

tax notes

New Research Credit Regulations: Good News for Software

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It was a happy day for the software industry when the Treasury Department and the IRS issued proposed regulations on how development of software would be eligible for the research tax credit. In the preamble to the proposed regs, the agencies state (and we agree) that they expect the regs to have a positive economic effect on a substantial number of small entities. Manufacturers, sellers on the web (both retail and business-to-business), banks and financial institutions are all potential beneficiaries.

The proposed regs are not only a boon for those engaged in software development; perceptive readers will recognize that the regs also have broad benefits for industries seeking to qualify for the research credit.

Historically, the grind in software development's eligibility for the research credit has been the definition of internal use software (IUS) – that is, software that is not sold, leased or licensed to a third party. In brief, if the software is considered IUS, companies have a higher hurdle to clear for that work to be eligible for the research credit. The proposed regs put a fence around what is IUS, limit the definition of IUS (a good thing for taxpayers) and effectively expand what is not IUS (also good for taxpayers).

New Proposed Regulations

Treasury and the IRS went to great lengths to draw clear lines regarding IUS – an area of the law that had previously been murky and uncertain. The agencies recognized that many small businesses develop software to run their businesses and at the same time interact with customers (think of sales on the web). By narrowing the definition of what constitutes IUS, the guidance reflects the realities of software development in the economy and ensures that the research credit will be available to benefit more small businesses.

Let's look at how Treasury and the IRS actually expanded the research credit for software. In the past, if you developed software that was sold, leased, or licensed and was not considered IUS, the taxpayer simply had to satisfy the traditional four-part test of the research credit – which is, in short, developing a new or improved product by eliminating uncertainties through a process of experimentation that was technological in nature.

Now, under the new regs, software is not considered IUS if the software is “sold, leased, licensed or otherwise marketed to third parties” and still meets the four-part test for research (emphasis added).

Treasury further clarified in the proposed regulations that IUS only refers to software that is developed for general and administrative functions that facilitate or support a taxpayer's trade or business. For IUS, general and administrative functions are defined for the first time as limited to financial management functions, HR management functions and support services.

The new rules take a giant step forward when it comes to developing software that allows you to interact with your customers. Specifically, the rules state that software that enables a business to interact with a third party (that is, a customer) is appropriately excluded from the definition of IUS. (As an example, FedEx, which challenged the government's definition of IUS in court, developed software that allows customers to track packages. With this new definition, the software would not be considered IUS).

By narrowing the initial definition of what constitutes IUS, Treasury and the IRS have made it much easier for companies to claim the research credit for software they have developed to provide services to customers.

Clarity on Internal Use Software

While it is easier for businesses to have software development qualify for the research credit, if the software is not IUS, it is still possible for IUS to qualify for the research credit – there is just a higher threshold that must be met.

Along with the normal four-part research test, there is a heightened three-part “high threshold of innovation” test for IUS qualifying for the research credit. The heightened test – driven by the legislative history – requires that: (1) software is innovative, (2) its development involves significant economic risk and (3) is not commercially available.

The heightened “significant economic risk” requirement is now a two-part test.

First, the taxpayer must have “substantial uncertainty” about either the taxpayer's ability to do something or the best method to solve the problem (there is not a heightened requirement for uncertainty regarding appropriate design). This is an entirely new requirement for IUS, but it has additional benefits to industries outside the software world, where the IRS has essentially tried to apply such a heightened standard for the research credit in other fields without any legal authority. This new guidance should end such freelancing by IRS examiners.

Second, the taxpayer must devote “substantial resources” to development (defined as whether the result can be achieved within a time frame that will allow the substantial resources committed to be recovered within a reasonable period – fun).

For “innovative” software, the heightened test’s new definition reflects a real-world understanding: “Software is innovative if the software would result in 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. This is a measurable objective standard, not a determination of the unique or novel nature of the software or the software development process” (emphasis added).

This is an important point that applies beyond the software industry – time and again we have emphasized that the research credit not only encompasses a unique or novel development process or product, but also encompasses changes that will result in cost reduction, energy and economic efficiencies, and improved speed. It is good to see that Treasury recognizes that economic growth and development fueled by research takes many shapes and forms.

Summary

For many years, determining whether the software you have developed was internal or external use has been difficult at best. If you found yourself dealing with IUS in exam with the IRS, you may have felt as if the Service was doing everything possible to make it impossible to qualify. With the proposed regs, Treasury and the IRS have recognized that the IUS requirements should not be so restrictive that the test is impossible to meet. The proposed regs provide a narrower scope that will allow more companies – especially small and medium-size companies – to qualify for the research credit and make it more straightforward for those developing IUS to apply the high threshold of innovation test.

Finally, the proposed regs communicate to other industries that the IRS should not be applying a “substantial uncertainty” outside IUS and that the IRS should bear in mind that the research credit applies broadly – encompassing not just products, but also improvements that lead to reductions in cost, speed and other substantial and economically significant improvements for the company.



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