Entertainment, Media and Communications Tax Newsletter

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Top 10 Accounting Method ideas for EMC companies

In today's "cash is king" world, many companies have found significant benefit from using accounting methods planning to reduce taxes and increase cash flow.

Moreover, accounting methods planning has taken on increased significance recently in light of potential tax reform. Companies want to decrease their deferred tax assets in case of a decrease in the corporate income tax rates or to compute earnings and profits of controlled foreign corporations in case of a repatriation of earnings.

For EMC companies, there are numerous tax accounting method opportunities specific to their industry to defer income and accelerate deductions that could help achieve these objectives. This article highlights the Top 10 of these industry specific cash tax method change opportunities.

For additional examples of opportunities to defer income and accelerate deductions that are generally applicable, see the WNTS Insight "Top automatic accounting method changes for 2011 returns," of August 24, 2012. Note that some of the accounting method change opportunities highlighted require the advance consent ("nonautomatic") of the IRS and a Form 3115, Application for Change in Accounting Method, must be filed on or before the last day of the taxable year. Other changes are eligible for automatic consent ("automatic"), and therefore the Form 3115 generally is required to be filed with a taxpayer's timely filed tax return (including extensions).

1) Deferral of advance payments

What companies sometimes do. EMC companies often receive advance payments in connection with the performance of services, licensing of property, or future provision of goods or publications.

For example, telecommunication companies often receive advance payments for voice and data services to be provided in future years. Entertainment companies may receive advance payments related to agreements to license syndicated films or television series for a defined period. In the television industry, companies may defer revenue related to barter exchanges where advertising airtime is exchanged for the right to programming. And publishers may receive advance payments in connection with the subscription of newspapers, magazines, or other periodicals.

In some cases, EMC companies include such advance payments in income in the year of receipt. Moreover, some of these companies that accelerate the recognition of advance payments for tax purposes fail to include that book-tax difference in their income forecast calculation, thereby failing to accelerate the recovery of any related creative properties that are depreciated using an income forecast method.

Opportunity to defer revenue recognition. An opportunity may exist for EMC companies to defer the recognition of income from advance payments, such as those received for services, goods, licenses, and barter arrangements, under Revenue Procedure 2004-34. This revenue procedure allows taxpayers to defer the tax recognition of qualifying advance payments until the earlier of the recognition of such income for financial statement purposes or the end of the tax year following receipt of the payment.

A change in method of accounting to the deferral method under Revenue Procedure 2004-34 is an automatic change. For taxpayers that continue to recognize part or all of their advance payments for tax purposes, but fail to properly include them under the income forecast method, a change to accelerate cost recovery by properly recognizing accelerated advance payments under the income forecast method is a nonautomatic method change.

In addition, publishers that receive advance payments in connection with the subscription of newspapers, magazines, or other periodicals may defer the recognition of the amounts received under Section 455. Section 455 provides that prepaid subscription income is included in gross income for the taxable years during which the liability to furnish or deliver the newspaper, magazine, or other periodical exists. Accordingly, Section 455 generally allows the tax recognition of prepaid subscriptions to correspond with the financial accounting recognition.

A change in method of accounting for prepaid subscription income is an automatic accounting method change and must be implemented on a cut-off basis (i.e., applies only to prepaid subscription income received on or after the beginning of the year of change).

2) Deferral of unbilled receivables

What companies sometimes do. Accounting for unbilled receivables related to licenses and services often presents another deferral opportunity for EMC companies. For example, in the film and television industries, it is common for producers that license film and television programming to use a "sale model" for financial accounting purposes. Under a sale model, revenue is recognized for financial accounting purposes when the film or television program is delivered to the customer, even though the agreement grants the customer a license to use the property for a fixed time.

In addition, telecommunication companies may enter into long-term service agreements to design, implement, and/or maintain voice, data, video, and IT networks for customers. Similarly, publishers may enter into long-term agreements to perform services such as educational testing.

