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The IRS Cuts Software Developers a Break

Why new IRS and Treasury regulations for internal-use software have opened the door for more companies to claim R&D tax credits.

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Earlier this year the U.S. Treasury Department released new regulations regarding internal-use software (IUS) and its eligibility for the Research and Development (R&D) Tax Credit. Thanks to these new regulations, software developers have received a substantial boost in their ability to claim R&D-based tax incentives.

Specifically, the new regulations benefit software developers by clarifying and narrowing the definition of IUS, or software that is not sold, leased or licensed to a third party. As IUS must meet a higher standard to qualify for the R&D Tax Credit than traditional software development, the narrowing of software defined as IUS effectively broadens the application of the credit, allowing for more businesses to claim the credit for their software development work.

“Through these proposed regulations, we are providing taxpayers with the clarity that they need to invest in software innovation,” said Mark J. Mazur, Treasury Assistant Secretary for Tax Policy, U.S. Department of the Treasury, in a January 2015 statement. *“Computer software plays a vital role in 21st century business activities, and today’s tax guidance will help encourage U.S. firms to make these important investments.”*

The R&D Tax Credit: How it Applies to Software

As written into the tax code, the R&D Tax Credit rewards companies for improving a product, process, formula, invention, software or technique, offering additional tax savings to companies taking active steps to improve in these areas. Given the high amount of R&D work required in designing and developing software, companies involved in technology and software development are generally some of the better candidates in claiming the credit, with many of their everyday projects tying directly to eligibility.

However, for companies seeking to qualify for the credit on the grounds of IUS software, the hurdle to qualify has traditionally been much higher, with companies needing to pass the high threshold of the innovation test, a three-prong test where the taxpayer must prove that the software is innovative, the software development involves significant economic risk and the software is not commercially available.

The recent change in the IUS regulations has opened the door for more companies to claim the credit by narrowing the amount of businesses that must meet this threshold. Case in point, **an energy consulting company received \$426,409 in federal credits** for four years' worth of projects related to the development of an IUS tool designed to conduct energy audits and identify energy opportunities.

New Guidance, New Rule, New Era

IUS had long been defined by the IRS as anything that is not a third-party-facing or commercially available product. The recent change in regulations from the Department of Treasury however clarifies and relaxes the IRS' position over IUS, which is now defined as software that 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.

Why is this change so important? The high threshold of innovation test has generated a great deal of confusion and aversion as companies have been repeatedly denied eligibility, in part, because of broad verbiage and outdated considerations. With the inclusion of these previously rejected companies in mind, the IRS is now reinterpreting both the definition of IUS software and the strict criteria to reflect the ever-evolving way companies use software to manage and interact with their B2B and B2C clientele.

Essentially, the Treasury and the IRS have clarified that any software designed to interact with third-party customers may now forego the high threshold of innovation test, even if that software was not designed with the goal of selling, leasing, licensing or otherwise marketing it to unrelated third parties.

Beneficiaries of the New Regulations

The new regulations are a huge victory for a large number of companies that have struggled to qualify for R&D credits in the past. They have also greatly increased the likelihood of qualifying for the credit, particularly among software companies designing and developing software that was previously defined as IUS.

Now, any system that allows a customer to initiate a transaction or review account data through a company's proprietary framework is no longer considered IUS, and can now qualify as commercial software. Some examples of systems now exempt from the high threshold of innovation include customer banking portals, bill-paying features, tracking systems for online purchases, cloud services and other data retrieval software and online ticket reservation software.

For example, **a mortgage and loans company received \$919,381 in federal credits** for four years' worth of projects related to the design and development of a speedier customer relationship management system (CRM). The company was able to claim such a high credit result by implementing the CRM with pre-existing data systems for seamless integration and interfacing.

Additionally, the new regulations also isolate several other situational IUS exclusions. The following instances are classified as non-IUS and are subject to the traditional standards for R&D software eligibility, including,

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software developed for sale, lease or license; software used in other qualified research and development activities; software used in a production process that qualifies as R&D; and software developed as part of a hardware/software product, such as embedded software.

For software and technology companies that perform any of the above activities, the new regulations could mean hundreds of thousands of dollars in added value to their bottom line. Considering the potential value on the table, software developers would be wise to explore their options with respect to the R&D Tax Credit.



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