



## Software Final Regulations Passed for the R&D Tax Credit

On Oct. 4, 2016, the IRS published T.D. 9786, final regulations that improve opportunities for businesses that engage in internal use software development to claim the R&D Tax Credit. The final regulations provide guidance in defining qualified research activities related to internal use, non-internal use and dual use software development. These final regulations are effective for tax years beginning on or after Oct. 4, 2016. For tax years ending on or after Jan. 20, 2015, and beginning before Oct. 4, 2016, the IRS will not challenge returns consistent with either the proposed or final regulations.

A) **Internal use software** is defined as software that is developed by or for the taxpayer primarily for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business. General and administrative functions are limited to:

- Financial Management: account payable and receivable, inventory management, and budgeting
- Human Resource Management: functions that manage the taxpayer's workforce
- Support Services: data processing functions or facilities services

In addition to the traditional 4-Part Test, internal use software must also meet three additional "High Threshold of Innovation" qualifiers:

- highly innovative
- involving significant economic risk
- being commercially unavailable for taxpayer use

B) **Non-internal use software** is defined as 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. Third parties are defined as any corporation, trade or business, or other person that is not treated as a single taxpayer with the taxpayer pursuant to section 41(f).

- execute banking transactions
- track the progress of delivery of goods
- receive services over the Internet
- purchase tickets for transportation or entertainment

\* Non-internal use software only needs to satisfy the standard 4-Part Test.

C) **Dual use software** is defined as software with both internal use and non-internal use components, is presumed to be internal use, unless the taxpayer can identify a subsection of the software system that enables interactions, functionalities and data revisions with third parties.

- **Safe Harbor:** a taxpayer may include 25% of the qualified research expenditures for the dual function subset as long as the software is used by third parties or the interaction with third parties is reasonably anticipated to constitute at least 10% of the dual function software's use.

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**These final regs acknowledge the investment that companies make in technology on an annual basis to remain competitive in their respective industries.**

-TJ Sponsel  
Managing Director  
McGuire Sponsel

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