Typically for book purposes, this service revenue is recognized using a percentage of completion method. To the extent the book recognition results in an unbilled receivable (i.e., revenue recognized that has not been billed or paid), book revenue may be recognized prior to when revenue should be recognized for tax purposes, which is the earliest of when: (1) performance occurs (i.e., as the licensee has the right to use the film or television program, or as the services are provided), (2) payment is received, or (3) payment is due.

As a result, taxpayers that follow their book revenue recognition method for unbilled licensing or service receivables likely are accelerating revenue for tax purposes.

Opportunity to defer revenue recognition. An opportunity may exist for EMC companies currently recognizing unbilled licensing revenue based on a sale model or unbilled service revenue using a percentage of completion method to change their method of accounting for tax purposes. They may be able to defer the recognition of such revenue until the earliest of when performance under the contract occurs (i.e., as the licensee has the right to use the intangible or as the services are performed), payment is received, or payment is due and the amount can be determined with reasonable accuracy. Note that corollary adjustments also must be made to defer income under the income forecast calculation, if applicable.

A change in method of accounting for unbilled receivables is a nonautomatic accounting method change. Refer to the June 2012 Entertainment, media and communications tax newsletter for additional information relating to the unbilled receivables accounting method opportunity.

3) Capitalization of costs to produce creative property

What companies sometimes do. EMC companies involved in the production of creative property or the production and distribution of inventory generally are subject to the requirement under Section 263A to capitalize direct costs and indirect costs that are properly allocable to tangible property produced and tangible property acquired for resale. For purposes of Section 263A, tangible personal property includes "films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator."

Because of the complexity of the rules under Section 263A, some taxpayers may find they are overcapitalizing costs to their creative property and/or inventory. For example, for publishers, Section 263A excludes from capitalization royalties paid to authors for books that have been sold and certain distribution costs.

For tax years ending on or before December 31, 2011, Section 181 allows a taxpayer to treat the cost of any qualified film or television production as a current deduction. Some taxpayers may claim less of a deduction than is otherwise allowable under Section 181 — for example, by overlooking the application of Section 181 to costs incurred subsequent to the initial production year.

Opportunity to accelerate deductions. An opportunity exists for EMC companies that are overcapitalizing costs to their creative property or to inventory to change to more favorable cost capitalization methods. A change in method of accounting for costs required to be capitalized under Section 263A is generally a nonautomatic accounting method change for creative property and an automatic accounting method change for inventory property.

An opportunity also may exist for EMC companies to maximize their Section 181 election, such as by including costs related to qualified films that are incurred subsequent to when the film is placed in service.

4) Capitalized interest

What companies sometimes do. For financial accounting purposes, interest generally is required to be capitalized to an asset that is constructed or otherwise produced for an enterprise's own use or intended for sale or lease, and that is constructed or otherwise produced as a discrete project, to the extent the asset requires a period of time to get it ready for its intended use. For tax purposes, interest must be capitalized during the production of certain "designated property," namely real property and tangible personal property with either a 20-year recovery period, a production period that exceeds two years, or a production period that exceeds one year with a cost that exceeds $1 million.

Both financial accounting and the tax law rely on the "avoided cost" theory to require the capitalization of interest. However, the amounts capitalized will not be the same, primarily because of differences in the types of property subject to interest capitalization, the measure of costs attracting interest, the determination of the production period, the determination of eligible debt, and the consideration of related party debt for tax purposes.

For example, for financial accounting purposes, EMC companies often capitalize interest related to the development of software, the production of films, and the acquisition of wireless licenses. Although the book and tax rules differ, some companies follow their financial accounting methods to capitalize interest.

Opportunity to accelerate deductions. An opportunity may exist for EMC companies to deduct (or reduce) the amount of interest capitalized for financial accounting purposes, particularly if companies are capitalizing interest related to software, wireless licenses, or other intangibles where capitalization is not required. A change in the treatment of interest required to be capitalized under Section 263A(f) is a nonautomatic accounting method change.

