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Recent Extension and Modification of the Research Credit Provides New Opportunities for Financial Institutions

With the two-year extension, AIRC enhancement, and a new simplified method, the research credit offers a more attractive opportunity for financial institutions than ever before.

GEORGE ELIAS AND MICHAEL KRAJCER

On December 20, 2006 the President signed into law the Tax Relief and Health Care Act of 2006, praising it as "a good piece of pro-growth legislation."[1] The Act included a multitude of tax relief measures, but of particular interest to financial institutions are the provisions concerning the credit for increasing research activities ("research credit").[2]

Once the President signed the related bill (H.R. 6111) into law, the R&D credit was seamlessly extended through December 31, 2007.[3] This brought great relief to interested tax departments, which had been previously left in a quandary regarding their related year-end tax planning. In addition, beginning in 2007, many taxpayers which may have not previously qualified for the credit may now do so under a new Alternative Simplified Credit (ASC) regime.

The purpose of the research credit is to stimulate development of new and improved products, processes, and computer software, by rewarding companies with tax incentives to offset the related research expenditures. The research credit has historically provided a significant benefit to the manufacturing industry, which has been struggling with ever increasing foreign competition in a global economy. Financial institutions, which more than ever before are forced to compete with nontraditional and foreign competition, may wish to investigate the benefits that the research credit provides.

THE RESEARCH CREDIT FOR 2006

The ASC method does not apply to tax years ending in 2006. Therefore, taxpayers will be required to compute the 2006 credit using the regular method or the Alternative Incremental Research Credit (AIRC) method. Limitations inherent to these methods can be detrimental to financial institutions that have a long history of mergers, acquisitions, and dispositions, and are thus unable to compute their fixed base percentage due to lack of financial data, or can calculate their fixed base percentage but are unable to take the credit due to their large gross receipts and resulting inflated base amount.

For example, assume that a calendar year financial institution has the following for 2006: fixed base

[1] PL 109-432 (2006).

[2] IRC Section 41.

[3] HR 6111 Sec. 104(a)(1). Prior to HR 6111 becoming law, the credit had expired for expenditures incurred after December 31, 2005.

George Elias is the firm's Director of Operations located in Cleveland,. Formerly, he was an Assistant Vice President at National City Bank's Corporate Tax Department. Michael Krajcer is the Technical Director of the Tax Projects Group, LLP, and was formerly the leader of Ernst & Young's IRS Practice and Procedure Group in Cleveland. As a Vice President at National City Bank, Mr. Krajcer was responsible for managing the bank's R&D Tax Credit study. The firm's website is at www.taxprojectsgroup.com.

percentage of 2%; qualified research expenditures ("QREs") of $500,000; and prior four years' average gross receipts of $300 million. Under the regular credit calculation method, the financial institution will not be able to claim the credit because the base amount will exceed the current year QREs. The computation would be as follows:

Current year QREs	$ 500,000
Prior four year average	
gross receipts (2002-2005)	$300,000,000
Fixed base percentage	2.00%
Base amount	$ 6,000,000
Current year QREs less base amount	
($500,000 - $6,000,000)	($5,500,000)

Because the financial institution had QREs of only $500,000 in 2006, it would not qualify for the research credit. This is a prime example of a company with large gross receipts not benefiting from the credit, regardless of the fact that it may have been currently increasing its research expenditures. The new ASC method will now provide an opportunity for companies such as this to qualify for the research credit (see discussion following on computation under the new legislative changes).

Taxpayers that had not previously qualified for the R&D credit may now get it under a new Alternative Simplified Credit (ASC) regime.

NEW LEGISLATIVE CHANGES TO THE CREDIT

The passage of the research credit extender legislation brought several changes to the computation of the credit. First, taxpayers that have elected to compute their credit using the Alternative Incremental Research Credit (AIRC) method will enjoy a rate increase effective after December 31, 2006. The rates have been increased from 2.65%, 3.2%, and 3.75% to 3%, 4%, and 5%, respectively.

