DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9317]

RIN 1545–BF56

Computer Software Under Section 199(c)(5)(B)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations concerning the application of section 199 of the Internal Revenue Code, which provides a deduction for income attributable to domestic production activities. The final regulations are necessary to provide guidance regarding certain transactions involving online software and to clarify the rules regarding the application of section 199 to certain cooperatives. The regulations will affect taxpayers engaged in certain domestic production activities involving computer software and taxpayers engaged in certain domestic production activities in cooperative form.

DATES: *Effective Date:* These regulations are effective March 20, 2007.

Applicability Date: For dates of applicability, see § 1.199–8(i)(4) and (i)(7).

FOR FURTHER INFORMATION CONTACT: Paul Handleman or Lauren Ross Taylor, (202) 622–3040 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 to provide rules relating to the deduction for income attributable to domestic production activities under section 199 of the Internal Revenue Code (Code). Section 199 was added to the Code by section 102 of the American Jobs Creation Act of 2004 (Pub. L. 108–357, 118 Stat. 1418), and amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 25) and section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109–222, 120 Stat. 345). On June 1, 2006, the IRS and Treasury Department published in the **Federal Register** final regulations under section 199 (71 FR 31268). Also on June 1, 2006, the IRS and Treasury Department published in the **Federal Register** temporary and proposed regulations under section 199 providing guidance on certain transactions involving computer software (71 FR 31074 and 71 FR 31128, respectively). Written and electronic comments responding to the temporary and proposed regulations were received. After consideration of the comments, the proposed regulations are adopted as amended by this Treasury decision.

General Overview

Section 199(a)(1) allows a deduction equal to 9 percent (3 percent in the case of taxable years beginning in 2005 or 2006, and 6 percent in the case of taxable years beginning in 2007, 2008, or 2009) of the lesser of (A) the qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to section 199) for the taxable year (or, in the case of an individual, adjusted gross income (AGI)).

Qualified Production Activities Income

Section 199(c)(1) defines QPAI for any taxable year as an amount equal to the excess (if any) of (A) the taxpayer's domestic production gross receipts (DPGR) for such taxable year, over (B) the sum of (i) the cost of goods sold (CGS) that are allocable to such receipts; and (ii) other expenses, losses, or deductions (other than the deduction under section 199) that are properly allocable to such receipts.

Section 199(c)(4)(A)(i) defines DPGR, in part, to mean the taxpayer's gross receipts that are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States. Section 199(c)(5) defines QPP to mean: (A) Tangible personal property; (B) any computer software; and (C) any property described in section 168(f)(4) (certain sound recordings).

Patrons of Certain Cooperatives

Section 199(d)(3)(A) provides that any person who receives a qualified payment from a specified agricultural or horticultural cooperative shall be allowed for the taxable year in which such payment is received a deduction under section 199(a) equal to the portion of the deduction allowed under section 199(a) to such cooperative which is (i) allowed with respect to the portion of the QPAI to which such payment is attributable, and (ii) identified by such cooperative in a written notice mailed to such person during the payment period described in section 1382(d).

Section 199(d)(3)(B) provides that the taxable income of a specified agricultural or horticultural cooperative shall not be reduced under section 1382 by reason of that portion of any qualified payment as does not exceed the deduction allowable under section 199(d)(3)(A) with respect to such payment.

Section 199(d)(3)(C) provides that, for purposes of section 199, the taxable income of a specified agricultural or horticultural cooperative shall be computed without regard to any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

Section 199(d)(3)(E) provides that, for purposes of section 199(d)(3), the term *qualified payment* means, with respect to any person, any amount that (i) is described in section 1385(a)(1) or (3), (ii) is received by such person from a specified agricultural or horticultural cooperative, and (iii) is attributable to QPAI with respect to which a deduction is allowed to such cooperative under section 199(a).

Authority To Prescribe Regulations

Section 199(d)(8) authorizes the Secretary to prescribe such regulations as are necessary to carry out the purposes of section 199, including regulations that prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any activity described in section 199(c)(4)(A)(i).

Temporary Regulations

Section 1.199–3T(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.

However, § 1.199–3T(i)(6)(iii) provides two exceptions under which gross receipts derived by a taxpayer from providing computer software to customers for the customers' direct use while connected to the Internet will be treated as being derived from the lease, rental, license, sale, exchange, or other disposition of such computer software. Such gross receipts will be treated as DPGR if all the other requirements of section 199 are met (for example, the taxpayer MPGE computer software in whole or in significant part within the United States).