5) Author advances

What companies sometimes do. Publishing companies often make advance payments to authors, known as author advances, for the rights to publish the authors' books. For financial accounting purposes, money paid out for author advances generally is capitalized on the balance sheet as a prepaid asset that is reduced as the author earns related royalties.

Generally, this treatment is followed for tax purposes because author advances typically are not required to be capitalized into the basis of the manuscript under the UNICAP regulations. In most cases, the author is not required to repay the author advance if the advance exceeds royalties earned. For financial accounting purposes, if the author advances exceed expected future royalties, a write-down may be taken against the advance through a contra-asset account. Some taxpayers reverse this contra-asset account and take into account the worthless author advances when the amount is directly written off the balance sheet for financial accounting purposes, or later.

Opportunity to accelerate deductions. An opportunity may exist for EMC companies to accelerate the deduction for author advances, particularly for amounts paid to published authors. Taxpayers currently reversing the contra-asset account should review the threshold for writing off advances for financial accounting purposes and take into account a write down of an author advance at the time the advance is worthless under the tax law.

Alternatively, taxpayers should consider using an income forecast method to recover the author advance, which would allow the full amount of the advance to be recovered once the projected income from the book is fully earned.

A change in method of accounting for author advances is a nonautomatic accounting method change.

6) Unproductive creative property costs

What companies sometimes do. In the entertainment industry (specifically film and television companies), taxpayers incur costs to acquire and develop screenplays, scripts, story outlines, and motion picture production rights to books, plays, and other similar properties for potential future film development. Studios usually do not discard, release to the public domain, or otherwise dispose of the creative properties not set for production or sold; rather, studios typically retain their rights in the property indefinitely.

Companies in the music industry also may incur similar costs to acquire recordings and song compositions. Similarly, in the publishing industry, taxpayers incur prepublication costs related to designing and editing books.

For financial accounting purposes, these creative property costs are reviewed periodically to determine whether the related film, sound recording, or book will be produced or otherwise generate income. Under the financial accounting rules for films, it is presumed that a company will dispose of a film (whether by sale or abandonment) if it has not been set for production within three years from the time of the first capitalized transaction. In the film industry, as well as other industries, to the extent creative property is no longer considered an income-producing asset or will no longer be produced in the future, the basis in the creative property may be written off. Some taxpayers may reverse these write-downs for tax purposes to the extent an intangible asset has not been abandoned.

Opportunity to accelerate deductions. For tax purposes, taxpayers generally are required to capitalize creative property costs, and they may not recover these costs using the income forecast method if the creative property is not produced. However, Revenue Procedure 2004-36 provides a safe harbor method of accounting whereby a taxpayer may amortize qualifying creative property costs (e.g., costs incurred for television programs and films) properly written off for financial accounting purposes ratably over a 15-year recovery period beginning on the first day of the second half of the taxable year in which the taxpayer properly writes off the costs.

A change in method of accounting for the treatment of qualifying creative property costs is an automatic accounting method change.

7) Cost recovery of creative property

What companies sometimes do. For financial reporting purposes, EMC companies often depreciate their creative property (such as films, television programs, music masters, and manuscripts) using an income forecast method or a straight-line method. Under an income forecast method, the basis in the film or other creative property is recovered as income from use of the property is recognized. The income forecast method is allowable under the tax law; however, some companies instead follow the straight-line method that is used for financial accounting purposes for tax purposes.

In addition, some companies that use the income forecast method for tax purposes do not optimize this method by including contingent compensation to talent, generally known as "participations and residuals" (P&R), in the basis of the creative property to the extent allowable. For financial accounting purposes, P&R generally is deducted when revenue is recognized. In general, the tax law allows two different methods to account for P&R: (1) include the P&R in basis upfront and amortize the amounts using an income forecast method, consistent with the ruling in Transamerica Corp. v. U.S., 999 F.2d 1362, or (ii) deduct the P&R in the taxable year paid, consistent with the holding in Associated Patentees v. Commissioner, 4 T.C. 979 (1945).