The AIRC method is generally used by companies that have experienced an increase in sales while their research spending remained the same, or where research spending otherwise lags proportionally behind increases in gross receipts. Companies that experience this scenario may elect to use the AIRC method to compute their credit because they need not be concerned with the base amount under this method. Under the regular credit computation, the base amount increases as gross receipts increase. The AIRC eliminates the base amount from the computation and uses only QREs for the credit period and average gross receipts over the four preceding years. Once the AIRC election is made to compute the research credit, the method can not be changed unless a company obtains consent from the Internal Revenue Service. New legislation has provided a simplified method for companies that have elected to compute the credit using the AIRC method to elect out of this computation, effective January 1, 2007. The taxpayer needs only to make the current election on their Form 6765. If the taxpayer makes the appropriate election, the prior election shall be treated as revoked with the consent of The Secretary of the Treasury for such year.

Alternative Simplified Credit. The second major new piece of legislation relating to the research credit is the new Alternative Simplified Credit (ASC), which also became effective January 1, 2007. Beginning in 2007, taxpayers have the option of computing their credit using the two existing methods (regular or AIRC) or can elect the ASC method. This will make it necessary for companies to compute the credit under multiple methods in 2007, in order to determine which method will result in the greatest benefit. For taxpayers that claim the credit each year, this option of electing the appropriate method will only be available for the 2007 year. Once a method is chosen for the 2007 tax year, the taxpayer is required to continue using that method for all future years, and can revoke it only with the consent of the IRS.

The ASC method allows a taxpayer to claim a credit equal to 12% of the amount by which current year QREs exceed 50% of its average QREs for the three taxable years preceding the taxable year for which the credit is being computed. If the taxpayer has no QREs in any one of the three preceding taxable years, it is required to calculate the credit by multiplying its QREs for the taxable year by 6%.

The following example illustrates the computation of the research credit based on the ASC method. Assume the taxpayer in our first example had the following QREs: $600,000 in 2007, $500,000 in 2006, $250,000 in 2005 and $150,000 in 2004:

2007 QREs		$600,000
2006 QREs	$500,000	
2005 QREs	$250,000	
2004 QREs	$150,000	
Total QREs 3 Preceding		
Taxable Years	$900,000	
Average QREs ($900,000/3)		$300,000
Excess QREs for 2007		
($600,000 - $300,000)		$300,000
Percentage of Excess QREs		12%
2007 Research Credit		$ 36,000

If the taxpayer had no QREs in any one of the three preceding taxable years, then the credit would be computed by taking 6% of the 2007 QREs, which equates to $36,000 ($600,000 multiplied by 6%). Thus, under the new ASC regime, the financial institution in our first example qualifies for a credit of $36,000, whereas it would receive no credit under the regular method.

Hybrid Method. The new legislation also considers fiscal year-end taxpayers, and provides for a hybrid method to compute the credit. HR 6111 allows a taxpayer to compute the credit by combining two methods, prorated based on the number of days each method was in effect. For example, a taxpayer that has a fiscal year end of June 30, 2007 may compute half of the credit using the regular method or the AIRC method, and the other half of the credit using the ASC method. The two methods of computing the credit would then be combined and reported as a single credit on the 6/30/07 tax return.

APPLICATION OF THE R&D CREDIT TO FINANCIAL INSTITUTIONS

As illustrated by the above examples, the new ASC method will likely have a major impact on financial institutions that have large gross receipts relative to QREs, and companies that can not document their base period QREs and gross receipts under the regular method. Financial institutions may find it difficult to document this information due to numerous mergers, acquisitions, and dispositions that have taken place over the years. Although financial institutions may find it difficult to document information for this period, it is not necessarily impossible, and they should attempt to establish the fixed base percentage where feasible. Once the fixed base percentage is established, it does not change for future credit computations unless there is an acquisition or disposition that could affect the fixed base percentage calculation. If financial institutions can not document the QREs and gross receipts for the period of 1984 through 1988, then the new ASC method will certainly be beneficial. In 2007, taxpayers will have an opportunity to compute each method to determine which one will provide the greatest benefit based on that entity's facts and circumstances.