The exception in § 1.199–3T(i)(6)(iii)(A) applies to a taxpayer that derives gross receipts from providing computer software to customers for the customers' direct use while connected to the Internet (online software) and also derives gross receipts from customers that are unrelated to the taxpayer from the lease, rental, license, sale, exchange, or other disposition of computer software affixed to a tangible medium or downloaded from the Internet. The exception in § 1.199–3T(i)(6)(iii)(B) applies if a taxpayer derives gross receipts from providing online software and an unrelated person derives, on a regular and ongoing basis in the unrelated person's business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software to its customers affixed to a tangible medium or by allowing its customers to download the substantially identical computer software from the Internet.

Section 1.199–3T(i)(6)(iv) defines substantially identical software as computer software that, from a customer's perspective, has the same functional result as the online software and has a significant overlap of features or purpose with the online software. Section 1.199–3T(i)(6)(iv)(B) provides a safe harbor under which all computer software games are deemed to be substantially identical software.

The exceptions outlined in § 1.199–3T(i)(6)(iii) permit gross receipts derived from providing online software to be treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of software. However, because the rules for online software are exceptions, all other provisions of the temporary and final regulations do not necessarily apply to online software. Specifically, § 1.199–3T(i)(6)(iv)(E) provides that the computer software maintenance agreement exception provided in § 1.199–3(i)(4)(i)(B)(*5*) does not apply to online software. Section 1.199–3(i)(4)(i)(B)(*5*) provides that a taxpayer may include in DPGR, the gross receipts derived from services performed pursuant to a qualified computer software maintenance agreement.

Summary of Comments and Explanation of Provisions

A commentator suggested that the online software exceptions should apply to transactions where access to computer software is provided over any public or private communications network and not just the Internet. The final regulations adopt this suggestion.

A commentator suggested that the final regulations provide an example where computer software would not be considered substantially identical software. This suggestion has been adopted.

Commentators noted that, in the future, some computer software will only be available over the Internet. In addition, newly developed computer software provided over the Internet may not have a substantially identical counterpart. The IRS and Treasury Department recognize that the computer software industry is evolving and current industry trends may result in a more limited applicability of the online software exceptions provided in the final regulation. However, there are significant differences between transactions which provide customers with access to online software and transactions involving the transfer of software to customers affixed to a tangible medium or by download. Accordingly, in order to give meaning to the statutory language requiring a lease, rental, license, sale, exchange, or other disposition, the online software exceptions have been narrowly tailored and are intended to apply only to gross receipts derived from providing customers access to computer software for the customers' direct use while connected to the Internet and only when the taxpayer (or another person) also derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the computer software (or substantially identical software) affixed to a tangible medium or by download. The final regulations clarify that, with respect to online software, taxpayers are providing customers with access to the taxpayers' software as opposed to actually transferring the software to customers either affixed to a tangible medium or by allowing them to download the computer software from the Internet.

Commentators suggested that the rule in § 1.199–3T(i)(6)(iv)(E), precluding the application of the qualified computer software maintenance provision to online software, be deleted because it places taxpayers providing access to online software at a competitive disadvantage with taxpayers providing computer software to customers either affixed to a tangible medium or by allowing them to download the computer software from the Internet. In addition, commentators suggest that the advertising exception in § 1.199–3(i)(5) should be extended to include online software. The final regulations do not adopt these suggestions. As previously noted, the online software exceptions have been narrowly tailored and the IRS and Treasury Department do not believe the exceptions should be extended beyond gross receipts derived from providing customers access to computer software for the customers' direct use. Therefore, the final regulations do not extend the exception for qualified computer software maintenance agreements in § 1.199–3(i)(4)(i)(B)(*5*) or the advertising exception in § 1.199–3(i)(5) to online software.

The final regulations in § 1.199–3(i)(5)(ii)(B) do, however, extend the advertising exception to computer software that is 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. However, the advertising exception only applies to advertising placed or integrated into software that is either affixed to a tangible medium or provided through download and does not apply to advertising incorporated into online software. In addition, the IRS and Treasury Department have clarified that, except as otherwise provided in § 1.199–3(i)(5)(ii), gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities do not include advertising income or product-placement income.

