.

[15] As an alternative to , merchants can use certain software produced by third-parties to interface with and through a standard internet browser. Such third-party gateway software can be obtained through , in which case the merchant is charged a separate fee for the software.

The Taxpayer argues that the Platform is online software for section 199 purposes because customers access its functionality through an Internet connection. . The Taxpayer further argues that fees paid by merchants are DPGR under the third-party compatible exception of Treas. Reg. § 1.199-3(i)(6)(iii)(B). identified three payment processing software applications, , as the "substantially identical software" to Platform. , markets software under the name " " to banks, retailers, and independent payment processors. Taxpayer represents that is downloadable or locally installed software and provides authorization, clearing, and settlement functionality. offers and to financial institutions, merchant acquirers, and independent sales organizations. Taxpayer represents that software marketed as and is downloadable or locally installed and provides authorization, clearing, and settlement functionality.

LAW

I.R.C. § 199(a)[16] allows taxpayers a deduction (the "DPAD") equal to nine percent of the lesser of their "qualified production activities income" or their taxable income. Section 199(c)(1) defines "qualified production activities income" as the excess of the taxpayer's "domestic production gross receipts" for the year over the sum of the cost of goods sold and other expense, losses, and deductions allocable to such receipts. Section 199(c)(4)(A)(i)(I) defines "domestic production gross receipts [DPGR]," in part, as "the gross receipts of a taxpayer which are derived from - (i) any lease, rental, license, sale, exchange, or other disposition of – (I) qualifying production property which was manufactured, produced, grown, or extracted ["MPGE"] by the taxpayer in whole or in significant part within the United States." See also Treas. Reg. § 1.199-3(a). Section 199(c)(5) defines "qualifying production property" ("QPP") as including, *inter alia*, "any computer software."

Treas. Reg. § 1.199-3(i)(1)(i) provides that the "term derived from the lease, rental, license, sale, exchange, or other disposition is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities." The regulation further provides that "[a]pplicable 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)(4)(i)(A) provides that "gross receipts derived from the performance of services do not qualify as DPGR."

Treas. Reg. § 1.199-3(i)(6)(i) provides that "DPGR include 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."

[16] Except as otherwise noted, all section references herein are to the Internal Revenue Code as in effect for the year in issue.

Treas. Reg. § 1.199-3(i)(6)(ii) provides that "[g]ross 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 "[n]otwithstanding paragraph (i)(6)(ii), if a taxpayer derives gross receipts 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 (online software), then such gross receipts will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software only if" the taxpayer meets either Treas. Reg. § 1.199-3(i)(6)(iii)(A)(the "self-comparable exception") or Treas. Reg. § 1.199-3(i)(6)(iii)(B)(the "third-party comparable exception").

A taxpayer meets the self-comparable exception of Treas. Reg. § 1.199-3(i)(6)(iii)(A) if the taxpayer "derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the lease, rental, license, sale, exchange, or other disposition to customers that are unrelated persons . . . of computer software that (1) has only minor or immaterial differences from the online software; (2) has been 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 (for example, a disk or DVD) or by allowing them to download the computer software from the Internet."

A taxpayer meets the third-party comparable exception of Treas. Reg. § 1.199-3(i)(6)(iii)(B) if "[a]nother person derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software (as described in paragraph (i)(6)(iv)(A) of this section)(as compared to the taxpayer's online software) to its customers pursuant to an activity described in paragraph (i)(6)(iii)(A)(3) of this section [*i.e.*, by a tangible medium or download from the Internet]."

Treas. Reg. § 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 described paragraph (i)(6)(iii) of this section; and (2) has a significant overlap of features or purpose with the online software described paragraph (i)(6)(iii)."

Treas. Reg. § 1.199-3(i)(6)(v) sets forth nine examples illustrating the application of paragraph (i)(6)(relating to computer software).

Treas. Reg. § 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 Treas. Reg. § 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.

Treas. Reg. § 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 Treas. Reg. § 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.

Treas. Reg. § 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 Treas. Reg. § 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).

Treas. Reg. § 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 computer 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 tax preparation 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 Treas. Reg. § 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).

