American Institute of CPAs
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Washington, DC 20004-1081

August 19, 2016

Ms. Donna Young
Associate Chief Counsel
Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Modify the Regulations under Section 199 for Determining Qualified Gross Receipts from the Disposition of Computer Software

Dear Ms. Young:

The American Institute of CPAs (AICPA) appreciates the opportunity to submit comments with respect to the regulations under Internal Revenue Code (IRC or "Code") section 199[1] related to computer software. Specifically, our comments recommend modifications to the section 199 regulations for determining qualified gross receipts from the disposition of computer software.

The current regulatory framework makes a determination of whether gross receipts from software development are qualified for section 199 purposes based on whether the software is disposed via a tangible medium, by download, or through local or remote servers connected to the Internet ("online"). The statutory language of section 199 does not provide for this distinction. The AICPA believes the distinction in the regulations denies taxpayers developing certain software in the United States (U.S.) a section 199 deduction for otherwise qualifying activities. The result is inconsistent with the broad legislative intent of section 199 to incentivize domestic production.

The AICPA recommends that the Internal Revenue Service (IRS) and Treasury eliminate the distinction regarding the means of software delivery in the regulatory framework and allow gross receipts derived from the disposition of computer software to include gross receipts derived from providing software online without relying on the disposition of comparable software via download or tangible medium.

We recognize the concern that eliminating the regulatory distinction with respect to the means of software disposition may result in taxpayers claiming, as domestic production gross receipts, amounts derived from non-qualified services. To address this issue, we recommend the IRS

[1] All references herein to "Section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

and Treasury modify the section 199 regulations to define ‘provision of software online’ consistently with the definition of software that is not internal use software in the proposed regulations under section 41.[2] The IRS and Treasury could clarify the definition under section 199 that the provision of software online excludes the provision of non-qualifying services. Specifically, we recommend that Treasury explicitly state that the use of software by a customer online, while connected to the Internet, is not by itself considered the provision of a non-qualifying service.

For situations involving both the provision of software as well as non-qualifying services, taxpayers currently must engage specialists or perform in burdensome computations to determine gross receipts attributable to qualifying software dispositions versus non-qualifying services. These additional tax compliance activities are costly and time consuming. Therefore, we recommend that, where an allocation of gross receipts is required, the IRS and Treasury include a safe harbor in the regulations, providing for the allocation of gross receipts between the provision of software and non-qualifying services as discussed in the attached comment letter.

We believe that these modifications to the regulations under section 199, for determining qualifying dispositions of computer software and qualifying gross receipts, are necessary to provide taxpayers with much-needed clarity in applying the rules. We also believe the modifications will reduce future controversies between taxpayers and the IRS, and are consistent with the legislative intent to incentivize domestic development of all software, regardless of the medium of its disposition.

These comments were developed by the AICPA’s Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

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[2] See REG-153656-3.

We appreciate your consideration of our comments and proposed changes that are necessary to provide clarification to taxpayers. We welcome a further discussion of these issues and our comments. If you have any questions, please contact me at (801) 523-1051 or tlewis@sisna.com; or Jane Rohrs, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 370-2290, or jrohrs@deloitte.com; or Ogochukwu Anokwute, Lead Technical Manager-AICPA Tax Policy & Advocacy, at (202) 434-9231, or oanokwute@aicpa.org.

Sincerely,

Troy K. Lewis, CPA, CGMA
Chair, AICPA Tax Executive Committee

cc: The Honorable Mark J. Mazur, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable William Wilkins, Chief Counsel, Internal Revenue Service
Ms. Emily McMahon, Deputy Assistant Secretary for Tax Policy, Department of the Treasury
Mr. Thomas West, Tax Legislative Counsel, Department of the Treasury
Mr. Ken Beck, Taxation Specialist, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Curt Wilson, Deputy Chief Counsel (Technical), Internal Revenue Service
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Suggested Modifications to the Section 199 Regulations Related to the Disposition of Computer Software

Developed by the AICPA Tax Methods and Periods Technical Resource Panel Section 199 Working Group

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August 19, 2016

AMERICAN INSTITUTE OF CPAs

Recommendations to Modify the Regulations under Section 199 Regarding Determining Qualified Gross Receipts from the Disposition of Computer Software

I. Executive Summary

The AICPA provides the following recommendations to modify the regulations under section 199 for determining qualifying gross receipts from dispositions of computer software. We believe that if implemented, our recommendations will result in reduced controversies between taxpayers and the IRS and a more equitable application of section 199.

