

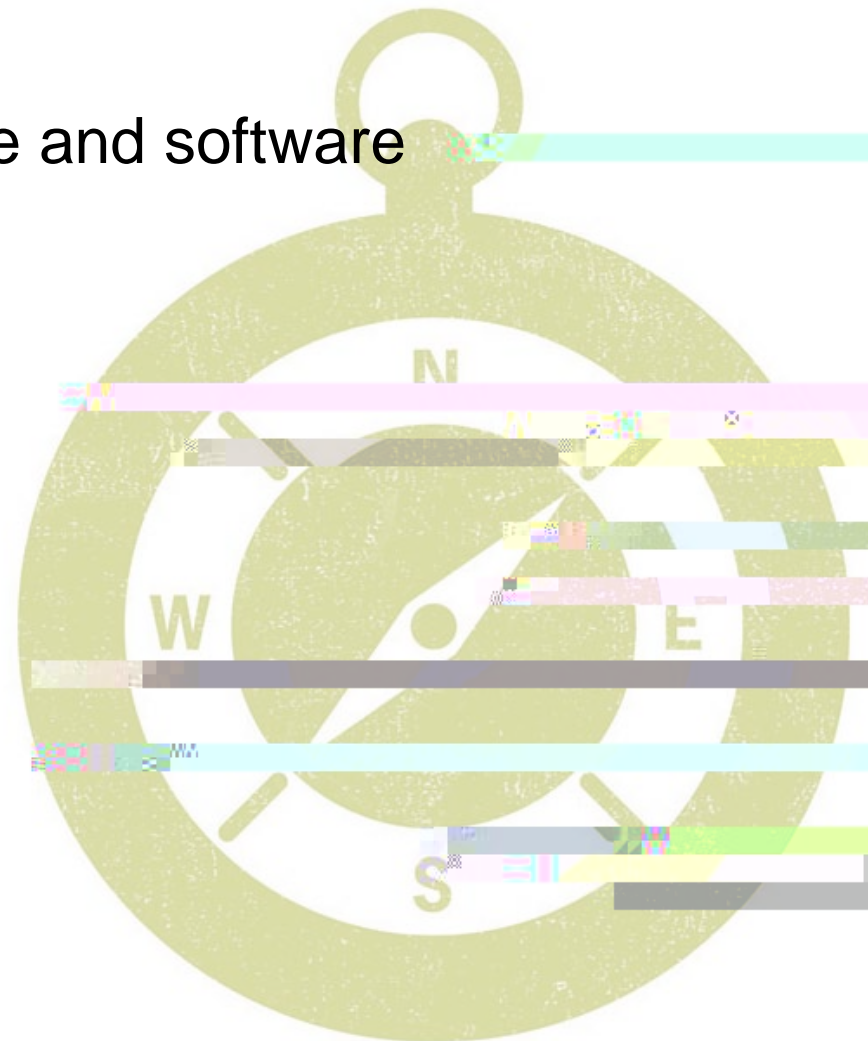


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11/9/15

Agenda

- 199 update for both hardware and software industry
- R&D Legislative Update
- Applying the 13.p3f174





Background of Section 199

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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-



