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CREDITS & INCENTIVES TALK WITH DELOITTE

Internal Use Software: Adapting to the Final Regulations Issued in 2016

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Since the enactment of the original federal research credit in 1981 under Internal Revenue Code ("IRC") Section 41, many states have developed credit and incentive regimes that are tied to research activities that take place within a state. Over the course of the last several decades, software development has become a common activity, from both a federal and state perspective, for which the underlying labor and consulting expenses have become part of taxpayers' research credit calculations. Because state tax authorities typically consider the analysis made by the IRS as they scrutinize state research incentive calculations, recent federal regulatory developments related to software are relevant for taxpayers with state-based research tax incentives.

Background

On October 4, 2016, final regulations (the "Final Regulations") were published in the Federal Register that provided rules for identifying software development activities that qualify for the federal research credit.¹ Specifically, those regulations define the term "internal-use software" as software developed "for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business."² Relative to software developed for use by third parties, qualification for the research credit is typically more difficult for activities relating to the development of internal-use software due to additional requirements specific to innovation, economic risk and non-commercial availability.³

In that context, the Final Regulations indicate that the regulatory definition of internal-use software is intended to target back office functions that many taxpayers would have regardless of the taxpayer's industry,⁴ which are limited to:

1. *Financial management* of the taxpayer and supporting recordkeeping, such as accounts payable and receivable, inventory management, budgeting, cost and fixed-asset accounting, economic forecasting, financial reporting, internal audit, risk management, and tax;
2. *Human resource management* of the taxpayer's workforce, including hiring, training, personnel records, payroll, and benefits; and
3. *Support services* that support the day-to-day operations of the taxpayer itself, such as data processing, facility services, graphic services, marketing, legal and government compliance services and security services.⁵

Qualified research activities—general "four part test"

Other than with respect to internal-use software activities, qualified research activities are generally identified by satisfying the following four requirements:

1. *Permitted purpose test*: The activity relates to a new or improved function, performance, reliability, or quality of a product, process, computer software, technique, formula, or invention, which is to be held for sale, lease, or license or used in the taxpayer's trade or business.⁶
2. *Technological in nature test*: The activity performed must fundamentally rely on principles of physical science, biological science, computer science, or engineering.⁷
3. *Technical uncertainty test*: The activity must be intended to discover information to eliminate uncertainty concerning the capability or method for developing or improving a product or process or the

appropriateness of the product design.⁸

4. *Process of experimentation test*: Substantially all of the activities must constitute elements of a process of experimentation involving (a) the identification of uncertainty concerning the development or improvement of a business component, (b) the identification of one or more alternatives intended to eliminate that uncertainty, and (c) the identification and the conduct of a process of evaluating the alternatives.⁹

Expenses allocable to software that falls within the definition of internal-use software under the Final Regulations may be treated as credit-eligible only if the taxpayer can further establish, under a three-part "high threshold of innovation test," that the software:

- is innovative;
- involves significant economic risk; and
- is not commercially available.¹⁰

The Final Regulations provide useful guidance that the "use of existing technology in new ways could be evidence of a high threshold of innovation if it resolves substantial uncertainty."¹¹ Furthermore, the Final Regulations clarify that software is innovative if the software were to result in an improvement in speed or reduction in cost or other measurable improvement that is substantial and economically significant, if the development is or would have been successful.¹² This appears to be a less stringent standard than the one previously applied by the IRS under the now defunct proposed regulations that the software be "unique or novel."¹³

Non-internal use software examples

The Final Regulations provide two specific examples of software that is not internal-use software:

1. Software to be commercially sold, leased, licensed, or otherwise marketed to third parties, or
2. Software to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's systems.¹⁴

The Preamble to the Final Regulations also notes that connectivity software that is not developed to be used for general administrative functions should be treated as non-internal use software. This is even if the software is not sold, leased, licensed, or otherwise marketed to third parties and is not developed to enable the taxpayer to interact with third parties or to allow third parties to review data on the taxpayer's system.¹⁵

Dual function software

With respect to software that is not commercially sold, leased, licensed or otherwise marketed, a new "dual function" rule applies to the analysis of the development activities (i.e., was the software developed for both internal and external use.)¹⁶ Specifically, with respect to hosted software applications that are accessed by third parties (but for which no specific license is paid), to the extent that the software is developed by the taxpayer for both internal use *and* to enable third-party interaction, the software is considered dual-function software.¹⁷ The practical effect of such a categorization is that a portion of the software is subject to an analysis as internal-use software while another portion is subject to an analysis as non-internal use software.

