



Software Finance & Tax Executives Council
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Mr. Eric Solomon
Acting Assistant Secretary of the Treasury for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Hon. Donald L. Korb
Chief Counsel
Internal Revenue Service
Room 3026
1111 Constitution Avenue, NW
Washington, DC 20224

**Re: Definition of Computer Software for Purposes of Section 199
And Follow-up Comments on Online Software Access**

Dear Messrs. Solomon and Korb:

I write on behalf of the Software Finance and Tax Executives Council (SoFTEC) to provide the software industry's view on how the term "any computer software" should be construed for purposes of I.R.C. Section 199(c)(5)(B) in upcoming proposed Treasury Regulations. Section 199 provides a deduction for qualified income derived from transactions with respect to certain qualified property. The deduction is generally available for gross receipts derived from qualifying production property, including computer software, produced by the taxpayer in whole or in significant part within the United States.

SoFTEC is a trade association providing software industry focused public policy advocacy in the areas of tax, finance and accounting. Because its member companies all undertake activities eligible for the Section 199 domestic production activity deduction, they all are keenly interested in the Treasury Department's recent and future guidance.

SoFTEC believes that proposed regulations under Section 199 should include a discussion and examples illustrating the various activities that are included in the process of computer software production and when gross receipts are considered derived from those activities.

In addition, SoFTEC would like to supplement its letter dated February 9, 2005 submitted in connection with your Notice 2005-14, by providing additional comments with regard to why gross receipts derived from online access to computer software qualify for the Section 199 deduction.

1. Existing Precedents and Interpretations:

In 1997 Congress amended Sec. 927(a)(2)(B) to specifically clarify that computer software export receipts qualified for Foreign Sales Corporation (FSC) benefits. In Microsoft Corp. v. Commissioner, 311 F.3d 1178 (9th Cir. 2002), rev'g 115 T.C. 228, the court held that computer software masters qualified as export property for FSC purposes prior to the legislative clarification. When Congress repealed FSC, it specifically provided that computer software qualified for 'extra-territorial income' (ETI) benefits under Sec. 943(a)(3) (B).

Computer software also qualifies for the new deduction relating to income attributable to domestic production activities under Sec. 199. Section 199(c)(4)(A) provides that:

“domestic production gross receipts’ means the gross receipts of the taxpayer which are derived from—

(i) any lease, rental, *license*, sale, exchange, or other disposition of—

(I) qualifying production property which was manufactured, *produced*, grown, or extracted by the taxpayer in whole or in significant part within the United States. [Emphasis added.]

Section 199(c)(5)(B) specifically states that “qualifying production property” includes “any computer software”.

While many often refer to this new deduction as a “manufacturing” deduction, the statutory language actually refers to a broader domestic “production” activities deduction. In Notice 2005-14, Treasury found that Congress intended for the deduction under § 199 to be available to taxpayers for a wide variety of production activities and interpreted the phrase “manufactured, *produced*, grown, or extracted” as including “*developing, improving, and creating*” qualified production property. Notice 2005-14, Secs. 3.04(3), 4.04(3)(a).

In addition, in the legislative history, Congress specifically included an example showing how software qualified under Section 199:

“It is intended that principles similar to those under the present-law extraterritorial income regime apply for this purpose. *See* Temp. Treas. Reg. sec. 1.927(a)-1T(f)(2)(i). For example, this exclusion generally does not apply to property leased by the taxpayer to a related person if the property is held for sublease, or is subleased, by the related person to an unrelated person for the ultimate use of such unrelated person. Similarly, the *license of computer software* to a related person for reproduction and sale, exchange, lease, rental or sublicense to an unrelated person for the ultimate use of such unrelated person is not treated as

excluded property by reason of the license to the related person.” [Emphasis added.]

H.R. Conf. Rep. No. 108-755, fn. 29.

Congress clearly intended that activity that qualified under ETI also would qualify for the new broader Section 199 domestic production activities deduction. In order to minimize disputes between the Service and taxpayers, it would be helpful if future guidance would include examples (see discussion below) and a discussion of what constitutes computer software “production.” Notice 2005-14 focuses on defining computer software and includes only a very limited discussion of the activities that could give rise to its “production.” See Notice 2005-14, Sec. 4.04(8)(c).

2. Definition of Computer Software:

Notice 2005-14 defines “computer software” as “any program or routine or any sequence of machine-readable code that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine.” Notice 2005-14 Sec. 4.04(8)(c). We believe that this is an accurate definition; however, further guidance is necessary with respect to what is meant by the phrase “the documentation required to describe and maintain that program or routine.” Is the phrase intended to refer only to the human-readable “source code” (as opposed to the machine readable “object code), or is it intended to be more expansive and include manuals and other documentation (regardless of form) that describe for users and others the computer software’s functionality and how to operate the computer software? We believe that Congress intended the more expansive reading.