Participations and residuals are defined rather broadly under the tax law as costs, "the amount of which by contract varies with the amount of income earned in connection with such property," and thus arguably this rule has broader applicability than the film industry, including potentially royalties paid to recording artists or to authors.

Opportunity to accelerate deductions. An opportunity exists for EMC companies currently using a straight-line method to recover the basis of creative property for tax purposes to change to an income forecast method. In most cases, the income forecast method allows quicker basis recovery than straight-line depreciation since the film or similar creative property typically generates the majority of its income in earlier years.

An opportunity also could exist for EMC companies that currently are deducting contingent compensation when paid to change and include such contingent amounts in basis when the property is placed in service and recover such amounts using an income forecast method. A change in method of accounting to use the income forecast method, or to change the treatment of participations and residuals under the income forecast method, is a nonautomatic accounting method change.

8) Deferred costs

What companies sometimes do. EMC companies may incur costs attributable to revenue recognized in a subsequent period and defer these costs for financial accounting purposes under the matching principle. Examples of such deferred costs include deferred session fees incurred by record labels in the music industry, samples provided by publishers, advances paid by publishers to established authors (that are otherwise not part of capitalized prepublication costs), launch support payments made by television networks, inducements to obtain customer contracts, and advertising and promotional liabilities.

Taxpayers that are following the financial accounting treatment potentially are deferring costs beyond the point required under the tax law.

Opportunity to accelerate deductions. An opportunity may exist for EMC companies that are following the financial accounting treatment of deferred costs because such costs could be currently deductible for tax purposes. In general, the tax law contains specific categories of costs that must be capitalized — generally costs that produce a definite future income stream — and these categories do not include costs that create only a mere hope or expectation of developing or maintaining a business relationship, amounts paid relating to contracts that are terminable at will, or amounts that have a benefit period of 12 months or less.

For example, advertising and promotional costs (including samples and marketing launch support costs) generally produce only speculative future benefits and are not required to be deferred and matched against related revenue.

In the event a taxpayer has inadvertently capitalized amounts that are not otherwise required to be capitalized under Section 263(a) (i.e., deferred costs), an automatic accounting method change may be filed to properly account for these items under Section 263(a).

9) Sales returns

What companies sometimes do. For financial accounting purposes, many EMC companies establish a reserve for future estimated returns of books, DVDs, CDs, and other merchandise ("sales returns"). Many taxpayers reverse the amount of the sales return reserve for tax purposes and take into account sales returns when they issue a refund or a credit memo.

Opportunity to accelerate deductions. Two opportunities exist for EMC companies to potentially accelerate the deduction for sales returns for tax purposes.

First, companies may apply the recurring item exception; they accrue a liability for sales returns to the extent they have a fixed liability that is reasonably determinable as of the end of the year and a refund or credit memo is issued within 8½ months of year end. Factors supporting a fixed liability at year end could include (i) notification of returns through correspondence with customers (e.g., phone calls or e-mail) or (ii) the returned goods are received by year end.

A change in method of accounting for the treatment of sales returns is a nonautomatic accounting method change.

Second, for magazines, paperback books, and records, a special provision allows certain sales returns to be excluded from gross income, rather than taken into account as deductions. Specifically, Section 458 allows taxpayers to elect not to include in gross income the income attributable to the sale of magazines, paperback books, and records returned to the taxpayer within (i) 2½ months for magazines and (ii) 4½ months for paperback books and records, after the close of the taxable year.

A change to account for sales returns under Section 458 is a nonautomatic accounting change. It is implemented with a "suspense account" that could significantly limit the cash flow benefit of changing to a Section 458 method.

10) Amounts received that are not contributions to capital under Section 118

What companies sometimes do. Telecommunication companies may receive payments from nonshareholders to reimburse them for the cost of relocating telecommunication poles and lines where such relocations are requested by the customer. For tax purposes, some EMC companies take the position that these relocation payments are contributions in aid of construction under Section 118 and include these amounts in gross income. In addition, these companies capitalize the cost of relocating the poles and lines and depreciate such costs over the applicable recovery period of the underlying asset.

