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Rules Governing Internal-Use Software Are Proposed

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Regulations

The IRS issued long-awaited proposed regulations on what type of internal-use software qualifies for the Sec. 41 research credit. Although the new rules are proposed, not final, the IRS says it will not challenge taxpayers' return positions that apply these rules currently.

Final regulations (T.D. 8930) on internal-use software and the research credit were released in 2001 but caused considerable controversy among practitioners. In response, in 2004 the IRS issued an advance notice of proposed rulemaking (2004 ANPRM), announcing that it would consider the comments it had received and promulgate new proposed regulations.

These proposed rules distinguish between software that was developed for internal use, which generally does not qualify for the credit, and software that was developed for external use, which generally may qualify for the credit. Internal-use software is software developed by (or for the benefit of) the taxpayer primarily for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. General and administrative functions are limited to financial management, human resources, and support services, including data processing and facilities management.

Software developed for internal use, however, can qualify for the credit if it meets a highthreshold- of-innovation test. That test requires software to meet three requirements:

1. Innovation (defined as a reduction in cost or improvement in speed or other measurable improvement that is substantial and economically significant, if the development is or would have been successful);

2. Significant economic risk to develop the software (i.e., the taxpayer has committed substantial resources to develop the software and, due to technical risk, there is substantial uncertainty that the costs of development will be recovered in a reasonable time); and

3. The software is not commercially available without considerable modification (i.e., the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements).

Dual-function internal software, which is software that serves both general and administrative and nongeneral and administrative functions, must overcome a presumption in the proposed rules that it is developed for internal use and thus does not qualify for the credit. The presumption will not apply if the taxpayer "can identify a subset of elements of dual function computer software that only enables a taxpayer to interact with third parties or to allow third parties to initiate functions or review data (third party subset)".

In addition, the rules will provide a safe harbor that applies to dual function software, if a thirdparty subset cannot be identified, or to the remaining subset of dual-function computer software after the third-party subset has been identified (dual-function subset). Under the safe harbor, 25% of the taxpayer's qualified research expenditures of the dual-function subset is included in computing the amount of the credit, if the taxpayer's research activities for the dualfunction subset are qualified research and the use of the dual function subset by third parties or by the taxpayer to interact with third parties is reasonably anticipated to constitute at least 10% of the dual-function subset's use.

Request for Comments

The IRS is requesting comments on all aspects of these proposed rules but is especially interested in comments on (1) the definition and treatment of connectivity software that allows multiple processes running on one or more machines to interact across a network, sometimes referred to as bridging software, integration software, or middleware; (2) for the dual-function safe harbor, comments on the ease of measuring the reasonably anticipated use of software; and (3) which facts and circumstances, other than those set out in the legislative history, should be considered in determining whether internal-use software satisfies the three prongs of the high-threshold-of-innovation test.

Effective Date

Although many commenters had requested that these regulations apply retroactively, the IRS decided to apply them prospectively. Therefore, they will apply to tax years ending on or after the date they are published as final in the Federal Register. However, the IRS will not challenge return positions applying these rules currently. In addition, these rules withdraw the 2004 ANPRM for tax years beginning on or after Jan. 20, 2015. Thus, for tax years ending before this date, taxpayers may choose to follow either the 2001 proposed or 2001 final regulations.