A commentator expressed concern that the exception for qualified computer software maintenance agreements in § 1.199–3(i)(4)(i)(B)(*5*) does not apply if the taxpayer separately offers maintenance in subsequent years. The mere fact that a taxpayer separately offers maintenance in subsequent years does not preclude eligibility for the exception.

A commentator interpreted the rule in § 1.199–3T(i)(6)(iii)(E) as possibly treating gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of future updates, cyclical releases, and rewrites of the underlying software as non-DPGR if the underlying software is online software. The rule in § 1.199–3T(i)(6)(iii)(E) only provides that the qualified computer software maintenance agreement exception does not apply to online software. Therefore, to the extent a taxpayer providing online software derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of future updates, cyclical releases, and rewrites of the underlying software, the gross receipts are DPGR assuming all the other requirements of § 1.199–3 are met.

A commentator noted that Example 6 in the temporary regulations concludes that the gross receipts derived from storage of customers' data and telephone support are non-DPGR. Example 6 is silent as to the amount of gross receipts derived from the storage of customers' data and telephone support and does not address whether the de minimis exception in § 1.199–3(i)(4)(i)(B)(*6*) is available. Numerous examples in the final regulations under section 199 also conclude that gross receipts are non-DPGR without reference to the de minimis exception in § 1.199–3(i)(4)(i)(B)(*6*). However, assuming all the requirements are met, the *de minimis* exception in § 1.199–3(i)(4)(i)(B)(*6*) can apply when an example concludes the gross receipts are non-DPGR.

The IRS and Treasury Department received a comment letter on the application of section 199 to agricultural and horticultural cooperatives under § 1.199–6 of the final regulations (71 FR 31312) published on June 1, 2006. The commentator noted that the sentence in § 1.199–6(h) stating that the cooperative may not apply section 199(d)(3) and § 1.199–6 to any portion of the section 199 deduction that is not passed through to its patrons is inconsistent with section 199(d)(3) which has no such limitation. These final regulations amend § 1.199–6(h) to remove the sentence.

In addition, consistent with the change to § 1.199–6(h), these final regulations amend § 1.199–6(l) to remove the phrase, ''To the extent a cooperative passes through the section 199 deduction to a patron'' and add the phrase, ''by the patron.''

The final regulations also amend § 1.199–6(c) to clarify that a cooperative's QPAI is computed without taking into account any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

Effective Date

Section 199 applies to taxable years beginning after December 31, 2004. These final regulations are applicable for taxable years beginning on or after March 20, 2007. In addition, § 1.199–8(i)(1) provides that, in certain circumstances, a taxpayer may rely on the guidance in Notice 2005–14 (2005–7 IRB 498), see § 601.602(d)(2), the proposed regulations under section 199 that were published in the **Federal Register** on November 4, 2005 (70 FR 67220), or the final regulations under section 199 that were published in the **Federal Register** on June 1, 2006 (71 FR 31268). Regardless of which guidance a taxpayer applies, the taxpayer may apply these final regulations to taxable years beginning after December 31, 2004, and before March 20, 2007.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to this regulation, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Paul Handleman and Lauren Ross Taylor, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.199–0 is amended by:

■ 1. Revising the entries for §§ 1.199–3(i)(5)(i) and (ii), 1.199–3(i)(6)(ii) through (v), 1.199–6(c), and 1.199–8(i)(4).

■ 2. Adding a new entry for § 1.199–8(i)(7).

The revisions and addition read as follows:

§ 1.199–0 Table of contents.

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§ 1.199–3 Domestic production gross receipts.

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(i) * * *

(5) * * *

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(ii) Exceptions.

(A) Tangible personal property.

(B) Computer software.

(C) Qualified film.

* * * * *

(6) * * *

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(A) Substantially identical software.

(B) Safe harbor for computer software games.

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(E) Qualified computer software maintenance agreements.

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§ 1.199–6 Agricultural and horticultural cooperatives.

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(c) Determining cooperative's qualified production activities income and taxable income.

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§ 1.199–8 Other rules.

* * * * *

(i) * * *

(4) Computer software.

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(7) Agricultural and horticultural cooperatives.

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■ **Par. 3.** Section 1.199–3 is amended by:

■ 1. Revising paragraphs (i)(5)(i) and (i)(5)(ii).

■ 2. Removing the language ''(i)(5)(ii)'' each place it appears in paragraph (i)(5)(iii) and adding the language ''(i)(5)(ii)(C)'' in its place.