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

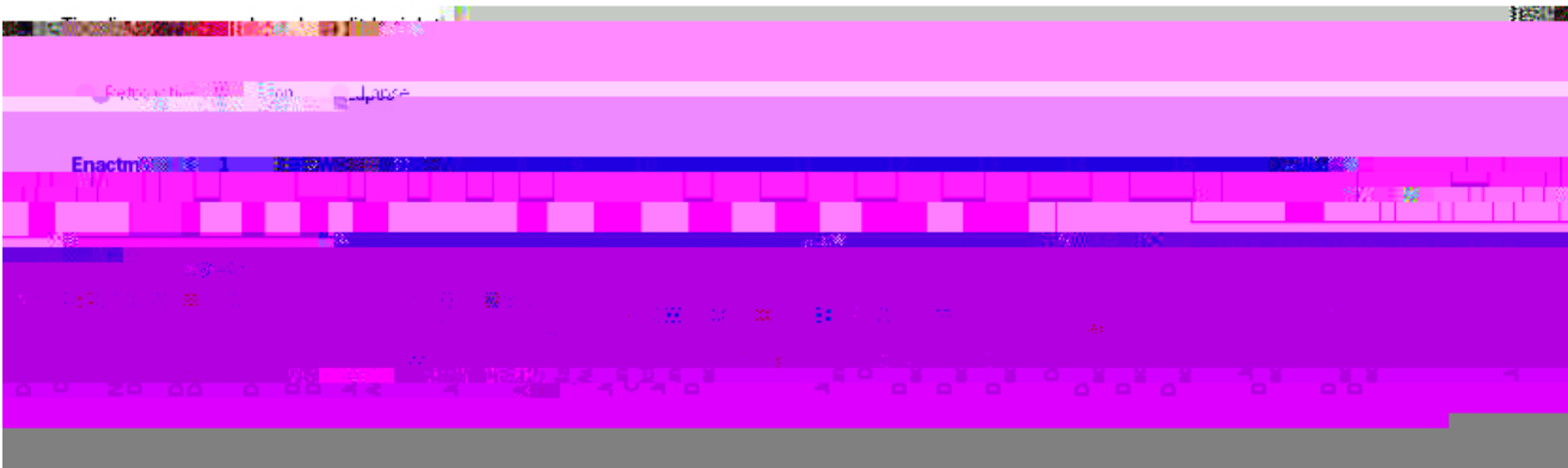
Current Section 199 Enforcement Priorities

- 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?

California: Recent Developments

- AB 93 & SB 90 – Partial Sales and Use tax Exemption for R&D Equipment
 - Å Effective 7/1/14 – partial sales and use tax exemption for equipment used in R&D
 - Å Reduces sales and use tax by 4.1875%: From the current 7.5% to 3.3125
- California R&D Credit Conformity
 - Å Sought to ease use for cf 0.01875% conformity

1.174-2 New Regulations

A

- Increase both Δ and Δ
- a Δ increase in Research Credit supply costs
- go Δ with Tangible Property Regulations
- some Δ that require analysis

New Opportunity

- Redefine **§ 179** to include "fully-functional representation or model of a product"

ÅNote: 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 **§ 179** are not relevant to determination of eligibility
- State that **§ 179** may be allowed
- Clarify that research ends when **§ 179** is resolved rather than when production begins







Internal-Use Regulations

Proposed IUS Regulations



Key Issues

⌘.

- impact on  -  software
- clarifying  software
- changes to  test
- exploring the 
- what  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);

