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Treasury finalizes new rules governing research credits for software development expenses

Final regulations were published in the Federal Register on October 4, 2016, providing rules for identifying software development projects that qualify for the research tax credit. See attached T.D. 9786. Specifically, these final regulations clarify the definition of the term "internal use software," which was added by Congress to the research credit statutory regime three decades ago — that is, at a time when on-line commerce was in its infancy. The final regulations also delineate the special credit-eligibility standards governing internal use software, and contain several examples illustrating in the context of software development efforts (for internal or external use software) the application of the "process of experimentation" requirement that must be satisfied for all research credit claims. The final regulations generally follow, but differ in some respects from, proposed regulations released in January of 2015. See the overview prepared by Deloitte Tax LLP of the proposed regulations relating to software development expenses that can be accessed through **_this link._**

Overall, the final regulations expand opportunities for businesses operating in a wide range of industries to claim tax credits for their software development expenses, by narrowing the definition of "internal use software" ("IUS") that qualifies for the federal research credit only if it is highly innovative.[1] The final regulations retain a so-called "dual function rule" which could create challenges in substantiating some research credit claims, but this could be offset for many taxpayers by the new, relaxed standards for determining if IUS is highly innovative. In general, the final

regulations are effective prospectively for tax years beginning after October 4, 2016, with limited exceptions as discussed below. The Treasury Department and IRS rejected commenters' recommendations to apply the final regulations retroactively back to 1986 (when the IUS concept was first enacted by Congress), which may have helped resolve ongoing examinations of research credits determined for past tax years.[2]

The following analysis focuses on the changes made in the final regulations, relative to the provisions of the proposed regulations previously released in January of 2015.

The final regulations provide for a narrow definition of IUS

The term "internal use software" is defined as software developed by (or on behalf of) the taxpayer "for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business."[3] This regulatory definition "is intended to target the back-office functions that most taxpayers would have regardless of the taxpayer's industry,"[4] and is limited to:

1. Financial management of the taxpayer and supporting record keeping, 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

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[1] The final regulations retain the rules that exclude from IUS treatment: (i) software developed for use in an activity that constitutes qualified research, (ii) software developed primarily for use in a production process that was developed through qualified research, and (iii) software that is part of a package of software/hardware developed together as a single product. Treas. Reg. § 1.41-4(c)(6)(ii).

[2] See Collected Comments on Proposed Regulations: Internal Use Software, 2015 TNT 73-20, providing copies of the 9 comment letters submitted to the Treasury Department and the Internal Revenue Service (IRS); Preamble to T.D. 9786 at pp. 31-32 (explaining why the Treasury Department and IRS decided to generally not allow retroactive application of the IUS regulations).

[3] Treas. Reg. § 1.41-4(c)(6)(iii). Moreover, Treas. Reg. § 1.41-4(c)(6)(iv) was clarified by T.D. 9786 to expressly provide that "[s] oftware is not developed primarily for the taxpayer's internal use if it is not developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's business."

[4] See Preamble of T.D. 9786 at p. 5

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]

This list of "general and administrative functions" in the final regulations remains unchanged from the proposed regulations released last year, and extends to numerous essential business functions. Importantly, however, another rule in the final regulations (as in the proposed regulations) specifically excludes from the definition of IUS any software that is developed either (a) "to be commercially sold, leased, licensed, or otherwise marketed to third parties" or(b) "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."[6]

Treasury rejects commenters' suggestions to further narrow the list of internal G&A functions

Some commenters requested that certain functions, such as inventory management and marketing, be removed from the list of "general and administrative functions" because such software applications can be viewed as an integral part of the modern "front office." Marketing software in particular can be viewed as inherently external-facing and intended to interact with third parties. In response, the Treasury Department and IRS acknowledged that:

"[S]oftware with functions such as marketing or inventory management may not provide solely back-office functions, but may also contain functions that enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system. Recognizing such situations, the proposed regulations provided rules under §1.41-4(c)(6)(iv)(C) (dual function rules) [which are retained and re-numbered in the final regulations] to evaluate

whether software that has both back-office and front-office functions is developed primarily for internal use."[7]

With regard to marketing software, the Treasury Department and IRS revised Example 4 to clarify that software developed solely for advertising purposes should be treated as IUS. In this example, a restaurant develops software for a website that allows potential customers to "review general information", such as items served, price, location, phone number, and hours of operation. The software does not otherwise allow the restaurant to interact with third parties or allow third parties to initiate functions or review data on the taxpayer's system. This example suggests that, if customers could also use the software to place pick-up orders, monitor the expected delivery schedule, or perhaps obtain detailed information on ingredients or sources of food items on the menu by accessing current data on the taxpayer's system, then the so-called "dual function rule" could apply so that a portion of the development costs would not be allocable to IUS.[8]