A. Eliminate the Regulatory Distinction in Determining Qualified Gross Receipts from Software Development Depending on the Manner in Which Software is Disposed.

Analysis

Under the current regulatory framework, the means of software delivery (e.g., by tangible medium, via download to a customer's computer, or online) is taken into consideration when determining whether gross receipts are qualified for purposes of section 199. To determine domestic production gross receipts (DPGR) from the disposition of computer software via a tangible medium or by Internet download, a taxpayer must show only that it received gross receipts from a qualified disposition (e.g., sale, license, etc.) of the software that was developed in whole or in significant part in the U.S. by the taxpayer.[3] However, to derive domestic production gross receipts from the disposition of online software, under the regulations, a taxpayer must also show that the taxpayer or a third party derives gross receipts on a regular and ongoing basis by providing similar software to customers that is either affixed to a tangible medium or by Internet download.[4] There is no such distinction in the statute.

Recently, companies that offer software only online have encountered significant challenges in identifying software that meets the comparable use exceptions. This issue is because of the rapid migration of all software, due to changing business requirements and customer preferences, to formats offered only online. We have provided examples of such common fact patterns in the discussion section of the letter.

As applied to such facts, the current regulations deny a section 199 deduction to taxpayers undertaking otherwise qualifying software development activities. This result is inconsistent

[3] Treasury Reg. §§ 1.199-3(a)(1); (j)(1).

[4] Specifically, to qualify as gross receipts from online software, a taxpayer must show either: (1) the taxpayer provides computer software that (a) has only minor or immaterial differences from the online software, (b) has been Manufactured, Grown, Produced or Extracted (MPGE) by the taxpayer in whole or in significant part within the United States, and (c) has been provided to customers either affixed to a tangible medium or by allowing customers to download the computer software from the Internet; or (2) another person derives, on a regular and ongoing basis, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software to customers either affixed to a tangible medium or by allowing customers to download the computer software from the Internet. Treas. Reg. §1.199-3(i)(6)(iii). These two tests are referred to herein as "comparable use exceptions.")

with the broad statutory language in section 199 and the legislative intent, which is to incentivize domestic production.

The current regulatory framework also incentivizes taxpayers to develop only online software meeting the comparable use exceptions (i.e., software brought to market via tangible format or by download) rather than all software. We believe that this regulatory distinction does not reflect the statutory language and is not consistent with the congressional intent in enacting section 199. We are also unaware of any policy reason to encourage U.S. development of software solely based on the medium in which it is disposed.

Recommendations

The AICPA recommends that the IRS and Treasury eliminate the distinction of the means of software delivery, in the regulatory framework under Treas. Reg. § 1.199-3(i)(6), by removing Treas. Reg. § 1.199-3(i)(6)(iii) and providing additional guidance for determining qualifying gross receipts derived from software development. We believe eliminating the regulatory distinction based on the manner in which software is disposed of will result in equitable treatment of U.S. development activities for all types of software.

We recognize that the IRS and Treasury are concerned that eliminating the distinction with respect to the means of software disposition may result in taxpayers treating as DPGR, amounts derived from non-qualified services. To clarify, when a transaction between a software developer and user includes a qualifying disposition versus merely the provision of non-qualifying services, we believe the tests in the proposed internal use software regulations ("IUS regulations")[5] under section 41 are instructive.

