Internal-use software and the research credit: Formal guidance needed to address long-standing issues

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In brief

As has been the case for several years, regulations on the exception from the definition of "qualified research" for internal-use software under Section 41(d)(4)(E) are listed on the 2013-2014 IRS/Treasury Priority Guidance Plan (commonly known as the business plan).

In a related development, the government on August 29 abandoned its appeal of the 2009 decision of the US District Court for the Western District of Tennessee holding that FedEx Corporation could rely on the internal-use software rules in final regulations issued in 2001 without also applying the stringent "discovery" test in those regulations.

Observation: While conceding the taxpayer's victory in *FedEx*, the government may continue to assert its arguments regarding which rules should apply to research credit claims related to internal-use software. This will be the situation until the IRS finalizes a single set of clear rules applicable to this important area.

In detail

Section 41

The Section 41 research credit is a credit against regular federal income tax. Enacted in 1981 to stimulate research and development in the United States, the credit is available to trades or businesses that increase their spending on "qualified research" activities. Under Section 41, qualified research means:

- Research that results in expenditures that are deductible under Section 174;
- Research that is intended to discover information that (1) is technological in nature and (2) will result in the development of a new or improved business component of the taxpayer; and
- Research that involves a process of experimentation related to a new or improved function, performance, or reliability or quality.

Certain research-related activities do not qualify for the research credit. Excluded activities generally include research activities associated with computer software that is developed primarily for internal use by the taxpayer (e.g., computer software to be used internally in general and administrative functions, such as payroll and bookkeeping). Research activities related to

internal-use software are ineligible for the credit, except to the extent permitted by regulations.

Internal-use software guidance

The 2003 final regulations contain the most recent IRS guidance regarding qualified research expenses. While these regulations clarify certain issues relating to qualified research expenses, they do not include guidance related to internal-use software (that paragraph is "reserved"). Therefore, as the IRS stated in Ann. 2004-9 (discussed below), until further guidance regarding internal-use software is issued, taxpayers may rely on regulations proposed in 2001. Alternatively, taxpayers may rely on the older 2001 final regulations, which were "replaced" by the 2003 final regulations.

Under the 2001 proposed regulations, software is presumed to be for internal use unless it is developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration, to unrelated third parties. However, under the 2001 proposed regulations, internal-use software may qualify for the research credit provided (1) the software meets the general requirements for the credit outlined in Section 41, (2) the software is not otherwise excludable under Section 41(d)(4) (other than subparagraph (E)), and (3) one of the following conditions is met:

- The taxpayer develops software for use in an activity that constitutes qualified research (other than the development of the internal-use software itself);
- The taxpayer develops software for use in a production process that meets the general requirements for the Section 41 credit;
- The taxpayer develops software for use in providing computer services to customers; or
- The software satisfies the "high threshold of innovation test."

Observation*:* In certain circumstances it may be possible to avoid the high threshold of innovation test, under the computer services provision. However, that provision generally will be available only when customers are conducting business with the company primarily for the use of the company's computer or software technology, not when customers merely are interacting with the company's software.

The 2001 proposed regulations explain that the high threshold of innovation test is met if:

- The software is innovative in that it is intended to be unique or novel and to differ in a significant and inventive way from prior software;
- The software development involves significant economic risk to the taxpayer in that there is substantial uncertainty because of technical risk; and
- The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without certain modifications.

Under the 2001 final regulations, internal-use software qualifies for the credit in much the same way it does under the 2001 proposed regulations. However, there are several differences between the 2001 final regulations and the 2001 proposed regulations. Most notably, the 2001 final regulations require only that software result in a reduction in cost, improvement in speed, or other improvement, with respect to satisfying the first prong of the high threshold of innovation test. At the same time, the 2001 final regulations include a very specific "discovery test" -- i.e., a requirement to undertake research to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

Observation: The 2001 proposed regulations arguably establish a higher standard with respect to the first prong of the high threshold of innovation test, requiring that the software be unique or novel and differ in a significant and inventive way from prior software implementations or methods. However, those regulations do not include a detailed discovery test as set forth in the 2001 final regulations and later revised in the 2003 final regulations.

Most recently, the IRS issued a notice of proposed rulemaking in early 2004 (Ann. 2004-9) that requested comments regarding rules for internal-use software under section 41(d)(4)(E), and specifically on the definition of internal-use software. Ann. 2004-9 also stated (1) that taxpayers wishing to rely on the rules for internal-use software in the 2001 final regulations also had to apply the stringent discovery test in those regulations and (2) that taxpayers instead could rely on the 2001 proposed regulations.

The IRS has not issued any guidance regarding internal-use software since 2004.

FedEx

In an order granting FedEx Corporation's motion for partial summary judgment on the legal standards for research credit claims, the US District Court for the Western District of Tennessee in 2009 held that FedEx may rely on the revised

definition of the discovery test set forth in the 2003 final regulations. This revised definition eliminated the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

The district court then held that FedEx may rely on the internal-use software test in the 2001 final regulations because the 2003 final regulations did not revise that test as enunciated in 2001. The district court declined to follow the statement in Ann. 2004-9 requiring taxpayers wishing to rely on the 2001 internal-use software test also to apply the older, more stringent discovery test.

The government appealed the district court's decision to the Sixth Circuit Court of Appeals in May 2013, but the Justice Department did not file an appellant brief. Under the terms of the parties' stipulation to dismiss, the appeal has been dismissed with prejudice by the Sixth Circuit.

For prior discussion of the *FedEx* decision, see WNTS Insight, "Stringent research credit test held not to apply to internal-use software," June 11, 2009.

Key issue

Regulations on the exception for internal-use software from the definition of qualified research under Section 41(d)(4)(E) have been on the IRS/Treasury business plan for several years. As noted in a June 2012 Joint Committee on Taxation staff (JCT) analysis of Obama Administration revenue proposals, several definitional issues affect the administrability of the research credit, including the definition of internal-use software.

The JCT states, "The uncertainty as to the availability of the research credit for the development of internal-use software may shift investment away from such research to other research which it is clear is eligible for the credit. Such a shift may not represent the efficient allocation of research funding."

The takeaway

As exemplified by the *FedEx* decision and the JCT discussion, there is a clear need for formal guidance regarding eligibility of internal-use software for the research credit; informal guidance like the 2004 Announcement has not resolved the issue. While the *FedEx* case has ended with a taxpayer-favorable result, the government is not bound by that decision in other cases.

Often the IRS, at the outset of an audit, seeks to require that a taxpayer choose to (1) apply the rules for internal-use software in the 2001 final regulations and the stringent discovery test in those regulations or (2) rely on the 2001 proposed regulations, as outlined in Ann. 2004-9. If a taxpayer fails to make this choice, the IRS generally follows the rules under the 2001 proposed regulations. Taxpayers following the approach to the various sets of regulations taken by FedEx therefore may continue to find their research credit claims with respect to internal-use software challenged by the IRS.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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