

# The IRS Issues Final Treasury Regulations Governing R&D Tax Credit Claims

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On October 3, 2016, the IRS issued Final Treasury Regulations setting forth guidance on research and development efforts in connection to Internal Use Software (IUS) for purposes of claiming the Research & Development Tax Credit (RTC) under I.R.C. § 41.

As a synopsis, the newly issued Final Treasury Regulations are substantially the same as the previously issued Proposed Treasury Regulations which were issued on January 20 of 2015(REG-153656-03). The previously issued Proposed Treasury Regulations were intended to provide a practicable definition of IUS while offering guidance for when IUS development satisfies the high threshold of innovation test required in order for IUS to qualify for the RTC. As it should be recalled, the previously issued Proposed Treasury Regulations were praised by tax professionals as a practical framework to identifying, gathering, and documenting IUS RTC claims. Consequently, it was not surprising that the regulations were later finalized in substantially similar form. As a reminder, Treasury Regulations provide the official interpretations of the Internal Revenue Code by the Treasury Department and have the force and effect of law. The most common forms of Treasury Regulations include:

- Proposed Treasury Regulations (e.g., binding only on the IRS and not the taxpayers);
- Temporary and Final Treasury Regulations (e.g., binding on both the IRS and the taxpayers); and
- Preambles (e.g., treated just like legislative histories to demonstrate congressional intent and may underlie either type of the aforementioned Treasury Regulations regardless of status as Proposed, Temporary, or Final).

Consequently, with the issuance of these Final Treasury Regulations governing IUS RTC claims, the onus for tax compliance is now binding upon both the IRS and the taxpayers effective October 4th of 2016 which represents the date in which these Final Treasury Regulations have been published within the Federal Register.

## Synopsis of the Final Treasury Regulations

### IUS Defined

The Final Treasury Regulations adopt the Proposed Treasury Regulations' definition of IUS as software primarily "developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. General and administrative functions include: (1) financial management and supporting recordkeeping, such as accounts payable and receivable, inventory management and budgeting; (2) human

resource management; and (3) support services that support the taxpayer's day-to-day operations." In addition, the Final Treasury Regulations further adopt, with some clarifications, the Proposed Treasury Regulations' definition of software not developed primarily for internal use as software that is "not developed for use in general and administrative functions that support the conduct of the taxpayer's trade or business." Examples of this software include software that is developed to be commercially sold, leased, licensed, or otherwise marketed to third parties; and software that is developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data.

### **High Threshold of Innovation Test**

Select IUS initiatives may be eligible for the RTC if, among other things, the software adheres to the three attributes of the high threshold of innovation test: (1) the software is innovative in that would result in a measurable improvement that is substantial and economically significant if the development is or would have been successful; (2) the development involves significant economic risk and there is substantial uncertainty due to technical risk; and (3) the software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the innovation and significant economic risk requirements.

### **Dual Function Software**

For software that serves both internal uses and external uses (i.e., Dual Function Software), the Final Treasury Regulations presume that such software is developed primarily for a taxpayer's internal use. However, this presumption does not apply in connection to the portion of the software for which the taxpayer can identify a subset of elements that enable the taxpayer to interact with third parties or allow third parties to initiate functions or review data on the taxpayer's system. It should be duly noted that the Final Treasury Regulations provide a safe harbor that allows a taxpayer to include 25% of the Qualified Research Expenditures (e.g., Wages, Supplies, and 3rd Party Contract Research) of the Dual Function Software in computing the amount of the taxpayer's RTC so long as the research constitutes qualified research and the use of the Dual Function Software by third parties is reasonably anticipated to constitute at least 10% of its use.

### **Intent of Software Development Benchmark**

The Final Treasury Regulations make clear that whether software is developed primarily for internal use depends on the intent of the taxpayer and the facts and circumstances as they exist at the beginning of the software development process. However, it should be duly noted that the Final Treasury Regulations leave open the question of what actually constitutes the beginning of the software development phase and therefore creating some uncertainty for taxpayers. Conceivably further administrative guidance may be later disseminated to the public that will address this matter and provide better clarity to get to a sustainable tax return filing position. It is imperative that taxpayers recognize that absent such administrative guidance, there is certainly some level of interpretation and tax compliance risk that needs to be mitigated as the IRS could take the position that the taxpayer did not have the necessary intent at the proper time. This is particularly possible if the purpose of the software development changes over a period of time that could conceivably span over multiple taxable years.

The Final Treasury Regulations are prospective only. The Final Treasury Regulations will apply to taxable years beginning on or after October 4, 2016. For tax years ending on or after January 20, 2015, and beginning before October 4, 2016, the IRS will not challenge any RTC claim that is consistent with the Proposed Treasury Regulations or the Final Treasury Regulations. The Final Treasury Regulations can be accessed at: <https://www.federalregister.gov/documents/2016/10/04/2016-23174/credit-for-increasing-research-activities>

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