Internal-use software



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

Internal-

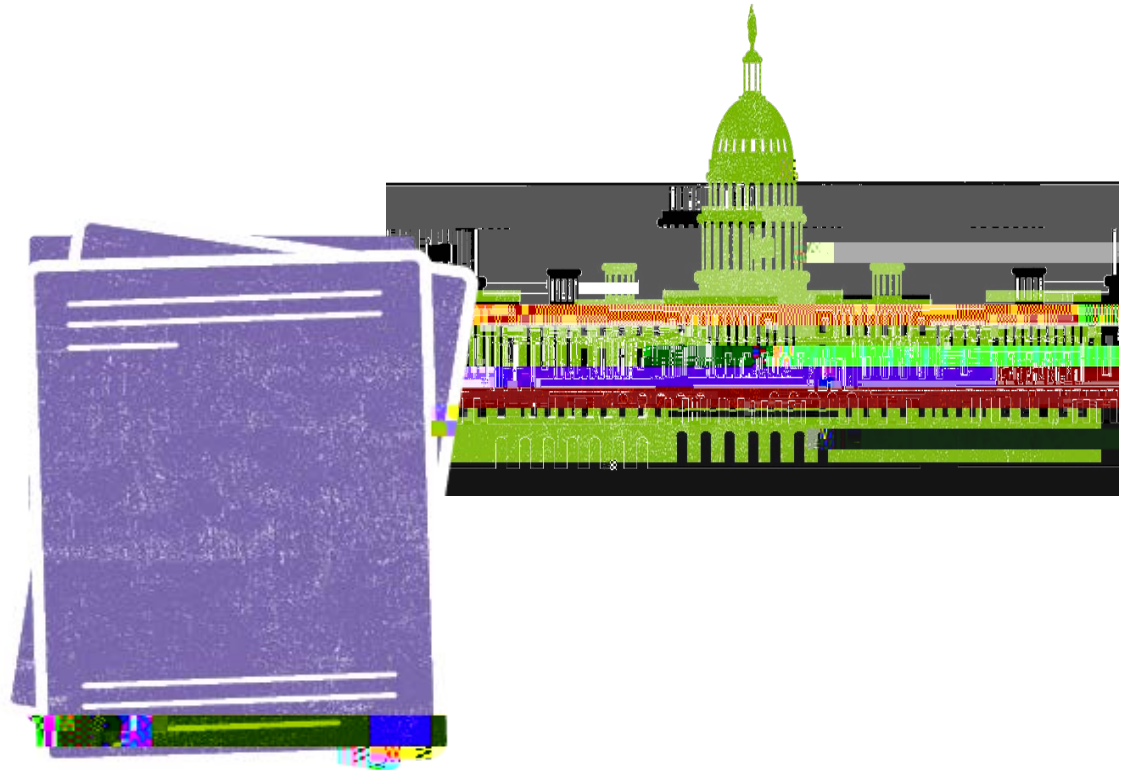
Internal-use software

- 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.

