Cloud Activities and Issues Under Sections 41 and 199

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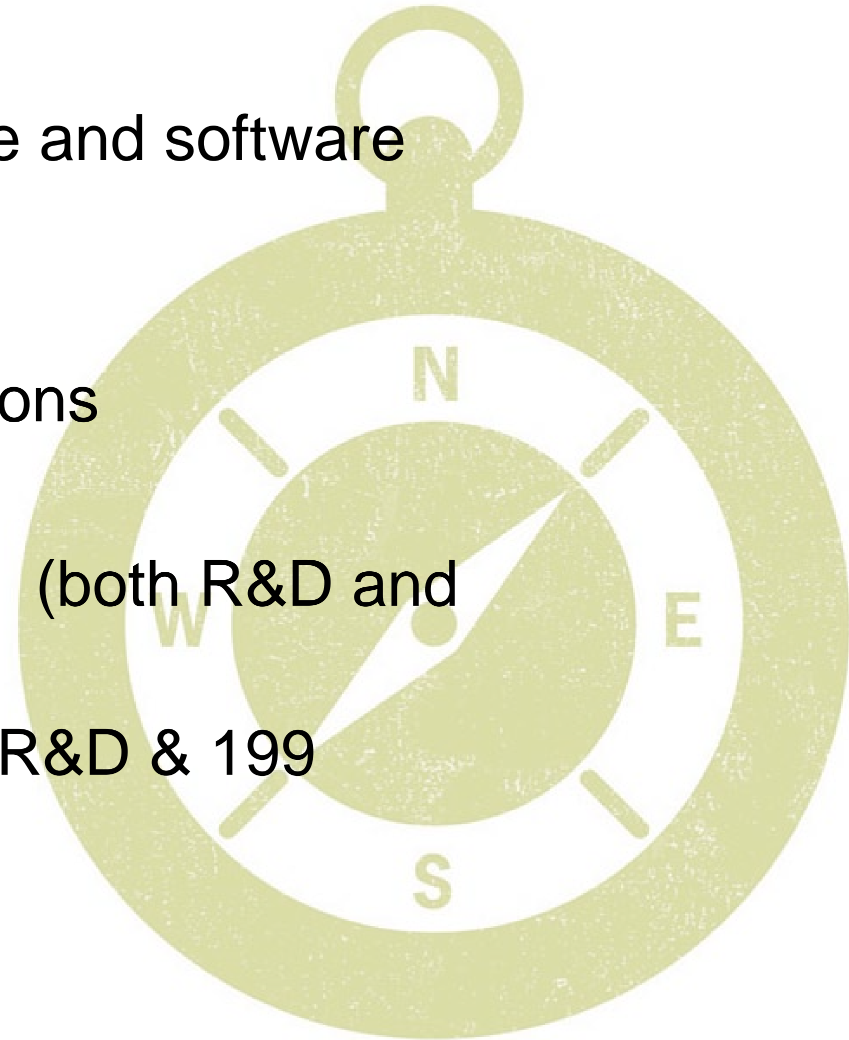
Agenda



- 199 update for both hardware and software industry
- R&D Legislative Update
- Applying the 1.174-2 regulations
- Proposed IUS regulations
- Discuss Recent Court Cases (both R&D and 199?)
- Common issues at exam for R&D & 199
- Questions

Section 199 Update

Background of Section 199

- Section 199 allows taxpayers to deduct 9% of the lesser of the qualified production activities income (QPAI) or taxable income
  - QPAI = Excess of domestic production gross receipts (DPGR) over allocable expenses
  - DPGR = Gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of (1) qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in the U.S.; (2) any qualified film produced by the taxpayer; or (3) electricity, natural gas, or potable water produced by the taxpayer in the U.S.
  - Section 199 deduction limited to 50% of the W-2 wages of the taxpayer for the taxable year
- Compliance costs for taxpayers are high
  - Must track and allocate revenues and expenses across the entire company
  - Substantiation requirements are burdensome
- IRS aggressively examines Section 199 claims, especially refund claims
- Litigation of Section 199 disputes is factually intensive and highly technical
- Section 199 is emerging as an issue reported on Schedule UTP

Section 199 and Software – General Rule

- Computer software can generate DPGR
  - Treas. Reg. 1.199-3(g)(6)(i): 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.
- Online services do not generate DPGR
  - Treas. Reg. 1.199-3(g)(6)(ii): 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.