DEVELOPING ISSUES—DEFINITION OF "INTERNAL-USE" SOFTWARE

The research credit was created in 1981 on the enactment of the Economic Recovery Tax Act.[4] The credit was intended to provide an incentive to taxpayers for increasing levels of qualified research expenditures. In 1986, the definition of qualified research was substantially changed by Congress, which added additional requirements for eligibility.[5] The modified definition contained four requirements, generally referred to as the four-part test, all of which must be met to qualify for the credit. The requirements are:

In 2007, taxpayers will have an opportunity to compute each method to determine which one will provide the greatest benefit based on that entity's facts and circumstances.

1. Expenditures must be deductible under IRC Section 174.
2. The application of the research is intended to be useful in the development of a new or improved business component of the taxpayer.
3. Substantially all the activity is undertaken for the purpose of discovering information that is technological in nature.
4. Substantially all of the research activities constitute elements of a process of experimentation.[6]

While the various interpretations of these requirements have created significant controversy since their inception, final treasury regulations issued in 2003 have put the most controversial of these issues to rest.[7] Most significantly, the notorious "discovery test," a theory widely used by the IRS to disallow research credit claims, has been specifically eliminated by the Treasury Department.[8] In addition, taxpayer favorable changes were made to rules relating to the definition of a "process of experimentation," eliminating a "bright-line test" which had been proposed earlier.[9] Under the final regulations, any process may qualify as long as it is evaluative in nature. Finally, proposed rules for documenting research, specific to the credit, were eliminated from inclusion in the final regulations. Unfortunately, these regulations did not finalize rules relating to internal-use software under Section 41(d)(4)(E), thereby leaving unaddressed an area historically subject to audit dispute.

[4] PL 97-34 (95 Stat. 172).

[5] PL 99-514 (100 Stat. 2085), Tax Reform Act of 1986.

[6] Section 41(d)(1).

[7] TD 9104 (69 Fed. Reg. 22, January 2, 2004).

[8] Reg. 1.41-4(a)(3)(ii).

[9] Reg. 1.41-4(a)(5).

Generally, a financial institution's claim for the research credit will be based on its computer software development expenditures. In the current high-tech electronic commerce environment, this investment in technology is critical for meeting customer demands and for remaining competitive in the marketplace. Today's technology savvy customers demand access to financial products electronically, and real-time information on their accounts. Competition facing a financial institution has also changed, with non-traditional and foreign competitors now posing a serious threat to the domestic industry.

Whether research activities relating to a computer software development project will qualify for the credit may depend on whether the project is considered to be for "internal use." Congress had identified internal-use software development as an activity excluded from the definition of qualified research, except to the extent allowed by regulations.[10] The legislative history of the Tax Reform Act of 1986 reflects this rule and provides examples (not a definition) of internal-use software:

> [T]he costs of developing software are not eligible for the credit where the software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services), except to the extent permitted by Treasury Regulations.[11]

This Conference Report further explains:

> The conferees intend that these regulations will make the costs of new or improved internal-use software eligible for the credit only if the taxpayer can establish, in addition to satisfying the general requirements for credit eligibility, (1) that the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); (2) that the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development and also there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period); and (3) that the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements just stated).[12]

Subsequent regulations have incorporated this Congressional intent, by requiring research in the development of internal-use software to meet an additional three-part test to qualify for the credit. This test, referred to as the high threshold of innovation test, requires: that the software be innovative, that the software development involves significant economic risk, and that the software is not commercially available for use by the taxpayer. Therefore, if a software development project is determined to be for internal-use, three additional tests must be met in addition to the general requirements (i.e. the four-part test) explained above. In light of this elevated standard, the definition of "internal-use" has become critical to financial institutions claiming the credit.