Traditionally, the term “computer program” referred only to the source and object codes while the common understanding was that “computer software” was a broader term that encompassed not only the underlying source and object code but also the accompanying manuals and other documentation.¹ When Congress used the phrase “any computer software,” it intended its ordinary meaning and intended to include such accompanying documentation and user manuals. Of course, the manner of delivering manuals and documentation has evolved over time and today such items instead of taking the form of paper manuals and the like are included in “read-me” files distributed as part of the computer program or are delivered via web-based interactive technical support. Revenues attributable to such manuals, documentation and interactive support are eligible for the Section 199 deduction because they are included within the definition of “computer software.”

¹ Compare the definition of “computer information” (includes documentation) with the definition of “computer program” (excludes documentation) in Sections 102(10) and 102(12), and paras. 8, 10 of the Official Comments to Section 102, of the Uniform Computer Information Transactions Act, National Conference of Commissioners on Uniform State Laws, 2002.

3. Computer Software Production Activities:

There can be no question but that Congress intended that receipts qualified under ETI would also qualify for the new broader Section 199 domestic production activities deduction. As such, we respectfully urge that you consider the strong beneficial impact if proposed Regulations under Section 199 were to include an example similar to the following:

Example: Corporation A, a U.S. corporation, develops and produces computer software programs that it licenses to customers. In producing computer software programs, Corporation A's employees perform the following activities in whole or in significant part in the U.S.: Corporation A software engineers write the different components of the source code that will be combined to produce the computer software program. Once the components are written and tested, they are processed through Corporation A's extensive in-house compilation process to produce the integrated computer software program. The programmers write components and add them to the computer software program during the compilation process. Once the initial compilation process is complete, the computer software program undergoes product stabilization in which the computer software program is tested, debugged and recompiled. Once stabilization is completed the master computer software program is licensed to Corporation A's customers. This process satisfies the requirements of IRC section 199(c)(4)(A)(i)(I) and the license revenue from Corporation A customers will qualify as domestic production gross receipts as defined by IRC section 199(c)(4).

Indeed, in Notice 2005-14, Treasury already construed the term "production" as including "design and development (for example, writing the programming code in the case of computer software...)." Notice 2005-14, Sec. 3.04(5)(d). We strongly believe that the proposed regulations should continue this interpretation.

Many SoFTEC members believe that the process of computer software development does not end with the release of a completed product to customers; it continues with further refinement that results from the detection of errors by customers and their correction, and the addition of new functionality; it is an ongoing, continuous process. Keeping in mind that software development is an ongoing process could help resolve questions with regard to what types of revenue derive from computer software.

Any activity that has an impact on the performance quality of a computer software product falls within the sphere of the software development process. There can be no question but that the activities of the designers, programmers and debuggers are within this sphere. Other activities are within the sphere as well. For instance, technical support personnel who are the front line interface between the software vendor and the software end users, frequently identify programming errors and problems with usability. These information flows result in changes to the software, making the activities of

technical support personnel part of the process of software development. The proposed Regulations might include an example similar to the following:

Example: A software vendor releases a new and enhanced version of its software to its customer base. The technical support personnel suddenly are hit with a deluge of with phone calls from users inquiring how to access one of the new features. The technical support personnel report to management that a good portion of the customer base is having trouble accessing the new feature. Management refers the issue to the design team that, upon examination, determines that the user interface for the new feature suffers from a poor design. The designers develop a new interface and give the job of programming the new design to the programmers. Once the programmers write new source code for the new user interface and it has been debugged, the new interface management releases it to the customer-base in the form of an interim software update and becomes part of the licensed product to new customers going forward. The technical support function, whether provided as a stand-alone product or as part of software maintenance, is an essential part of the process of computer software development. Technical support functions, to the extent that they are a part of the process of developing computer software, are activities the receipts from which qualify for the deduction under Section 199.

As this example illustrates, the development of computer software is an ongoing process that does not end when initial development is complete and the vendor releases a software product to the public. Many other activities comprise an ongoing process of refinement in response to customer feedback. The activities that result in a flow of information about the product from the customer to the software designers and programmers are every bit a part of the development of computer software as are the design and programming of the initial version of the software. All of those activities are “domestic production activities” associated with computer software and within the purview of Section 199. This interpretation is consistent with the interpretation given in Notice 2005-15 to the phrase “manufactured, produced, grown or extracted” as including activities relating to “improving” qualified production property. Notice 2005-14, Sec. 4.04(3).