Opportunity to exclude, or change character, of income. An opportunity may exist for telecommunication companies to treat relocation payments as nontaxable reimbursements of costs as opposed to taxable contributions in aid of construction. Specifically, under the well-established cost reimbursement doctrine, a taxpayer is not entitled to a deduction for an expenditure for which it has a fixed right to reimbursement at the end of the year. As a corollary, the courts and the IRS also agree that reimbursement payments are not income to the recipient. The courts' rationale underlying the cost reimbursement doctrine is that the expenditures and reimbursements represent loans or advances between the parties.

A change from treating relocation payments received as income and the costs as additional basis to applying the cost reimbursement doctrine generally is a nonautomatic accounting method change.

Cutting through recent developments in Gillette: California's MTC apportionment election and its impact on EMC companies

In our March 2012 newsletter, we discussed two regulation changes in California affecting the EMC industry: (1) the market sourcing regulation for taxpayers that elect a single sales factor apportionment formula effective in 2011 and (2) the film and TV industry special apportionment regulation. Now there are other California developments that EMC companies need to analyze in making apportionment determinations: the Gillette decision and its aftermath.

In light of the California Court of Appeal's Gillette decision, EMC businesses should consider whether there is an opportunity to reduce their California apportionment factors by electing an equally weighted apportionment formula in lieu of the state's double-weighted sales factor. There's much more to the analysis than simply shifting factor weighting. Considerations in calculating tax under the election include: modifying Joyce/Finnigan calculations, identifying gross receipts changes, altering reliance on certain regulations, and weighing other procedural implications. Recent legislative developments complicate matters as well.

The *Gillette* decision

California was a signatory to the Multistate Tax Compact, which includes a provision that obligates member states to offer taxpayers the option of using: (1) an equally weighted sales, property, and payroll apportionment factor or (2) a state's alternative formula. California adopted a double-weighted sales factor in 1993. The taxpayers in the Gillette case asserted that the compact, and its codification under California law, provided them an election to use an equally weighted apportionment factor for tax years at issue since 1993.

On July 24, 2012, in a 3-0 decision, a California Court of Appeal held that the compact is a valid interstate compact binding California to provisions that include the equally weighted apportionment provision, which is codified under California law. Having entered into the compact, California cannot, by subsequent legislation, unilaterally alter or amend its terms. The court said California can avoid the application of the apportionment election only by repealing the statutory provision adopting the compact, thereby withdrawing from the compact. Because California has not withdrawn from the compact by repealing the statute, the equally weighted apportionment election is available to taxpayers.

(For a more detailed summary of the Gillette decision, please see our July 25, 2012 publication, available here).

The aftermath

The case is scheduled for a rehearing. The California Franchise Tax Board filed a petition for rehearing on August 8, claiming that the court's decision did not determine whether California's double-weighted sales factor statute permits taxpayers to elect equally weighted factors (the "compact election") or whether the statute is unconstitutional and therefore invalid because it prohibits such an election. The following day, the court, on its own motion, ordered a rehearing and vacated its July 24 decision. Following the rehearing, subsequent appeals are expected.

On June 27, 2012, California enacted S.B. 1015, which repealed all provisions in California law related to the compact. Effective immediately and subject to taxpayer challenge, the repeal removes taxpayers' option of electing the equally weighted, three-factor apportionment formula relied upon in Gillette. However, S.B. 1015 did not pass each legislative house with a two-thirds vote as required by California Proposition 26 for revenue-raising bills, which renders S.B. 1015 susceptible to challenge.

S.B. 1015 also includes a provision regarding the "doctrine of elections" and states that any election that affects the computation of tax must be made on an originally, timely filed return. The legislation also states that this doctrine does not constitute a change in existing law; rather, it is declaratory of existing law. Such provision, if enforceable, may mean that any refund claims made on an amended return and based on an election to use an alternative apportionment formula are invalid. However, Gillette may draw such a conclusion into question as applied to the compact because the opinion stressed that "any repealing legislation must be prospective in nature."

