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# Final Regulations Expand Software-Development Activities Eligible for Research Tax Credits

## Summary

On October 3, 2016, the Internal Revenue Service (“IRS”) issued final regulations (T.D. 9786) 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. The final regulations have been anticipated after the IRS published taxpayer-friendly proposed regulations (REG-153656-03) in January 2015.

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

The final regulations retain a major portion of the proposed regulations with some modifications. This alert outlines the changes between the historical guidance and the proposed and final regulations and recommended action items. Please consult the final regulations for details potentially relevant to your particular circumstances.

## Details

### IUS vs. Non-IUS

The final regulations define “IUS” as the proposed regulations did, as software that is developed by (or for the benefit of) the taxpayer for use in general and administrative (“G&A”) back-office functions that facilitate or support the conduct of the taxpayer’s trade or business. G&A functions are limited to financial management functions, human resource management functions, and support services functions.

The final regulations clarify that software is not IUS if the software (1) is not developed for use in G&A functions that facilitate or support the conduct of the taxpayer’s trade or business; (2) is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; and (3) 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.

Similar to the proposed regulations, the final regulations provide that the determination of whether software is IUS depends on the intent of the taxpayer and the facts and circumstances at the beginning of the software development; subsequent events and intentions do not matter.

### Dual Function Software and Safe Harbor

The final regulations provide that software developed for use in G&A and non-G&A functions—“dual function” software—is presumed to be for internal use. However, the presumption does not apply if a taxpayer can identify a subset of elements of dual function software that only enables a taxpayer to interact with third parties or allows third parties to initiate functions or review data on the taxpayer’s system. The qualified research expenditures (“QRE”) allocable to third party subsets of the dual function software may be eligible for the research credit.

Like the proposed regulations, the final regulations provide a safe harbor that allows taxpayers to include 25 percent of the QREs of the dual function subset in computing the amount of the taxpayer’s credit, as long as the third-party functions are reasonably anticipated to constitute at least 10 percent of the dual function subset’s use.

### High Threshold of Innovation Test

Certain IUS development may qualify for the research credit if it meets an additional three-part “high threshold of innovation” (HTI) test.



Outlined in the 1986 legislative history and modified in the final regulations, the HTI test requires, first, that the software be innovative, as where the software results in a reduction in cost, improvement in speed, or other measurable improvement that is substantial and economically significant. Notably, the final 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. The proposed regulations required this uncertainty relate to either capability or methodology, but the final regulations do not. Instead, they provide that the focus should be on the level of uncertainty, and not the type of uncertainty, which means that uncertainty regarding the software's appropriate design can qualify. The regulations do suggest, though, that appropriate design uncertainty alone would rarely qualify as being substantial.

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.

The final regulations further clarify that, for purposes of the HTI test:

- Revolutionary discovery is not required; and
- The HTI test does not apply to the attempt to develop or improve software for use in (1) an activity that constitutes qualified research, (2) a production process to which the requirements of section 41 are met, or (3) a new or improved software and hardware product developed together by the taxpayer.

## Effective Date

The final regulations are prospective and apply to taxable years beginning on or after October 4, 2016, the date of their publication in the Federal Register. The proposed regulations state the IRS 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.

## Insights

Taxpayers who pay for the development of software should:

- Review their development efforts to address specific issues and opportunities the final regulations create, e.g., whether software treated as IUS under the old rules would be treated as IUS under the new rules, whether the significant economic risk tests' clarified "substantial uncertainty" test may now be met, whether any software is "dual function" software; and
- Consider whether and how the final regulations, notwithstanding their effective date, might be leveraged to support any software development expenses under examination by tax authorities.