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Domestic Production

In the second of a series of Mayer Brown articles regarding the IRS enforcement campaign effort, Cabell Chinnis and Paul DiSangro write that the domestic production activities deduction issue included in the first batch of campaigns may appear targeted to affect only broadcasters but could carry broader implications. ''IRS denial of the DPAD for online software in this factual setting may be a Trojan horse for a broader denial of the DPAD for all online software (including apps) that provides a service,'' the authors say.

DPAD Campaign Implicates Old Wounds and New Wounds

BY CABELL CHINNIS AND PAUL DISANGRO

As expected, the first batch of Internal Revenue Service enforcement campaigns includes a tax code Section 199 domestic production activities deduction (DPAD) issue.

At first glance, the DPAD campaign appears to be narrowly targeted to one industry, cable and television broadcasters. The issue appears irrelevant for other taxpayers—no DPAD for programming packages that include third-party content. A secondary issue, meriting one sentence, also appears contained—no DPAD for the online software access that customers use to control their viewing experience.

But a deeper analysis of the campaign reveals implications for a broad range of DPAD claims, in two ways. First, the campaign is revisiting an old wound inflicted on the IRS in two court defeats involving tangible goods. In those cases, the court upheld the DPAD for a product made of third-party content because a judge found the product to be new and different for the consumer.

Second, the campaign is seeking to inflict a new wound on taxpayers that claim the DPAD for online software access. IRS denial of the DPAD for online software in this factual setting may be a Trojan horse for a broader denial of the DPAD for all online software (including apps) that provides a service.

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Old Wound for IRS: A Qualifying Product Can Consist of Third-Party Content

The factual setting of the campaign is multi-channel video programming distributors and TV broadcasters (collectively, broadcasters) that treat groups of channels or programs as ''qualified film'' eligible for the DPAD. The broadcasters assert they are producers of qualified film when distributing channels and subscription packages that often include content produced by third parties. The campaign is silent on the IRS's position, but two recent technical advice memorandums (TAMs) solve the mystery.

In TAMs 201646004 and 201647007, in a factual setting similar to the campaign, the IRS asserts that a programming package isn't a qualified film for purposes of Section 199. A qualified film under Section 199(c)(6) is any property described in Section 168(f)(3), which is ''any motion picture film or videotape.'' The TAMs assert that a ''qualified film'' wouldn't include a programming package ''even under the most liberal reading of the phrase in section 168(f)(3).''

But to challenge this statement, one need not look further than the Treasury Regulations, which define qualified film broadly to include ''live or delayed television programming'' in Treas. Reg. Section 1.199-3(k)(1).

In proposed regulations (REG-136459-09) published Aug. 27, 2015, Treasury is seeking to carve away the DPAD for programming by ''clarify[ing]'' that film production activities don't include film transmission or distribution, including ''formatting that enables the film to be distributed.'' But for taxpayers who relied on the broad definition of qualified film in the current regulations, this clarification would likely be dismissed by a judge as merely the IRS's litigating position.

Both the campaign and the TAMs fail to address what is perhaps a taxpayer's strongest argument: The IRS has twice lost in court when trying to disqualify property that included third-party content.

In *United States v. Dean*, 2013 BL 226560, 945 F.Supp.2d 1110 (C.D. Cal. 2013), a gift basket company bought items from third parties (cheese, crackers, candies, baskets, etc.) and combined these items into gift baskets that it sold to customers. The IRS denied a DPAD for the gift baskets because they consisted of items manufactured by third parties. The court upheld the DPAD, reasoning that the taxpayer had changed the form and function of the individual items into a new product with a different demand.

The IRS's second court defeat was *Precision Dose, Inc. v. United States*, 2015 BL 309784 (N.D. Ill. 2015). The taxpayer made and sold individually packaged ''unit doses'' of medications (the medications themselves were third-party content) that were customized as a single dose to a patient. The taxpayer engaged in market research, prepared specifications and worked with vendors, conducted mixing studies, and designed and owned molds and lidding tools. Quoting the judge's finding in the *Dean* case that the taxpayer ''engages in a complex production process that results in a distinct final product,'' the court upheld the taxpayer's DPAD, and it did so on a summary judgment motion (i.e., without the need for a trial).

The same reasoning in the tangible property cases of *Dean* and *Precision Dose* applies to the video programming context as well. Broadcasters engage in extensive production activities to develop, produce, format, digitize, stream, test and deliver subscription packages to customers, with different market demands for various types of packages. Similar to *Dean* and *Precision Dose*, broadcasters can show a complex production process that results in a distinct final product for the subscriber. The IRS can argue that the qualified film rules are different than the tangible property rules, but is likely to encounter defeat on the key issue if history is a guide.

It is unclear at this time whether the campaign champion at IRS will acknowledge the IRS's substantial hazards on the key issue. The campaign's ''treatment streams'' refer to ''the development of an externally published practice unit, potential published guidance, and issue based exams, when warranted,'' suggesting that taxpayers may need to look beyond the IRS Large Business and International (LB&I) Division (and likely beyond IRS Appeals) for an appropriate outcome.