This November, California taxpayers will vote on the California Income Tax Calculations for Multistate Businesses Initiative, the "California Clean Jobs Energy Act" (#11-0080). The act would require multistate businesses to calculate their California income tax liability utilizing a single sales factor apportionment formula. If S.B. 1015 is void under Proposition 26, then taxpayers may still have an option to use the compact election.

Finally, on August 13, 2012, the California Assembly passed A.B. 1500, which would require single sales factor apportionment in 2013. The bill has moved on to the Senate for consideration.

What this all means for EMC companies

The potential impact of Gillette raises many questions for EMC companies to consider:

- What will be the result of the rehearing?
- For the extended 2011 tax return that will be filed shortly, what options do taxpayers have with respect to decisions around apportionment and the compact election? Single sales factor with market sourcing, or double-weighted three-factor with cost of performance? How does the compact election fit into all of this? What penalties should be considered?
- Is it too late to file refund claims taking the compact election?
- Other than the sales factor weighting, what other impact does the compact have on the tax return, including the treatment of certain gross receipts such as treasury receipts; Joyce versus Finnigan; and the applicability of special industry apportionment regulations?
- What should be done regarding S.B. 1015's requirement that elections should be made on an originally filed return?
- Whether the election is made on an original or amended return, what are the implications from an ASC 740 perspective of the Gillette decision, the passage of S.B. 1015, and the pending November business initiatives vote?
- Are there other states where a taxpayer may elect to take an equally weighted apportionment factor?

Conclusion

While the court in the Gillette case has vacated its original decision and a new opinion is forthcoming, EMC companies should determine whether the equally weighted sales factor election may be beneficial. If the analysis indicates that refund claims should be filed, the applicable refund claims should be submitted prior to resolution of the Gillette litigation to mitigate the impact of procedural hurdles the Franchise Tax Board may institute in the face of an adverse outcome.

IRS provides EMC companies with roadmap to determine whether online software qualifies for Section 199 benefits

EMC companies have long struggled with applying the safe harbors to qualify online software for the Section 199 domestic production activities deduction. Recently, the IRS National Office provided some very useful guidance (CCA 201226025).

General rules

Subject to a W-2 wage limitation, the Section 199 deduction is computed as 9% of the lesser of qualified production activities income (QPAI) or taxable income.

In general, a taxpayer's QPAI equals its domestic production gross receipts (DPGR) over the sum of (1) the cost of goods sold allocable to such receipts and (2) other expenses, losses, or deductions that are properly allocable to such receipts. DPGR includes gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States. QPP includes tangible personal property, any computer software, and sound recordings.

A taxpayer must determine, based on all the facts and circumstances, whether gross receipts qualify as DPGR on an "item-by-item" basis. If property offered for sale to customers does not meet all the eligibility requirements under Section 199, the taxpayer must treat as an item any component of the property offered for sale that does meet the requirements. That is, the taxpayer must "shrink back" nonqualifying property into its qualifying components, if any (the "shrink-back rule").

Section 199 treatment of online software

As a general matter, gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet services that offer 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.

However, there are two online software safe harbor exceptions. One of the exceptions, the "third-party comparable" exception in Reg. sec. 1.199-3(i)(6)(iii)(B), is the primary issue addressed in CCA 201226025 .

Under this exception, gross receipts derived by the taxpayer from providing access to online software for the customers' direct use are treated as being derived from the lease, rental, license, sale, exchange, or other disposition of computer software if "another person" derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of "substantially identical software" to its customers affixed to a tangible medium or by download from the Internet (collectively "tangible medium" or "offline software"). The Section 199 regulations define substantially identical software as software that (i) from a customer's perspective has the same functional result as the online software and (ii) has a significant overlap of features or purpose with the online software.

In this regard, all computer software games are deemed to be substantially identical software.