Also, we recommend that the IRS and Treasury clarify in a new definition, that the provision of software online excludes the provision of non-qualifying services. This added definition would specify that there is no qualified disposition of computer software where the software is used only by the taxpayer to provide non-qualifying services. Conversely, the new definition would specify that the online use of software (as described below) by a customer while connected to the Internet is a qualified disposition and therefore could give rise to DPGR.

We believe these suggested changes will provide for a regulatory test that more accurately conforms to statutory language and congressional intent.

B. Add a Safe Harbor to the Regulations for Allocating Gross Receipts Related to the Disposition of Software Versus Receipts from Non-Qualifying Services.

Analysis

Taxpayers often offer software "bundled" with other services to customers for a combined fee. As services are generally non-qualifying for purposes of section 199, taxpayers must allocate their gross receipts between the qualifying portion attributable to software and the non-qualifying portion attributable to services (or other non-qualifying benefits/rights provided to the customer).

[5] REG-153656-03.

The burden that taxpayers incur in determining this allocation, and the controversy the allocation generates upon IRS examination, is significant. In many cases, in order to determine the appropriate allocation, taxpayers engage in a transfer pricing analysis or, if needed, hire consultants to perform a transfer pricing analysis. The time expended and cost incurred for this analysis is substantial and taxpayers often face additional time and cost of defending their transfer pricing methodology upon IRS examination.

Recommendation

The AICPA recommends that where such an allocation of gross receipts is required,[6] the IRS and Treasury add a safe harbor to the regulations providing for the allocation of gross receipts related to the disposition of software versus non-qualifying services based on reasonable factors.[7]

We believe implementing a safe harbor for taxpayers to allocate gross receipts between qualifying software dispositions and non-qualifying services will simplify the determination of qualified gross receipts, and will reduce future controversies between taxpayers and the IRS.

The AICPA believes that our recommended clarifications and simplifications will make the regulations for determining DPGR from dispositions of computer software more administrable and fair, in addition to reducing controversies with the IRS.

II. Discussion and Recommendations

A. Eliminate the Regulatory Distinction in Determining Qualified Gross Receipts from Software Development Depending on the Manner of Computer Software's Disposition.

1. Overview of Regulations for Determining Qualified Gross Receipts from the Disposition of Computer Software

a. Broad Statutory Language

Section 199 allows taxpayers to claim a deduction for nine percent of the lesser of qualified production activities income (QPAI) resulting from domestic production activities or taxable income,[8] limited to 50 percent of the taxpayer's wages that are allocable to DPGR.[9]

QPAI is defined as the excess of DPGR over the sum of (a) the cost of goods sold allocable to such receipts; and (b) other expenses, losses, or deductions properly allocable to such receipts.[10]

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[6] Where taxpayers do not provide any other goods or services in connection with the disposition of computer software, the gross receipts from providing online access to such software is fully qualified domestic production gross receipts.

[7] The safe harbor is not intended to prevent taxpayers from using other reasonable methods to determine qualified gross receipts.

[8] Taxable income is determined without regard to the Section 199 deduction. Sec. 199(a)(1)(B). The applicable percentage is nine percent for taxable years beginning on or after taxable year 2010. Sec. 199(a); see also Treas. Reg. § 1.199-1(a).

[9] Section 199(b)(2)(B).

[10] Section 199(c)(1).

Under section 199, DPGR means, among other items, "the gross receipts of the taxpayer which are derived from … any lease, rental, license, sale, exchange, or other disposition of … qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the U.S."[11] The definition of qualifying production property includes "any computer software."[12]

There is no distinction under section 199 as to the manner of disposition of computer software for purposes of determining qualification of receipts as DPGR (i.e., disposition by tangible medium, by Internet download, or online). In other words, the statutory language in section 199 does not exclude from qualification as DPGR, gross receipts from the disposition of computer software that is available only online.