DISCUSSION

At issue here is whether merchant discount fees earned by constitute DPGR eligible to be included in the calculation of the domestic production activity deduction of section 199(a). In its , the Taxpayer does not argue that the merchant discount fees are within the general definition of DPGR found in section 199(c)(4)(A)(i)(I), nor does it dispute that the fees are paid for online services, which, under Treas. Reg. § 1.199-3(i)(6)(ii), are generally excluded from the definition of DPGR. Rather, the Taxpayer relies on the third-party comparable exception of Treas. Reg. § 1.199-3(i)(6)(iii)(B), arguing that the merchant discount fees are derived from the use of the computer software comprising the Platform, and that because third-parties derive gross receipts from the disposition of substantially identical software, the merchant discount fees are treated as DPGR under the third-party comparable exception.

Even though the Taxpayer apparently concedes that the merchant discount fees do not come within the general definition of DPGR and that the fees were paid for the provision of online services, we believe the analysis here should begin with a discussion of why the fees do not qualify as DPGR under the statutory definition and the online services regulation. As discussed below, the Taxpayer interprets the third-party comparable exception too broadly, essentially reading it as converting *all* gross receipts from the provision of online services to DPGR any time a third-party comparable exists, irrespective of the gross receipts' actual derivation. The fallacy of the Taxpayer's interpretation is best understood in the context of why the merchant discount fees fail the DPGR test in the first instance.

The Merchant Discount Fees Do Not Constitute DPGR as Defined by Section 199(c)(4)(A)(i)(I).

To constitute DPGR, the merchant discount fees must be "gross receipts of a taxpayer which are derived from - (i) any lease, rental, license, sale, exchange, or other disposition of - (I) qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." I.R.C. § 199(c)(4)(A)(i)(I). There is no dispute that the merchant discount fees constitute "gross receipts of [the] taxpayer" and that the software comprising the Platform (*i.e.*, , , and) constitutes "qualifying production property."[17] Additionally, it is our understanding that the exam team does not contest that the software comprising the Platform was "manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." Thus, the issue of whether the merchant discount fees are DPGR as defined by the statute turns on whether such fees were "derived from . . . any lease, rental, license, sale, exchange, or other disposition" of the Platform.

[17] Section 199(c)(5)(B) defines "qualifying production property" as, *inter alia*, "any computer software."

Generally, whether a taxpayer's gross receipts are "derived from . . . any disposition" of qualifying production property ("QPP") is best analyzed as a two-prong inquiry: first, was there a disposition, and second, were the gross receipts in question derived from that disposition. Here, neither prong is met.

There was no "disposition" of the Platform as did not lease, rent, license, sell, exchange, or otherwise dispose of the Platform under Treas. Reg. § 1.199-3(i)(6)(i). To satisfy this requirement, a taxpayer must have provided the computer software to the customer. This can be done by affixing it to a tangible medium or allowing a download from the Internet. did not do this. To the contrary, it maintained sole control, possession of, and right to, the Platform at all times. The main components of the Platform (, , and) reside solely on servers, and does not provide the software to the merchants through tangible media or download.[18] Additionally, and consistent with this conclusion, merchants did not obtain any legal rights to the Platform; to the contrary, the expressly provides that merchants have no rights in any software.[19] Thus there was no "disposition" of the Platform, and the first prong of the inquiry is not met. And as there was no disposition of the Platform, it follows, *a fortiori,* that no gross receipts were derived from a disposition of the Platform and thus the second prong of inquiry is not met either.[20]

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[18] The Taxpayer could argue that there was a disposition of the software. is an app that merchants registered to use can download onto their mobile devices to allow them to interface with and through . It is not necessary for a merchant to download to receive merchant acquiring services from (nor, for that matter, is it necessary to register for to receive merchant acquiring services). charges a separate fee for use of , but does not charge an additional fee for the use of the app. Assuming, *arguendo*, that there was a disposition of the software, such a disposition would not, in our view, have any bearing on the issue at hand since the gross receipts derived from any such a disposition are derived from a separate transaction and not reflected in the merchant discount fee.

[19] The provide that " ."

[20] Even assuming, *arguendo*, that there was a disposition of the Platform, it does not follow that the merchant discount fees were derived therefrom. To the contrary, the facts discussed below at pages 19 -20, demonstrate the merchant discount fees were paid for, and derived from, the Taxpayer's provision of merchant acquiring services.