Exceptions to Software Rule

- Treas. Reg. 1.199-3(g)(iii): 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

Online Software Regulations

- Nothing in the statute mentions online software
  - Legislative history suggests Congress wanted broad application of tax benefit
- Are the current regulations valid?
  - Did Treasury adequately consider and address comments (*Altera*)
  - Has Congress spoken directly on the issue
  - Is Treasury's interpretation permissible
- Software Guidance Project
  - Not imminent
  - Supposed to take New Economy changes into account
  - Recent taxpayer-unfriendly regulations suggest otherwise
    - Path of least resistance

IRS Guidance on Online Software

- CCA 201226025
  - Can a taxpayer aggregate third-party software products that together are equivalent to the taxpayer's online software?
  - No, but taxpayer can apply the "shrink back rule" to identify features of its online software that are equivalent to third-party software products
  - No guidance how to allocate gross receipts
- AM 2014-008
  - If a taxpayer's free banking app is downloaded on customers' devices for online use, do the fees generated for banking services generate DPGR?
  - No. taxpayer does not generate DPGR because app is free and gross receipts are generated for banking services
  - Also, downloading an app does not count as "downloading" of software (!)
  - B2B software is not substantially identical to customer app

Software as a Service and Section 199

- DPGR is not generated from services – but is SaaS really a “service”?
- Treas. Reg. 1.199-3(i)(1)(i): Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange or other disposition, whether it is a service, or whether it is some combination thereof.
  - How is the income from providing SaaS characterized?
  - IRS has an incentive to define “services” broadly in this context
    - But compare *ADVO* – printing services deemed MPGE (of contract manufacturer)
- Online software exceptions – is there a disk or download equivalent?
- What if a taxpayer develops software that is licensed to someone who I turns offers it to customers as a service?

The Cloud and Section 199

- Place of production – is it MPGE'd in the United States?
  - Same analysis as for software generally
  - Place of storage should not matter
- Does it generate DPGR?
  - Is downloading to the cloud for use on a customer device a "download," or providing a "service"?
  - Does it meet the "online software" exceptions

Hardware and Section 199

- Manufacturing hardware is MPGE
- Contract manufacturing (Treas. Reg. 1.199-3(f)(1))
  - Current regulations – benefits & burdens analysis
    - Who owns the QPP while MPGE is taking place?
    - Challenging for the IRS to determine who owns the QPP
  - New regulations – contract manufacturer always wins
    - Who is performing MPGE on the QPP?

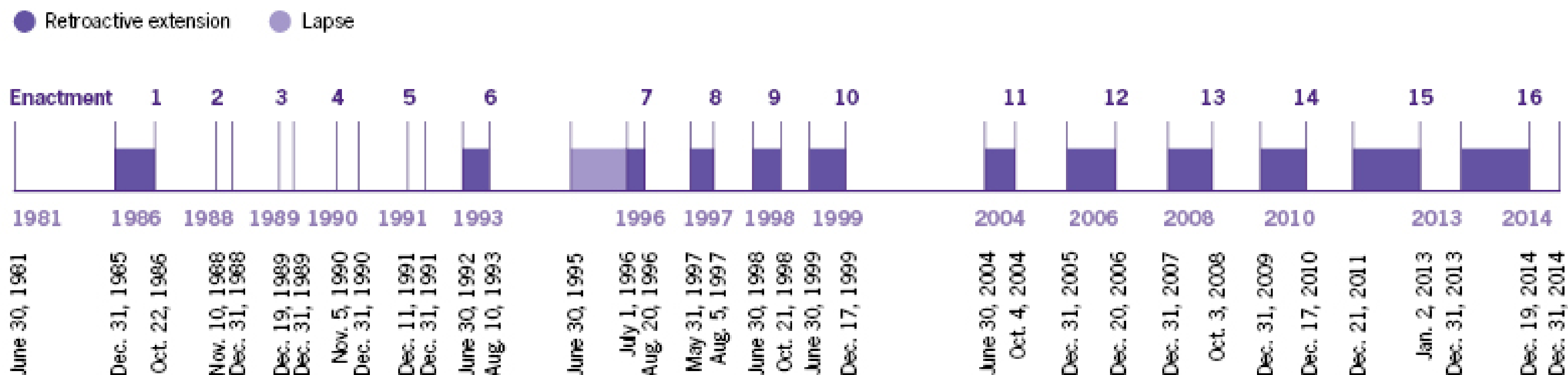
Current Section 199 Enforcement Priorities

- New Section 199 Regulations, 80 Fed. Reg. 51978 (8/27/2015)
  - Contract Manufacturer Always Wins -- new Treas. Reg. 1.199-3(f)(1)
  - Repackaging is not MPGE -- new Treas. Reg. 1.199-3(e)(2)
  - Allocation of prior period expenses – new Treas. Reg. 1.199-4(b)(2)(iii)(B)
  - Comment period ends 11/25/2015 – first *post-Altera* rulemaking for Sec. 199
- Computer Software
  - New guidance under §199 relating to computer software still in development
  - Online Software
- Allocation/sourcing Issues
  - Consistency of Section 861 method of allocation
  - Example: software acquired from overseas but substantially modified in US after acquisition
- 199 often requires more education of exam on the rules
  - International examiners often involved and apply transfer pricing approaches
  - Need a thorough understanding of the business and supply chain

Legislative Update

Research credit legislative outlook

- R&D credit expired at the end of 2014
- Congress has bad record of extending on time



