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Denial of Section 199 Deduction for Certain Computer Software Fees

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BY

A recent Chief Counsel Advice memorandum determined that fees in connection with access to online software represented services and, as such, should not be considered qualified gross receipts for purposes of the Section 199 deduction.

Section 199 provides a deduction for businesses engaged, in whole or significant part, in manufacturing or production in the United States. This includes, among other activities, the sale, lease, rental, license, or exchange of computer software.

Calculation of the Section 199 deduction is complex and utilizes, in part, qualified gross receipts in the calculation. Treasury Regulation Section 1.199-3(i)(6)(ii) clarifies the meaning of qualified gross receipts in relation to computer software. The regulation provides that, in the absence of recognized exceptions, gross receipts derived from “services” are not qualified gross receipts in the disposition of computer software. Services include customer and technical support, telephone services, and online services.

In the facts outlined by the memorandum, the taxpayer operated online software platforms that enabled users to engage in certain online activities, including the operation of websites, user and non-user interface software applications, servers where computer software is hosted (data centers), other hardware, and the computer network. The taxpayer charged a fee for users to access the online software platforms, but not a fee for software provided on the platforms. The taxpayer included revenues from this fee as qualified gross receipts in calculating its Section 199 deduction.

The Chief Counsel determined the taxpayer could not include the fees as qualified gross receipts in the calculation of the Section 199 deduction. Specifically, the Chief Counsel held that the fees were not for direct use of software, but were instead for access to the services provided by online software platforms. No exceptions applied to the facts in question. Accordingly, because the fees represented services, they were not qualified gross receipts.

The ruling in this matter was limited to the taxpayer in question, but its reasoning could serve as guidance in future decisions. Toward this end, taxpayers in similar circumstances should review their user agreements, business models, and other facts to determine eligibility to claim a Section 199 deduction.

Sources

- <https://www.irs.gov/pub/irs-wd/201724026.pdf>
- <https://taxnews.ey.com/news/2017-0998-irs-concludes-taxpayer-derives-certain-gross-receipts-from-online-services-and-not-online-software>

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