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Domestic Production

Kevin Spencer, Robin Greenhouse and Jean Pawlow of McDermott Will & Emery write that IRS regulations and the government's position regarding application of the domestic production deduction for computer software are too restrictive and haven't kept pace with technological advances. The authors outline how the IRS's conclusions in its guidance are incorrect, along with arguments taxpayers can use to defend their Section 199 software deductions.

The IRS's Assault on Section 199 (Computer Software) Doesn't Compute

BY KEVIN SPENCER, ROBIN GREENHOUSE AND JEAN PAWLOW

Internal Revenue Code Section 199 permits taxpayers to claim a 9 percent deduction related to the costs to develop software within the U.S. The relevant regulations and their interpretation, however, place substantial restrictions on claiming the benefit.

Moreover, the regulations and the government's position haven't kept up with the technological advances in computer software.

Before claiming the deduction on your return, consider that the Internal Revenue Service has this issue within its sights, and perhaps it will be the subject of one of their new ''campaigns.''

In 2004, Congress enacted I.R.C. Section 199 to tip the scales of global competitiveness more in favor of American business. The main motivation of the statute was to create jobs by encouraging businesses to manufacture and produce their products in the U.S. The tax benefit, however, isn't available for services, a theme that pervades many of the provisions in the statute and regulations.

I.R.C. Section 199 explicitly applies to the production of ''any computer software'' (I.R.C. Section 199(c)(5)). The regulations, however, greatly narrow its definition, and restrict the application of the statute, raising the question of whether its congressional purpose has been thwarted by its implementation and governance.

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First Principles

I.R.C. Section 199(a) provides a deduction of 9 percent of the lesser of:

- ''qualified production activities income'' (QPAI) of the taxpayer for the year; or
- taxable income.

I.R.C. Section 199(b) limits the deduction to 50 percent of the wages that are attributable to the domestic production activities.

I.R.C. Section 199(c) defines QPAI as the taxpayer's ''domestic production gross receipts'' (DPGR) for the year less the costs of goods sold and expenses allocable to DPGR. DPGR is further defined in I.R.C. Section 199(c)(4)(A)(i)(I) as gross receipts of a taxpayer that are derived from the lease, rental, license, sale, exchange or other disposition (collectively ''disposition'') of ''qualifying production property'' (QPP), which was ''manufactured, produced, grown, or extracted'' (MPGE) by the taxpayer in whole or in significant part within the U.S.

I.R.C. Section 199(c)(5) includes ''any computer software'' as QPP. Treasury Regulations Section 1.199-3(i)(6)(i) provides that DPGR includes gross receipts of the taxpayer that are derived from the disposition of computer software produced by the taxpayer in whole or in significant part within the U.S.

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Treas. Reg. Section 1.199-3(i)(6)(ii) expands upon the statute and provides, however, 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 don't constitute gross receipts derived from a disposition of computer software.

Recognizing that a taxpayer can make a disposition of software by placing it on a tangible medium (like on a disc) or by providing the customer with access to the software while connected to the internet or private communications network, the regulations include two ''comparable'' exceptions. Treas. Reg. Section 1.199-3(i)(6)(iii) provides an exception that if a taxpayer derives gross receipts from providing customers access to computer software produced in whole or significant part by the taxpayer within the U.S. for the customers' direct use while connected to the internet or any other public or private communications network (online software), then such gross receipts will be treated as derived from the disposition of computer software only if:

- The so-called self-comparable exception applies. Pursuant to Treas. Reg. Section 1.199-3(i)(6)(iii)(A), the I.R.C. Section 199 deduction is permitted for online software if a taxpayer derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the disposition of computer software to customers that are unrelated persons that: has only minor or immaterial differences from the online software; was MPGE by the taxpayer in whole or in significant part within the U.S.; and has been provided to such customers affixed to a tangible medium or by allowing them to download the computer software from the internet; or

- The ''third-party comparable exception'' applies. Pursuant to Treas. Reg. Section 1.199-3(i)(6)(iii)(B), the I.R.C. Section 199 deduction is permitted for online software if another person derives, on a regular and ongoing basis in its business, gross receipts from the disposition of substantially identical software (as compared to the taxpayer's online software) to its customers pursuant to an activity described in Treas. Reg. Section 1.199-3(i)(6)(iii)(A)(3) (i.e., by a tangible medium or downloaded from the internet). ''Substantially identical software'' is defined in Treas. Reg. Section 1.199-3(i)(6)(iv)(A) as 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 (Treas. Reg. Section 1.199-3(i)(6)(v) contains several examples that are helpful in understanding the contours of this provision).

