



New Internal-Use Software Regulations Have Been Finalized

On October 4th, the Treasury Department issued final regulations narrowing the definition of internal-use software (IUS). The final regulations (T.D. 9786) by and large adopt the proposed regulations issued on January 20, 2015, and are widely considered taxpayer-friendly for narrowing the definition of IUS. In other words, the new rules are notable for clarifying what is not considered internal-use software, since IUS is subject to a three-prong high threshold of innovation test while non-IUS software development is subject to a less restrictive standard.

The final regulations clarify that internal-use software is software developed for “back office” general and administrative functions (financial management, human resources management, support services) which facilitate or support the conduct of the taxpayer’s business and are neither marketed to nor interact with potential clients.

More importantly, the final regulations clarify what is not included in IUS. Software that a taxpayer offers for sale, lease or license or otherwise markets to third parties, or developed to enable a taxpayer to interact with third parties or allow third parties to initiate functions or review data on the taxpayer’s system, is not considered internal-use and is thus subject to a lower threshold to qualify for the credit.

The new rules apply from Oct. 4, 2016, as the IRS rejected recommendations to make them retroactive. Despite the “prospective-only” application, however, the IRS will not challenge returns consistent with the proposed regulations and filed on or after January 20, 2015. As a result, taxpayers claiming R&D credits for IUS in earlier years must still use the previous rules.

Interestingly, under the consistency rule, taxpayers using the new rules to calculate their current R&D credit will need to adjust their base year calculations using the new rules, but cannot amend returns to claim the credit using the new calculations. Instead, they must use the old rules to claim the credit for earlier years, resulting in two sets of calculations.

Please consider Think, LLP to assist with the R&D Tax Credit. Our experienced, capable professionals have performed thousands of studies and are well versed on the complexities of the rules and regulations. Give us a call or email us with your questions. We look forward to hearing from you.

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