Research credit legislative outlook

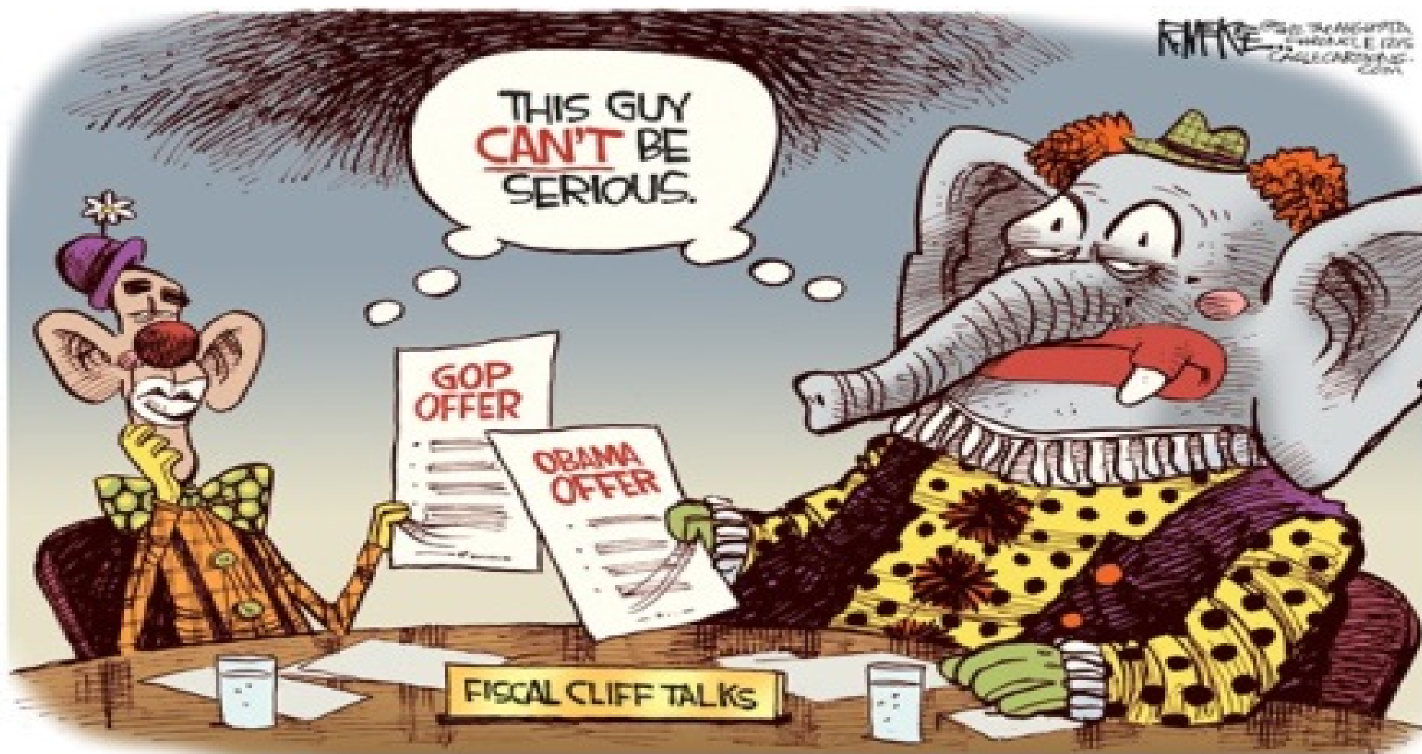
- What's taking so long this year?
  - In past years they've fought over whether to pay for the extenders or not, but no one's arguing for offsets this year
  - Delay is over whether to make any of these provision permanent

Can we get a deal on a better credit?

- Senate bill
  - Allow credit to offset AMT
  - $250k refundable against payroll tax if < 5 years and $5 million in receipts
- House Bill:
  - Make ASC permanent at rate of 20%
  - Allow private companies with < 50 million in receipts to offset AMT

Can they move a permanent bill?

Both sides confident on permanent deal because both sides think other will cave.



California: Recent Developments

- AB 93 & SB 90 – Partial Sales and Use tax Exemption for R&D Equipment
  - Effective 7/1/14 – partial sales and use tax exemption for equipment used in R&D
  - Reduces sales and use tax by 4.1875%: From the current 7.5% to 3.3125
- California R&D Credit Conformity
  - Sought to ease use for calculating credit
  - However, bills failed in appropriations committee or vetoed by Governor
  - Rethinking how to approach with Governor who is opposed to tax credits
- In 2015 the FTB released its policies and best practices for adopting the results of IRS examinations of the research credit:
  - FTB will generally apply the results of an IRS examination.
  - FTB may examine computational or state issues where California does not conform to the federal research credit, but examiners should attempt to minimize the duplication of audit requests on taxpayers.
  - If the IRS "no changed" the research credit in a prior year, FTB will generally accept the prior year IRS determination to the extent the activities and expenses from the prior year are the same or, substantially similar to, the activities and expenses claimed in the year under audit.