New Wound for Taxpayers: DPAD Denial for Online Software Access

Keeping high-paying software jobs in the U.S. was so important to Congress that ''software'' got its own category in Section 199 (aside qualified films and tangible personal property). It is perplexing then that the IRS continues to dedicate its dwindling resources to denying the DPAD for software. Yet multiple taxpayers across industries are being denied a DPAD for the software they develop in the U.S.

While favorable settlements at Appeals were obtainable in the past, recent experience indicates that taxpayers can expect no better than a 30 percent settlement offer per an unofficial national position at Appeals.

Some taxpayers that appear to be experiencing unacceptable outcomes administratively are choosing to litigate. Two petitions have been filed in U.S. Tax Court in the last three months and a third case is rumored to be on its way. See *Vesta Corp. v. Commissioner*, No. 26847-16 (T.C., filed 12/14/16) (challenging a DPAD denial for an electronic transaction payment processing software platform developed in the U.S.), and *BATS Glob. Mkt. Holdings, Inc. v. Commissioner*, No. 1068-17 (T.C., filed 1/13/17) (challenging a DPAD denial for an electronic securities trading software platform developed in the U.S.).

The IRS's disagreement is superficially contained to ''online software''—that is, software accessible through an internet connection—but because almost all software nowadays interacts with the internet, as a practical matter the IRS's position threatens to write the DPAD for software out of the code. On multiple occasions, exam teams have argued that software must be capable of running ''100 percent offline'' in order to satisfy the comparability necessary for online software to qualify for the DPAD.

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The IRS also seeks to deny the DPAD for online software if the taxpayer provides any other goods or services in connection with the online software. In 2016, in an email excerpt published as chief counsel advice (CCA 201603028), IRS counsel made this argument, relying on Examples 4 through 8 in Treas. Reg. Section 1.199-3(i)(6)(v).

However, Example 6 holds the opposite, allowing a DPAD for providing customers online access to payroll management software in connection with other services (providing storage of customers' data and telephone support). Gross receipts allocable to the payroll management online software qualify, while gross receipts allocable to data storage and telephone support don't qualify. See also H. Conf. Rept. No. 108-755 at 1351 n.27 (''The conferees intend that the Secretary provide guidance drawing on the principles of section 482 by

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which such a taxpayer can allocate gross receipts between qualified and nonqualified gross receipts.''); Treas. Reg. Section 1.199-1(d)(1) (allowing ''any reasonable method'' to allocate between qualifying and non-qualifying gross receipts). This allocation principle runs throughout the Section 199 rules, and the IRS's attempt to shut it off in the online software context wouldn't likely survive judicial scrutiny.

On some occasions, exam teams have been willing to consider a negligible DPAD for the small amount of software that is downloaded to a device (e.g., an app on a phone or tablet). But the teams will deny most of the DPAD under the theory that the rest of the software resides on the taxpayer's servers (ignoring the fact that it is the customer's use of the app software that sets the server software in motion). For that small amount of software residing on a customer's device, the IRS will find a theory to deny the DPAD even when the taxpayer provides evidence of third-party comparable software sold in tangible form. See legal advice memorandum AM 2014-008 (evidence that a third-party app maker sold a mobile banking app to the taxpayer's competitor banks was deemed not comparable because the competitor banks have a different perspective than the app users).

From this advice memorandum to the reported input of the dedicated DPAD Issue Practice Group (IPG), taxpayers are encountering a consistent denial of DPAD claims for online software. This history suggests that taxpayers are unlikely to obtain an appropriate outcome in an LB&I examination on an online software issue. Taxpayers may fare no better in Appeals.

In this context, it is unsurprising that an attack on online software has found its way into the DPAD campaign. The attack comes in the form of an observation: ''[T]axpayers maintain that they provide online access to computer software for the customers' direct use (incident to taxpayers' transmission activities, including customers' use of the set-top boxes).'' Readers can discern the campaign's attempt at minimizing the relevance of the online software as ''incident'' to transmission activities.

But with the facts properly positioned, there should be a substantial DPAD allowed for the online software that the customers directly access to control their viewing experience. The DPAD should be substantial because there is identifiable and allocable value in the software that allows customers to control and customize their viewing experience. Further, the DPAD shouldn't be limited to a small amount of software on the set-top box (or in apps on other devices), because it is with that software that the customer accesses all the software that allows for their viewing experience.

Prognosis for the DPAD Campaign?

The DPAD campaign, while on its face limited to broadcasters, is an important piece of the IRS's broader, coordinated plan on the DPAD, particularly for software.

If the DPAD is important to your company, it is time to assess your exposure and defenses in the context of this campaign, as well as in the nationally coordinated efforts at LB&I and in Appeals. If your DPAD is under audit, then your approach should be informed by these developments, with an understanding that a favorable outcome may best be achieved by positioning for litigation.