Bats Global Markets Holdings, Inc. v. Commissioner, 158 T. C. No. 5 (2022)

The U. S. Tax Court ruled that Bats Global Markets Holdings, Inc. could not claim transaction, routing, and logical port fees as domestic production gross receipts (DPGR) under I. R. C. § 199. The court determined these fees were derived from services rather than direct use of software, thus not qualifying for the deduction. This decision clarifies the scope of DPGR, impacting how software-related services are treated for tax purposes.

Parties

Bats Global Markets Holdings, Inc. and its subsidiaries (Petitioner) v. Commissioner of Internal Revenue (Respondent). Bats Global Markets Holdings, Inc. was the petitioner throughout the litigation in the United States Tax Court.

Facts

Bats Global Markets Holdings, Inc. (Bats Global), a Delaware corporation, operated national securities exchanges and developed proprietary computer software for these exchanges. Bats Global charged customers fees for transaction execution, routing to external markets, and logical port connectivity. These fees, collectively referred to as the Fees, were claimed as domestic production gross receipts (DPGR) for the purpose of calculating deductions under I. R. C. § 199 for the tax years 2011-2013. The Commissioner of Internal Revenue determined that none of these fees qualified as DPGR.

Procedural History

The Commissioner issued a notice of deficiency to Bats Global, determining deficiencies for the tax years 2011, 2012, and 2013. Bats Global timely sought redetermination in the U. S. Tax Court. After concessions by Bats Global regarding certain fees, the remaining issue was whether the Fees qualified as DPGR. The case proceeded to trial, and the Tax Court issued its opinion on March 31, 2022, under a de novo standard of review.

Issue(s)

Whether the Fees charged by Bats Global for transaction execution, routing to external markets, and logical port connectivity qualify as domestic production gross receipts (DPGR) under I. R. C. § 199 and Treasury Regulation § 1. 199-3(i)(6)(iii)?

Rule(s) of Law

Under I. R. C. § 199, a taxpayer may claim a deduction based on domestic production gross receipts (DPGR), which includes gross receipts derived from the disposition of qualifying production property (QPP), such as computer software, manufactured, produced, grown, or extracted by the taxpayer in the United States.

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Treasury Regulation § 1. 199-3(i)(6)(iii) provides that gross receipts derived from providing customers access to computer software for direct use while connected to the internet or other networks are treated as DPGR if the taxpayer or a third party derives gross receipts from the disposition of the same or substantially identical software in a tangible medium or by download.

Holding

The Tax Court held that Bats Global's Fees do not qualify as DPGR under Treasury Regulation § 1. 199-3(i)(6)(iii) because they were derived from services provided to customers rather than from providing customers direct access to computer software for their use. Additionally, the court found that Bats Global did not meet the third-party comparable exception under Treasury Regulation § 1. 199-3(i)(6)(iii)(B), as the software offered by third parties was not substantially identical to Bats Global's software.

Reasoning

The court analyzed the nature of the Fees and found that they were payments for services related to trade execution, routing, and connectivity rather than for the direct use of software by customers. The court emphasized that the logical port fees provided connectivity to the exchanges, the routing fees were for services performed by Bats Trading, Inc. , and the transaction fees were for trade execution services. The court rejected Bats Global's argument that these fees were derived from the use of its trading software, as customers did not directly use this software but rather interacted with the exchanges through it.

The court also considered whether Bats Global met the third-party comparable exception. To qualify, a third party must derive gross receipts from the disposition of substantially identical software. The court determined that the software offered by third parties (e. g. , NYSE Technologies, Cinnober, and MillenniumIT) was not substantially identical to Bats Global's software because it was used to operate exchanges, whereas Bats Global's customers used the software to trade on the exchanges. The court interpreted "substantially identical" to mean software that achieves the same functional result from a customer's perspective and has a significant overlap of features or purpose.

The court's interpretation was guided by the plain meaning of the regulation and the specific context of the third-party comparable exception. The court also considered the regulatory examples and the safe harbor for computer software games, which did not apply to Bats Global's situation. The court concluded that the Fees were not eligible for the DPGR deduction because they were derived from services, and Bats Global did not meet the requirements for the third-party comparable exception.

Disposition

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The Tax Court's decision was entered under Rule 155, meaning the court ruled against Bats Global's claim that the Fees qualified as DPGR, and the case was closed with instructions for the parties to compute the tax liability based on the court's findings.

Significance/Impact

The decision in Bats Global Markets Holdings, Inc. v. Commissioner clarifies the scope of DPGR under I. R. C. § 199 and the application of Treasury Regulation § 1. 199-3(i)(6)(iii). It emphasizes that for fees to qualify as DPGR, they must be derived from the direct use of software by customers, not merely from services facilitated by software. This ruling impacts how companies that use software to provide services, particularly in regulated industries like securities exchanges, can claim deductions under § 199. The decision also provides guidance on the interpretation of "substantially identical software" under the third-party comparable exception, which may influence future cases involving software-related deductions. Subsequent courts and taxpayers will likely refer to this case when determining the eligibility of fees for DPGR status.

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