The Merchant Discount Fees Were Paid for Online Services

Not only do the merchant discount fees fall outside the general statutory definition of DPGR, they are also amounts paid for "online services," which, under subparagraph (i)(6)(ii) of Treas. Reg. § 1.199-3, are not derived from a disposition of computer software. Treas. Reg. § 1.199-3(i)(6)(i) provides that "[i]n general, DPGR include the gross receipts of the taxpayer that are derived from the . . . disposition of computer software." Subparagraph (i)(6)(ii), however, provides that "[g]ross 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" (emphasis added). Subparagraph (i)(6)(ii) should not be viewed as an exception to subparagraph (i)(6)(i), but rather as the application of the general statutory definition of DPGR to situations where online services are provided. That is, it clarifies that amounts paid for services delivered online are still considered to be derived from the provision of services, not from a disposition of the software.

Treas. Reg. § 1.199-3(i)(6)(ii) does not expressly define the term "online services" but 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. The regulations enumerate three examples of online services (internet access services, online banking services, and providing access to publications online), but this list is clearly non-exhaustive because "other similar services" are also included. The examples also make it clear that the term "online services" encompasses more than the three types of services enumerated. For instance, Example 2 of Treas. Reg. § 1.199-3(i)(6)(iv), involves the provision of online auctions services, which are not expressly listed in subparagraph (i)(6)(ii), but the example illustrates that enabling customers to participate in an online auction constitutes an on-line service.[21]

As discussed below (see pages 19 - 20), the merchant discount fees at issue were derived from the provision of services, specifically merchant acquiring services. In our view, merchant acquiring services are a form of banking services and the provision

[21] On-line services can also encompass situations where a taxpayer derives gross receipts from providing access to computer software for a customer's direct use as contemplated by Treas. Reg. § 1.199-3(i)(6)(iii), but does not meet the self-comparable or third-party comparable exceptions in Treas. Reg. § 1.199-3(i)(6)(iii)(A) and (B). In those cases the taxpayer's gross receipts are not treated as from a disposition of computer software under Treas. Reg. § 1.199-3(i)(6)(ii). See Example 7 of Treas. Reg. § 1.199-3(i)(6)(v).

of such services online constitutes the provision of "online banking services."[22] However, even if merchant acquiring services are not considered banking services, and the provision of merchant acquiring services online are therefore not considered online banking services, the services provides are plainly analogous to online banking services. Like banking services provided online, the merchant acquiring services provided by are financial services (the movement of money) that computer software enables to be delivered online. In each case, it is the service, not means of delivery, that the customers are paying for. Thus, even if the merchant acquiring services provided by are not "online banking services," they are still "online services" and therefore under Treas. Reg. § 1.199-3(i)(6)(ii), the merchant discount fees are not derived from the disposition of computer software.

The Merchant Discount Fees Do Not Meet the Requirements of the Flush Language of Treas. Reg. § 1.199-3(i)(6)(iii).

As discussed above, the merchant discount fees both fall outside the statutory definition of DPGR and are paid for online services. None-the-less, the Taxpayer claims that the merchant discount fees qualify as DPGR under the provisions of Treas. Reg. § 1.199-3(i)(6)(iii)(B). Treas. Reg. § 1.199-3(i)(6)(iii) sets forth two circumstances where gross receipts derived from providing customers access to "online software" will be treated as having been derived from the disposition of computer software. The first is found in subparagraph (i)(6)(iii)(A) and is commonly referred to as the "self-comparable exception."[23] The second, and the one upon which the Taxpayer relies, is found in subparagraph (i)(6)(iii)(B) and is commonly referred to as the "third-party comparable exception." As discussed below, we are of the view that the third-party comparable exception is not met because the "substantially identical software" requirement set out in subparagraph (i)(6)(iii)(B) is not satisfied. More fundamentally, however, neither exception applies because the merchant discount fees do not meet the threshold requirements set out in the flush language of subparagraph (i)(6)(iii).