Applying the 1.174-2 Regulations

1.174-2 New Regulations

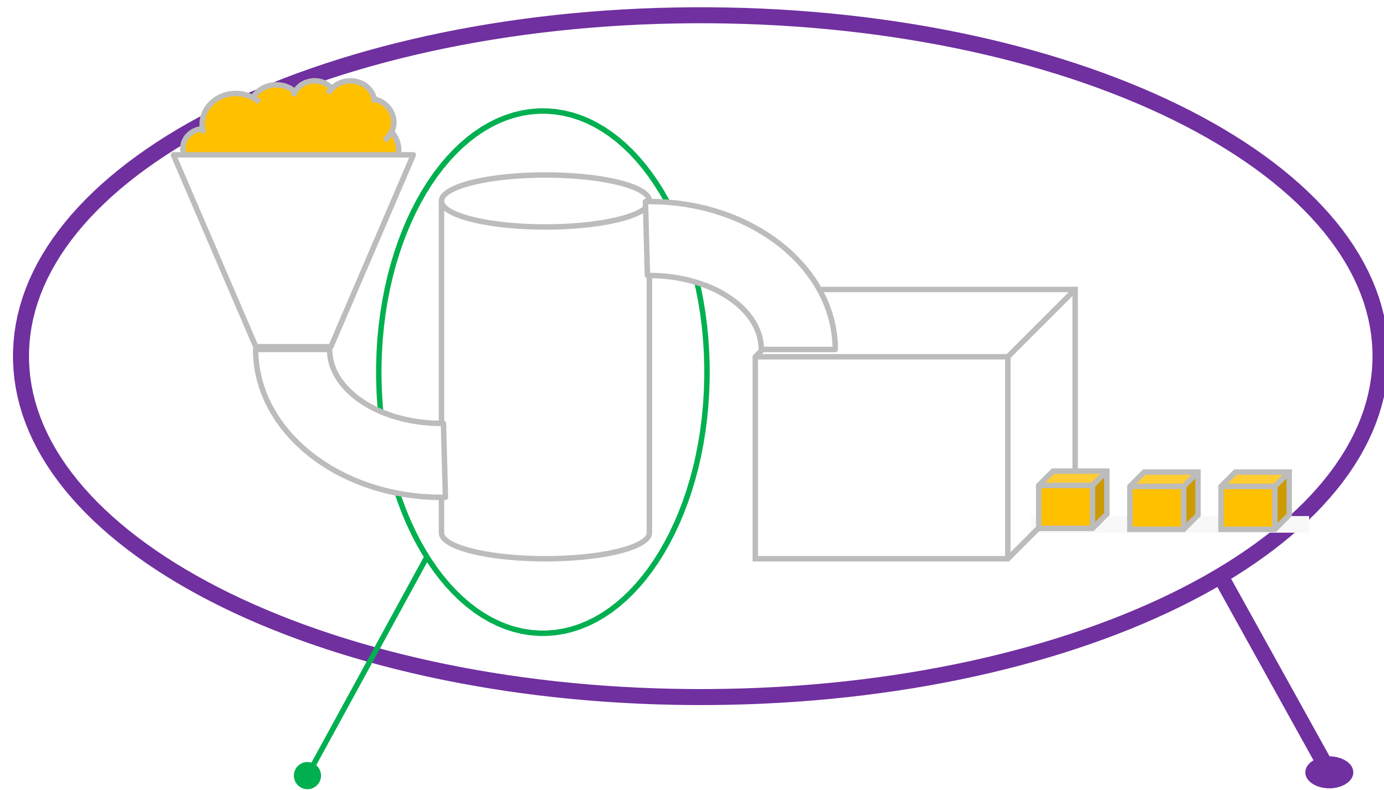
A BIG DEAL

- Increase both **DEDUCTIONS** and **CREDITS**
- a **SIGNIFICANT** increase in Research Credit supply costs
- go **HAND in HAND** with Tangible Property Regulations
- some **TECHNICAL HOOPS** that require analysis

New Opportunity

- Redefine **PILOT MODEL** to include "fully-functional representation or model of a product"
  - Note: Product includes any pilot model, process, formula, invention, technique, patent, or similar property used by the taxpayer in its trade or business as well as products sold for sale, lease or license.
- Emphasize that **SUBSEQUENT EVENTS** are not relevant to determination of eligibility
- State that **DEPRECIABLE PROPERTY** may be allowed
- Clarify that research ends when **UNCERTAINTY** is resolved rather then when production begins

Uncertainty is key



Uncertainty or **UNCERTAINTY**

Finer Points

- Requires **FACT BASED** analysis
- As before, **DOCUMENTATION** is critical
- Not all §174 costs will be §41 **QUALIFIED SUPPLIES**
- Amounts **PAID TO OTHERS** require additional scrutiny
- Shrink back concept still exist- must have overarching integration risks- similar to fan blade example.

Internal-Use Regulations

Proposed IUS Regulations

almost there…

- proposed regulations applied **PROSPECTIVELY,**
- IRS will not challenge return positions consistent with these proposed regulations for taxable years ending **ON** or **AFTER** the date of these proposed regulations (**JANUARY 16, 2015**)
- public hearing on **APRIL 17, 2015**

Key Issues

discussion points…

- impact on **NON-INTERNAL USE** software
- clarifying **DUAL FUNCTION** software
- changes to **HIGH THRESHOLD OF INNOVATION** test
- exploring the **EXAMPLES**
- what **CHANGES** would you like to see?