4. Software Installation:

Section 199 permits a deduction for gross receipts with respect to qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States. As noted above, Congress intended a broad construction for this statutory language. In Notice 2005-14, Treasury construes this statutory language as including “installing” qualifying production property. Notice 2005-14, Secs. 3.04(3), 4.04(3)(a).

With respect to computer software, “installing” can encompass a broad scope of activities beyond simply loading a copy of software onto a computer. Many times, as

part of the installation process, the vendor must configure the new software so that it operates properly with the customer's preexisting hardware system or communicates with other preexisting software. In addition, there are other actions necessary before the new software product will operate properly with the customer's system. The vendor may need to involve its designers and programmers, not to add new functionality to the software product, but to resolve issues related to the integration of new and existing hardware components with the software product or to resolve issues related to the interface of the new software product with the existing customer's information technology environment. Further, existing software systems may require modification so that they can communicate with the new software product or operate with new capabilities provided by the new software product. This is the software industry equivalent of "using a hammer to bend some metal to get it to fit right." All of these activities fall within the scope of "installing" as that term applies to software.

5. Gross Receipts from Online Access to Software:

In Notice 2005-14, the Treasury interpreted the phrase "any lease, rental, license, sale, exchange, or other disposition of" computer software in Section 199(c)(4)(A)(i) as requiring a physical transfer of a copy of a computer program from the software vendor to the customer in order for gross receipts from software to qualify for deduction under Section 199. Notice 2005-14 Sec. 3.04(8)(a). Following are additional reasons why such an interpretation is erroneous.

A. The online software access interpretation in Notice 2005-14 exceeds Treasury interpretative authority.

The holding in Notice 2005-14 relating to gross receipts derived from providing online access to software is premised on grant of regulatory authority in Section 199(d)(7). However, the legislative history of the American Jobs Creation Act shows that Congress specifically intended that means or methods of distributing qualified property were to receive no consideration in determining whether gross receipts therefrom qualified for deduction under Section 199. Specifically, the "film footnote" provides that means and methods of distributing qualified films should receive no consideration. H.R. Conf. Rep. No. 108-755, fn. 30. A colloquy on the Senate floor between the Chairman and Ranking Member of the Senate Finance Committee at the time it enacted this legislation makes it clear that Congress did not intend to create a special rule just for films. (S. 11036, Oct. 10, 2004). Taken together, the "film footnote" and the floor colloquy show that Congress did not intend to extend the interpretative authority granted in Section 199(d)(7) to allow Treasury to make distinctions based on means and methods of distributing qualified property. Treasury's interpretation with regard to online software access completely negates the colloquy.

We believe that additional support for the proposition that Treasury lacks authority to discriminate among means and methods of distributing qualifying property appears in the so-called "coffee example." H.R. Conf. Rep. No. 108-755, fn. 27. In that example, a taxpayer roasts and packages coffee beans. The taxpayer sells the roasted

coffee through a variety of unrelated third-party vendors and sells roasted coffee at the taxpayer's own retail establishments. The taxpayer, at its retail establishments, also prepares and sells brewed coffee to customers. Under the example, the gross receipts from sales of the roasted coffee beans to unrelated third parties, the sales of beans to customers at its retail outlets and, to the extent that the receipts from sales of the brewed coffee to customers are attributable to the use of the roasted beans, all qualify under Section 199. The means and methods of distributing the roasted coffee beans in the "coffee example" did not matter with regard to whether gross receipts from selling or using the beans qualified for the Section 199 deduction.

There is ample support in the legislative record for the conclusion that Treasury exceeded its regulatory authority with regard to its online software access interpretation.

B. Gross receipts from online software access are derived from a "lease, rental, license, sale, exchange, or other disposition of" computer software within the meaning of Section 199(c)(4)(A)(i).

In the Notice, Treasury construed the phrase "lease, rental, license, sale, exchange, or other disposition" as requiring that there be a physical transfer of a copy of computer software to a customer in order for gross receipts to qualify under Section 199. In the case of gross receipts from allowing online access to software, there is never a transfer of a copy of the computer program to the customer. We believe that this holding in the Notice is a misinterpretation of the word "license" in the statute.

The ordinary meaning of the term "license" connotes nothing more than "permission" to use. When viewed in this light, it is indisputable that those gaining online access to a software vendor's software do so with the permission of the software vendor. This permission constitutes the "license" within the meaning of the statute necessary to qualify for the deduction under Section 199.

Indeed, Section 102(41) of the Uniform Computer Information Transactions Act (UCITA)² specifically defines a license as including "a contract that authorizes access to or use" of computer information, which includes computer software. It is a misapprehension of the definition of the term "license" to construe it as requiring the transfer of possession of qualifying property. Because it used the word "license" in Section 199(c)(4)(A)(i), Congress did not intend transfer of possession of a copy of computer software as a requirement in order for gross receipts to qualify for deduction under Section 199.