Treas. Reg. § 1.199-3(i)(6)(iii) provides, in pertinent part:

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[22] "Online banking services" are not defined in the regulations, and accordingly it is appropriate to consider common usage and understanding. Most money transfers (ETFs, direct deposits, check processing) are conducted through the banks and are commonly thought of as banking services. Functionally, a credit card payment is the equivalent of payment by check; in either case, the merchant is relying on financial institutions to process the transaction and transfer the funds to its account. Thus, the processing of a card transaction would commonly be considered a banking (or at least a financial) service.

[23] The Taxpayer does not satisfy, and does not argue that it satisfies, the self-comparable exception. Treas. Reg. § 1.199-3(i)(6)(iii)(A) requires, *inter alia*, that the taxpayer derive, on a regular and ongoing basis, gross receipts from the disposition of software that has only minor or immaterial differences from the on-line software, and that such software have been provided to customers "either affixed to a tangible medium (for example, a disk or DVD) or by allowing them to download the computer software from the Internet." Here did not provide customers with comparable software through a tangible medium or by download from the Internet.

> (iii) Exceptions. Notwithstanding paragraph (i)(6)(ii) of this section, *if a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer in 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 lease, rental, license, sale, exchange, or other disposition of computer software only if –
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> . . .
>
> > (B) Another person derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software (as described in paragraph (i)(6)(iv)(A) of this section)(as compared to the taxpayer's online software) to its customers pursuant to an activity described in paragraph (i)(6)(iii)(A)(3) of this section.

(emphasis added).

In its , the Taxpayer focuses on subparagraph (i)(6)(iii)(B) while ignoring the introductory subordinate clause in the flush language of (i)(6)(iii)(italicized in the quote above). The subordinate clause limits the circumstances under which subparagraph (i)(6)(iii) can apply to those where "a taxpayer derives gross receipts from providing customers access to computer software . . . for the customers' direct use while connected to the Internet." Where a taxpayer's gross receipts are not derived from providing customers with access to computer software for the customers' direct use while connected to the Internet, subparagraphs (i)(6)(iii)(A) and (B) are inapplicable.

As noted above, whether a taxpayer's gross receipts are "derived from [a] disposition" of QPP is best analyzed as a two-prong inquiry: first, was there a disposition, and second, were the gross receipts derived from that disposition. Where the QPP in question is online software, subparagraphs (i)(6)(iii)(A) and (B) provide the means to satisfy the disposition prong. Specifically, it deems there to have been a disposition of the online software where the taxpayer or a third-party has leased, rented, licensed, sold, exchanged, or otherwise disposed of comparable software. The existence of a self-comparable or third-party comparable shows that customers can use the software independent of an online connection and that the online connection is an alternative means of delivering software for the customer's use, and not just a means of delivering a service. As discussed separately below, the third-party comparable exception is not met here because the taxpayer has not satisfied the "substantially identical software" requirement set out in subparagraph (i)(6)(iii)(B).

While Treas. Reg. § 1.199-3(i)(6)(iii) provides a means of satisfying the statutory requirement that there be a disposition of QPP, the statutory requirement that the gross receipts be derived from the disposition is explicitly retained in the language of the subparagraph's introductory subordinate clause requiring that the taxpayer "derives gross receipts from providing customers access to computer software . . . for the customers' direct use while connected to the Internet." Put otherwise, subparagraphs 1.199-3(i)(6)(iii)(A) and (B) serve to delineate circumstances where a taxpayer will be treated as making a "disposition" of online software, while the flush language in Treas. Reg. § 1.199-3(i)(6)(iii) serves to preserve the requirement that the gross receipts be derived from such disposition rather than from the provision of services enabled by the software. The requisite causal connection must still exist between the disposition of the software and the gross receipts. The only difference is that under subparagraph (i)(6)(iii), the gross receipts may be derived from a *deemed* disposition (*i.e.*, providing access to software over the Internet), rather than from an *actual* disposition (*e.g.*, a lease, rental, license, sale, or exchange of software).

The merchant discount fees here cannot qualify as DPGR under subparagraph (i)(6)(iii) because they were not derived "from providing customers access to computer software . . . for the customers' direct use[24] while connected to the Internet." What the merchant discount fees were derived from was the provision of merchant acquiring services, as is shown by the following:

1. Merchants contract with for merchant acquiring services, not software or access to software. That is, they contract with to provide for the authorization, clearance, and settlement of their card transactions and, ultimately, for payment of the amounts due them. The authorization, clearance, and settlement processes all require affiliations with credit card networks and acquiring banks. The merchants do not, and as a practical matter could not, maintain these affiliations. , on-the-other hand, maintains and bears the costs of all requisite affiliations. also assumes certain financial risks. Specifically, because it may pay the merchant before the card issuer pays it, assumes all the risks inherent in what is essentially a factoring transaction. assumes other risks as well, such as the risk of charge-back losses arising when a merchant becomes insolvent between the time a transaction is paid and the time a charge-back arises.