Internal-use software

- 2015 proposed Treasury Regulations
- Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if—
  - The software development satisfies the requirements of section 41(d)(1) (i.e., the four-part test);
  - The software development is not otherwise excluded under section 41(d)(4); and
  - The software satisfies the high threshold of innovation test.

Internal-use software

- Internal-use software defined
  - Computer software and hardware developed as a single product (or to the costs to modify an acquired computer software and hardware package), of which the software is an integral part, that is used directly by the taxpayer in providing services in its trade or business is not treated as IUS.
  - If the taxpayer develops the software for use in an activity that constitutes qualified research (other than the development of the internal use software itself) it does not have to satisfy the IUS rules.
  - If the taxpayer develops the software for use in a production process to which the requirements of section 41(d)(1) are met it does not have to satisfy the IUS rules.

Internal-use software

- Internal-use software defined
- Computer software is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use if the software is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. Software that the taxpayer develops primarily for a related party's internal use will be considered internal use software.
- HR, Finance, Support
- Internal-use software does not include:
  - (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.

Internal-use software

- Proposed Regulations High Threshold of Innovation Tests
- Innovative test
  - Reverts to TRA 1986 legislative history / T.D. 8930
  - Reduction in cost, improvement in speed, or other metric based
  - Eliminates 2001 proposed regulations standard requiring software to be "unique or novel and differ in significant and inventive ways from prior software implementations and methods"
- Significant economic risk test
  - Still does not define "significant" economic risk
  - Clearly states does not require a risk of failure
  - Limits risk to technical uncertainty involving the "capability" or "method" – not uncertainty of "appropriate design"
- Not commercially available test is unchanged

Internal-use software

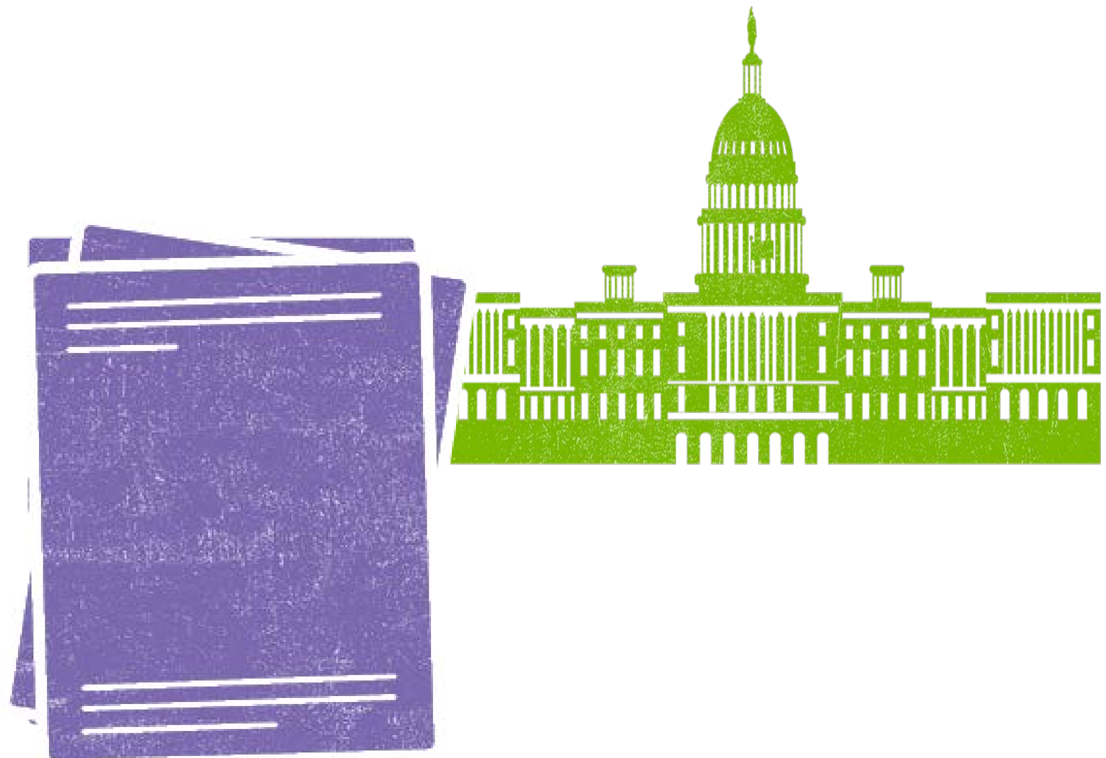
- Effective date
  - The proposed regulations, once finalized, will be prospective only, and the rules contained in these regulations are proposed to apply to taxable years ending on or after the date of publication of the Treasury Decision adopting these rules as final regulations in the Federal Register.
  - Notwithstanding the prospective effective date, the IRS will not challenge return positions consistent with these proposed regulations for taxable years ending on or after the date these proposed regulations are published.

