

AN ALERT FROM THE BDO R&D TAX PRACTICE

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THE IRS PROPOSED TAXPAYER-FRIENDLY REGULATIONS ON THE SECTION 41 RESEARCH TAX CREDIT AND ITS TREATMENT OF EXPENDITURES RELATED TO THE DEVELOPMENT OF SOFTWARE

INTRODUCTION

On January 16, 2015, the Internal Revenue Service proposed long anticipated and taxpayer-friendly regulations concerning the section 41 research tax credit (“research credit”) and its treatment of expenditures related to the development of software, both internal-use software (“IUS”) and non-IUS.

Under the new regulations and historically, IUS development generally must meet a higher standard to qualify than non-IUS development. The proposed regulations, however, narrow considerably the definition of “IUS” and thereby broaden considerably the range of software development expenditures eligible for the credit.

This alert outlines this and other major changes and recommended action items. Please consult the regulations for all details potentially relevant to your particular circumstances.

IUS VS. NON-IUS

Under the new regulations, whether software is IUS depends on the initial intent of the taxpayer and the facts and circumstances at the beginning of the software development.

The regulations move the definition of IUS closer to the language of section 41, defining “IUS” as software that is developed by (or for the benefit of) the taxpayer for internal use if the software is developed by the taxpayer for back-

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office functions of the taxpayer, namely financial management functions, human resource management functions, and support services functions as internal use.

Significantly, the regulations provide that software will not be treated as IUS if it is developed to either (1) be commercially sold, leased, licensed, or otherwise marketed to third parties, (2) enable a taxpayer to interact with third parties, or (3) allow third parties to initiate functions or review data on the taxpayer's system.

Thus, if the software benefits third parties, it may not be treated as IUS as it would have been under prior law. Examples of such non-IUS software, per the new regulations, include software developed to allow third parties to execute banking transactions, track the progress of a delivery of goods, search a taxpayer's inventory for goods, store and retrieve a third party's digital files, purchase tickets for transportation or entertainment, and receive services over the Internet.

DUAL FUNCTION COMPUTER SOFTWARE

The regulations provide that software that serves both general and administrative and non-general and administrative functions—"dual function computer software"—is presumed to be for internal use. However, if a taxpayer can identify a subset of elements of the dual-function software that enables third-party interaction, then the presumption will not apply to the related expenses. The research expenses identified as a third-party subset may be eligible for the research credit.

A safe harbor may be applied if a taxpayer cannot identify a third-party subset or to the remaining subset after the third-party subset has been separated—"dual function subset." The safe harbor enables a taxpayer to include 25% of the subset's qualified research expenses, as long as the third-party functions are reasonably anticipated to constitute at least 10% of dual function subset's use.

HIGH THRESHOLD OF INNOVATION TEST

Certain IUS development may qualify for the research credit if it meets the additional three-part test outlined in legislative history from 1986 and importantly modified in the new regulations.

First, the software must be innovative, as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant. Notably, the proposed regulations abandon the higher standard of earlier regulations requiring that the software be unique and novel, and differ in a significant way from prior software implementations.

Second, the software development must involve significant economic risk, as where the taxpayer commits substantial resources to the development and there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. Importantly, the new regulations require capability or methodological uncertainty for there to be substantial uncertainty because of technical risk. Uncertainty regarding only appropriate design, sufficient for purposes of non-IUS development, is insufficient for IUS development to meet this test.

Third and finally, the software must not be commercially available for use by the taxpayer, as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements.

EFFECTIVE DATE

The proposed regulations, once finalized, would be prospective only and effective for taxable years ending on or after the date the final regulations are published in the *Federal Register*. However, the regulations state that the Service will not challenge return positions consistent with the proposed regulations for taxable years ending on or after January 20, 2015, the date they were published in the *Federal Register*.

COMMENTS AND PUBLIC HEARING

A public hearing has been scheduled for April 17, 2015, at the IRS Auditorium in Washington. The Service has requested written or electronic comments, due on March 23, 2015, approximately 60 days after these proposed regulations were published. Comments on all aspects of the proposed regulations are requested, but comments on the following are specifically invited:

- The appropriate definition and treatment of connectivity software;
- The dual function computer software safe harbor; and
- Other facts and circumstances to be considered in determining whether IUS satisfies the high threshold of innovation test.

RECOMMENDATIONS

Taxpayers who pay for the development of software should:

- Review their development efforts to address specific issues and opportunities the proposed regulations create (for example, whether software treated as IUS under the old rules would be treated as IUS under the new rules, whether the significant economic risk test's clarified "substantial uncertainty" test is met, and whether any software is "dual function" software);
- Consider whether and how the proposed regulations, notwithstanding their effective date, might be leveraged to support any software development expenses under examination; and
- Consider whether and what comments or questions might be usefully submitted to the Service to help improve the regulations.

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