Substantiation challenges in applying the dual function rule

Despite significant concerns expressed by commenters about the dual function rule — which applies when software is developed for use in the taxpayer's own G&A functions and to enable a taxpayer to interact with third parties or allow third parties to initiate functions or review data — it was not modified in the final regulations. The substantiation burdens imposed on some taxpayers when applying this rule could potentially be significant, yet the Treasury Department and IRS concluded that no changes were warranted. Consider, for example, the fact-pattern in Example 4 (discussed above), if modified so that the hypothetical software system provides advertising of general restaurant information and also allows other third-party interactions.

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[5] When determining whether general and administrative functions facilitate or support the conduct of the taxpayer's own trade or business (rather than the taxpayer's business being the provision of G&A services to others), the "single taxpayer" concept of § 41(f)(1) applies, so that software developed by the taxpayer for the internal use of another company that is a member of the same controlled group (generally determined by applying a more-than 50% ownership test) is treated as developed for the taxpayer's own internal use. See Treas. Reg. § 1.41-4(c)(6)(iii)(A).

[6] See Treas. Reg. § 1.41-4(c)(6)(iv). Again, because the "single taxpayer" concept of § 41(f)(1) applies, software is not treated as sold or licensed to, or enabling the interaction with, a third party unless that party is not a member of taxpayer's controlled group. In addition, Treas. Reg. § 1.41-4(c)(6)(vi)(E) provides that, for purposes of determining whether software was developed to enable third-party interaction, third parties do not include any persons that use the software to support the general and administrative functions of the taxpayer (e.g., if a taxpayer develops software to be used by an independent contractor when it provides payroll or other "back-office" functions to the taxpayer). See also Example 6 of Treas. Reg. § 1.41-4(c)(6)(viii)(involving software allowing interaction with vendors to improve the taxpayer's inventory management).

[7] Preamble to T.D. 9786 at p. 4

[8] Compare Example 4 with Examples 7, 8, and 11-14 of Treas. Reg. § 1.41-4(c)(6)(viii). See also Preamble to T.D. 9786 at pp. 29-30 (discussing restaurant software example).

The taxpayer would need to substantiate the expenses allocable to the efforts to develop only the third-party interaction features of the software (e.g., enabling the placement of restaurant orders, monitor delivery schedules or investigating the ingredients included in a particular dish) in order to avoid the application of the high threshold of innovation test to this aspect of the development project (the so-called "third party subset"). This substantiation would be required to overcome the initial presumption that dual function software in its entirety constitutes IUS.[9]

If the development is too integrated to segregate such expenses, then the taxpayer would have to prove that all of the software is highly innovative to qualify the development expenses for the credit; or the taxpayer could attempt to substantiate that the software is eligible for the safe-harbor cost allocation rule, effectively deeming 25 percent of the project development costs to not be allocable to IUS. However, this safe-harbor rule applies only if, at the outset of the development efforts, the taxpayer reasonably anticipated (using an "objective, reasonable method") that the third-party interactions with the software will constitute at least 10% of the dual function use.

In cases where a significant portion of the software development effort relates to anticipated third-party interactions, the dual function rule extracts a high price for taxpayers who cannot substantiate one or more discreet subsets of software that only enable third-party interactions, i.e., by limiting the deemed non-IUS costs to only 25% of the total project development expenses. On the other hand, if most of the dual function software development relates to internal G&A functionality (but not greater than 90%), then the safe harbor could be taxpayer favorable in the event that the overall development project is not highly innovative.

