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This thought leadership paper is about the final regulations on Research & Development credit, issued by the IRS, for internal use software.

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Introduction:

The US Treasury Department and the Internal Revenue Service *(hereinafter referred as 'the IRS')* released in October 2016, the final regulations *(TD 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 taxpayer's internal use. Software being the integral part of any business in today's world, it is a huge step forward by the IRS, since it provides more certainty in regards the R&D credit available to the taxpayers and also a huge tax benefit to many taxpayers.

Effective date for applicability of final regulations under section 41:

The final regulations are set to apply to taxable years beginning on or after October 4, 2016. For tax years ending on or after January 20, 2015 and beginning before October 4, 2016, the IRS will not be challenging any return that has consistently complied with the proposed regulations or these final regulations. For taxable years ending before January 20, 2015, taxpayers may choose to follow either one of the two alternatives:
(i) all the internal use software provisions from final regulations of January 3, 2001 (T.D. 8930); or
(ii) all the internal use software provisions contained in proposed regulations from December 26, 2001.

IRC section 41 in context of internal use software:

Section 41 of the Internal Revenue Code of 1986 allows a credit for certain qualified research expenditures. Section 41(d)(4)(E) usually excludes research related to internal use software except:
(i) when the internal use software is to be used in an activity that itself constitutes qualified research, or
(ii) when it is to be used for an otherwise qualifying production process, or
(iii) to the extent provided by the regulation.

Important clarifications in the final regulations:

Definition of Internal use software:

The final regulations have adopted the proposed regulations' definition of internal use software as software primarily 'developed by the taxpayer for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business.'

'General and administrative functions' includes the:
(i) financial management and supporting recordkeeping, such as accounts payable and receivable, inventory management and budgeting;
(ii) human resource management, such as managing the employees of the taxpayer; and

(iii) support services that support the taxpayer's day-to-day operations.

Definition of software not developed primarily for internal use:

Software that is '**not** developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business.' If the software is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties, then it is classified as software not developed primarily for internal use. If the company originally develops software primarily for internal use, but later makes improvements to the software with the intent to hold the improved software to be sold, leased, licensed, or otherwise marketed to third parties, or to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system using the improved software, the improvements will be considered separate from the existing software and will not be considered developed primarily for internal use.

High threshold of innovation test:

Certain internal use software may however be eligible for the credit only if the software satisfies, along with other things, the three elements of the high threshold of innovation test:

(i) the software is innovative if that would result in a measurable improvement which is substantially and economically significant if the development is or would have been successful, such as reduction in the time taken to complete a process or reduction in the cost of the process, etc.;
(ii) the development involves significant economic risk and there is a substantial uncertainty which arises due to technical risk, that the resources committed to the development, would be recovered within reasonable time; and
(iii) the software is not commercially available and the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the innovation and significant economic risk requirements.

The final regulations do not require that the uncertainty should relate to uncertainty about capability or methodology; design uncertainty may also be considered into the analysis.

Dual function software and safe harbor rule:

The software which is used by both the internal and external users is presumed to be developed by the taxpayer, primarily for internal use. This presumption does not apply with respect to the portion of the software for which the taxpayer can identify a subset of elements that enable the taxpayer to interact with third parties or allow third parties to initiate functions or review data on the taxpayer's system. With respect to the rest of the dual function software, the regulations provide a safe harbor. In the Safe Harbor definition, it is mentioned that 'the safe harbor allows a taxpayer to include 25 percent of the qualified research expenditures of the dual function software *(or dual function subset)* in computing the amount of the taxpayer's credit so long as the research constitutes qualified research and the use of the dual function software *(or subset)* by third parties is reasonably anticipated to constitute at least 10 percent of its use.'

<u>Conclusion:</u>

The taxpayers may rely on these final regulations with immediate effect. The new regulations are consistent with the general concepts of the proposed regulations and the businesses who develop internal use software now have more clarity on the regulations and how they can benefit from R&D credit. Taxpayers that develop

software for their own trade or business may be able obtain a larger research tax credit due to the broader exclusions from the definition of internal use software. It is advisable for such taxpayers to stay cautious in claiming research tax credits for internal use software, as it will be very difficult to meet the additional high threshold of innovation test. A detailed R&D credit study is recommended before claiming such credit since stakes can be too high and therefore it is advised to be careful and have it well documented.