taxnotes® federal

Volume 187, Number 5 ■ May 5, 2025

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by Jessica Theilken, Monisha Santamaria, and Natalie Tucker

Reprinted from *Tax Notes Federal*, May 5, 2025, p. 845

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Jessica Theilken

Monisha Santamaria

Natalie Tucker

Jessica Theilken is a managing director in the Washington National Tax (WNT) methods group of KPMG LLP, Monisha Santamaria is a principal in the WNT passthroughs group, and Natalie Tucker is a partner in the WNT methods group.

In this article, the authors offer reasons why Congress should update the definition of software to align with modern changes in technology, especially if a domestic manufacturing incentive is included in the upcoming tax bill.

Congress should modernize the definition of software in the context of domestic manufacturing if former section 199, or a variation of it, is revived to provide a domestic manufacturing incentive. This is necessary not only to hedge against future disagreements between taxpayers and the IRS when it comes to qualifying software activities[1] but also to account for the expansion of the industry and the very significant evolution of technology that has occurred in the last two decades since the former section 199 rules were first introduced.[2]

The definition of manufacturing and to what extent it includes the development of software should be top of mind for software developers and policymakers considering a domestic manufacturing incentive in an upcoming tax bill. The real potential for effectuating a "reduced" federal income tax rate for companies engaged in domestic manufacturing activities[3] and recent court decisions, such as *Express Scripts*,[4] make defining this terminology crucial.

Express Scripts highlights the fact that taxpayers engaged in certain software development activities may be excluded, perhaps inadvertently, from this potential rate reduction unless the definition of manufacturing and software is modernized. In *Express Scripts*, the

[1] There are many controversies concerning the application of former section 199, but this article focuses on the qualification of software development activities for the DPAD. Other issues beyond the scope of this article include contract manufacturing arrangements and embedded services. *See, e.g.*, LB&I-4-0112-001, superseded by LB&I-04-0713-006, which was then superseded by LB&I-04-1013-008 (each providing guidance on the benefits and burdens analysis in contract manufacturing arrangements); and *Bloomberg v. Commissioner*, T.C. Memo. 2024-108 (a portion of gross receipts derived from software was DPGR despite the software also enabling the provision of other services).

[2] International Trade Administration, "SelectUSA Software and Information Technology Industry Overview" (last accessed Apr. 25, 2025) (citing a CompTIA study that there are approximately 585,000 software and IT services companies in the United States).

[3] Jessica Theilken et al., "New Year, Old Tax Law: Will Section 199 Make a Comeback?" *Tax Notes Federal*, Jan. 20, 2025, p. 515.

[4] *Express Scripts Inc. v. United States*, No. 4:21-cv-00737 (E.D. Mo. Mar. 18, 2025).

court denied a taxpayer's domestic production activities deduction (DPAD) for the license of computer software, continuing a contentious debate between the IRS and taxpayers about the types of manufacturing activities eligible for the domestic manufacturing incentive under former section 199. When it comes to online software, the IRS has repeatedly argued (and courts have recently agreed) that taxpayers have not manufactured qualified property for sale or license to their customers, but rather are themselves using the software in question to provide nonqualifying services to customers.

Express Scripts was decided after President Trump called for a new reduction in the federal income tax rate for companies engaged in domestic manufacturing activities, which may take the form of a deduction, rather than a rate decrease. If Congress tries to accomplish this by reinstating the former section 199 regime, there is a risk that certain software development activities may be excluded, perhaps inadvertently, from the benefit. Thus, Congress may, and likely should, revisit the definition of manufacturing, especially in the context of taxpayers engaged in software development activities.

Background of the DPAD

Former section 199, which was repealed by the Tax Cuts and Jobs Act, provided a tax deduction in an amount generally equal to 9 percent of the lesser of the taxpayer's income from qualified production activities income or taxable income (determined without regard to the DPAD) for the tax year, but limited to 50 percent of the taxpayer's qualifying W-2 wages.[5]

Under the former rules, qualified production activities income was computed as a taxpayer's domestic production gross receipts (DPGR) less allocable cost of goods sold and other deductions. DPGR included gross receipts derived from any lease, license, rental, sale, exchange, or other disposition of qualified production property (QPP) that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States. QPP that gave rise to DPGR included tangible personal property, software, and film and sound recordings. DPGR could also be derived from certain statutorily permitted services, such as engineering or architectural services performed in the United States for the construction of real property in the United States.

DPAD Treatment of Software

While former section 199 provided that QPP included "any computer software," the regulations under that section narrowed the definition of software. Under the regulations, software was defined to include only software provided on a disk or through an internet download (that is, software transferred to a customer rather than software that's merely available for customer use). Further, the regulations treated software made available through online access as nonqualifying services, the receipts of which could not be treated as DPGR unless one of two safe harbors were met. The safe harbors looked to whether either the taxpayer or a third party provided "substantially identical" software to customers through a tangible medium (such as a CD) or download. As such, under the former section 199 regulations, software developers needed to show not only that they produced software in the United States but also that they (or a third party) provided the software to customers by disk or internet download.

Gross receipts derived from the provision of services generally were not eligible to be treated as DPGR in computing the DPAD. Thus, in situations in which the taxpayer provided embedded services to customers that were not separately charged to customers from the license or other disposition of computer software, the taxpayer was generally required to allocate the

[5]When enacted, the DPAD percentage was phased in starting at 3 percent for tax years beginning in 2005 and 2006; 6 percent for tax years beginning in 2007, 2008, and 2009; and 9 percent for tax years beginning after 2009. A 3 percent haircut in the DPAD percentage generally applied to taxpayers with oil-related qualified production activities income. *See* former section 199(d)(9). This deduction effectively reduced the corporate income tax rate on qualified production activities income.

gross receipts between the qualifying and nonqualifying activities.[6] The regulations also provided that gross receipts derived from customer and technical support and online services (such as internet access, online banking, access to online electronic books, newspapers, and journals) did not constitute gross receipts from the disposition of QPP.