Computer Software Controversy With the IRS

The line between what constitutes a nondeductible service and a deductible disposition of computer software gets blurred as technology advances the development, application and use of computer software. Since I.R.C. Section 199 was enacted in 2004, there have been substantial changes in the development, deployment and use of computer software.

What was traditionally considered a ''computer'' is no longer the sole province of software. Today we find sophisticated software in phones, cars, television cable boxes and even our refrigerators. Moreover, the way in which we interact with the world has changed dramatically. Go to any restaurant and count the number of people who are staring at their phones, texting and looking up reviews of the restaurant on Google!

One of the areas that has seen substantial change is online access to computer software. Unlike in 2004, today we spend most of our time shopping, paying bills and banking online through our computers, smartphones and tablets. The amount invested each year to develop online software by U.S. businesses staying connected with consumers, employees and suppliers is in the billions of dollars.

The relevant regulations deny a deduction for this investment unless the taxpayer meets one of the two aforementioned ''comparables'' exceptions, even though these exceptions don't reflect technological advances. For example, the current trend in software development is focused on a closed system with access only through the ''cloud.'' Because there is no equivalent computer software available on a disc or by download, under the IRS's formulation, all cloud-based computer software, despite being produced in the U.S., might be denied the I.R.C. Section 199 benefit.

Moreover, the IRS's interpretation of its regulations further limits the benefit's applicability. It is clear that the IRS doesn't like I.R.C. Section 199, and will interpret that provision as narrowly as possible to deny deductions to taxpayers who have otherwise fulfilled Congress's mandate.

GLAM's Gone Wild!

A good example of the disconnect between Congress's purpose for the I.R.C. Section 199 software deduction and the IRS's implementation is the so-called Banking App Glam. (A ''GLAM'' or ''generic legal advice memorandum'' is legal advice, signed by executives in the IRS's national office of the Office of Chief Counsel, and issued to IRS personnel who are national program executives and managers. GLAMS are issued to assist IRS personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues.)

In 2014, the IRS published the Banking App Glam, AM 2014-008 (Dec. 5, 2014), in which it concluded that a bank didn't derive DPGR when the taxpayer permitted its customers to download a free ''app'' that allows them to interact and access its online banking services.

The taxpayer provided customer banking services, and interacted in various ways, including online through its website and an app it developed. Through its app, customers could access their bank accounts, transfer and wire funds, and deposit checks. From the bank's perspective, all of the actions were the same regardless of whether executed in person or virtually—the bank's internal computers would process the transactions. Accordingly, for the app to have its intended functionality, it had to be connected to the bank's network via the internet—the app had very little independent functionality.

Customers who used the app were required to accept the terms and conditions of use under the bank's nonexclusive, limited license. The app was free to download and to use, and the bank earned revenue from activities that customers performed with the app, for example, wire transfer transactions. For financial reporting purposes, the taxpayer recognized the rev-

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enue generated through the app as banking services revenue, and ascribed no portion of the revenue to the licensing of the app. Other banks have similar apps that provided similar banking activities.

The IRS framed its arguments as:

- whether downloading the free app was a disposition for purposes of I.R.C. Section 199;
- whether the revenue generated by the customer's interactions with the app was DPGR; and
- whether the bank met either of the comparable exceptions for online software.