2. The manner in which prices the merchant discount fee supports the conclusion that the fee is charged for merchant acquiring services. The merchant discount is a percentage of the face amount of the transaction being processed plus a small per transaction charge. The percentage charged a particular merchant varies based on factors such as the merchant's transaction volume and risk profile. The merchant's risk profile is based on factors such as the nature of the merchant's business, whether the merchant conducts card-not-present transactions (*i.e.*, phone and mail orders), the merchant's chargeback risk (higher with longer sales-to-delivery time),

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[24] The term "direct use" is not defined in the regulations, but the merchants' use of the Platform is, at best, highly indirect. The merchants themselves do not operate or manipulate the software comprising the Platform to perform the authentication, authorization, clearance, and settlement functions necessary to process the card transactions. Their "use" of the Platform is limited to transmitting requests for authorization and settlement to the Platform so that can process the merchants' card transactions. And even this "use" is actually performed by POS devices or, in some cases, or third-party software.

and the fraud risk associated with the merchant's business. These factors are consistent with the pricing of financial intermediary services, but inconsistent with the pricing of software.

3. The agreements between and the merchants characterize the merchant discount fee as an amount paid for services. The , for example, defines the merchant discount fee as " " elsewhere it characterizes the fee as an amount paid " ." . Nowhere in the agreements is the merchant discount fee characterized as a payment for the use of, or an interest in, the software composing the Platform.

Merchants pay for the specialized services it is able to provide due to its financial standing, card network and bank affiliations, and expertise in processing card transactions; they do not pay it for access to the Platform.[25] Because the merchant discount fees were derived from the provision of services, not from providing access to the Platform, the requisite causal connection between any deemed disposition of the Platform and the fees is lacking and the requirements of the flush language of Treas. Reg. § 1.199-3(i)(6)(iii) are therefore not satisfied.

In the , the Taxpayer cites Example 4 of Treas. Reg. § 1.199-3(i)(6)(iv) in support of the argument that software used to provide a service can generate DPGR under the regulations:

. Examples 4 and 5 of the regulation discuss gross receipts that O, the taxpayer in the example, earns from providing customers access to tax preparation software for their direct use over the Internet while meeting the self-comparable exception (Example 4) or the third-party comparable exception (Example 5).

Examples 4 and 5 are distinguishable from the present case because O is not performing a service for its customers, but rather is providing its customers with a tool that enables its customers to perform a task for themselves. Tax return preparation is a service when performed by a third-party, but it's clear in the examples that O is not

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[25] The merchant discount fee can be contrasted with the fees charges for use of the system and third-party gateway software. and the third-party gateway software allow merchants to interface with and using a standard internet browser or mobile device. These fees, which are only paid by merchants wanting to use a non-POS gateway, are separate from and in addition to the merchant discount fee. That charges separate, additional fees for the use of such gateway software reinforces the conclusion that the merchant discount fee is paid not for software or its use, but for something else, *i.e.*, the provision of merchant banking services.

actually acting as a return preparer. O provides customers with "access to the computer software for the customers' direct use while connected to the Internet," which software has "only minor or immaterial differences" from software O sells to customers on compact disc or by download. Treas. Reg. § 1.199-3(i)(6)(iv), Ex. 4. Tax preparation software of the type that can be bought on a compact disc or by download gives the user tools that facilitate data entry and compilation, mathematical calculations, and form preparation. But such software still allows the user to manipulate and navigate the software, make editorial decisions, and control the ultimate outcome of the process. By contrast, a merchant's interaction with the Platform is much more limited and regimented. The merchant sends basic data (*e.g.*, card number and purchase price), and receives limited feedback (*e.g.*, transaction authorized or not), but cannot manipulate the software or affect how the card transaction will be processed. Merchants pay to achieve an end result, whereas the customers in Examples 4 and 5 pay O for tools that enable them to achieve an end result for themselves. The former is the performance of a service, whereas the latter is not.