A similar distinction in the methods and means of disposition for purposes of section 199 was previously addressed in the context of qualified film. When section 199 was first enacted, the regulations stipulated that the airing of a taxpayer's qualified film (e.g., television programming), over the taxpayer's own broadcast, cable, or satellite television outlet, did not constitute a qualifying disposition for purposes of section 199. This stipulation was because the broadcast was not considered a lease, rental, license, sale, exchange, or other disposition of the qualified film.[13] This rule in the regulations was inconsistent with legislative intent[14] and effectively precluded certain producers of qualified film from claiming the section 199 deduction, despite such producers undertaking the same qualifying activities as other taxpayers that chose to license or sell their films to third parties. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (the Tax Extenders Act),[15] enacted October 3, 2008, addressed the discrepancy by adding a sentence to section 199(c)(6) explicitly stating that the methods and means of distributing a qualified film did not affect the availability of section 199. Thus, the distribution of a qualified film via open air broadcast or the Internet, whether viewed online or downloaded, is considered a qualifying disposition for section 199.[16] In 2015, Treasury and the IRS issued proposed section 199 regulations modifying the qualified film rules to conform to original legislative intent and a clarifying amendment to the statute.[17]

Consistent with the modification of the regulations addressing qualified film, the AICPA believes that the current distinction between online access of software versus a "qualifying disposition" of software is arbitrary and contrary to legislative intent.

b. Broad Legislative Intent

Section 199 was added to the Code by the American Jobs Creation Act of 2004[18] to incentivize domestic manufacturing.[19] The broad purpose of section 199 was described in the Conference Report as follows:

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[11] Section 199(c)(4)(A)(i)(I).
[12] Section 199(c)(5)(B).
[13] Treas. Reg. § 199-3(k)(3)(ii).
[14] H. Conf. Rept. 108-755, at 273 (2004).
[15] Pub. L. 110-343, sec. 502(c)(2), at 122 Stat. 3876.
[16] Staff of the Joint Committee on Taxation, "Technical Explanation of H.R. 7060, the 'Renewable Energy and Job Creation Tax Act of 2008'" (JCX-75-08) (9/25/2008), at p. 120.
[17] Prop. Treas. Reg. § 1.199–3(k)(3)(i).
[18] Pub. L. 108-357, sec. 102(a), 118 Stat. 1424.
[19] See H. Conf. Rept. 108-755, at 265-275 (2004).

> Exploration of fundamental tax reform. The conferees acknowledge that Congress has not reduced the statutory corporate income tax rate since 1986. According to the Organization of Economic Cooperation and Development (OECD), the combined corporate income tax rate, as defined by the OECD, in most instances is lower than the U.S. corporate income tax rate. Higher corporate tax rates factor into the United States' ability to attract and retain economically vibrant industries, which create good jobs and contribute to overall economic growth. This legislation was crafted to repeal an export tax benefit that was deemed inconsistent with obligations of the United States under the Agreement on Subsidies and Countervailing Measures and other international trade agreements. This legislation replaces the benefit with tax relief specifically designed to be economically equivalent to a 3 percentage point reduction in U.S. based manufacturing. The conferees recognize that manufacturers are a segment of the economy that has faced significant challenges during the nation's recent economic slowdown. The conferees recognize that trading partners of the United States retain subsidies for domestic manufacturers and exports through their indirect tax systems. The conferees are concerned about the adverse competitive impact of these subsidies on U.S. manufacturers. These concerns should be considered in the context of the benefits of a unified top tax rate for all corporate taxpayers, including manufacturing, in terms of efficiency and fairness. The conferees also expect that the tax-writing committees will explore a unified top corporate tax rate in the context of fundamental tax reform.[20]

As demonstrated by the Conference Report, the congressional intent behind the statute was to incentivize domestic manufacturing.