The IRS determined that the app fit squarely within the definition of online software described in Treas. Reg. Section 1.199-3(i)(6)(iii), pointing out that it didn't operate unless connected to the internet. The IRS interpreted the regulations as inferring that merely downloading an app isn't a ''disposition'' for Section 199 purposes:

> While the Section 199 regulations contain reference to computer software downloads as dispositions, the intent is to include downloaded software that has independent functionality after customers have downloaded it and are no longer connected to the Internet.

The IRS interpreted the regulations as inferring that merely downloading an app isn't a ''disposition'' for Section 199 purposes.

To the IRS, this makes sense ''if customers can only use downloaded computer software while connected to the Internet, the software cannot be materially distinguished from other software that customers access and directly use while connected to the Internet that is not downloaded (*i.e.*, it is equivalent to online software).''

The example in the regulations relates to software for tax preparation (see Treas. Reg. Section 1.199-3(i)(6)(v), Ex. 4). In the example, the taxpayer produces tax preparation software that can be downloaded to the customer's computer, provided on a disc or used directly while connected on the internet. The IRS distinguished the app from the tax preparation software because the latter has functionality while not connected to the internet—the preparation of a tax return. Accordingly, the IRS determined that downloading the app wasn't a disposition for I.R.C. Section 199 purposes.

In the GLAM, the IRS also determined that the bank didn't derive any gross receipts from the disposition of the app. Again, the IRS interpreted the regulations as requiring gross receipts to be ''directly derived from the disposition'' of QPP. The IRS determined that the bank didn't charge a fee for downloading the app, and instead derived gross receipts only from banking services accessed through the use of the app.

Lastly, the IRS determined that the bank failed to meet either of the comparable exceptions. The bank failed to meet the self-comparable exception as it didn't dispose of any computer software. And the third-party comparable computer software that the bank identified wasn't ''substantially identical'' to the bank's app from the customer's perspective.

The IRS's conclusions are incorrect for at least three reasons.

A Disposition Occurs When An App Is Downloaded to a Customer's Device

The IRS argued that the bank's app fits squarely within the definition of online software in Treas. Reg. Section 1.199-3(i)(6)(iii): ''providing customers access to computer software . . . for the customers' direct use while connected to the Internet or any other public or private communications network.'' The IRS found that because the app provided the same functionality as directly accessing the taxpayer's website, and didn't function unless customers were connected to the internet, there was no disposition for I.R.C. Section 199 purposes.

The IRS's position is too broad, and not supported by the statute or legislative history. Downloading an app onto a customer's device should be considered a ''disposition'' for I.R.C. Section 199 purposes. Instead, the IRS stretches commonsense definitions.

There is no authority to require that downloaded computer software have free-standing functionality. Indeed, all that is required is that there is a disposition of computer software. Moreover, to avoid this battle with the IRS all that taxpayers will have to do is to build in some independent functionality into their apps.

Taxpayers Earn Revenue From the Disposition of Apps

I.R.C. Section 199(c)(4)(A)(i)(I) requires that gross receipts of a taxpayer are directly derived from the lease, rental, license, sale, exchange or other disposition of QPP. Because the bank didn't charge, for example, a download fee, the IRS ruled that it didn't ''directly'' derive revenue from its disposition.

Whether a taxpayer directly or indirectly charges for the software customer's use shouldn't matter. The key question should be whether the taxpayers can reasonably and rationally allocate revenue to the downloaded computer software. Requiring a direct exchange (money for software) is very formalistic, and doesn't comport with the evolving nature of e-commerce. Indeed, businesses give items away all of the time for the purpose of enticing customers and their business.

The Banking App Meets The Third-Party Comparables Exception

Under the third-party comparable exception, there must be other taxpayers that derive gross receipts on a regular and continuing basis from the disposition of software that is substantially identical to the taxpayer's online software and either affixed to a tangible medium or downloaded. To be substantially identical, the computer software must have the same functionality as the online software from the customer's perspective, and have significant overlap of features or purpose with the online software. See Treas. Reg. Section 1.199-3(i)(6)(iv)(A).