The Treasury Department first addressed the definition of internal-use software in 1997, via proposed regulations. The definition, or more accurately the lack thereof, in the regulations followed the 1986 Conference Report language, stating, in part:

> Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (e)(2) of this section. Generally, research with respect to computer software is not eligible for the research credit where software is used internally, for example, in general and administrative functions … (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services).[13]

The proposed regulations included an exception to the internal-use software definition for certain software developed by the taxpayer as a part of a new or improved package of computer software and hardware developed together as a single product. However, the proposed regulations failed to provide a specific definition of internal-use software. Instead, the regulations stated that the determination would be based on the facts and circumstances of each case:

[10] Section 41(d)(4) provides a list of activities that are excluded from the definition of "qualified research." IRC Section 41(d)(4)(E) states:

> Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in—
>
> (i) an activity which constitutes qualified research (determined with regard to this subparagraph), or
>
> (ii) (ii) a production process with respect to which the requirements of paragraph (1) are met.

[11] HR Conf. Rep. 99-841, 99th Cong., 2d Sess., at 73.

[12] Id.

[13] Prop. Reg. 1.41-4(e)(1) (1997).

> All relevant facts and circumstances are to be considered in determining if computer software is developed primarily for the taxpayer's internal use. If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph (e) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.[14]

Recognizing that there had been dramatic changes in the technological environment of financial institutions and other service industries since the time they directed Treasury to issue regulations, Congress stated, upon extending the credit in 1999:

> In extending the research credit, the conferees are concerned that the definition of qualified research be administered in a manner that is consistent with the intent Congress has expressed in enacting and extending the research credit. The conferees urge the Secretary to consider carefully the comments he has and may receive regarding the proposed regulations relating to the computation of the credit under section 41(c) and the definition of qualified research under section 41(d), particularly regarding the "common knowledge" standard. The conferees further note the rapid pace of technological advance, especially in service-related industries, and urge the Secretary to consider carefully the comments he has and may receive in promulgating regulations in connection with what constitutes "internal use" with regard to software expenditures. The conferees also observe that software research, that otherwise satisfies the requirements of section 41, which is undertaken to support the provision of a service, should not be deemed "internal use" solely because the business component involves the provision of a service.[15]

In an effort to implement this new direction, the Treasury Department issued final regulations in Jan. of 2001.[16] These regulations defined internal-use in the following manner:

> Software is developed primarily for the taxpayer's internal use if the software is to be used internally, for example, in general administrative functions of the taxpayer (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services)....[17]

This definition did little to further define the term "internal-use," but simply described two categories of internal-use software and offered examples of each. The categories, "used internally" and "in providing noncomputer services," now serve as a replacement to the facts and circumstances standard promulgated in the 1997 proposed regulations.

Shortly after its issuance, TD 8930 was suspended for review, in light of the outpour of concern by the taxpayer community.[18] The Treasury Department and the IRS promised to review the regulation and to reconsider comments previously submitted.

A permanent credit would provide certainty to tax planning in this area, and thus allow taxpayers the ability to be bolder in their research investment strategy.

The Treasury Department's most recent attempt to resolve this issue came in the form of proposed regulations issued in December of 2001.[19] These regulations took a novel approach to defining "internal use" by basing it on how the developed software was charged to a customer, not its functionality. The regulations state, in part:

> Unless computer software is developed to be commercially sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties, computer software is presumed developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use.[20]

By incorporating this bright-line test into the definition of internal use, Treasury is tragically ignoring the way that software technology is used by service industries in today's marketplace. The financial services industry provides a perfect example of the technological revolution that has taken place since the credit was enacted in 1986. No longer can a financial institution simply focus its software development efforts on back-room functions (e.g., data processing activities), and expect to remain competitive in the marketplace. Today's electronic marketplace demands that financial institutions offer new products and services based on innovative hardware and software technologies.

Recognizing the concern that the bright-line test contained in the 2001 proposed regulations may be over-inclusive, Treasury and the IRS issued an

[14] Prop. Reg. 1.41-4(e)(4).

