Favorable Ruling in FedEx Case Provides Opportunity for Financial Institutions Developing Internal-Use Software to Claim the Research Tax Credit

MICHAEL A. KRAJCER

In a ruling that provides taxpayers with much needed clarification, the U.S. District Court for the Western District of Tennessee held that the Internal Revenue Service (IRS) could not require the FedEx Corporation (FedEx) to apply the so-called "discovery" test in order to claim the research credit for its development of internal-use software.[1] Although the IRS had previously eliminated the test through final regulations, it had attempted to resurrect the test's imposition via an agency announcement.[2] Based on the district court's ruling, however, financial institutions developing software for internal-use can avail themselves of more favorable standards which will result in a substantially increased ability to qualify those projects for the research credit.

REGULATORY OVERVIEW

Qualification Hurdles. In order to qualify for the research tax credit, research activity must meet the definition of "qualified research" under Code Section 41(d). Per Section 41(d)(4)(E), research on computer software by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer is not considered "qualified research" except to the extent provided in the regulations. The Secretary of the Treasury has issued several sets of regulations addressing the definition of "qualified research," including the requirements for internal-use software development to qualify for the credit.

On January 3, 2001, the Treasury issued final regulations (the "2001 Final Regulations") that were effective for expenditures paid or incurred on or after January 3, 2001, but the regulations addressing internal-use software were applicable to years beginning after December 31, 1985.[3] The 2001 Final Regulations impose a "discovery" test that requires that research be undertaken to "obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering."[4]

Pursuant to the 2001 Final Regulations, the requirements for "internal-use software" to qualify as "qualified research" are:

> (A) The software is innovative in that the software is intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant;
>
> (B) The software development involves significant economic risk in that the taxpayer commits substantial resources to the development and there is a substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period; and
>
> (C) 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 requirements of paragraphs (c)(6)(vi)(A) and (B) of this section.[5]

These three requirements are referred to as the "high threshold of innovation" test, and are imposed

[1] FedEx Corp. v. United States, 2009, U.S. Dist. LEXIS 5986; 2009-1 USTC ¶ 50,435, 103 AFTR 2d 2009-2722 (W.D. Tenn. June 9, 2009).

[2] Announcement 2004-9, 2004-6 IRB 441.

Michael A. Krajcer is the President of Global Tax Consulting LLC. He may be reached by email at michael.krajcer@globaltaxllc.com.

[3] Treas. Reg. § 1.41-4(c) & (d), T.D. 8930, 66 Fed. Reg. 280.

[4] Treas. Reg. § 1.41-4(a)(3).

[5] Treas. Reg. § 1.41(c)(6)(vi)(A)-(C).

in addition to the general four-part test required of all "qualified research." Shortly after these regulations were published, the IRS issued notice that the regulations were under review, but could still be relied upon.[6]

Proposed Changes to 2001 Regulations. On December 26, 2001, the Treasury published related proposed regulations (the "Proposed Regulations"), applicable to taxable years ending on or after December 26, 2001.[7] However, the Proposed Regulations provided expanded application by stating, "Notwithstanding this prospective effective date, Treasury and the IRS believe that these rules prescribe the proper treatment of the expenditures they address, and the IRS generally will not challenge return positions consistent with the proposed regulations."[8]

The Proposed Regulations contained significant changes to the 2001 Final Regulations, including an elimination of the "discovery" test, stating:

> Accordingly, Treasury and the IRS have eliminated in these proposed regulations the requirement that qualified research must be undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering. Rather, Treasury and the IRS believe that the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" is intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not.[9]

In addition, the Proposed Regulations substantially modified the first requirement of the "high threshold of innovation" test to read:

> (A) The software is innovative in that the software is intended to be unique or novel and is intended to differ in a significant and inventive way from prior software implementations or methods[.][10]

This modified definition of "innovation" is substantially more difficult to meet than the previous version, and appears to add its own discovery test for internal-use software development.

"Internal-Use Software" Not Addressed in 2003 Final Regulations. The Proposed Regulations were finalized on December 31, 2003 (the "2003 Final Regulations").[11] Generally, the regulations are applicable to taxable years ending on or after December 31, 2003, however the application period was expanded to taxable years ending before December 31, 2003, if the "return positions are consistent with these final regulations."[12]

The 2003 Final Regulations did not adopt the "internal-use software" test from the Proposed Regulations. In fact no new "internal-use software" test was adopted in the 2003 Final Regulations; instead the relevant section was "Reserved."[13] Subsequently, the IRS acknowledged that the 2003 Final Regulations did not address internal-use software, and provided the following guidance to taxpayers in an Advance Notice of Proposed Rulemaking (ANPR):