In a letter to Treasury explaining the intent of Congress for various provisions of section 199, the Chairman of the House Committee on Ways & Means and the Chairman and Ranking Member of the Senate Committee on Finance, instructed Treasury to "consider further, the treatment of online access to computer software and, in particular, whether such treatment should be similar to the treatment of computer software distributed by other means, such as by physical delivery or delivery via Internet download."[21] Treasury was directed to include the results of its consideration of the issue in future published guidance and was instructed to note that, "gross receipts from the provision of services are not treated as domestic production gross receipts regardless of the fact that computer software may be used to facilitate such service transactions."[22]

In the more than 10 years that have passed since the drafting of the letter from Congress to Treasury, online computer software has become ubiquitous for business activities for almost every industry. Fully automated software programs now handle business transactions historically conducted by a taxpayer's employees. As software continues to replace manual functions previously performed by employees, and the manner of delivery of software moves from tangible medium and downloadable formats to online, the outdated language of the

[20] H. Conf. Rept. 108-755, at 274-275 (2004).
[21] Letter dated July 21, 2005, to John W. Snow from William M. Thomas, Charles E. Grassley, Jr., and Max Baucus.
[22] *Id.*

regulations is no longer effective in carrying out congressional intent to reward software development activities undertaken in the U.S. Accordingly, updated guidance is necessary to assist taxpayers with distinguishing between the disposition of software in a qualifying manner versus the provision of non-qualifying services. As will be further discussed below, the AICPA believes the definition of internal use software under the proposed section 41 regulations may be leveraged for purposes of determining when a taxpayer is providing non-qualifying services for section 199.

c. Determining Qualified Gross Receipts from Disposition of Computer Software

Treasury Reg. § 1.199-3(i)(6)(i) provides the following rule specifically addressing DPGR related to software:

> 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. Such gross receipts qualify as DPGR even if the customer provides the computer software to its employees or others over the Internet.

Under Treas. Reg. § 1.199-3(i)(6)(ii), gross receipts derived from online services which utilize software (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals) and other similar services do not qualify as DPGR.

However, Treas. Reg. § 1.199-3(i)(6)(iii) provides two exceptions for gross receipts derived from online services which utilize software. The regulations allow as DPGR, gross receipts derived from providing customers access to computer software MPGE in whole or significant part by the taxpayer within the U.S. for the customer's direct use while connected to the Internet or any other public or private communications network (online software) 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 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 compared to the taxpayer's online software) to its customers.

Thus, the regulatory test for determining whether DPGR includes gross receipts derived from a disposition of computer software, differentiates qualification of gross receipts from computer software depending on the manner in which the software is disposed. For gross receipts from the disposition of computer software via a tangible medium or by Internet download to qualify, a taxpayer must show only that the taxpayer received gross receipts from a qualified disposition (e.g., sale, license, etc.) of the software developed in whole or in significant part in the U.S. by the taxpayer.[23] However, for gross receipts from the disposition of online software to qualify, a taxpayer must also show that the taxpayer or a third party provides to customers similar software affixed to a tangible medium or by Internet download.

2. Eliminate Regulatory Distinction between Types of Disposition of Computer Software

Analysis

Section 199 does not distinguish the qualification of gross receipts from the disposition of computer software as DPGR based on the means of software delivery, whether it is via a tangible medium, by download, or by providing computer software online. The lack of distinction is consistent with the broad congressional intent behind section 199, which is to incentivize a variety of qualifying domestic production activities.

The AICPA is unaware of any policy reason for determining the qualification of gross receipts from dispositions of computer software as DPGR based on the means of delivery when the statute makes no such distinction.

The regulatory distinction operates to deny a section 199 deduction to producers of certain types of online software, including software functioning only in the cloud or other hosted environment, where the producers or third parties do not dispose of similar software via a tangible medium or by Internet download. This manner of software delivery is prevalent with many types of industries that rely on innovative computer software to transact business.

In today's business environment, businesses offer more and more software programs via online access only. For example, certain innovative types of social media software include analytic capabilities that help customers select music and videos while browsing, as well as connecting the customers to persons of similar interests. This software currently is produced only by companies offering software in a cloud-based environment. While developers of such software derive gross receipts from providing customers the software online, they are ineligible for a section 199 deduction for otherwise qualifying development activities since the software is not available outside the cloud, and thus not brought to market via a tangible format or by download by prime or third party producers of the software.

