

Treasury Issues Proposed Rules Which May Make it Easier for Investment Managers to Qualify for Research Tax Credits

In January 2015, the US Department of the Treasury (“Treasury”) issued a new set of proposed regulations [REG-153656-03, released 1/16/2015] defining “internal use software” and clarifying the requirements needed for a taxpayer to claim a federal income tax credit for software development costs. As noted by the Treasury in the preamble, these proposed regulations are intended to expand the opportunities for taxpayers to claim research credits for software-related expenses. A tax credit may be preferable to a tax deduction because a credit reduces a taxpayer’s liability on a dollar-for-dollar basis, while a deduction benefits a taxpayer based on the product of the deduction times the marginal tax rate of the taxpayer.

Background

In 1986, Congress made significant modifications to restrict the ability of taxpayers to claim a research tax credit for “internal use software.” For this purpose, “internal use software” is generally software that is not developed to be licensed or sold to third parties, but rather is intended for internal use. In the intervening years, various proposed rules have been issued, but it was not until the January 2015 proposed regulations were issued that many taxpayers could meet the standards to claim a research tax credit for “internal use software.”

The 2015 proposed regulations

“Internal use software” is limited under the proposed regulations to software developed by [or on behalf of] the taxpayer for “general and administrative functions that facilitate or support the conduct of the taxpayer’s trade or business.” The revised definition of “internal use software” and the exclusions from “internal use software” have expanded what may potentially qualify for the credit. It is likely that software developed to enable proprietary trading programs and algorithms, as well as other portfolio management tools, may be eligible for the credit. This software may be treated as internal use or non-internal use depending on the individual facts and circumstances of the software development.

“Internal use software” may be eligible for the research tax credit if a three-part “high threshold of innovation test” is satisfied. The three parts include:

1. **Innovation requirement** – Software is innovative if the software would result in a reduction of cost or improvement of speed or other measurable improvement [in performance] that is substantial and economically significant, assuming the development is or would have been successful. Treasury intends this to be an objective standard to reduce the potential for controversy.
2. **Significant economic risk** – Under this test, software development involves significant economic risk “if the taxpayer commits substantial resources to the development and there is substantial uncertainty because of technical risk, that such resources would be recovered in a reasonable period.”
3. **Commercial availability** – “Internal use software” must not be commercially available – that is to say, it cannot be purchased, leased, or licensed and used for its intended purpose without modifications that would themselves qualify for the innovation and significant economic risk tests.

Proprietary trading software and other software developed by investment managers may meet this three-part test depending on the facts and circumstances of each development. Software would not be deemed for internal use if such software 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. As such, costs associated with such software, including interfaces with counterparties, may be eligible for the research tax credit without having to meet the high threshold of innovation test.

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