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



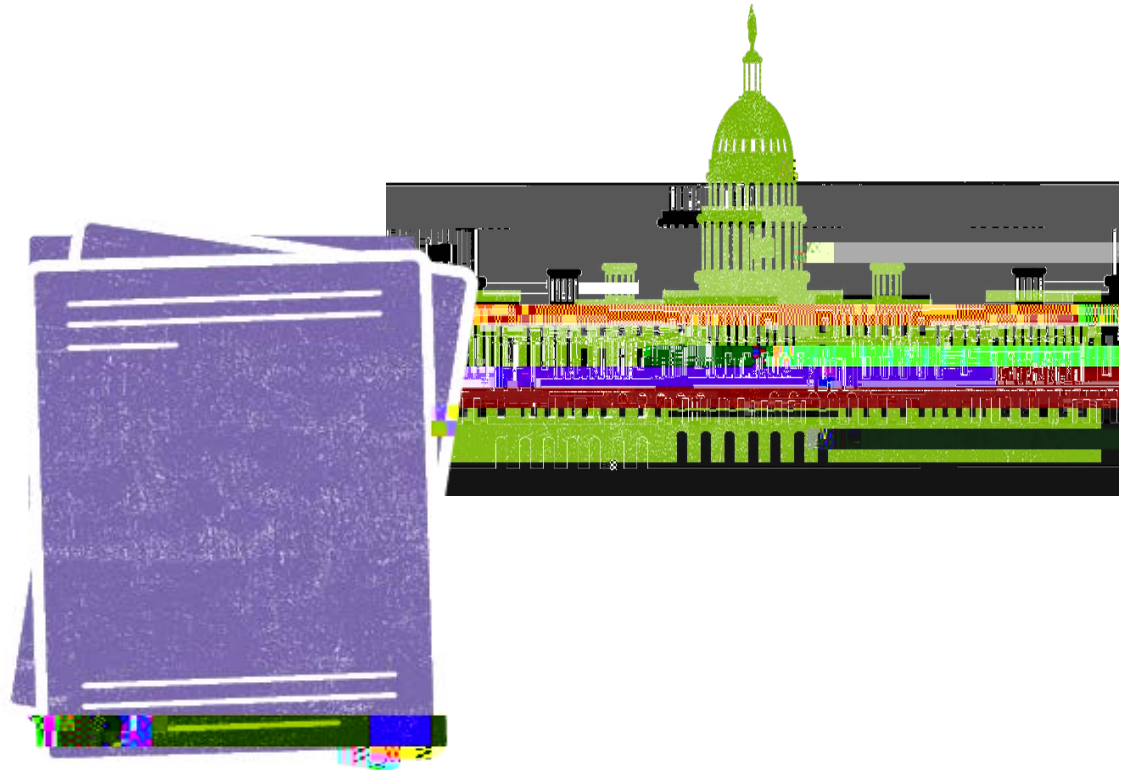


Suder v. Comm'r (Continued)

Tax Court Findings:

- Allowable qualified

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



Dynetics vs. U.S.

- Dynetics Case Overview

- Å 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).

- Å Payments made to the Taxpayer were not contingent on the success of the research and were thus not eligible for the credit.

-

Dynetics vs. U.S. (Continued)

Tax Court Findings:

- Course of Dealing ("COD")

Å 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.

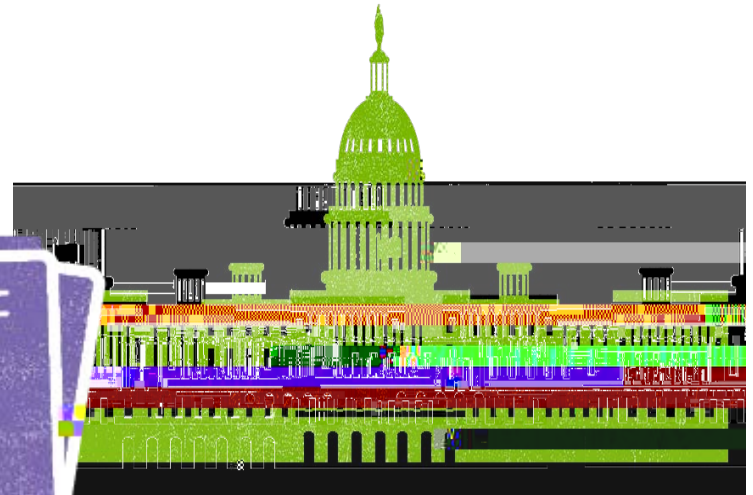
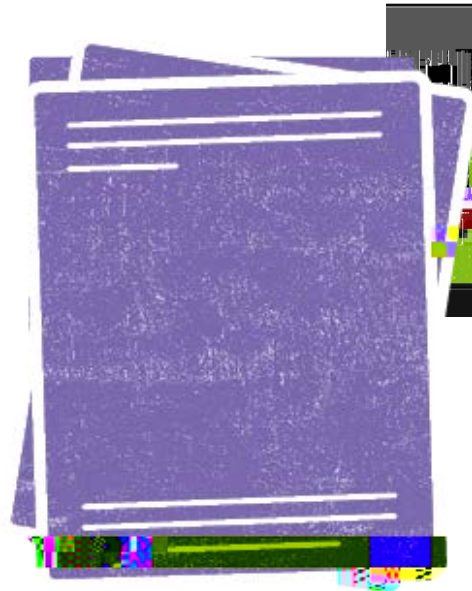
Å The Court agreed with the IRS that the COD argument is parol evidence and can only be considered if the contract is ambiguous, which the 6 contracts were not.

- Inspection of Warranty Clause

Å Taxpayer argued that all 7 contracts included an inspection or warranty clause, which shifted risk of performance to Dynetics.

Å 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

- Å District Court had granted summary judgement in favor of the government finding that taxpayer's research activities were funded

- Å

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 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 raised all facts before [33.4(e)-1(s)] TJ 86.93d

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
 -

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



