

Cloud Activities and Issues under IRC Sections 41 and 199

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In a relatively short amount of time, cloud computing has seen substantial growth, and the demand for cloud services continues to increase, due to its convenience and low cost of operation. As more vendors and startups offer services on the cloud (also known as SaaS, Software as a Service), the more complex it is to understand where these services fit in the tax world.

At this year's 31st Annual High-Tech Tax Institute, Kevin Dangers, Partner at EY, and Rob Kovacev, Partner at Steptoe and Johnson, informed the attendants about issues that cloud companies are facing under Sections 41 and 199. The two presenters talked about updates in the two sections, proposed IUS (internal-use software) regulations, and IRS exam advice. These represent important topics for the tax directors of Silicon Valley companies.

IRC §199 Issues

Software companies are eligible to claim IRC Sect. 199 deductions if its DPGR (Domestic Product Gross Receipts) are derived from the lease, rental, license, sale, exchange, or other disposition of computer software made in the US. Online services are explicitly not included in the Code which gives rise to the question whether or not SaaS is really a service. As of now, online software companies can claim a deduction if they can find an equivalent third-party tangible software product either in whole or by feature via the shrink back rule.

While industry is complaining about this artificial barrier between online services and other software products, the IRS, with its limited resources, is likely to take the path of least resistance in the new Software Guidance Project and perhaps exclude online services outright.

Expiring Research Credit and Proposed IUS Regulations

In terms of the Research Credit, it expired at the end of 2014. Congress has a bad reputation for letting this credit expire and then extending retroactively many times over the years. This makes it difficult for tax directors to plan their estimated liabilities when they do not know whether this credit will be around. Currently there are talks of making the research credit permanent but no agreement has been reached. However, the expectation is that the credit will be extended as it has been in the past.

Earlier this year, the IRS issued proposed regulations relating to the eligibility of IUS to be included in the research credit. It defines IUS to include software that is developed in-house to be used for internal purposes only, and not for commercial or third-party purposes. It needs to meet the four-part test laid out in IRC Sect. 41 as well as the three-part High Threshold of Innovation. The effective date is not yet known but the proposed regulations are applied prospectively from January 16, 2015.

IRS Exam Advice

The IRS is an important consideration when claiming Section 199 deductions and research credits. Research credits are a hot audit item and the IRC Sect. 199 deduction is being looked at more closely these days. It is positioning companies on the defensive when they are dealing with exam agents without sufficient knowledge regarding their operations and are receiving conflicting guidance from National Office and Field Counsel. The speakers' advice in dealing with R&D/199 cases is to get substantiation in order before the audit; arrange a presentation for the exam team regarding the nature of the business and potential issues they could focus on; and suggest simple techniques such as sampling to get around voluminous document requests. If taken to court it is more favorable to choose the district court as they will likely have greater software knowledge than the tax court.

In their conclusion, the speakers appeared cautiously optimistic for the future of deductions and credits on SaaS companies. There are bills in the House and Senate that

would allow a credit to offset the AMT (Alternative Minimum Tax); the research credit is likely to be extended in 2016 for 2015; and the OECD (Organization for Economic Cooperation and Development) is essentially blessing R&D credits and incentives in the U.S. which is a good thing for R&D.