■ 3. Revising paragraphs (i)(6)(ii), (i)(6)(iii), (i)(6)(iv), and (i)(6)(v).

The revisions read as follows:

§ 1.199–3 Domestic production gross receipts.

* * * * *

(i) * * *

(5) * * *

(i) *In general.* Except as provided in paragraph (i)(5)(ii) of this section, gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of QPP, a qualified film, or utilities do not include advertising income and product-placement income.

(ii) *Exceptions*—(A) *Tangible personal property.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of newspapers, magazines, telephone directories, periodicals, and other similar printed publications that are MPGE in whole or in significant part within the United States include advertising income from advertisements placed in those media, but only if the gross receipts, if any, derived from the lease, rental, license, sale, exchange, or other disposition of the newspapers, magazines, telephone directories, or periodicals are (or would be) DPGR.

(B) *Computer software.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other 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 lease, rental, license, sale, exchange, or other disposition of computer software are (or would be) DPGR. For this purpose, advertising income and product-placement income mean compensation for placing or integrating advertising or a product into the computer software. This paragraph (i)(5)(ii)(B) does not extend to the exceptions provided in paragraph (i)(6)(iii) of this section. See paragraph (i)(6)(iv)(F) of this section.

(C) *Qualified film.* A taxpayer's gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film include advertising income and product-placement income with respect to that qualified film, but only if the gross receipts, if any, derived from the lease, rental, license, sale, exchange, or other disposition of a qualified film are (or would be) DPGR. For this purpose, advertising income and product-placement income mean compensation for placing or integrating advertising or a product into the qualified film.

* * * * *

(6) * * *

(ii) *Gross receipts derived from services.* 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.

(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 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 being derived from the lease, rental, license, sale, exchange, or other disposition of computer software only if—

(A) The taxpayer also 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 not related persons (as defined in paragraph (b)(1) of this section) 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 either affixed to a tangible medium (for example, a disk or DVD) or by allowing them to download the computer software from the Internet; or

(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.

(iv) *Definitions and special rules*—(A) *Substantially identical software.* For purposes of paragraph (i)(6)(iii)(B) of this section, *substantially identical software* is computer software that—

(*1*) From a customer's perspective, has the same functional result as the online software described in paragraph (i)(6)(iii) of this section; and

(*2*) Has a significant overlap of features or purpose with the online software described in paragraph (i)(6)(iii) of this section.

(B) *Safe harbor for computer software games.* For purposes of paragraph (i)(6)(iv)(A) of this section, all computer software games are deemed to be substantially identical software. For example, computer software sports games are deemed to be substantially identical to computer software card games.

(C) *Regular and ongoing basis.* For purposes of paragraph (i)(6)(iii) of this section, in the case of a newly-formed trade or business or a taxpayer in its first taxable year, the taxpayer is considered to be engaged in an activity described in paragraph (i)(6)(iii) of this section on a regular and ongoing basis if the taxpayer reasonably expects that it will engage in the activity on a regular and ongoing basis.

(D) *Attribution.* For purposes of paragraph (i)(6)(iii)(A) of this section—

(*1*) All members of an expanded affiliated group (as defined in § 1.199–7(a)(1)) are treated as a single taxpayer; and

(*2*) In the case of an EAG partnership (as defined in § 1.199–3T(i)(8)), the EAG partnership and all members of the EAG to which the EAG partnership's partners belong are treated as a single taxpayer.

(E) *Qualified computer software maintenance agreements.* Paragraph (i)(4)(i)(B)(*5*) of this section does not apply if the computer software is online software under paragraph (i)(6)(iii) of this section.

(F) *Advertising income and product-placement income.* Paragraph (i)(5)(ii)(B) of this section does not apply if the computer software is online software under paragraph (i)(6)(iii) of this section. If a taxpayer provides a customer with access to online software in conjunction with providing computer software to such customer either affixed to a tangible medium or by download, paragraph (i)(5)(ii)(B) of this section will only apply to compensation for the placement or integration of advertising or a product into the computer software transferred to such customer either affixed to the tangible medium or by download.

(v) *Examples.* The following examples illustrate the application of this paragraph (i)(6):

Example 1. 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 paragraph (i)(6)(ii) of this section, gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non-DPGR.

Example 2. 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 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.

Example 3. 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 paragraph (i)(6)(ii) of this section, 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.