> With respect to internal-use software for taxable years beginning after December 31, 1985, and until further guidance is published in the Federal Register, taxpayers may continue to rely upon all of the provisions relating to internal-use software in the 2001 proposed regulations. Alternatively, taxpayers may continue to rely upon all of the provisions relating to internal-use software in T.D. 8930. For example, taxpayers relying upon the internal-use software rules of T.D. 8930 must also apply the "discovery" test as set forth in T.D.8930.[14]

TAXPAYER APPEALS IRS DENIAL OF RESEARCH CREDIT

FedEx claimed $11.6 million of research tax credits on its federal income tax returns for fiscal years ending May 1997 through May 2000, relating to expenditures incurred in developing a new computer business system. The purpose of the new system was to provide better revenue controls to ensure timely and accurate billing and to eliminate "revenue leakage." No system was currently commercially available to meet all of FedEx's requirements, and FedEx eventually abandoned the project because of technological challenges that were too great to overcome.

The IRS denied the research credits relating to the project, whereby, the taxpayer paid the assessed taxes and filed a claim in district court. As part of its recovery action, plaintiff FedEx filed a motion for partial summary judgment on the legal standards governing the research credits in question. FedEx sought summary judgment on the legal standards for the "discovery" test under Section 41(d)(1)(B) and the "internal-use

[6] Notice 2001-19; 2001-10 IRB 784.

[7] Proposed Treas. Reg. § 1.41-4(c) & (d), 66 Fed. Reg. 66362 (Dec. 26, 2001).

[8] Id.

[9] Id. in Preamble.

[10] Proposed Treas. Reg. 1.41-4(c)(6)(vi).

[11] Treas. Reg. § 1.41-4(d), TD 9104, 69 Fed. Reg. 22.

[12] Id.

[13] Id.

[14] Announcement 2004-9, 2004-6 IRB 441 (Feb. 9, 2004) (internal footnote omitted).

software" test under Section 41(d)(4)(E). More specifically, FedEx argued that it could use the "internal-use software" test included in regulations issued in 2001 without having to comply with the accompanying "discovery" test, which was eliminated in subsequent regulations. The IRS disagreed, citing its own published announcement holding otherwise.

DISTRICT COURT'S RULING OFFERS COMFORT TO TAXPAYERS

In granting FedEx the motion for partial summary judgment the court held that a taxpayer may rely upon the "internal-use software" test articulated in the 2001 Final Regulations simply because the legal standard had never been amended. Clearly the 2003 Final Regulations did not amend the legal standard, since those regulations purposefully did not address the issue, reserving the matter for the future. The district court also stated, "The Treasury could have issued Temporary Regulations to address the 'internal-use software' provision, but the IRS chose, instead, to rely on an announcement to articulate its position. The 2004 Announcement does not override the Treasury's 2003 Final Regulations, which carry the force and effect of law."[15]

[15] FedEx Corp,, 2009 U.S. Dist. LEXIS 59856, at *15.

The court also held that use of the ANPR to reincarnate the "discovery" test was impermissible, stating:

> An agency's interpretation of its own regulation is owed substantial deference only when it is consistent with the regulation it interprets. The Court is not required to defer to the IRS' interpretation "if an 'alternative reading is compelled by . . . other indications of the [IRS'] intent at the time of the regulation's promulgation.'" . . . When the Proposed Regulations and the 2003 Final Regulations were promulgated, the Treasury and the IRS clearly stated their intent to revise the "discovery" test to reflect Congressional intent. The IRS' subsequent attempt to require Plaintiff to adhere to the "discovery" test embodied in the 2001 Final Regulations is contrary to the IRS' stated intent in adopting the 2003 Final Regulations and contrary to the IRS' stated understanding of Congressional intent. Accordingly, the IRS' interpretation in the 2004 Announcement is not due substantial deference.[16]

As the IRS had clearly recognized the fact in published regulation that the "discovery" test does not reflect congressional intent, its subsequent announcement imposing the same test is invalid. Therefore, FedEx can rely upon the "internal-use software" test articulated in the 2001 Final Regulations (including the favorable "innovation" definition), while not subjecting itself to the "discovery" test.

[16] Id.

PRACTICAL IMPLICATIONS FOR FINANCIAL INSTITUTIONS

Financial institutions continue to invest significant resources into business system software development, in order to create and maintain a competitive advantage. This software will generally fall under the definition of "internal-use," and as such be subject to a higher standard of qualification for the research credit than is otherwise required. However, based on the ruling of the court in *FedEx*, the qualifying standard for internal-use software is considerably lower than what the IRS had announced. A financial institution now has specific authority to cite for not applying the "discovery" test while still taking advantage of a much simpler and easily attainable standard of innovation. ■

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