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Taxpayer-Favorable Regulations Expand the R&D Tax Credit for Customer-Facing Software Development

Recognizing the vital role that computer technology plays in the U.S. economy, the IRS has issued proposed regulations expanding the research credit for software development. Financial institutions in particular will benefit from these new rules, which focus on software that enables third-party interaction with businesses. Financial institutions investing in technologies to deploy and support solutions such as online banking, online investment services, web-based insurance quoting services, and mobile apps, may now have part of the related development expense subsidized by federal and state governments. The newly proposed regulations continue a recent line of "pro-taxpayer" regulations relating to the research credit, which will expand the utilization of this incentive and reduce the controversy that has historically existed in this area.

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For a financial institution considering claiming the Internal Revenue Code Section 41 Credit for Increasing Research Activities (the "research credit") relating to its software development activities, a primary question is whether or not the developed software was intended for internal use. The answer to this question will determine the number of requirements that must be met for credit qualification. If the software was intended for internal use, there are additional requirements for credit qualification, which do not apply to non-internal-use software. These additional requirements act to hold internal-use software (IUS) to a heightened qualification standard, and thus may prevent some development activity from qualifying for the credit.

Recently proposed regulations have revised the definition of IUS, specifically excluding third-party interactive-type software from the definition—and thus from having to meet the related additional qualification requirements.[1] These regulations will serve to greatly expand the credit, and should reduce controversy between taxpayers and the IRS. In the Preamble to the regulations, Treasury explains:

> The role that computer software plays in business activities is very different today than it was when the exclusion for internal use software was enacted in 1986. Today, computer software is used in all aspects of business activity, especially in providing goods and services to third parties, and such software has played a vital role in increasing the productivity of the U.S. economy and in making the U.S. more competitive globally.[2]

To recognize the increasing impact that software has on both business operations and the overall domestic economy, the regulations are meant to limit the definition of IUS to software developed primarily for, "use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business."[3] This definition is intended to

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[1] Prop. Treas. Reg. § 1.41-1, 80 Fed. Reg. 2624, 2635 (Jan. 20, 2015).

[2] Id. at 2626.

[3] Id.

target back-office functions, which, regardless of their industry, most businesses would have. And now, under the proposed regulations, software that is developed with the intent of facilitating third-party interaction will not be defined as internal use, as well as software developed to be commercially sold, leased, or licensed.

The Preamble includes specific examples of software which will now be excluded from the definition of internal use:

- Executing banking transactions;
- Tracking the progress of delivered goods;
- Searching a retailer's inventory;
- Storing and retrieving a third party's digital files;
- Purchasing tickets for transportation or entertainment; and
- Receiving services over the internet.

Software development in the following areas should now be treated as non-internal-use software: personal and business online portals, product application systems, online banking applications, mobile banking applications, insurance quoting systems, and online bill paying/ funds transfer/statement retrieval.

Specific to financial institutions, software development in the following areas should now be treated as non-internal-use software: personal and business online portals, product application systems, online banking applications, mobile banking applications, insurance quoting systems, and online bill paying/ funds transfer/statement retrieval.

In addition to redefining IUS, the proposed regulations address the additional requirements for qualification that IUS development must meet to be credit eligible. The three additional requirements, collectively referred to as the "high threshold of innovation test," include tests for innovation, significant economic risk, and commercial availability. While the innovation test and commercial availability test were incorporated into the regulations with little to no change, the significant economic risk test was purposefully enhanced. As proposed, the development uncertainty required under this test would no longer be met if solely "appropriate design" uncertainty is involved. There now must be uncertainty in either the capability or method of developing the software for the test to be met, regardless of whether clear design uncertainty exists at the outset of the development. If the requisite uncertainty does exist, the test requires that, due to that uncertainty, there be a risk that substantial resources devoted to the development may not be recovered within a reasonable time.

Given that the high threshold of innovation test for IUS may now be more of a challenge for taxpayers to meet, it will be imperative to identify and document non-IUS development clearly and accurately so as to avoid the test altogether. Note that the purpose that the software is intended for will be determined at the beginning of the software development. Therefore, it will be critically important going forward for taxpayers to address and document the intended function of planned software development, especially relating to customer-facing features, at the outset of the project.

BACKGROUND TO THE PROPOSED REGULATIONS

The need for regulations relating to the definition and eligibility requirements of IUS arose because when the research credit was enacted under the Tax Reform Act of 1986 (TRA 86),[4] software developed for internal use was generally excluded. Code Section 41(d)(4)(E) provides:

> Computer software. 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) a production process with respect to which the requirements of paragraph (1) are met.