Aggregation of third-party comparable software not permitted

The CCA involves a taxpayer that provides its customers access to its online software. The taxpayer identified other unrelated third parties that had computer software products that the taxpayer represented were similar to the taxpayer's online software and were offered to customers affixed to a tangible medium. The taxpayer represented that, in the aggregate, the third-party computer software products were equivalent to the taxpayer's online software.

The CCA states that the greatest number of the taxpayer's online software features that were contained within a single third party's computer software program was Y, a number less than X, where X represented the total features within the taxpayer's online software. In other words, it appears that the taxpayer could not identify any offline computer software program offered by a third party to customers that contained all of the features as the taxpayer's online software. However, the taxpayer could identify several third-party offline computer software programs that contained some, but not all, of the features of the taxpayer's online software.

The first issue addressed by the CCA was whether the taxpayer could aggregate the collective third-party offline computer software programs to permit the taxpayer's online software to satisfy the third-party comparable exception. The IRS National Office concluded that the "plain language of [the third-party comparable exception] does not contemplate aggregating multiple third-party software programs…because integration in software can provide a different customer experience than a disjointed accumulation of software programs."

According to the CCA, the functionality, features, and purpose of the taxpayer's online software must be replicated by a single competitor's offline software to be considered "substantially identical software." Those conditions were not met in this case.

Combining third-party comparable exception and shrink-back rule allowed

The second issue addressed by the CCA was whether the taxpayer could apply the shrink-back rule to qualify for Section 199 any eligible components of the taxpayer's online software that individually satisfied the third-party comparable exception.

The shrink-back rule requires taxpayers to treat as an item any component of the property offered for sale that does meet the Section 199 requirements. In applying the rule to the third-party comparable exception, a taxpayer must determine whether there is substantially identical software offered via tangible medium for any component of the taxpayer's online software. That is, any third-party software will be considered substantially identical to a component of the taxpayer's online software, if such third-party software (i) from a customer's perspective, has the same functional result as the taxpayer's online software and (ii) has a significant overlap of features or purpose with the taxpayer's online software.

In this regard, the CCA concluded that gross receipts attributable to a component of the online software should qualify as DPGR to the extent the taxpayer can show that an individual component of its online software has a substantially identical offline counterpart (assuming all other Section 199 requirements are met).

Therefore, the taxpayer could qualify any eligible component of its online software program through the combined application of the shrink-back rule and the third-party comparable exception — that is, for those features of the taxpayer's online software for which third-party comparable offline software programs existed.

It is important to note that the taxpayer would be required to demonstrate that each feature satisfied the general Section 199 requirements. In addition, although the CCA accurately notes that gross receipts allocable to the online software features that satisfied the Section 199 requirements will constitute DPGR, the CCA does not explain how the gross receipts the taxpayer derives from its overall online software program should be allocated between qualifying and nonqualifying features.

The Section 199 regulations provide that gross receipts must be allocated between DPGR and non-DPGR using any reasonable method based on all the facts and circumstances. Our experience indicates that application of Section 482 principles to the various features could be one reasonable way of allocating such gross receipts.

Conclusion

The CCA offers valuable insight. Specifically, EMC companies that have MPGE online software in the United States should evaluate whether such software, or any component thereof, satisfies the third-party comparable exception (or, alternatively, the "self-comparable" exception, under which the company itself offers, via tangible medium, to its customers computer software that has minor or immaterial differences when compared to the company's online software).

An EMC company seeking to claim Section 199 benefits under the third-party comparable exception should compile a well-documented analysis that assesses functionalities, features, or purposes and establishes the proper value of the taxpayer's gross receipts that are attributable to its qualifying online software.

To have a deeper discussion on the topics covered in this issue, please contact:

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Recommended reading:

Global entertainment and media outlook 2012-2016

http://www.pwc.com/us/en/industry/entertainment-media/publications/global-entertainment-media-outlook.jhtml

Global CEO Survey - Entertainment & Media Industry insights 2015

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