Additionally, in certain industries, customers may no longer desire to use computer software affixed to a compact disc or available for download from the Internet. Instead, they may only want to use an online product leveraging a hosted environment for a variety of reasons, including reduced hardware costs and access to automatic upgrades and bug fixes. Under the current regulatory framework, producers of such online software products are ineligible for a section 199 deduction for otherwise qualifying development activities since, due to customer preferences and trends beyond the producers control, the software is not brought to market via a tangible format or by download by prime or third-party producers of such software.

[23] Treasury Reg. §§ 1.199-3(a)(1); (j)(1).

In some cases, only a single competitor may develop software that satisfies the third party's comparable requirement for a given taxpayer's online software. If the competitor goes out of business or migrates its software to an online-only environment, the taxpayer is ineligible for a section 199 deduction under the current regulatory framework since the comparable software is no longer brought to market via a tangible medium or by Internet download. Presumably, the competitor that migrates its software to an online-only environment is ineligible for a section 199 deduction as well.

In all of these fact patterns, the software producer would qualify for a section 199 deduction under the statutory language, although the software producer is denied a deduction under the current regulatory framework. The software producer's eligibility for a section 199 deduction is currently dependent on the manner in which the software is delivered, not whether the computer software is MPGE in whole or significant part by the taxpayer within the U.S.

Further, the current regulations incentivize taxpayers to develop only online software meeting the comparable use exceptions (i.e., software brought to market via tangible format or by download) rather than all software. The regulations act as a disincentive to U.S. software production where taxpayers produce only online software, and may ultimately drive software production offshore for industries that fully migrate to online-only access.

The AICPA is unaware of any policy reason for drawing these distinctions in the regulatory framework when none exists in the statutory language of section 199. The regulations are becoming increasingly inapplicable, as business operations are trending towards online-only distribution. Taxpayers are denied a section 199 deduction for otherwise qualifying development activities under the current regulations. We believe eliminating the regulatory distinction based on the manner of disposition of software, will treat the means of software disposition similarly and consistent with the broad language in section 199 and the congressional intent behind the Statute.

Recommendations

The AICPA recommends that the IRS and Treasury eliminate the distinction in the qualification of gross receipts, from the disposition of computer software as DPGR based on the means of software delivery, under Treas. Reg. § 1.199-3(i)(6), and provide a new test for determining qualifying gross receipts from software dispositions.

3. New Test for Determining DPGR from the Disposition of Software

Analysis

We recognize that the IRS and Treasury are concerned that eliminating the distinction with respect to the means of software disposition may result in taxpayers qualifying as domestic production gross receipts amounts derived from non-qualified services. In determining when a transaction includes a qualifying disposition of computer software for purposes of section 199 versus merely the provision of non-qualifying services, we believe the tests in the proposed IUS regulations[24] are instructive.

[24] See REG-153656-03.

Although the requirements of section 41 differ from those in section 199, taxpayers have faced similar uncertainties in applying the rules under both sections to rapidly evolving business practices. In particular, the preamble to the proposed IUS regulations[25] notes the following:

> The role that computer software plays in business activities is very different today than it was when the exclusion for internal use software was enacted in 1986. Today, computer software is used in all aspects of business activity, especially in providing goods and services to third parties, and such software has played a vital role in increasing the productivity of the U.S. economy and in making the U.S. more competitive globally.

Under section 41, which allows a credit for increasing research expenditures, the definition of qualified research excludes research with respect to computer software developed primarily for internal use by the taxpayer. In recent years, there has been a significant amount of controversy related to the determination of whether a taxpayer's developed software constitutes IUS. In January 2015, the IRS and Treasury released proposed IUS regulations[26] to reduce confusion and simplify the rules of application for IUS software.