The Merchant Discount Fees Do Not Come Within the Third-Party Comparable Exception of Treas. Reg. § 1.199-3(i)(6)(iii)(B).

Even assuming, *arguendo*, that derived the merchant discount fees from providing merchants with access to the Platform for the merchants' direct use and that the fees therefore meet the requirements of the flush language of Treas. Reg. § 1.199-3(i)(6)(iii), the fees would still not come within the third-party comparable exception of subparagraph (i)(6)(iii)(B). This is so because the comparable software proffered by the Taxpayer is not "substantially identical software" as required by the regulation because it does not have the same "functional result" from the customers' perspective.[26]

Subparagraph (i)(6)(iii)(B) of Treas. Reg. § 1.199-3 provides that a third-party comparable exists where:

> Another person derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software (as described in paragraph (i)(6)(iv)(A) of this section)(as compared to the taxpayer's online software) to its customers pursuant to an activity described in paragraph (i)(6)(iii)(A)(3) of this section.

Subparagraph (i)(6)(iv)(A) defines "substantially identical software" as computer software that (1) "[f]rom a customer's perspective, has the same functional result" as the taxpayer's software; and (2) has "a significant overlap of features or purpose" with the

[26] To constitute "substantially identical software," software must also have "a significant overlap of features or purpose" with the taxpayer's software. Treas. Reg. § 1.199-3(i)(6)(iv)(A)(2). Insufficient facts are known about and for us to opine as to whether there is a "significant overlap of features or purpose" between the Platform and or . We note, however, that the Taxpayer has the burden of proof on this matter, and has not, to date, demonstrated the requisite overlap of features or purpose.

taxpayer's software. The Taxpayer proffers two specific examples of "substantially identical software:" produced by (" "),[27] and produced by ( ).[28] .

According to its ,[29] " ."

. These services include merchant acquiring services as well as administering payment card accounts for issuing banks and financial institutions under long-term contracts. . However, also licenses its processing systems to certain clients that process their transactions in-house. . Public information regarding and is very limited. It appears that and are used by and its licensees to conduct merchant acquiring services, which suggests that this software has functionality broadly similar to Platform, but the information available is insufficient to make a detailed comparison.

In its ,[30] states " ." . The lists several software packages marketed to companies that process payment cards, including , which it describes as " ." The states that " ." .

As noted above, the substantial identity test is only met if, "[f]rom a customer's perspective," the putative comparable software "has the same functional result" as the taxpayer's software. This raises the question of who, in the present case, are the respective "customers" of and of and . In the case of the , its customers are merchants that contract for merchant acquiring services; put otherwise, they are the vendors whose card transactions are being processed. In the case of and , their customers are, apparently, financial institutions and card processors that process card transactions for third-parties. The "functional result" obtained by customer is the authentication, authorization, clearance, settlement, and, ultimately, payment of its card transactions. The "functional result" obtained by a customer of or is the processing of large volumes of card transactions for third-parties. customer's purpose for accessing the Platform is to obtain merchant acquiring services, and the features available to it are limited to

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this purpose. The purpose of a card processor licensing or is to offer card processing services to a large group of merchants and the features available to a licensee of or are presumably far more varied as the licensee controls the entire processing system and must have the ability to make certain choices about how it processes the transactions. Thus, viewed from the appropriate customer's perspective, and do not have the same functional result as the Platform, and are not "substantially identical" to the Platform.[31]

This advice has been reviewed and approved by the Office of the Associate Chief Counsel (Passthroughs and Special Industries).

If you have any questions with regard to this matter, please contact Senior Counsel ( ).

Associate Area Counsel (LB&I)

By: ______________________________

Senior Counsel ( )
(Large Business & International)

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[31] See also, GLAM 2014-008, 2014 GLAM Lexis 6 (Nov. 21, 2014) concluding, *inter alia*, that a third-party's app to enable access to banking services from a mobile device had a different functional result and did not have a significant overlap of purpose with the taxpayer bank's similar app where the third-party's customers were banks and the taxpayer's customers were its accountholders. The GLAM is not being used or cited as precedent.