Internal-use software

- Effective date
  - "The rules in these proposed regulations are not, and should not be viewed as, an interpretation of prior regulatory guidance or of the TRA 1986 legislative history. For example, software not developed for internal use under these proposed regulations, such as software developed to enable a taxpayer to interact with third parties, may or may not have been IUS under prior law."
  - For taxable years ending before the date the proposed regulations are published in the Federal Register, taxpayers may choose to follow either all of the IUS provisions of §1.41-4(c)(6) in T.D. 8930 or all of the IUS provisions of §1.41-4(c)(6) in the 2001 proposed regulations. Note the IRS has partially conceded the *FedEx* decision.

Controversy Overview

Eric G. Suder v. Comm'r
(T.C. Memo 2014-201)



Suder v. Comm'r

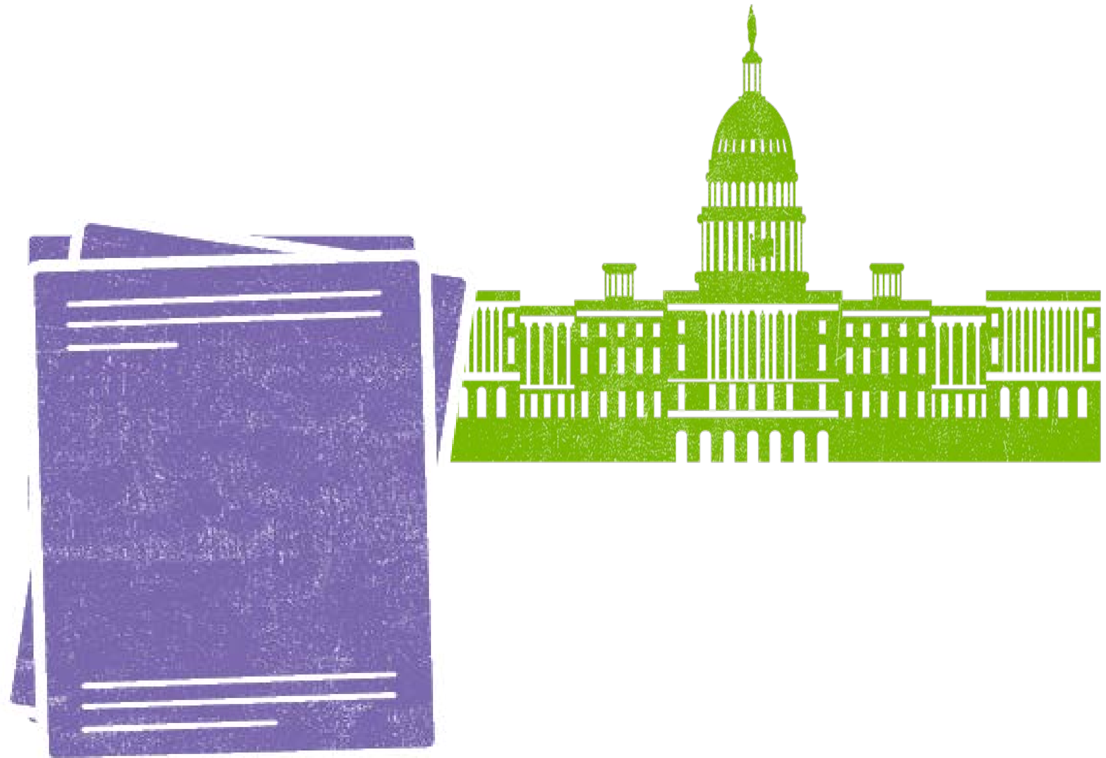
- Suder Case Overview
  - On October 1, 2014 the US Tax Court ruled the Taxpayer performed qualified research on most projects (11 of 12 project were analyzed).
  - Compensation paid to the Company's CEO was unreasonable under 174(e) and did not constitute qualified research expenditures.
- Facts of the Case
  - Founded by Eric Suder, Estech Systems, Inc. develops telephone related products.
  - Mr. Suder serves as the CEO and 90% owner.
  - From 2004-2007, Mr. Suder spent most of his time developing ideas for new products and ways to improve the Company's processes.
  - Mr. Suder spent little time managing the day-to-day operations.
  - Wages claimed by the Company for Mr. Suder totaled $8.6M in 2004, and over $10M in 2005-2007.

Suder v. Comm'r (Continued)

Tax Court Findings:

- Allowable qualified research activities included senior management strategy and project meetings, regression analysis, and beta testing within customer environments.
- The Tax Court accepted the Taxpayer's estimated percentage of time based on credible and reliable testimony as a method for providing adequate documentation of claimed QREs.
- The Tax Court concluded that Mr. Suder's compensation was unreasonable compared to compensation paid to CEO's of similar companies (Taxpayer beware… Section 162 does not equal Section 41 compensation).

Dynetics Inc. v. U.S. (121 Fed.Cl. 492)



Dynetics vs. U.S.

- Dynetics Case Overview
  - The US Court of Federal Claims granted partial summary judgment that the Taxpayer was not entitled to credits for research expenses which were considered funded research as accorded under IRC Section 41(d)(4)(H).
  - Payments made to the Taxpayer were not contingent on the success of the research and were thus not eligible for the credit.