C. Online access to software is not a service; it is a transaction involving computer software under Treas. Reg. Sec. 1.861-18. Notice 2005-14, with regard to online access to computer software, is inconsistent with Treas. Reg. Sec. 1.861-18.

Notice 2005-14 concludes: "[a] service provided using computer software that does not involve a transfer of the computer software does not result in gross receipts that

² National Conference of Commissioners on Uniform State Laws, 2002.

are derived from the lease, rental, license, sale, exchange, or other disposition of computer software.” Notice 2005-14 Sec. 3.04(7)(d). We believe that online access to software is not the same as “a service provided using computer software.” Providing online access to software is merely another channel of software distribution that is functionally no different than providing a customer with a copy of the software product or allowing the customer to download a copy of the software from the Internet.

We believe that online software access is a multiple element arrangement and, depending on the facts and circumstances of the transaction, involves the delivery of (1) software access (2) equipment rental and (3) in some cases, information technology services. Section 199 applies separately to each element and the gross receipts allocated accordingly. In some cases, the gross receipts attributable to one or more elements will be de minimis. Online software access transactions, to the extent they involve software, are not services transactions; they are transactions involving computer software to which the provisions of Treas. Reg. Sec. 1.861-18 apply.

In the event that Treasury, in the proposed regulations, carries forward the interpretation stated in the Notice, it would be helpful if it included some analysis as to how online software access is a “service” within the meaning of Section 199.

Treas. Reg. Sec. 1.861-18 provides that transactions involving computer programs be classified into one of four categories: (1) transfers of copyright rights, (2) transfers of copyrighted articles, (3) provision of services for the development or modification of the computer program or (4) the provision of know-how relating to computer programming techniques. These regulations would classify a transaction involving online access to software as a lease, giving rise to rental income. Section 199 permits deduction for gross receipts from either a lease or a rental of computer software.

A transaction involving online access to computer software would not be classified as a transfer of a copyright right because such a transaction conveys none of the rights described in Treas. Reg. Sec. 1.861-18(c)(2) (rights to make copies for distribution to the public, to make derivative works, to publicly perform to or public display). Nor would the Regulation classify the transaction as a provision of services because there is no obligation by the vendor to develop or modify a computer program. The regulation also would not classify the transaction as the provision of know-how relating to computer programming techniques. By default, the regulations classify a transaction involving online access to software as a transfer of a copyrighted article.

Treas. Reg. Sec. 1.861-18(f)(2) provides as follows:

The determination of whether a transfer of a copyrighted article is a sale or exchange is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the

owner of the copyrighted article, will be classified as a lease generating rental income.

Because a transaction involving online access to computer software transfers no benefits or burdens of ownership of any copyrighted article except for the rights of access and use, the transaction would not be further classified as a sale or exchange under Section 1.861-18(f)(2); it would be further classified as a lease giving rise to rental income. Because these Regulations would classify a transaction involving online access to computer software as a transfer of a copyrighted article and would further classify it as a lease, giving rise to rental income, gross receipts from online access to software are eligible for deduction under Section 199. Notice 2005-14, with regard to online access to computer software, is inconsistent with Treasury Regulation Section 1.861-18.

Notice 2005-14 also fails to give effect to the requirement in Treas. Reg. Sec. 1-861-18(f)(3) that “consideration must be given as appropriate to the special characteristics of computer programs in transactions that take advantage of these characteristics.” The Regulation points to “the ability to make perfect copies at minimal cost” as an example of a special characteristic that must be given consideration in classifying a transaction involving a computer program. We believe that the ability to transfer the functionality of a computer program to a customer without the necessity of transferring a copy of the program is another example of a transaction that takes advantage of just such a special characteristic.

Last, Notice 2005-14 fails to take into account Treas. Reg. Section 1.861-18(g)(2) which provides that:

Means of transfer not to be taken into account. The rules of this section shall be applied irrespective of the physical or electronic or other medium used to effectuate a transfer of a computer program.

We believe that Treas. Reg. Sec. 1.861-18(g)(2) is a direction that means and methods of distribution of computer software are not to be taken into account in determining the tax consequences of a transaction involving computer software. Online software access transactions involve transfers of rights to use to the software and such transfers are sufficient to bring them within Reg. Section 1.861-18(g)(2). Notice 2005-14, as regards online access to software, fails to give effect to this direction.

For these reasons, notice 2005-14 is inconsistent with Treas. Reg. Section 1.861-18.

5. Conclusion:

We appreciate the opportunity to present these comments and hope that you will find them helpful as you move forward with developing proposed Regulations under Section 199. Feel free to contact us if you have any questions.

Respectfully submitted,



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