The IRS provides mixed Section 199 guidance on US government contracts

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In brief

In a recently released Technical Advice Memorandum (TAM 201314043), the IRS National Office determined that a taxpayer that meets the special rule for government contracts under Section 199(c)(4)(C) may be treated as deriving gross receipts from a lease, rental, license, sale, exchange, or other disposition (disposition) of property in cases in which the property is not delivered to the government.

The IRS also concluded that any of the taxpayer's gross receipts derived from the Federal government that were related to the transfer of intangible rights and data were allocable to non-qualified services and non-qualified property provided by the taxpayer and therefore were not domestic production gross receipts (DPGR).

Taxpayers that enter into contracts with the US government as well as taxpayers that enter into contracts that provide for the transfer of both qualifying property and intangible assets should consider the potential effects of this TAM.

In detail

Background

The taxpayer, a government contractor, entered into two contracts with the US government, both of which were part of system development and acquisition programs. Under both contracts, the taxpayer engaged in design and development activities consistent with those performed under an Engineering and Manufacturing Development (EMD) contract. *Note:* An EMD contract, according to the TAM, is "a research and development contract for the definition of system functionality and interfaces, complete hardware and software detailed design, and reduce system-level risk. It also includes a demonstration of the ability of the system to operate in a useful way consistent with the approved key performance parameters and that system production can be supported by demonstrated manufacturing processes."

The first contract (Contract 1) required the taxpayer to perform detailed design, prototype construction, software development, integration, and testing activities. In Contract 1, delivery of the tangible personal property produced was not required, and title to the property produced reverted from the government back to the taxpayer after production and testing of the property. Prior to full completion of the subject matter of Contract 1, the government terminated the contract for convenience. As a result of the termination, the taxpayer received a settlement. The taxpayer took the position that the entire settlement was DPGR.

The second contract (Contract 2) involved a subcontract to a prime contract between "Corporation X" and the US government that required the taxpayer to produce and deliver hardware and software. Under Contract 2, the taxpayer was required to provide unlimited rights to the external shape or geometry of the items delivered under the purchase order, subject to claims for less than unlimited rights. The taxpayer provided to Corporation X a statement of limited and restricted rights to protect the taxpayer's rights and the rights of the taxpayer's subcontractors in technical data, computer software, and computer software documentation to which the government did not obtain unlimited rights under certain provisions of the Defense Acquisition Regulations System (DFARS). The taxpayer took the position that all gross receipts under Contract 2 were DPGR.

The TAM addresses two separate issues raised by the IRS Large Business and International division (LB&I):

- The first issue considers whether the special rule for government contracts under Section 199(c)(4)(C) eliminates the requirement under Section 199(c)(4)(A)(i) that DPGR must be attributable to the disposition of qualifying production property (QPP) manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or significant part within the United States.
- The second issue involves a determination as to whether any of the gross receipts derived by the taxpayer from the two contracts are non-DPGR because the gross receipts are attributable to nonqualified services or property (e.g., data or intangible rights).

Special rule for government contractors

Section 199(c)(4)(A)(i) provides, in part, that DPGR includes gross receipts derived from any disposition of QPP that was MPGE by a taxpayer in whole or significant part within the United States (the disposition rule). However, Section 199(c)(4)(C) provides a special rule for certain government contracts under which, if all requirements are met, a taxpayer is treated as meeting the disposition rule.

With respect to Contract 1, the IRS found that the taxpayer met the three requirements imposed by Section 199(c)(4)(C) to treat the gross receipts derived from the MPGE of QPP described in Section 199(c)(4)(A)(i)(I) as meeting the requirements of the disposition rule. First, the taxpayer produced tangible personal property that was MPGE in whole or significant part in the United States. Second, Contract 1 was entered into with the US government and expressly required the taxpayer to produce certain tangible personal property. Third, Contract 1 included the requisite Federal Acquisition Regulations (FAR) title vesting requirement, meaning the US government held title to the tangible personal property prior to the completion of production of the property.

LB&I had argued that Congress did not intend Section 199(c)(4)(C) to allow the taxpayer's gross receipts to qualify as DPGR, because the taxpayer never delivered any property to the government under Contract 1. In rejecting this argument, the TAM noted that the plain language of Section 199(c)(4)(C) does not impose the requirements that LB&I sought to apply to the taxpayer and instead held that delivery is not required for the special disposition rule to apply.

According to the IRS, it was irrelevant whether title reverts back to the taxpayer for purposes of Section 199(c)(4)(C), because the statute does not address whether title can or cannot revert back to a taxpayer at any future point.

Furthermore, the IRS found that the prototypes produced under Contract 1 were tested until destruction, with the remainder to be used or consumed within the context of the contract. Because the property was used or consumed under the contract and the reversion of title and delivery of the prototypes to the taxpayer would have little to no value, the TAM concluded that the treatment of the gross receipts from Contract 1 attributable to QPP as DPGR was consistent with the purpose of Section 199.