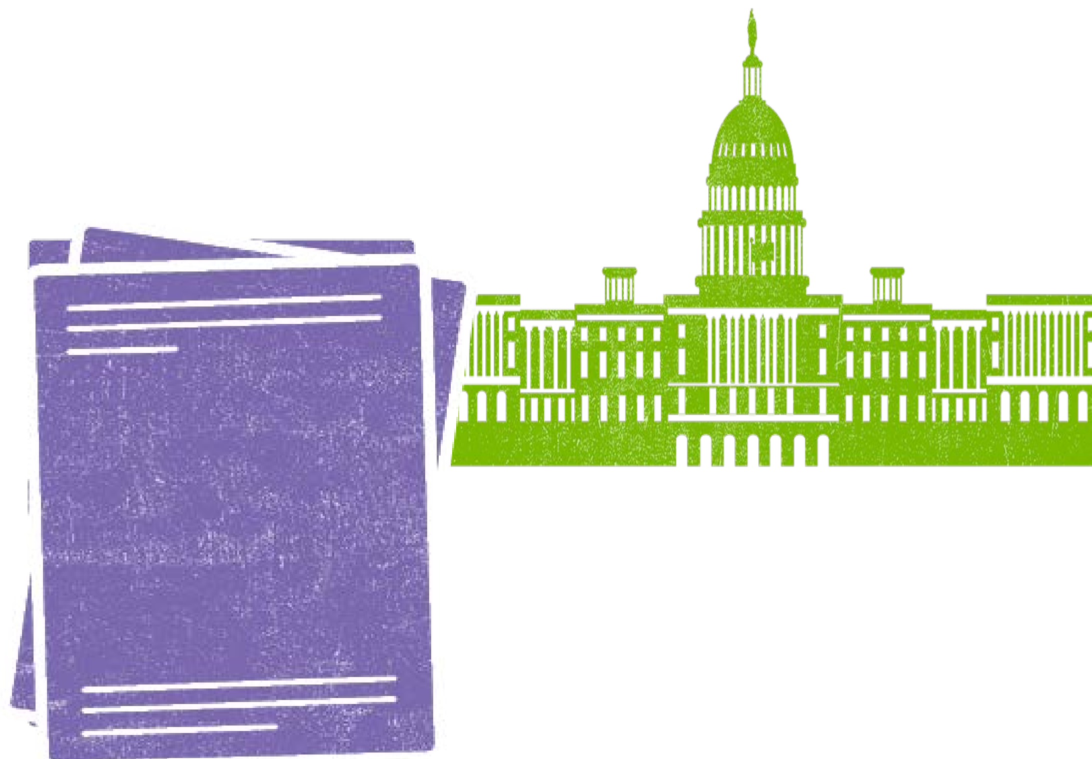
- Facts of the Case
  - The Taxpayer is an engineering company that developed missile defense and ammunition deployment systems; and equipment calibration techniques and aerodynamic vehicles.
  - The Taxpayer filed amended tax returns (refund claims) for the years 2003 – 2005.
  - Projects were performed under contracts with various payment arrangements, including cost-plus fixed fee, fixed-price level-of-effort, cost-plus fixed-fee level-of-effort, and time and materials.
  - Seven sample contracts (of more than 100) were reviewed to determine whether the work performed constituted funded research.

Dynetics vs. U.S. (Continued)

Tax Court Findings:

- Course of Dealing ("COD")
  - Taxpayer argued that 6 of the 7 contracts established a COD regardless of the language of the contract due to the long term client relationship.
  - The Court agreed with the IRS that the COD argument is parol evidence and can only be considered if the contract is ambiguous, which the 6 contracts were not.
- Inspection of Warranty Clause
  - Taxpayer argued that all 7 contracts included an inspection or warranty clause, which shifted risk of performance to Dynetics.
  - The Court agreed with the IRS that Dynetics does not expressly accept contractual responsibility for any product.

Geosyntec v. U.S. (14-11107 -11th Cir.)



Geosyntec vs. U.S.

- Geosyntec Case Overview
  - District Court had granted summary judgement in favor of the government finding that taxpayer's research activities were funded
  - The circuit court affirmed that decision finding that the two contracts presented to the court were funded research.
- Facts of the Case
  - The Taxpayer is an engineering company that designs civil engineering solutions.
  - The Taxpayer presented two contracts to the court the Cherry Island Landfill contract and the Waste Management groundwater remediation contract.
  - Both contracts had a fixed fee with a cap.
  - Contracts provided that taxpayer was eligible for additional compensation
  - Work was to be performed under nationally recognized standard of engineering care
  - The parties and the court relied heavily on the 1995 Fairchild case.