Example 4. 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 paragraph (i)(6)(iii)(A) of this section, 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).

Example 5. 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 paragraph (i)(6)(iii)(B) of this section, 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).

Example 6. Q produces payroll management computer software within the United States. For a fee, Q provides customers access to the payroll management computer software for the customers' direct use while connected to the Internet. This is Q's sole method of providing access to its payroll management computer software to customers. In conjunction with the payroll management computer software, Q provides storage of customers' data and telephone support. One of Q's competitors, R, derives, on a regular and ongoing basis in its business, gross receipts from the sale to customers of R's substantially identical payroll management software that has been affixed to a compact disc as well as from the sale to customers of R's substantially identical payroll management software that customers have downloaded from the Internet. Under paragraph (i)(6)(iii)(B) of this section, Q's gross receipts derived from providing access to its payroll management 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). However, Q's gross receipts derived from the fees that are properly allocable to the storage of customers' data and telephone support are non-DPGR.

Example 7. The facts are the same as in *Example 6,* except that R produces inventory computer software, not payroll management computer software. R's inventory computer software is not substantially identical software as defined in paragraph (i)(6)(iv)(A) of this section because R's inventory software, from a customer's perspective, does not have the same functional result as Q's payroll management computer software and does not have significant overlap of features or purpose with Q's payroll management computer software. No other person provides substantially identical software to customers affixed to a compact disc or by download. Under paragraph (i)(6)(ii) of this section, gross receipts derived from providing access to Q's payroll online software do not constitute gross receipts derived from a lease, rental, license, sale, exchange or other disposition of payroll computer software. Therefore, Q's gross receipts derived from the payroll management computer software are non-DPGR.

Example 8. S produces computer software games within the United States. S derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are not related to S of S's computer software games that have been affixed to a compact disc as well as from the sale to customers of S's computer software games that customers have downloaded from the Internet. S also derives gross receipts from providing customers access to the computer software games for the customers' direct use while connected to the Internet (online software games). The computer software games sold on compact disc or by download have only minor or immaterial differences from the online software games, and S does not provide any other goods or services in connection with the online software games. Under paragraph (i)(6)(iii)(A) of this section, S's gross receipts derived from providing customers access to its online software games 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).

Example 9. The facts are the same as in *Example 8*, except S's gross receipts also include advertising income from integrating advertisers' logos into the computer software games. Under paragraph (i)(5)(ii)(B) of this section, for S's computer software games sold affixed to a compact disc or by download, S's advertising income is treated as gross receipts derived from the sale of the computer software games and, therefore, is DPGR (assuming all the other requirements of this section are met). However, under paragraphs (i)(5)(i) and (i)(6)(iv)(F) of this section, for S's online software games, S's advertising income is not derived from the lease, rental, license, sale, exchange, or other disposition of computer software and, therefore, is non-DPGR.

■ **Par. 4.** Section 1.199–3T is amended by revising paragraphs (i)(1), (i)(2), (i)(3), (i)(4), (i)(5), and (i)(6) to read as follows:

§ 1.199–3T Domestic production gross receipts (temporary).

* * * * *

(i) *Derived from the lease, rental, license, sale, exchange or other disposition.*

(1) through (6) [Reserved]. For further guidance, see § 1.199–3(i)(1) through (6).

* * * * *

■ **Par. 5.** Section 1.199–6 is amended by:

■ 1. Revising paragraphs (c) and (l).

■ 2. Removing the language ''qualified production activities income (QPAI) (as defined in § 1.199–1(c))'' from paragraph (e) and adding ''QPAI'' in its place.

■ 3. Removing the language ''However, the cooperative may not apply section 199(d)(3) and this section to any portion of the section 199 deduction that is not passed through to its patrons.'' from paragraph (h).

The revisions read as follows:

§ 1.199–6 Agricultural and horticultural cooperatives.

* * * * *

(c) *Determining cooperative's qualified production activities income and taxable income.* For purposes of determining its section 199 deduction, the cooperative's qualified production activities income (QPAI) (as defined in § 1.199–1(c)) and taxable income are computed without taking into account any deduction allowable under section 1382(b) or (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

* * * * *

(l) *No double counting.* A qualified payment received by a patron of a cooperative is not taken into account by the patron for purposes of section 199.

■ **Par. 6.** Section 1.199–8 is amended by:

■ 1. Revising paragraph (i)(4).

■ 2. Adding new paragraph (i)(7).

