

## IRS Issues Final Regulations Related to the R&D Tax Credit and Internal Use Software

On Oct. 4, 2016, the Internal Revenue Service (IRS) published T.D. 9786, final regulations that improve opportunities for businesses that engage in internal use software development to qualify and claim the R&D Tax Credit. These final regulations are effective for tax years beginning on or after the date in the Federal Register. Similar to the proposed regulations issued in January 2015, the final regulations provide guidance in defining qualified research activities related to internal use, non-internal use, and dual use software development.

Internal use software is developed by the taxpayer to support or facilitate their business operations with general and administrative functions, including financial management, human resource management and support services. If identified as internal use, the development efforts must meet the standard four-part test in addition to the three-part test of being highly innovative, involving significant economic risk, and being commercially unavailable for taxpayer use. Conversely, software that is not defined as internal use is not subject to the three additional High Threshold of Innovation qualifiers. This includes any developed software that is intended to be:

- commercially sold, leased, licensed, or otherwise marketed to third parties,
- enables the taxpayer to interact with third parties, or
- allows third-parties to initiate functions or review data on the taxpayer's system.

Non-internal use software only needs to satisfy the standard four-part test. Furthermore, the internal use software rules do not apply to software that is developed for use in an activity that constitutes qualified research, use in a production process that meets the requirements of IRC §41(d)(1), or a new or improved package of software and hardware developed together by the taxpayer as a single product.

Dual use software, which is defined as software with both internal use and non-internal use components, is presumed to be internal use, unless the taxpayer can identify and quantify a subsection of the software system that enables interactions, functionalities, and data revisions with the taxpayer and third parties. The qualified costs associated with the non-internal use software can potentially be included.

The proposed regulations stated that substantial uncertainty existed if the information available at the start of the taxpayer's activities did not establish the method or capability for developing or improving the software. The final regulations eliminate these references to capability and method uncertainty, but elaborate that internal use software research activities that involve uncertainty relating to the appropriate design and not the capability or methodology would rarely satisfy substantial uncertainty for purposes of the High Threshold of Innovation Test.

As a reminder, the R&D Tax Credit rewards companies based on their investment in developing new products or processes. The IRS emphasis is placed on the qualitative aspects of the research and experimentation. Effective credits are typically five to six percent of annual qualified research expenditures, which include wages, supplies and contract research.

These final regulations offer favorable guidelines and clarification for businesses that develop new and improved software intended to be sold or used as third-party interactivity. Many companies previously ineligible to claim the R&D Tax Credit might now be able to. The recent internal use software regulations and PATH Act demonstrate that the IRS recognizes investing in technology and innovations is crucial to a company's success.