Anchin Alert

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Tax Credits Clarity Provides Great Opportunity for Businesses Regarding Internal Use Software

On October 3rd, 2016, the Treasury and IRS released final regulations regarding Internal Use Software ("IUS") expenditures as related to the Section 41 Research & Development ("R&D") tax credit. These final regulations contain several important changes related to the definition of IUS, the definition of "high threshold of innovation", and offer additional guidance for claiming the R&D tax credit for IUS expenditures. Overall, these regulations provide welcomed clarity to a long controversial area, which should encourage taxpayers to explore the opportunity of claiming R&D tax credits.

The regulations clarify the definition of internal use software. IUS is now defined as software developed by the taxpayer for general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. These general and administrative functions are limited to human resource management, financial management, and support services functions. This is to be distinguished from commercial software, which is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties, and software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. This updated definition of IUS removes a significant amount of ambiguity that existed for taxpayers, particularly software as a service and online retailer companies. This distinction is important since software developed by the taxpayer that is considered to be IUS must meet the additional three-part high threshold of innovation test in addition to the four-part test in order to qualify for the R&D tax credit.

To meet the high threshold of innovation test, the developed internal use software must be innovative, the development must involve significant economic risk, and the software must not be commercially available to the taxpayer. The final regulations clarify that internally developed software is considered innovative if the development would result in a substantial and economically significant reduction in cost, improvement in speed, or other measurable improvement. The regulations also reiterate that significant economic risk exists only if the taxpayer commits substantial resources to the development and the likelihood that such resources will be recovered within a reasonable period of time is substantially uncertain. In defining substantial uncertainty, the final regulations note that the uncertainty must relate to the capability or methodology, but not the appropriate design of the business component to create a higher threshold for eligibility than Congress originally intended for IUS.

The final regulations state that whether software is or is not developed primarily for internal use depends upon the facts and circumstances of the taxpayer at the beginning of the software development. If a taxpayer originally develops software primarily intended for internal use but later makes improvements to the software with the intent to hold the improved software for commercial sale, lease, or license, or to allow third parties to initiate functions or review data on the taxpayer's system, the improvements will be considered separate from the existing software and will not be considered developed primarily for internal use. Additionally, the regulations provide a safe harbor for expenditures related to the development of such dual-purpose software.

According to the regulations, a qualifying taxpayer may include 25 percent of the qualifying research expenditures related to the dual-purpose software in the calculation of the R&D credit. This safe harbor applies only if the taxpayer anticipates that at least 10 percent of the dual-purpose software will be used for third-party purposes.

Finally, the new regulations provide examples that illustrate their applicability to computer software. Specifically, the examples address the process of experimentation and high threshold of innovation tests, as well as the application of the new dual function computer software rules.

To discuss how these regulations may affect your R&D tax credit calculation, or for more information, please contact Yair Holtzman, Partner and Practice Leader of Anchin's Research and Development Tax Credits Group at 914.860.5599.

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