[15] H. Rept. 106-478, Conf. Rept. To HR 1180, The Ticket to Work and Work Incentives Improvement Act of 1999, p. 132.

[16] TD 8930, 66 FR 280 (January 3, 2001).

[17] Reg. 1.41-4(c)(6)(iii).

[18] Notice 2001-19, TD 8930 to be reviewed (March 5, 2001).

[19] 66 Fed. Reg. 66362 (December 26, 2001).

[20] Prop. Reg. 1.41-4(c)(6)(iv).

Advance Notice of Proposed Rulemaking, requesting comments from the public.[21] The ANPRM notes several commentators have requested a definition of internal-use based on the functionality of the underlying software (i.e., whether it is customer-facing or for the service provider's own use). The ANPRM explains that incorporating this change may make the definition more complex without providing additional clarity, and thus "could not be readily applied by taxpayers or administered by the IRS."[22] Although tax law administration is clearly a valid concern, it does not justify the promulgation

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of the current bright-line test, which has no basis in statute or legislative history. Further, Treasury and the IRS expressed concern about their ability to effectuate Congressional intent, while also considering technological development taking place in computer software today.[23] While true, Treasury must effectuate Congressional intent in drafting its regulations, that intent should not be viewed in a vacuum.

Since the 1986 Act, the financial institution industry has undergone a technological revolution. The new electronic marketplace has forced financial institutions to create innovative services and distribution channels, which are generally based on computer software technology. Congress clearly realized the importance of continued technological advancement in the service-related industries, as noted in the legislative history of the 1999 Act.[24] A revised definition of internal-use software, excluding software used to interface with customers, will provide considerable incentive to financial institutions to continue technological advancements, as Congress intended.

On a final note, the IRS has included in its Priority Guidance Plan a project addressing "Proposed regulations under Section 41 regarding the exception from the definition of qualified research" for internal use software under Section 41(d)(4)(E).[25] Although there is no guarantee that this project will be completed by the end of the guidance plan year (i.e., June 30, 2007), the recent extension and expansion of the credit will hopefully force this issue to Treasury's front burner.

DEVELOPING ISSUES—PERMANENCY OF THE CREDIT

One of the greatest impairments to the effectiveness of the research credit is its lack of permanency. To date, the credit has expired and been subsequently extended twelve times. A permanent credit would provide certainty to tax planning in this area, and thus allow taxpayers the ability to be bolder in their research investment strategy. In his American Competitiveness Initiative, President Bush noted this impairment along with others (i.e., complexity and antiquated formula) and has supported making the credit permanent.

A permanent credit has also received bi-partisan support in Congress, and a bill requesting this change has recently been introduced by Senate Finance Committee Chair Max Baucus (D-Mont).[26] This bill also proposes to enhance and expand the credit, in order to provide incentives to improve domestic research competitiveness.[27]

CONCLUSION

With the recent two-year extension, AIRC enhancement, and addition of a simplified method, the research credit currently offers a more attractive opportunity for financial institutions than ever before. In addition, with the demise of the "discovery test" and other taxpayer-friendly provisions found in the 2003 Final Regulations, significant audit issues have been eliminated. Finally, the strong bi-partisan support of a permanent credit gives hope for increased certainty in related tax planning in the future.

On the other hand, with the lack of final rules addressing internal-use software, significant areas of controversy still remain. However, financial institutions that are investing significant resources in new technology should not fail to consider claiming the research credit. Congress has clearly stated its intent for service industries to benefit from this incentive in light of the technological advances being developed therein. ■

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21 Announcement 2004-9, 2004-6 IRB 441 (February 9, 2004).

22 Id., within the discussion section.

23 Id.

24 Refer to the Conference Report language quoted above.

25 2006-2007 Priority Guidance Plan (August 15, 2006).

26 S. 41, The Research Competitiveness Act of 2007 (January 4, 2007).

27 Id.