Geosyntec vs. U.S. (Continued)

Taxpayer's arguments

- Financial risk inherent in fix price contracts
- Financial risk in that TP only gets paid if project is within budget.
- The totality of the contract provisions allocated risk of failure even if not expressly stated

Court's opinion

- Cost-of-performance is not financial risk – the only issue is whether payment was contingent on the success of the research
- Taxpayer's work was not subject to inspection and testing before acceptance
- Assurance the performance meets standard of care does not mandate success

Controversy

Common Issues in R&D/199 Exams

- Engineer/agent lacks knowledge of taxpayer's business
  - Does the agent think he knows the taxpayer's business better than the taxpayer does?
- Too much deference to Engineers who may not have an incentive to reach a resolution
- Asks for the wrong/too much information
  - Exam may not realize how burdensome a request really is
  - Effect of new IDR Enforcement Directive
- Looking for the "easy out"
  - Substantiation
  - Technical "gotchas"
- Unclear/conflicting guidance from National Office/Field Counsel

IRS Examination “Rules of the Road”

- Internal Revenue Manual
- Revenue Procedures
- LB&I Directives
- Central location for research credit guidance: http://www.irs.gov/Businesses/Research-Credit
  - Audit Technique Guides
  - Relevant Directives
  - Guidelines
- No central location yet for Section 199 guidance
  - **www.irs.gov**/pub/irs-utl/quickref**199**.pdf (published in 2009)
  - www.irs.gov/pub/irs-utl/minimum_checks__2_.pdf
  - Several LB&I Directives issued after 2009

IRS Appeals in R&D/199 Cases

- New AJAC procedures – Appeals officers are supposed to act more like judges
  - Appeals will not assist Exam with case development
  - Appeals generally will not raise new issues or reopen agreed issues
  - Focus on hazards of litigation as well as technical merits
- Perfect the record *before* going to Appeals
  - Make sure Exam has all relevant facts before 30-day letter
    - "New" facts may be referred back to Exam for factual development
  - Consider introducing expert reports at Exam stage
  - Protest must raise all areas of disagreement with Exam
    - Omitting an issue could waive Appeals consideration
- In theory, research credit and Section 199 cases should be amenable to Appeals resolution
  - Anecdotal trend against taxpayers in Appeals?

Amended Returns/Refund Claims

- Statue of Limitations
  - Refund claim must be filed within three years of filing return or two years of paying tax, whichever is later
  - Cannot file suit until claim is denied or six months has passed
  - Must file suit within two years of disallowance
- Contents of Refund Claim
  - Form 1120X with Statement of Claim
  - Must clearly set forth the grounds for refund (the "variance doctrine")
- Increased likelihood of audit?
  - Anecdotal evidence of increased scrutiny
  - Cost/benefit analysis is required
- Research Credit Study/Section 199 Analysis as Basis for Refund Claim
  - Valuable way to capture all appropriate deductions
    - Adequate substantiation is key
  - IRS may be targeting overly-aggressive studies
  - Rule of common sense: too good to be true?

Strategies for Dealing with Exam

- Get substantiation in order before audit
  - Gather documentation about methodology
  - Identify business-side witnesses
  - Preserving and maintaining backup to studies
- Early presentation to Exam on nature of business and fronting potential issues
- Develop strategy for dealing with burdensome requests and managing voluminous materials
  - Field directive on sampling in research credit exams
  - If it makes Exam's life easier, even less-scientific approaches may work
- Communication is key – don't let problems fester

Anticipating R&D/199 Litigation

- Research credit/Section 199 cases are different than most tax cases
  - Intensely fact-specific; no one-size-fits-all approach
    - Factual disputes complicate and expand scope of litigation
  - Taxpayer has superior knowledge of its business, technology, and industry
  - Must educate the court about technology and business
- Early preparation for litigation is key
  - Controlling the Narrative/Establishing Themes
  - Preserving Documents and Testimony
    - Substantiation
    - Litigation holds
    - Electronically Stored Information (ESI)
  - Securing Experts
  - Managing Privilege Concerns
  - Planning for Collateral Issues
  - Choice of forum considerations
    - Tax Court v. District Court v. Court of Federal Claims

But I Don’t Want To Litigate!

- Exam is implicitly, and Appeals is explicitly, a negotiation
- BATNA – best alternative to a negotiated agreement
  - If there is a credible threat that you will litigate and win, your settlement outcomes improve even if you never go to court
- For R&D and 199 cases, the BATNA of litigation is better than in most tax cases
  - Refund forums are viable alternative to Tax Court
  - Silicon Valley tax litigation handled by the United States Attorney
  - Tax Court represented by IRS chief counsel – impact of budget crunch
- Make clear that you consider litigation to be on the table
  - Don’t threaten, just keep the door open

A Word About BEPS

- Action Item No. 5 - "Countering Harmful Practices More Effectively, Taking into Account Transparency and Substance“
  - Explicitly recognizes that "IP-intensive industries are a key driver of growth and employment and that countries are free to provide tax incentives for research and development (R&D) activities."
  - Dictates a "nexus" requirement, linking the tax benefit to "qualified expenses," i.e., R&D expenses directly connected to an IP asset.
  - Criticizes patent boxes based on nexus concerns, not because they provide a tax incentive for IP
- Are R&D tax incentives the next wave of planning opportunities?
- US Innovation Box proposals

Questions?