Design and development services may be treated as MPGE activities

Reg. sec. 1.199-3(i)(4)(i) provides that gross receipts derived from the provision of services generally do not qualify as DPGR. However, Example 5 in the regulations illustrates that certain services may be treated as MPGE activities to the extent they are performed by the taxpayer as part of the MPGE of QPP while the taxpayer has the benefits and burdens of ownership under Federal income tax principles.

Under this rule, activities such as materials analysis and selection, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, diagnosis and correction of system failure, and packaging for shipment to customers may be treated as part of the MPGE of QPP if the taxpayer otherwise MPGE the QPP.

LB&I had concluded that the design and development activities performed by the taxpayer under the two contracts could not be treated as part of the MPGE of QPP, and that gross receipts from these design and development activities were derived from nonqualified services that must be treated as non-DPGR. In rejecting this argument, the TAM articulated the position that design and development activities alone are activities that create intangible property that is ineligible for the Section 199 deduction (except in cases of software or sound recordings).

However, the TAM concluded that a taxpayer that designs, develops, and produces tangible personal property for disposition may treat what would otherwise be "non-MPGE" activities as part of the MPGE of QPP; therefore, it is unnecessary for the taxpayer to allocate gross receipts to these potentially nonqualifying activities or services. In response to LB&I's argument that design and development are not activities listed in Example 5, the IRS stated that Example 5 is not an exclusive list of non-MPGE activities that can be treated as part of the MPGE of QPP when a taxpayer MPGE that QPP.

Allocation of gross receipts to non-qualified property

Reg. sec. 1.199-3(i)(4)(i) also provides that gross receipts from the disposition of nonqualified property generally do not qualify as DPGR. In its analysis, the TAM compared the rights transferred to a customer on the sale of equipment to a situation in which a customer contracts with another party to design a piece of equipment that the customer desires to manufacture. According to the IRS, the transfer of equipment and certain rights of ownership in that equipment to a customer would amount to a transfer of tangible personal property that would not require an allocation of gross receipts between DPGR and non-DPGR.

In contrast, a manufacturer's transfer of rights related to the design of the equipment, data, and other information necessary to produce the property, exclusive production rights, and exclusive rights to use any other technology created in the course of developing the equipment would require the manufacturer to allocate gross receipts between DPGR related to the tangible equipment and non-DPGR related to the intangible property.

Under both contracts, the taxpayer transferred technical data and rights to the technical data that the TAM and LB&I viewed as intangibles that are not QPP. The taxpayer argued that the technical data and rights to the technical data transferred did not have any value to the government because the government did not receive the right to reproduce the property in its entirety and did not receive any more rights than a customer in a basic sale contract for custom-designed property. According to the taxpayer, a customer must receive, at a minimum, the right to reproduce the entire property to have a separate intangible to which gross receipts are allocable.

The TAM disagreed, stating that the rights that the government received as a part of both contracts were distinguishable from the rights a customer would receive in a normal commercial setting. By way of analogy, the IRS noted that the taxpayer's position would suggest that if a customer received only a portion of an underlying manuscript, the portion transferred would have no value to the customer because the customer could not reproduce the book in its entirety.

While acknowledging that the portion transferred is likely less valuable than the entire manuscript, the IRS concluded it is not reasonable to say that a portion of the rights to the manuscript completely lacks value. Because the government received technical data and varying rights allowing it to use the technical data under both contracts, the TAM concluded that these rights had a value to the government. Accordingly, the IRS found that the taxpayer's gross receipts were allocable between DPGR from the tangible property and non-DPGR from the nonqualifying intangible property.

In sum, the TAM determined that the contracts at issue consisted of both the production of property and the production of information. The IRS further determined that the contracts were most similar to other EMD contracts that are for both creating designs and data related to how those designs perform as well as producing property that shows the designs can be created in working form. As a result, the IRS noted that the purpose of the contracts was the transfer of both tangible and intangible property, and that a portion of gross receipts from the contracts was allocable to transferred intangible property and therefore was non-DPGR.

Computer software and computer software documentation

In addition to tangible property, technical data, and the associated rights to the technical data, the contracts also called for the development of computer software and computer software documentation. Computer software under Reg. sec. 1.199-3(j)(3)(i) includes any documentation required to describe and maintain the computer program or routine. Therefore, the TAM concluded that to the extent the property the taxpayer transferred was computer software that meets the requirements of Section 199(c)(4)(A)(i)(I), the taxpayer's gross receipts attributable to that property were DPGR.

The takeaway

The issues addressed by the TAM affect any taxpayer that enters into contracts with the US government. It is important to keep in mind the special rule for government contracts set forth in Section 199(c)(4)(A)(i) that modifies the disposition rule in Reg. sec. 1.199-3(i)(1)(i) and the "by the taxpayer" requirement in Reg. sec. 1.199-3(f). These special rules with respect to government contracts may benefit companies that derive gross receipts from government contracts and currently are not qualifying their gross receipts under such contracts as DPGR.

However, it is also important to note that part of the IRS analysis and conclusions in the TAM may affect taxpayers in other contexts. In particular, taxpayers should evaluate whether gross receipts derived from a bundled contract for the provision of tangible personal property as well as intangible property (e.g., certain data and intangible rights) must be allocated between DPGR and non-DPGR.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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