Unsurprisingly, taxpayers and the IRS have clashed repeatedly over the application of former section 199 to computer software, particularly online software. In the most recent example, Express Scripts (a pharmacy benefit management company) claimed a section 199 deduction related to its licensing of claims adjudication software to customers. In denying the deduction, the IRS said that the software constituted the provision of services, not the disposition of QPP. In determining that the taxpayer itself used the claims adjudication software to perform services for its customers and holding for the IRS, the court rejected the taxpayer's argument that the license of the software was included in a bundled fee charged to its plan sponsor customers.

A year before, the Seventh Circuit in *Direct Supply*[7] affirmed a district court's decision that online software used to provide nursing home customers with customized equipment and supply catalogs did not generate DPGR because the taxpayer did not dispose of the software but rather used it to provide services to customers. In applying the third-party disposition exception for online software, the courts disagreed that the third-party comparable software identified by the taxpayer was "substantially identical" to the software at issue.

In another recent decision, *BATS Global*, the Tax Court also determined that the taxpayer's third-party comparable did not meet the requirements of the former section 199 regulations.[8] The Tenth Circuit agreed with the Tax Court's finding that the taxpayer used its market trading software to provide customers with services instead of providing its customers with the trading software to operate on electronic markets.

The Future of Software Development as 'Manufacturing'

The continued controversy involving online software's eligibility for the DPAD highlights the fact that if Congress reinstates former section 199 or a variation of it, modernization of the activities that qualify as "manufacturing" is crucial for software development. Even at the time of former section 927's enactment, the precursor to the DPAD, Congress saw the need to allow for that modernization, saying that "in light of the rapid innovations in the computer and software industries, the Committee intends that the term 'computer software' be construed broadly to accommodate technological changes in the products produced by both industries."[9] In the nearly three decades since this statement was entered into the Congressional Record and two decades since the former section 199 regulations were issued, the software industry has significantly evolved. Today, it is exceedingly uncommon for software to be provided to customers through a tangible medium. Further, as software is increasingly hosted in the cloud,[10] the need for customers to download software programs and have them installed on premises is steadily decreasing and may soon be a relic of the past. Any new rules providing the guidelines by which software development activities are considered manufacturing should evolve accordingly.

In developing the rules for what activities qualify as manufacturing, Congress should

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[6]The regulations provided two exceptions to the general rule related to software. First, embedded service revenue could be included in computing the DPAD if it was less than 5 percent of the gross receipts received for the software. Second, the embedded service revenue could be included in the computation of the DPAD if it was derived from a "qualified maintenance agreement" that entitled customers to "receive future updates, cyclical releases, rewrites of the underlying software, or customer support services for the computer software." The latter exception only applied if the agreement was not separately priced or separately offered to customers. *See* former reg. section 1.199-3(i)(4)(i)(B)(5) and (6).

[7]*Direct Supply Inc. v. United States*, 635 F. Supp. 3d 685 (E.D. Wis. 2022), *aff'd*, 96 F.4th 1031 (7th Cir. 2024).

[8]*BATS Global Marketing Holdings Inc. v. Commissioner*, 158 T.C. 118 (2022), *aff'd*, No. 22-9002 (10th Cir. 2023).

[9]H.R. Conf. Rep. No. 105-220 at 636 (1997).

[10]*See, e.g.*, reg. section 1.861-19(b), which defines (for multiple purposes of the code) a cloud transaction as "a transaction through which a person obtains on-demand network access to computer hardware, digital content (as defined in section 1.861-18(a)(2)), or other similar resources. A cloud transaction does not include network access to download digital content for storage and use on a person's computer or other electronic device."

consider allowing for the incentive to broadly apply to software developers, including those that license software for a customer's use while connected to the internet. Software offered to customers through online access should not be excluded or subject to an additional requirement to identify substantially identical software offered via disk or internet download. These restrictions were intended to prevent taxpayers that provide nonqualifying services from inappropriately claiming benefits under the DPAD, but these rules are extremely archaic in today's technological environment.

A revised section 199 provision could still retain a rule that excludes taxpayers performing nonqualifying services from claiming domestic manufacturing benefits by requiring that a taxpayer provide a right for a customer to use the entity's software to cause a computer to perform a desired function rather than provide access to the entity's software to receive the results of the taxpayer themselves using software to perform those tasks. Software developed in the United States and licensed to customers for their use while connected to the internet because the software is provided via a hosted solution should not be disqualified from the benefits of a domestic manufacturing incentive, especially since the function of the software would be no different from the customer's standpoint than if it had been installed on their premises. Further, Congress should consider explicitly instructing Treasury to periodically update the definition of software to accommodate technological changes and to keep pace with the ever-changing world.

Conclusion

There is still uncertainty about whether and how a future tax bill will provide a tax incentive to taxpayers performing manufacturing activities in the United States. A provision that incorporates some or all the rules under former section 199 may be seen favorably by taxpayers, given the familiarity of those rules and the fact that taxpayers in a variety of industries saw reductions in their effective income tax rates under that regime. But it's vital that any provision intended to encourage domestic manufacturing is written to allow for technological changes in the software industry that have occurred since similar rules were last promulgated. By modernizing the definition of the activities included in manufacturing, Congress can encourage companies in many industries to produce their goods in the United States, fulfilling that policy goal.[11] ■

[11]The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP.