

Anchin Alert

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Proposed Regulations Provide Clarity and Guidance Related to Computer Software as it Applies to the R&D Tax Credit

On January 16, the Treasury and IRS released proposed regulations (REG-153656-03) regarding internal use software (“IUS”) expenditures as related to the Section 41 Research & Development (“R&D”) tax credit. The proposed regulations contain several important changes related to claiming the R&D tax credit for IUS expenditures.

First, the regulations clarify the definition of internal use software. According to the regulations, IUS is defined as software developed by the taxpayer for general and administrative functions. These general and administrative functions are limited to human resource management, financial management, and support services. Further, software developed by the taxpayer that enables the taxpayer to interact with third parties, allows third parties to initiate functions or review data on the taxpayer’s system, or is otherwise commercially sold, leased, licensed, or marketed to third parties is not classified as IUS. This distinction is important since software developed by the taxpayer that is considered to be IUS must meet the three-part high threshold of innovation test in addition to the four-part test in order to qualify for the R&D tax credit.

Next, to meet the high threshold of innovation, the developed internal use software must be innovative, the development must involve significant economic risk, and the software must not be commercially available to the taxpayer. The proposed regulations clarify that internally developed software is considered innovative if the development would result in a substantial and economically significant reduction in cost, improvement in speed, or other measurable improvement. The regulations also reiterate that significant economic risk exists only if the taxpayer commits substantial resources to the development and the likelihood that such resources will be recovered within a reasonable period of time is substantially uncertain. In defining substantial uncertainty, the proposed regulations note that the uncertainty must relate to the capability or methodology, but not the appropriate design of the business component to create a higher threshold for eligibility than Congress originally intended for IUS.

Additionally, the regulations provide that dual-purpose software that is developed for both internal and third-party use is presumed to be internal use software. However, the portion of qualifying expenditures related to third-party use may still be eligible for the R&D credit. Additionally, the regulations provide a safe harbor for expenditures related to the development of such dual-purpose software. According to the regulations, a qualifying taxpayer may include 25 percent of the qualifying research expenditures related to the dual-purpose software in the calculation of the R&D credit. This safe harbor applies only if the taxpayer anticipates that at least 10 percent of the dual-purpose software will be used for third-party purposes.

Finally, the proposed regulations provide examples that illustrate their applicability to computer software. Specifically, the examples address the process of experimentation and high threshold of innovation tests, as well as the application of the new dual function computer software rules.

To discuss how these proposed regulations may affect your R&D tax credit calculation, or for more information, please contact Yair Holtzman, Partner and Practice Leader of Anchin’s Research and Development Tax Credits Group at 914.860.5599.



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