As noted above, the final regulations could present substantiation challenges to businesses that regularly develop and improve a significant amount dual function software. Taxpayers may want to confer with their company's lead software developer(s) to devise a plan for reasonably identifying the development expenses allocable to those elements/features of a software system that <u>only</u> enable third-party interactions. If this is not feasible, then relying on the safe harbor will require taxpayers to articulate a reasonable, objective approach for estimating (at the beginning of the development efforts) that at least 10% of the anticipated use of the software will be for third-party interactions.[10]

Software developed with the intent of being commercially sold, leased, licensed, or otherwise marketed to third parties is not subject to the dual function rule

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 is 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.[11]

Moreover, this statement in the Preamble along with the structure of the final regulatory provisions supports the conclusion that, if software developed by (or on behalf of) a taxpayer is intended to be sold, leased, licensed, or otherwise marketed to others and, at the same time, the taxpayer also intends to use the same software in its own back-room G&A functions, then that software should be treated as non-IUS and <u>not</u> be subject to the dual function rule. In this regard, the final regulations reiterate that

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[9] See Treas. Reg. § 1.41-4(c)(6)(vi)(A) and (B). The Treasury Department and IRS indicated that they believe the "third party subset rule" applicable to dual function software in Treas. Reg. § 1.41-4(c)(6)(vi)(B) reflects "principles similar to the shrink back rule" found in Treas. Reg. § 1.41-4(b)(2). See Preamble to T.D. 9786 at p. 14.

[10] See Treas. Reg. § 1.41-4(c)(6)(vi)(C)(providing that an "objective, reasonable method within the taxpayer's industry" for estimating anticipated third-party interaction with software "may include, but is not limited to, processing time, amount of data transfer, and number of software user interface screens."); Preamble to T.D. 9786 at p. 20 ("any objective, reasonable method within the taxpayer's industry may be used for purposes of the safe harbor"). See also Examples 12-14 of Treas. Reg. § 1.41-4(c)(6)(viii)(illustrating application of safe-harbor rule for dual function software).

[11] See Preamble to T.D. 9786 at pp. 12-13.

the facts-and-circumstances inquiry into the taxpayer's subjective intent regarding the future use or disposition of software (assuming that the development efforts are successful) must focus on the point in time when a software development project, or particular improvement effort, is first undertaken.[12]

Characterization of "hosted" and "connectivity" software

As noted above, the final regulations specifically provide that IUS excludes software that is developed to be commercially sold, leased, licensed, or "otherwise marketed" to third parties. In this regard, the Preamble to T.D. 9786 suggests that this exclusion should be broadly interpreted in view of the evolving nature of on-line commercial technology:

"The Treasury Department and the IRS understand that a taxpayer may develop software where the full functionality of that software is provided to a third party even though there is no transfer of a copy of the software. The Treasury Department and the IRS believe the phrase 'software that is developed to be commercially sold, leased, licensed or otherwise marketed to third parties' is sufficiently broad to encompass hosted software and other software where there is no transfer of a copy of the software."[13]

Also reflecting recent technological advances in how software is effectively sold or otherwise made available to others, the final regulations include a new Example 9 involving a taxpayer described as "a provider of cloud-based software." The hypothetical taxpayer develops enterprise application software (including customer relationship management, sales automation, and accounting software) to be accessed online and used by its customers. The example concludes that the software is not IUS because, at the beginning of the development, the taxpayer intended to develop software for

commercial sale, lease, license, or to be otherwise marketed to third parties.[14]

In addition, the IRS had asked for comments to be submitted regarding the appropriate treatment for research credit purposes of so-called "connectivity software" (sometimes referred to as "middleware") that allows multiple processes running on one or more machines to interact across a network. The Treasury Department and the IRS noted that, with wide use and availability of ERP software, few companies currently engage in developing connectivity software, such that special rules need not be incorporated into the framework of the final regulations:

"Whether certain software is developed to be used primarily for internal use should be based on the function the software provides, rather than the type of software. For example, connectivity software that is developed to connect a taxpayer's existing payroll software with financial budgeting software to allow an exchange of data between the two software modules would be considered to be developed for the taxpayer's internal use because the connectivity software's function is to be used in human resources and financial management functions."[15]

On the other hand, there will be situations where "connectivity" or "middleware" software was not developed to enable internal G&A functions and, thus, is properly characterized as non-IUS. For example, the connectivity software may connect content with an e-commerce site that is developed for third-party use, e.g., hosted gaming software. The Treasury Department and IRS addressed this type of software by noting that:

"[A]ny software that is not developed to be used in a general and administrative function will not be considered to be developed for internal use. This is the case even if the software is not developed to be commercially sold, leased, licensed, or

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[12] See Treas. Reg. § 1.41-4(c)(6)(iv) and (v)(addressing situations where development efforts originally are undertaken with one intended use of the software, but improvements to that software system are subsequently attempted with a different intended use of the improved software); Preamble to T.D. 9786 at pp. 10-12 (discussing software development efforts that span multiple years); Example 10 of Treas. Reg. § 1.41-4(c)(6)(viii)(involving "technical and functional" enhancements developed to sell to third parties software that originally was development several years earlier for internal G&A use by the taxpayer itself). It should be noted that (as with the proposed regulations) the final regulations do not include a specific provision, nor a specific example, conclusively stating that, if a taxpayer is incurring software development expenses at time when it simultaneously has the dual objectives/motives of both (1) using that software for its own G&A functions, and (2) selling, leasing, licensing, or otherwise marketing the same software to third parties, then none of the development costs incurred in furtherance of such dual objectives are allocable to IUS. Nevertheless, we believe this is an appropriate reading of the final regulations.

[13] See Preamble to T.D. 9786 at pp. 6-7 (explaining why there is no need to add the word "hosted" or clarify the "otherwise marketed" language in Treas. Reg. § 1.41-4(c)(6)(iv)(A)).

[14] See Example 9 of Treas. Reg. § 1.41-4(c)(6)(viii).

[15] Preamble to T.D. 9786 at p. 9.

otherwise marketed to third parties, or is not 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."[16]

The final regulations adopt taxpayer-favorable changes to the standards for determining if IUS software qualifies for the credit because it is highly innovative

Consistent with the 1986 Act legislative history and proposed regulations, costs allocable to software that falls within the definitional scope of IUS under the final regulations may be treated as credit-eligible expenses only if the taxpayer can establish that the software:

1. is innovative;

2. involves significant economic risk; and

3. is not commercially available. [17]

On the whole, the specific language of the final regulations helps to refine in a taxpayer-favorable way this three-part "high threshold of innovation test." Before examining some of the subtle changes to this language, it is important to note that a sentence was removed from Treas. Reg. § 1.41-4(c)(6)(vii)(D), which in its proposed form had stated: "It is not always necessary to have a revolutionary discovery or creation of new technologies such as a new programming language, operating system, architecture, or algorithm to satisfy the high threshold of innovation test." Regarding the deletion of this language, the Preamble to the final regulations indicates:

"[A] commenter is concerned that the sentence

can be read to imply that in some situations it will be necessary to have a revolutionary discovery to qualify internal use software for the research credit. The Treasury Department and the IRS did not intend the inclusion of this statement to have the interpretation suggested or taken by the commenter. Accordingly, the Treasury Department and the IRS agree that this statement should be removed from the final regulations because a revolutionary discovery is not required to meet the high threshold of innovation test."[18]

The final regulations retain, however, the favorable interpretive guidance that the "use of existing technology in new ways could be evidence of a high threshold of innovation if it resolves substantial uncertainty" and also include the four examples from the proposed regulations illustrating (in a somewhat conclusory manner) the application of the three-part innovation test.[19]

With respect to the first prong of the high threshold of innovation test, the clarifying language of the final regulations is taxpayer favorable because it abandons a standard proposed many years earlier that equated innovativeness with software that was viewed by industry experts as "unique or novel."[20]

Instead, the final regulations clarify that software is innovative if it would result in a reduction in cost or improvement in speed or other measurable improvement that is substantial and economically significant, if the development is or would have been successful. This is a measurable objective standard, not a determination of the unique or novel nature of the software or the software development process.[21]

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[16] Id. See also Treas. Reg. § 1.41-4(c)(6)(iv) as modified by T.D. 9786 to include the words "such as" so that the two categories of (1) software developed to be sold or otherwise marketed to third parties, and (2) software developed to enable third-party interactions, are examples (and not the exclusive tests) of software that is deemed to not be developed primarily for the taxpayer's internal use and, thus, outside the scope of IUS.

[17] Treas. Reg. § 1.41-4(c)(6)(vii)(A).

[18] Preamble to T.D. 9786 at p. 24.

[19] Treas. Reg. § 1.41-4(c)(6)(vii)(D); Examples 15-18 of Treas. Reg. § 1.41-4(c)(6)(viii).

[20] Prop. Treas. Reg. §1.41-(c)(6)(vi)(A), 66 FR 66362.

[21] Treas. Reg. § 1.41-4(c)(6)(vii)(B). Examples 15-18 of Treas. Reg. § 1.41-4(c)(6)(viii) each indicate in their "Facts" that the software development project "if successful, would provide a reduction in cost and improvement in speed that is substantial and economically significant" but do not indicate how any quantitative measurements in this regard may have been calculated/estimated by the hypothetical taxpayers.

Final regulations abandon the position reflected in the proposed regulations that significant economic risk must involve more than mere "design" uncertainty

With respect to second prong of the three-part test governing IUS, the most recent proposed regulations had provided that software development will be treated as involving "significant economic risk" if:

"the taxpayer commits substantial resources to the development and if there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period. This standard does not require technical uncertainty regarding whether the final result can ever be achieved, but rather whether the final result can be achieved within a timeframe that will allow the substantial resources committed to the development to be recovered within a reasonable period. Substantial uncertainty exists if, at the beginning of the taxpayer's activities, the information available to the taxpayer does not establish the capability or method for developing or improving the software."[22]

In other words, under the proposed regulations, mere uncertainty about the "appropriate design" — which is sufficient for research expense deduction and credit purposes[23] — of software code would have been insufficient to establish "significant economic risk" with respect to IUS. Commenters raised concerns, however, that the statute and regulations do not define the concepts of capability, methodology, and design uncertainty. Moreover, these three types of uncertainties are inherently related to each other, and it is often difficult for taxpayers to clearly state or describe which type of uncertainty they face.[24]

The Treasury Department and IRS ultimately agreed with commenters on this "design uncertainty" issue, concluding:

"[T]he Treasury Department and the IRS understand that it is difficult to delineate the types of technical uncertainties and attempting to do so may lead to unnecessary burdens on both taxpayers and the IRS. Furthermore, the appropriate design uncertainty of internal use software may be inextricably linked to substantial uncertainty regarding capability or method. The focus of the significant economic risk test should be on the level of uncertainty that exists and not the types of uncertainty. For these reasons, the final regulations remove the reference to capability and method uncertainty."[25]

Application of process of experimentation requirement to all software research

In addition to the provisions defining IUS and clarifying the high threshold of innovation test, the final regulations also include six examples illustrating the application of the "process of experimentation" requirement to software development in general, regardless of whether or not the software constitutes IUS.[26] These six examples contained in the final regulations are identical to examples included in the proposed regulations, focusing on whether or not the hypothetical taxpayer is merely evaluating the functionality of available software products (or selecting templates already built into a purchased ERP system) or, instead, is designing and systematically testing new algorithms in an attempt to resolve workload distribution, data synchronization, or similar problems.[27]

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[22] See Prop. Treas. Reg. § 1.41-4(c)(6)(v)(C).

[23] See Treas. Reg. § 1.174-2(a)(1); Treas. Reg. § 1.41-4(a)(5)(i).

[24] Preamble to T.D. 9786 at pp. 22-23.

[25] Id at p. 23. Although it is positive development that the final regulations do not contain a per se rule that mere "design uncertainty" never reaches the level of "substantial uncertainty" required for a credit-eligible IUS project, the Preamble contains the following statement that may lead to semantic disputes between taxpayers and IRS agents during examinations of IUS research credit claims: "However, the Treasury Department and the IRS believe that internal use software research activities that involve only uncertainty related to appropriate design, and not capability or methodology, would rarely qualify as having substantial uncertainty for purposes of the high threshold of innovation test." Id. With respect to the standards retained in Treas. Reg. § 1.41-4(c)(6)(vii)(C) focusing on whether a taxpayer's commitment of substantial resources to an IUS project is likely to be recovered within a reasonable period of time, the Treasury Department and the IRS view these as "factual determinations to be resolved based on the taxpayer's facts and circumstances and, therefore, further explanation or examples would be too specific and not helpful." Id at 24.

[26] See § 41(d)(1)(C); Examples 5-10 of Treas. Reg. § 1.41-4(a)(8).

[27] See overview prepared by Deloitte Tax LLP for further details about the proposed regulations. See also Preamble to T.D. 9786 at pp. 25-29 (no presumption intended that activities related to developing web design or ERP software in particular cannot satisfy the "process of experimentation" requirement).

Effective-date provisions

The new rules governing IUS are generally effective for taxable years beginning on or after the date the regulations were published in the Federal Register (i.e., October 4, 2016).[28] However, the IRS will not challenge tax-return positions that are consistent with <u>either</u> the final regulations in T.D. 9786 <u>or</u> the January 2015 proposed regulations if taken on a tax return for a tax year that ends on or after January 20, 2015, provided that such tax year begins before October 4, 2016. As a consequence of this effective-date language, almost all taxpayers will have the opportunity to amend their 2015 returns to reflect the new, taxpayer-favorable IUS rules and clarifications contained in the final regulations, and also can choose to apply these new rules and clarifications to determine research credits claimed on their 2016 returns (including a fiscal year that begins no later than October 3, 2016 and ends during 2017). At the same time, if a taxpayer had been applying the IUS provisions of the January 2015 proposed regulations when it previously determined research credits for financial reporting purposes, then it will not be required to apply the provisions of the final regulations to any tax year beginning prior to October 4, 2016 — that is, a calendar-year taxpayer can wait and first apply the new IUS rules of T.D. 9786 when it determines its research credit for calendar-year 2017.[29]

All of the commenters argued that the final regulations should be retroactive, because they are interpreting a statutory provision that has been in effect for 30 years. Rejecting these comments, the Treasury Department and IRS decided that a prospective approach was appropriate (with the limited exceptions for certain 2015 and 2016 returns, as described above),

explaining that:

"Retroactive application of these final regulations may provide an unfair advantage to taxpayers whose prior taxable years are not closed by the statute of limitations. Furthermore, retroactively determining whether taxpayers engaged in research activity does not further the purpose of section 41 which is to encourage taxpayers to engage in qualifying research activities within the United States and would impose a significant administrative burden on the IRS."[30]

Implications of effective-date provisions on IRS exams

In the Preamble to the final regulations, the Treasury Department and IRS indicate that it is the Government's administrative position that, in view of the rapid evolution of software technology, "these final regulations are not, and should not be viewed as, an interpretation of prior regulatory guidance. Software not developed for internal use under these final regulations, such as software developed to enable a taxpayer to interact with third parties, may or may not have been internal use software under prior law."[31]

Consequently, IRS Examiners and Appeals Officers presumably will not be weighing the interpretative guidance in the IUS provisions and examples of final regulations when evaluating research credits determined by taxpayers for pre-effective-date tax years. Indeed, the Preamble of T.D. 9786 indicates that the final regulations "more narrowly define internal use software than the rules that apply for prior periods."[32]

IRS examiners are likely, therefore, to refer to this comment if taxpayers attempt to explicitly apply the IUS rules or examples in the final regulations as interpretive guidance to pre-2015 tax years.

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[28] Treas. Reg. § 1.41-4(e). However, the six new examples in Treas. Reg. § 1.41-4(a)(8) applying the "process of experimentation" requirement to software development activities are effective for taxable years ending on or after December 31, 2003.

[29] For taxable years beginning on or after January 20, 2015, taxpayers are no longer able to choose to follow either all of the IUS provisions of Treas. Reg. § 1.41-4(c)(6) in the regulations (later withdrawn) published on January 3, 2001 in the Federal Register (T.D. 8930; 66 FR 280) or all of the IUS provisions of Treas. Reg. § 1.41-4(c)(6) contained in the proposed regulations (REG-112991-01) published on December 26, 2001 in the Federal Register (66 FR 66362). In effect, this means that a 2015 calendar-year taxpayer could elect to apply one of the two sets of internal use software regulations issued in 2001, or (alternatively) could elect to apply either the 2015 proposed regulations or the final 2016 regulations when determining its research credit for that 2015 year. In contrast, a 2016 calendar-year taxpayer can only elect to apply either the 2015 proposed regulations or the 2016 final regulations when determining its research credit for that 2016 year.

[30] Preamble to T.D. 9786 at p. 31

[31] Id. at 32.

[32] Id.

Base consistency

Because the research credit is an incremental credit, taxpayers must be consistent in their determination of qualified research expenses in the base years and in the current year for which a credit is being determined. This "consistency rule" applies regardless of whether the taxpayer elects the alternative simplified credit or the traditional credit. See §41(c)(6) and Treas. Reg. §1.41-9(c)(2). Consequently, taxpayers who identify software development expenses as credit eligible based on the final regulations must apply the same legal standards to expenses incurred in the base-period years. This may be challenging for taxpayers who claim a traditional credit, because consistency must be achieved for the 1984-1988 base period (unless the taxpayer is a start-up company). Some taxpayers may have applied prior proposed IUS guidance in a manner that generally achieves (for § 41 purposes) the same result as applying the rules in the final regulations. For example, an e-commence company may have treated all of the software developed for customer use as providing a "computer service" which under prior proposed guidance was excluded from the scope of IUS. Similar software might no longer be considered IUS under the final regulations, because it was "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." In these situations, the "consistency rule" might not result in significant adjustments being required to the qualified research expenses previously determined by the taxpayer for base-period years, even though the taxpayer theoretically is applying new regulatory rules and examples governing software development expenses.

Questions or comments

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