The IRS ruled in the Banking App Glam that the taxpayer failed the third-party comparison exception. The IRS argued that from the customer's perspective the app provided a different functional result, and didn't have substantial overlap in purpose. The IRS explained:

> From A's and Z's customers' perspective, the computer software provides a different functional result and does not have a significant overlap of purpose. A's customers who are account holders, use A's online software to order individual banking services, while Z's customers, A's competitor banks, use Z's App to provide banking services to multiple account holders.

The IRS's position is untenable. Apps that are available to customers to interact with their bank are substantially the same and provide the same functionality. Here, the IRS intentionally interpreted the exception in a narrow manner so that the app would fail its test.

The Banking App Glam underscores the IRS's narrow and antiquated approach to the I.R.C. Section 199 deduction for computer software.

First, when convenient, the IRS interprets its own guidance and authority in the narrowest manner to achieve its goal of denying this benefit.

Second, the IRS's approach doesn't recognize that technology has advanced as the delivery of computer software is no longer the exclusive province of a disc. Indeed, numerous computers are now sold without even a CD or DVD player as part of their hardware makeup. Computer software that is downloaded to a device and that must be connected to the internet to obtain its full functionality is still computer software—its character doesn't change merely because its delivery has become less hardware dependent.

Lastly, the business model has changed, where taxpayers give customers ''free'' software to entice their business. This new paradigm doesn't vitiate the direct correlation between computer software and the revenue generated from its use.

In Defense of Your I.R.C. Section 199 Computer Software Deduction

The I.R.C. Section 199 issue is being coordinated within the IRS. This means that the IRS has devoted substantial resources to make a few individuals substantive experts on the issues and the government's perspective. From a tax policy perspective, the IRS tries to treat all similarly situated taxpayers uniformly. Accordingly, there is an effort to fit every case into a limited series to resolve ''similar'' cases similarly.

The IRS has developed a template of extensive information document requests (IDRs) for examination teams to easily and quickly send to taxpayers. For example, recently one of our clients received 100 IDRs focused on the Section 199 computer software issue. This isn't unusual.

The IRS's hard-line approach has spurred substantial controversy. Indeed, there are presently three docketed court cases relating to the I.R.C. Section 199 computer software issue (*Vesta Corp. v. Commissioner*, Tax Court Docket No. 26847-16; *BATS Glob. Mkts. Holdings, Inc. v. Commissioner,* Tax Court docket No. 1068-17; *Bloomberg LP v. Commissioner*, Tax Court Docket No. 3755-17). Moreover, we are aware of numerous other cases under audit and at IRS Appeals in which taxpayers are pushing back against the IRS's unreasonable position. Until a court decides this issue, we can expect a continuing increase in controversy in this area.

To defend your I.R.C. Section 199 computer software deduction, you have several options. First, you can argue the facts and distinguish your situation from the published guidance and the examples in the regulations. Focus on the technology, and get into the details. For example, when a customer downloads an app to his or her phone, from a technological perspective understand what is happening.

Second, argue the law. The published guidance, like the Banking App Glam, isn't considered binding authority, and is merely a position taken by the IRS in that specific case. (See I.R.C. Section 6110(k)(3) (''Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent'').) It shouldn't be afforded any deference. (But see *Auer v. Robbins*, 519 U.S. 452 (1997) (government's position raised in an amicus brief was afforded deference by the Supreme Court; government wasn't, however, a litigant in the case).)

Lastly, argue tax policy. When in doubt, the congressional intent behind I.R.C. Section 199 should drive the result. Congress enacted the statute to encourage taxpayers to produce in the U.S. and not abroad. The regulations go far beyond what Congress intended, and install tests and rules that make the statute applicable in only the most limited situations. By taking the narrowest of interpretations, the IRS is thwarting the reason behind the law, leaving taxpayers caught.

The IRS has substantial hazards in its extreme position. A favorable court decision, however, could rebalance the IRS's position. Depending upon the size of the benefit from claiming the I.R.C. Section 199 deduction, strategically it may make sense to claim the benefit (on an original or amended return), and battle with the IRS on exam and at Appeals pending a favorable court decision.

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