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Final regulations: Research credit for internal use software

The Treasury Department and IRS today released for publication in the Federal Register final regulations (T.D. 9786) concerning the application of the credit for increasing research activities pursuant to section 41 for computer software that is developed by or for the taxpayer, for the taxpayer's internal use—i.e., "internal use software."

The **final regulations** [PDF 247 KB] adopt rules that were proposed in January 2015, with changes reflecting amendments made in response to comments that were received about the proposed regulations. Examples are included in the final regulations to illustrate application of the general process of experimentation requirements to software.

The final regulations will be published in the Federal Register on Tuesday, October 4, 2016, and are applicable to tax years beginning on or after the date of their publication in the Federal Register. The effective date from the proposed regulations is generally retained with slight modifications; however, the preamble states that the IRS will not challenge return positions consistent with all of the paragraph of (c)(6) of these final regulations or all of the paragraph of (c)(6) of the proposed regulations for any tax year that ends on or after January 20, 2015.

KPMG observation

The publication of internal use software (IUS) final regulations is a significant achievement by Treasury and the IRS, and the regulations will hopefully lead to significantly less controversy between taxpayers, practitioners, and the IRS.

The final regulation affect nearly every business, and many companies have been shying away from claiming credits resulting from their software development activities used to support their business because the area has been fraught with controversy for the past 15-plus years. As a result, now is a good time for taxpayers to further review whether they may be eligible for research credits regarding software development.

Background

Under section 41(d)(4)(E), no research credit is allowed for internal use software development except as provided by regulations. The IRS earlier issued several regulatory proposals on the subject, and assured taxpayers that a credit is allowed if the software development meets some additional requirements, referred to as the "high threshold of innovation test."

Regulations were proposed in January 2015 to provide a comprehensive set of rules dealing with the requirements for a research credit for internal use software development. The preamble to the final regulations describes the comments received, in response to the proposed regulations, and the reasons why (or why not) the comments or suggestions were not adopted and included in the final regulations.

Definition of "internal use software"

Under the regulations, software is developed by (or for the benefit of) the taxpayer primarily for internal use if the software is developed by the taxpayer for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. The preamble to the final regulations explains that the list of general and administrative functions is intended to include "back office" functions that most taxpayers would have regardless of the industry sector, but that determining the character of a function as "back office" will vary depending on the facts and circumstances of each taxpayer.

Software not developed primarily for internal use

The final regulations clarify that software is not developed primarily for the taxpayer's internal use if it is not developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business, such as: (1) software developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; and (2) software developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.

Software developed to be commercially sold, leased, licensed, or marketed

Software that is developed to be commercially sold, leased, licensed, or otherwise marketed is treated as software **not** developed primarily for internal use. This is consistent with the January 2015 proposed IUS regulations which dropped a requirement in the December 26, 2001 proposed IUS regulations that there be "separately stated consideration." The preamble notes that in response to a comment, software that is "hosted" or developed but no copy of the software is transferred is included in this definition, and an example has been added to the final regulations to illustrate this point.

Software developed to enable taxpayer to interact with third parties

Certain software that benefits third parties by enabling them to interact and/or initiate transactions with the taxpayer may be excluded from the definition of internal use software. The final regulations clarify that software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system are examples of software that is not developed primarily for the taxpayer's internal use. Also, the final regulations provide that the determination of whether software is developed for internal use or to enable a taxpayer to interact with third parties (or to allow third parties to initiate functions or review data on the taxpayer's system) depends on the intent of the taxpayer and the facts and circumstances at the beginning of the software development. In the final regulations, the examples are revised to reflect this standard.

There are also examples in Reg. section 1.41-4(c)(6)(viii) illustrating rules regarding software developed to enable taxpayer to interact with third parties (see Examples 7 and 8), and what constitutes a third party (see Example 6). These examples need to be carefully considered.

Connectivity software

The final regulations do not include a special rule for connectivity software, but clarify that software is not developed by (or for the benefit of) the taxpayer, primarily for the taxpayer's internal use if the software is not developed for use in general or administrative functions. It also depends on the intent of the taxpayer and the facts and circumstances at the beginning of the software development.

Dual function software

"Dual function software" (software used both internally by a taxpayer and by third parties) is presumed to be for internal use. However, if the taxpayer can identify subsets of elements that facilitate third-party interaction, or enable third parties to initiate functions or review data, those subsets will not be presumed to be for internal use and may be eligible for the research credit without application of the three-part high threshold of innovation test.

Safe harbor, objective reasonable method

A safe harbor allows taxpayers to count 25% of the research expenses of the remaining subsets of the dual function software as qualified research expenses, if it is reasonably anticipated that the third-party functions will constitute at least 10% of their use. An objective, reasonable method must be used to estimate the dual function subset's use by third parties or by the taxpayer to interact with third parties, and such use must be estimated at the beginning of the computer software development.

Examples 12 and 14 in Reg. section 1.41-4(c)(6)(viii) indicate that if a taxpayer chooses to apply the dual function safe harbor and claim 25% of the costs of software that otherwise meets the requirements of qualifying research, the taxpayer may not apply the internal use software rules to the other 75% of the dual function software.

Production process software

By statute, software that is developed for use in a production process that meets the requirements for qualified research is not considered developed for internal use.

High threshold of innovation test

Internal use software development may satisfy the standard as qualified research if it meets a three-part high threshold of innovation test. In the proposed regulations, this was set as a higher standard than for other business components to be qualified research, but the test was not to be so restrictive as to make the test impossible to meet. The test turned on whether substantial uncertainty existed at the beginning of the taxpayer's activities.

The final regulations remove references to capability and method uncertainty, but the preamble explains that internal use software research activities that involve uncertainty related to appropriate design (and not capability or methodology) would rarely qualify as having substantial uncertainty for purposes of the high threshold of

innovation test. The removal of the references to capability and method uncertainty are a significant improvement of the final regulations.

The final regulations remove a statement about “revolutionary discovery” because this is not required to meet the high threshold of innovation test.

The preamble to the final regulations also describes commentary received about the examples that were included with the proposed regulations and the reasons why the comments were not adopted in the final regulations or if changes were made to the examples to clarify the illustration.

Effective date

The preamble explains that for tax years ending before January 20, 2015, taxpayers may choose to follow either: (1) all of the internal use software provisions from final regulations of January 3, 2001 (T.D. 8930); or (2) all of the internal use software provisions contained in proposed regulations from December 26, 2001.

The preamble to today’s final regulations states that the IRS will not challenge return positions consistent with the final regulations for any tax year that both ends on or after January 20, 2015. Although tax professionals with KPMG had requested that taxpayers be permitted to apply the regulations to earlier years (which would be consistent with Notice 87-12), the regulations state:

“Retroactive application of these final regulations may provide an unfair advantage to taxpayers whose prior taxable years are not closed by the statute of limitations. Furthermore, retroactively determining whether taxpayers engaged in research activities does not further the purpose of section 41 which is to encourage taxpayers to engage in qualifying research activities within the United States and would impose a significant administrative burden on the IRS.”

KPMG’s Research Credit Services team

KPMG’s Research Credit Services (RCS) team has extensive experience with the R&D tax credit and can assist with the R&D credit claims process. For more information, contact any of the individuals listed below:

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