Under the proposed IUS regulations, software is developed by (or for the benefit of) the taxpayer primarily for internal use if the software is developed by the taxpayer for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. Importantly, the proposed IUS regulations specify that computer software is *not* developed primarily for the taxpayer's internal use if either: (1) the software is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; or (2) the software is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. Treasury and the IRS intended this regulation to describe the transactions where the benefits to the computer software are transferred to someone other than the software developer.[27]

Recommendations

In place of the current regulatory test for determining qualifying gross receipts from a disposition of computer software, the AICPA recommends adding a sentence to Treas. Reg. § 1.199-3(i)(6)(i) as follows:

> DPGR includes 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 U.S. Such gross receipts qualify as DPGR even if the customer provides the computer software to its employees or others over the Internet. <u>*For purposes of this paragraph, the term 'other disposition' under paragraph (i)(1) of this section includes, among other activities, the provision of software access via the Internet or any other public or private communications network.*</u>

[25] *Id.*
[26] *Id.*
[27] *Id.*

The recommended language makes clear that the term "other disposition of computer software" includes the provision of computer software over the Internet.

The AICPA believes the transfer of the software's benefit to the user through the types of dispositions enumerated in the proposed IUS regulations defined as non-IUS software is indicative of a disposition of software for section 199. Thus, we recommend the IRS and Treasury modify Treas. Reg. § 1.199-3(i)(6)(i) to state that a taxpayer is deemed to provide computer software online, and is not providing a service, if there is a disposition of the software that is similar to the dispositions enumerated in the proposed IUS regulations with respect to software not primarily developed primarily for the taxpayer's internal use. The IRS and Treasury could further clarify that the provision of software online excludes the provision of non-qualifying services. This clarification would establish a useful distinction between a qualified disposition of computer software and the provision of non-qualifying services. The IRS and Treasury should add the following definition clarifying whether provision of computer software online includes a disposition qualifying for section 199:

> *Provision of software online.* A taxpayer will be deemed to provide access to its software online if (1) the software is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; or (2) the software is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. The provision of computer software online excludes the provision of services, such as customer and technical support, as well as services facilitated by software accessible only by the taxpayer. However, software that replaces a service or software that facilitates a service still constitutes qualifying production property under section 199, to the extent the software itself is accessed online by third parties and all other requirements under section 199 are met. Thus, providing access to online software is not the provision of a non-qualifying service with respect to functions performed by a computer using taxpayer-developed software without intervention.

The final IUS regulations have not yet been published in the Final Register as of the date of this letter. Should the definition of non-internal use software in the final regulations differ from proposed Treas. Reg. § 1.41-4(c)(6)(iv), we recommend that the section 199 definition of the provision of software retain the reference to the language in the proposed IUS regulations.

The following examples demonstrate the application of the suggested changes described above:

> *Example 1*
>
> Assume a taxpayer develops tax preparation software entirely in the U.S. The taxpayer's software meets the definition of computer software under section 199. The taxpayer uses the internally developed tax preparation software to provide tax preparation services to its customers. The taxpayer's customers do not interact with the software in any manner; that is, the software is not downloaded or installed on customers' computers, nor provided to the customers online. The taxpayer charges its customers $50X for the provision of tax return services using such software. Although

the tax preparation software facilitates the provision of such services to taxpayer's customers, there is no disposition of computer software to customers. Accordingly, the $50X of gross receipts generated by the taxpayer are attributable only to the provision of services, and therefore are not DPGR.

Example 2

Assume a taxpayer develops tax preparation software entirely in the U.S. The taxpayer's software meets the definition of computer software under section 199. In contrast to Example 1, the taxpayer allows its clients to prepare their own tax returns using the taxpayer's tax preparation software. The tax preparation software is provided via online access only. The taxpayer charges its customers a fee of $50X to use the online tax preparation software. The taxpayer offers no other goods or services in connection with the online tax preparation software. Assume the definition of "other disposition of computer software" under Treas. Reg. § 1.199-3(i)(6)(i) of this section is expanded to specifically include the provision of computer software online. Further, the software in this example is considered non-internal use software under proposed Treas. Reg. § 1.41-4(c)(6)(iv), as it is developed for commercial sale, lease, licensing, or otherwise marketing to third parties. In this case, the taxpayer's $50X are gross receipts derived from a qualifying disposition of computer software. Accordingly, taxpayer's $50X of gross receipts generated by the taxpayer are attributable to the disposition of computer software, and therefore constitute DPGR.

We believe these suggested regulatory modifications will alleviate the concern that eliminating the regulatory distinction between the means of software disposition will lead to a blurred line between receipts from qualifying disposition of computer software versus provision of services. The modifications will reduce future controversies and the amount of taxpayer and IRS resources required for such disputes.

B. Add a Safe Harbor to the Regulations for Allocating Gross Receipts Related to Software Versus Receipts from Non-Qualifying Services.

<u>Analysis</u>

Many taxpayers offer customers a combination of software and services for a single price. Since services generally do not give rise to DPGR, taxpayers must allocate their gross receipts between the qualifying portion attributable to the software disposition and the non-qualifying portion attributable to services (or other non-qualifying benefits/rights provided to the customer).

Under Treas. Reg. § 1.199-3(d)(1), a taxpayer may determine whether gross receipts qualify as DPGR on an item by item basis using any reasonable method based on all of the facts and circumstances. Further, the preamble to the section 199 regulations provides that taxpayers may rely on section 482 principles in determining its qualifying amount of gross receipts.[28] These facts and circumstances-type determinations are time consuming and expensive for taxpayers, and represent a significant source of controversy during IRS examinations.

[28] REG–105847–05.

Recommendations

To reduce the level of controversy, as well as the burden of the allocation computations for taxpayers, the AICPA recommends that, where such an allocation of gross receipts is required, the IRS and Treasury add a safe harbor to the regulations providing a method for allocating gross receipts between gross receipts related to the software disposition and gross receipts related to non-qualifying services.

The AICPA is aware that in establishing a safe harbor to allocate gross receipts, no single method will adequately capture every taxpayer's unique facts and circumstances. The AICPA suggests that the IRS and Treasury solicit suggestions from taxpayers in the preamble to the proposed regulations under section 199, related to computer software of an objective test that is widely applicable. In addition, we believe it is helpful for the IRS and Treasury to solicit feedback from industry groups for additional safe harbor suggestions.

Alternatively, the IRS and Treasury could propose a labor-based safe harbor (e.g., by comparing labor associated with developing software to labor associated with providing non-qualifying services/components) or a fixed percentage safe harbor for allocating a portion of the taxpayer's gross receipts to the software disposition component of the transaction.

We believe implementing a safe harbor for taxpayers to allocate gross receipts between qualifying software dispositions and non-qualifying services is critical for simplification of administration and will reduce future controversies between taxpayers and the IRS and the undue burden of a facts and circumstances allocation methodology.

III. Conclusion

The AICPA believes the current regulations for determining qualified gross receipts for section 199 purposes makes an unjustified distinction in the qualification of gross receipts from the disposition of computer software as DPGR based on the means of software disposition. There is no such distinction in the statute. This distinction operates to deny a section 199 deduction to taxpayers developing certain software, which we believe is inconsistent with the broad language and intent of section 199. Therefore, we recommend that the IRS and Treasury eliminate the current regulations that distinguish between software provided in a tangible medium, through download or online.

Qualification of receipts as DPGR should not depend on the type of disposition of computer software since there is no such distinction in the statute. The regulations should clarify that gross receipts derived from a disposition of software online is included in DPGR. To prevent gross receipts from services from being included in the definition of DPGR, the IRS and Treasury can specify when a transaction between a taxpayer and software user includes a qualifying disposition, versus merely the provision of non-qualifying services, based on whether the transaction includes a disposition enumerated in the proposed IUS regulations with respect to software that is not primarily for internal use.

In addition, to simplify the determination of DPGR from the disposition of software versus provision of services, the AICPA recommends that, where such an allocation of gross receipts is required, the IRS and Treasury add a safe harbor providing for the allocation of gross receipts related to the disposition of software versus non-qualifying services.

The AICPA believes that issuing these recommendations will clarify and simplify the current regulatory framework for determining whether gross receipts qualify as DPGR, and reduce controversies with the IRS and taxpayer burden, and encourage U.S. software production, as intended by Congress.