The revision and addition read as follows:

§ 1.199–8 Other rules.

* * * * *

(i) * * *

(4) *Computer software.* Section 1.199–3(i)(5)(ii)(B) and (i)(6)(ii) through (v) are applicable for taxable years beginning on or after March 20, 2007. A taxpayer may apply § 1.199–3(i)(5)(ii)(B) and (i)(6)(ii) through (v) to taxable years beginning after December 31, 2004, and before March 20, 2007.

* * * * *

(7) *Agricultural and horticultural cooperatives.* Section 1.199–6(c) is

applicable for taxable years beginning on or after March 20, 2007. A taxpayer may apply § 1.199–(6)(c) to taxable years beginning after December 31, 2004, and before March 20, 2007.

■ **Par. 7.** Section 1.199–8T is amended by revising paragraphs (i)(1), (i)(2), (i)(3), and (i)(4) to read as follows:

§ 1.199–8T Other rules (temporary).

* * * * *

(i) *Effective dates.* (1) through (4) [Reserved]. For further guidance, see § 1.199–8(i)(1) through (4).

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Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Approved: March 14, 2007.

Eric Solomon,

Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9316]

RIN 1545–BG14

Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. These regulations affect corporations and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective March 20, 2007.

Applicability Date: For dates of applicability, see § 1.368–1T(e)(8)(ii).

FOR FURTHER INFORMATION CONTACT: Lisa S. Dobson at (202) 622–7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations described in section 368 of the Code. In addition to complying with the statutory and certain other requirements, to qualify as a reorganization, a transaction generally must satisfy the continuity of interest (COI) requirement. COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.

On August 10, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG–129706–04) in the **Federal Register** (69 FR 48429) (2004 proposed regulations) identifying certain circumstances in which the determination of whether a proprietary interest in the target corporation is preserved would be made by reference to the value of the issuing corporation's stock on the day before there is an agreement to effect the potential reorganization. On September 16, 2005, the IRS and Treasury Department published final regulations in the **Federal Register** (TD 9225, 70 FR 54631) (2005 final regulations) which retained the general framework of the 2004 proposed regulations but made several modifications in response to the comments received regarding the proposed regulations. Specifically, the 2005 final regulations provide that in determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization is valued on the last business day before the first date such contract is a binding contract (the signing date), if the contract provides for fixed consideration (the signing date rule).

After consideration of comments relating to the 2005 final regulations, the IRS and Treasury Department are revising those regulations as set forth in this Treasury decision. These temporary regulations provide guidance for measuring whether the COI requirement is satisfied. The following sections specifically describe the revisions.

A. Applicability of the Signing Date Rule

For purposes of determining whether COI is satisfied, the 2005 final regulations require the consideration to be exchanged for the proprietary interests in the target corporation to be valued on the last business day before the first date such contract is a binding contract, if such contract provides for fixed consideration. As noted in the preamble to the 2005 final regulations, the signing date rule is based on the principle that, where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. However, if the contract does not provide for fixed consideration, the signing date value of the issuing corporation stock is not relevant for purposes of determining the extent to which a proprietary interest in the target corporation is preserved.

These temporary regulations continue to apply the signing date rule where the contract provides for fixed consideration. If the contract does not provide for fixed consideration, the temporary regulations provide that the signing date rule is not applicable. Further, these temporary regulations clarify that where fixed consideration includes other property that is identified by value, that specified value is the value of such other property to be used in determining whether COI is satisfied.

B. Definition of Fixed Consideration

As noted above, the temporary regulations provide that the signing date rule only applies to contracts that provide for fixed consideration. These temporary regulations modify the definition of fixed consideration.

The 2005 final regulations provide four circumstances in which a contract will be treated as providing for fixed consideration. Generally, under the 2005 final regulations, a contract provides for fixed consideration if (1) the contract states the number of shares of the issuing corporation plus the amount of money and any other property to be exchanged for all proprietary interests in the target corporation; (2) the contract states the number of shares of the issuing corporation plus the amount of money and any other property to be exchanged for each proprietary interest in the target corporation; (3) the contract states the percentage of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation; or (4) the contract states the percentage of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation.

These temporary regulations combine the first two circumstances into one sentence that defines fixed consideration. No substantive change to these two definitions of fixed consideration is intended with this amendment.

The target corporation shareholders are generally subject to the economic fortunes of the issuing corporation as of