Production Deduction Reg Hearing Features Online Software, Item Rules

by Sheryl Stratton

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Although the January 11 IRS hearing on proposed domestic production deduction rules looked to be a marathon, with 15 witnesses scheduled to appear, it turned out to be a rather straightforward affair in which half of the speakers were accounting students.

The focus of software industry representatives and others was on providing suggestions for safe harbors and simplifying conventions for the highly complex rules.

Proposed Rules

The proposed regs, which would be effective for tax years beginning after December 31, 2004, expand on interim guidance (Notice 2005-14) issued in January 2005 on the new section 199 deduction, which was enacted as part of the American Jobs Creation Act of 2004 (P.L. 108-357). Until the proposed regs become final, taxpayers may rely on Notice 2005-14 and the proposed regs. (For REG-105847-05, see *Doc 2005-21302* [PDF] or *2005 TNT 203-6*. For Notice 2005-14, 2005-7 IRB 498, see *Doc 2005-1241* [PDF] or *2005 TNT 13-7*.)

Under the proposed regs, companies may deduct 3 percent of income from domestic production activities for 2005 and 2006. The deduction rises to 6 percent for 2007-2009 and to 9 percent for 2010 and later. Qualifying domestic production activities include the manufacture of personal property; software development; film and music production; the production of electricity, natural gas, or water; and construction, engineering, and architectural services.

Online Software

The regs' proposed treatment of online use of software has drawn the attention of the software industry and congressional taxwriters. The regs provide a list of software gross receipts that do not qualify for the deduction: "gross receipts derived from Internet access services, online services, customer and technical support, telephone services, online electronic books and journals, games played through a Web site, provider-controlled software online access services, and other similar services."

Government officials have consistently stated that an access service or online use of software is not a qualifying disposition as required by the statutory language.

George Manousos of the Treasury Office of Tax Policy asked the two representatives from software groups which disposition online access fits into -- lease, rental, license, sale, exchange, or other disposition of a copy of computer software.

The software industry characterizes the use of software functionality as a license, responded Mark E. Nebergall, on behalf of the Software Finance and Tax Executives Council (SoFTEC). But it could also be considered the sale of the right to use the software, he said.

"Other disposition" would cover it as well, said Gary Sprague of Baker & McKenzie in Palo Alto, Calif., on behalf of the Software Coalition.

In any event, the test for qualifying production activities should focus on what the online customer is getting, the software industry representatives argued.

Section 199 treatment should be extended to companies that provide access to software functionality through hosting arrangements, according to Sprague. Delivering software applications through hosting is only the latest development in the industry's continuing evolution toward more efficient delivery methods for its software products, he said.

One thing that typifies the software industry is the continued evolution of distribution methods, said Nebergall. The essential element in any software distribution technique is the transfer to the customer of the right to use the software's functionality, he said. The transfer of a physical copy of the software is not the essential element in the transaction -- it is the transfer of the agreed-upon right or rights of usage, he said. Companies that make their software functionality remotely available transfer to their customers the same use rights that accompany transfers of copies of software.

Section 199 applies to gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of any computer software, Nebergall said.

"In describing the types of agreements for which section 199 treatment is available, Congress could hardly have used broader language," Nebergall said. The statutory language is certainly broad enough to encompass the contracts used to deliver software use rights to customers, he said.

It is possible to draft a regulation that distinguishes between the delivery mechanism and the item being delivered, Sprague said, acknowledging the government's concern that service transactions conducted online should not qualify. The principal determinant of whether a software hosting transaction qualifies for the section 199 deduction should be whether the principal object of the transaction, from the customer's perspective, is to obtain access to the functionality of the software involved, explained Sprague: "The key conceptual point here is to separate the utility of the Internet to deliver goods or services from the nature of the item being delivered."

Sprague said that among the factors for the government to consider are: (1) the significant software development costs incurred by the company providing the hosted software in relation to its overall development costs properly allocable to that revenue; (2) the substantiality of the software access component of the item being delivered, ignoring costs relating to the delivery mechanism; and (3) whether the transaction is analogous to other distributions of computer software.