If a taxpayer can identify a subset of elements that exist only to enable third parties to interact with the taxpayer, initiate functions, or review data on the taxpayer's system, then the software would not be considered internal-use for that subset of elements. Additionally, as long as the third-party functions are anticipated to account for at least 10% of the software's use, a safe harbor rule for computing the research tax credit applies and permits the taxpayer to treat 25% of the identified research expenditures as related to the development of non-internal use software.¹⁸

The Preamble to the Final Regulations clarifies that the dual function rule does not apply to software intended to be developed to be commercially sold, leased, licensed or otherwise marketed to third parties, even if the same software also was developed for the purpose of enabling the taxpayer to interact with third parties or allowing third parties to initiate functions or review data on the taxpayer/s system.¹⁹

Process of experimentation

The Final Regulations provide six examples illustrating the application of the process of experimentation requirement to software development, regardless of whether or not the software constitutes internal-use software.²⁰ The examples focus on whether a hypothetical taxpayer was designing and testing new algorithms in an attempt to resolve workload distribution, data synchronization or similar problems, or, instead, merely analyzing the functionality of available software products.²¹

Recent audit trends

Some recent audit trends observed by the authors with respect to software development activities include the following:

(1) For software expenses related to the development of platforms to allow access by third parties to the taxpayer's data (for which no separate consideration is paid), the IRS may potentially seek to apply a blanket assertion that the software is dual function software.

- The taxpayer should make explicit in the work paper calculations that the software being treated as non-internal use is a subset of the entire platform, and not the entire platform itself. The taxpayer should be prepared to challenge an assertion by the auditor that because development software potentially relates to back office functions that it should be treated as a dual function project.
- The utilization of a detailed time-tracking system may help a taxpayer carve out the subset of elements that are being qualified as non-internal use software. Alternatively, the utilization of detailed surveys allocating costs to business components as well as to activities (both qualified and non-qualified) may also be helpful in establishing costs associated with a non-internal use.

(2) Examiners subjecting software projects, otherwise designed to allow third-party access to taxpayer data, to an internal-use standard through an overly broad application of the dual function rules.

(3) Examiners treating projects as non-internal use, but then deeming them ineligible by asserting that no process of experimentation occurred.

(4) From a state research credit perspective, non-employee consultants who perform qualified software development activities who report into the taxpayer's time tracking system often allows for a more accurate identification of where the qualified activities took place. This may have additional value when working with state tax auditors looking for support for qualified contract research expenses.

Final thoughts

Many state tax authorities begin their research credit reviews by looking to the analyses performed/audited for federal purposes. While the general consensus among taxpayers and practitioners is that the resolution of software claims will be more streamlined at the federal exam level through application of the Final Regulations, the fact that the IRS is still adapting its approach to examinations under the new rules may slow down a taxpayer's corresponding state examination of software expenses during this period of transition.

More specifically, it is possible that auditors may not appreciate the limited scope of the "Dual Function" rule and could adopt unforeseen interpretations. Although the authors anticipate that the Final Regulations will, ultimately, give rise to more efficient federal (and state) examinations of research credits that arise from software development activities, it may be a few years before this point is reached.

¹ See T.D. 9786

² Treas. Reg. § 1.41-4(c)(6)(iii).

³ Treas. Reg. § 1.41-4(c)(6)(vii)(A).

⁴ See Preamble of T.D. 9786.

⁵ See Preamble to T.D. 9786 at p. 5.

⁶ See IRC Sections 41(d)(1)(B)(ii) and (d)(2)(B).

⁷ IRC Section 41(d)(1)(B)(i).

⁸ IRC Section 41(d)(1)(A).

⁹ IRC Section 41(d)(1)(C).

¹⁰ Treas. Reg. § 1.41-4(c)(6)(vii)(A) .

¹¹ Treas. Reg. § 1.41-4(c)(6)(vi)(A) ; Examples 15-18 of Treas. Reg. § 1.41-4(c)(6)(viii) .

¹² Treas. Reg. § 1.41-4(c)(6)(viii)(B).

¹³ Prop. Treas. Reg. § 1.41-4(c)(6)(vi)(A) , 66 Fed. Reg. 66362.

¹⁴ See Treas. Reg. § 1.41-4(c)(6)(vi)(E) .

¹⁵ Preamble to T.D. 9786.

¹⁶ See Preamble to T.D. 9786.

¹⁷ See Treas. Reg. § 1.41-4(c) .

¹⁸ Example 12 and example 14 in Treas. Reg. § 1.41-4(c)(6)(viii) indicate that if a taxpayer were to apply the dual function safe harbor and claim 25% of the software qualified costs that otherwise meet the requirements of qualifying research, the taxpayer may not apply the internal use rules to the other 75% of the dual function software.

¹⁹ See Preamble to T.D. 9786, at pp. 12-13.

²⁰ See examples five through 10 of Treas. Reg. § 1.41-4(a)(8) .

²¹ See Preamble to T.C. 9786.