In written comments, SoFTEC also proposed an objective test that could be used to determine when a transaction involved qualifying computer software, Nebergall noted. The test focuses on the quantum of gross receipts derived from the transaction that are properly allocable to

computer software, he explained. SoFTEC also proposed simplifying safe harbors.

Nebergall and Sprague also suggested that the final regs make clear that income from integrated software maintenance contracts qualifies as gross receipts for section 199 purposes.

Itemizing

Section 199 requires calculating the qualified production activities income, which in turn requires identifying a taxpayer's "items" of income. One of the foremost topics about the proposed regs has been how the government defines the term "item" for purposes of qualifying for the deduction. The government created a "shrinkback" rule, which requires that the taxpayer shrink back a nonqualifying activity to the largest component that does qualify.

The design, engineering, and production necessary to install multiple manufactured and purchased component parts represent major assembly and are so closely integrated into a single process that they make shrinkback of qualifying installation into each item impractical if not impossible, said Nicholas Gruidl of RSM McGladrey Inc. and McGladrey & Pullen LLP. The final regulations should clarify that when the integrated installation of manufactured and purchased components also represents major assembly, the assembly is a single item, so that application of the exceptions in the proposed regs would apply to the major assembly activity as a whole, he said.

Gruidl cited shoe soles as an example of a product line that should be treated as a single item. Manousos asked how product line could be defined for a manufacturer that makes all kinds of shoes. Gruidl acknowledged the necessity of analyzing each product, but suggested that it could be handled with a simplifying safe harbor convention.

David Schneider, special counsel to the IRS associate chief counsel (passthroughs and special industries), expressed concern about sales from a manufacturer's nondomestic activities getting swept into domestic production gross receipts. Gruidl acknowledged the concern, but said he is seeking a safe harbor for the companies with straightforward domestic operation issues.

Passthrough Problems

Builders' representatives asked the government to simplify computations required of owners of interests in passthrough entities.

Richard R. **Shavell** of Associated Builders and Contractors Inc. said the administrative effect on S corporation shareholders and other passthrough entities could be reduced by providing an election to compute the deduction entirely at the entity level for passthrough entities.

Patrick M. Malayter, a partner in BKD, a large Midwestern CPA firm, suggested augmenting the rules with illustrations of how the deduction would be determined by individual passthrough entity owners when a large number of taxpayers will be required to determine the deduction at an "owner level."

Grad Students Offer Solutions

Steven C. Dilley, a lawyer, CPA, and professor of accounting at Michigan State University, talked about the deduction's potential tax savings for small corporations and individuals, emphasizing the offsetting and potentially overshadowing costs of compliance with the regs' myriad requirements. Providing more simplified methods could help with the compliance burden, he pointed out.

Dilley was accompanied by several students working on their master's degrees in accounting. The students, who had submitted written comments to the government based on case studies created by Dilley, made oral presentations of their suggested solutions for fixing the rules.

Documents

The following documents are available from Tax Analysts:

- Comments from Nicholas P. Gruidl, RSM McGladrey Inc. and McGladrey & Pullen. *Doc 2005-25773* [**PDF**]; *2005 TNT 246-18*
- January 2006 comments from Thomas J. Purcell III and Barry Tovig, AICPA. *Doc 2006-576* [**PDF**]
- March 2005 comments from Purcell. *Doc 2005-7717* [**PDF**]; *2005 TNT 72-27*
- Comments from Gary D. Sprague, Software Coalition. *Doc 2005-7517* [**PDF**]; *2005 TNT 72-24*
- Comments from Mark E. Nebergall, SoFTEC. *Doc 2006-565* [**PDF**]
- Comments from Leslie J. Schneider, Ivins, Phillips & Baker. *Doc 2006-258* [**PDF**]; *2006 TNT 4-27*
- Comments from Associated Builders and Contractors Inc. *Doc 2006-566* [**PDF**]
- Comments from Patrick M. Malayter, BKD LLP. *Doc 2006-254* [**PDF**]; *2006 TNT 4-24*

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