As noted in the statute, Congress authorized the Treasury Department to issue regulations describing circumstances under which IUS may qualify for the credit. The legislative history of TRA 86 sheds some light on what Congress intended to be treated as IUS at the time:

> Accordingly, the 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.[5]

[4] P.L. 99-514 (100 Stat. 2085), Tax Reform Act of 1986.

[5] H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess., at 73.

The legislative history also describes a high threshold of innovation test, made up of three parts, all of which must be met in addition to meeting the general four-part test for credit eligibility:

> 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).[6]

The last word from Congress on the matter came in 1999, when the credit was extended as part of the Tax Relief Extension Act of 1999.[7] In advice offered to Treasury, Congress noted that regulations should be written to reflect the advancement in technology that has helped to drive the growth in service-related industries. In addition, Congress cautioned that the function of the software, provision of a service, should not be a sole determining factor for IUS categorization. The report states:

> 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.[8]

PRIOR REGULATORY GUIDANCE

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

> 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).[9]

In addition, these regulations require that the determination of whether computer software is developed for internal use be based on all the relevant facts and circumstances of each case.[10] Finally, the legislative history's three-part high threshold of innovation test was incorporated under these regulations.[11]

In an effort to provide further guidance, the Treasury Department issued final regulations in January 2001.[12] These regulations incorporated the same general definition of IUS that was utilized in the 1997 regulations, but also provided separate rules for software used to deliver computer services and software used to deliver noncomputer services. In addition, the facts-and-circumstances standard promulgated in the 1997 proposed regulations was not included in the 2001 final regulations.

Shortly after issuance, the 2001 final regulations were suspended for review, The Treasury Department and the IRS promised to review the regulation and to reconsider comments previously submitted.[13]

The Treasury Department follow up to the review of the 2001 final regulations, came in the form of proposed regulations issued in December of 2001.[14] These regulations took a new approach to defining "internal use," basing the definition on how the developed software was charged to a customer, not on 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.[15]

[6] Id.

[7] P.L. 106-170 (113 Stat. 1860, 1999).

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

[9] Prop. Treas. Reg. § 1.41-4(e)(1) (1997).

[10] Prop. Treas. Reg. § 1.41-4(e)(4) (1997).

[11] Prop. Treas. Reg. § 1.41-4(e)(5) (1997).

[12] T.D. 8930, 66 Fed. Reg. 280 (January 3, 2001).

[13] Notice 2001-19, T.D. 8930 to be reviewed (Mar. 5, 2001).

[14] Prop. Treas. Reg. § 1.41-4, 66 Fed. Reg. 66362 (Dec. 26, 2001).

[15] Prop. Treas. Reg. § 1.41-4(c)(6)(iv)(2001).

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These regulations also revised the innovation requirement of the high threshold of innovation test to read, "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."[16]

Recognizing the concern that the bright-line test contained in the 2001 proposed regulations may be over-inclusive, the Treasury Department and the Internal Revenue Service issued an Advance Notice of Proposed Rulemaking, requesting comments from the public.[17]

THE 2015 PROPOSED REGULATIONS

Published in the Federal Register on January 20, 2015, the proposed regulations address a number of topics. As detailed below, the regulations propose a new definition of IUS and non-IUS; clarify the intent of, and revise, some components of the high threshold of innovation test; and provide examples of the proper application of the process of experimentation test, which applies to all computer software development.

No longer will software fall under the IUS definition solely because it lacked a separate charge for its usage. In addition, the new definition eliminates altogether software developed for "noncomputer services."

Internal-Use Software Defined. The Preamble notes the difficulty of reconciling a current and useful definition of IUS with congressional intent formulated almost 30 years ago, stating, "The role that computer software plays in business activities is very different today than it was when the exclusion for internal use software was enacted in 1986."[18] All aspects of business activity now use computer software, and it has increased the productivity of the economy in the U.S. and made it more globally competitive.[19] Accordingly, the definition of IUS should evolve, and has in these regulations.

The regulations define IUS as follows:

> Computer software is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use if the software is developed for use in *general and administrative functions* that facilitate or support the conduct of the taxpayer's trade or business.[20]

In addition, if the taxpayer develops software for the internal use of a related party, it will be classified as IUS.[21]

The new definition of IUS is very limited in scope compared to the 2001 proposed regulations' presumptive approach.[22] No longer will software fall under the IUS definition solely because it lacked a separate charge for its usage. In addition, the new definition eliminates altogether software developed for "noncomputer services," which had been part of the definition in both the 1997 proposed regulations and 2001 final regulations.

The regulations contain an extensive list of these "general and administrative" functions, for which related software development will be considered IUS, as follows:

> (1) Financial management. Financial management functions are functions that involve the financial management of the taxpayer and the supporting recordkeeping. Financial management functions include, but are not limited to, functions such as accounts payable, accounts receivable, inventory management, budgeting, cash management, cost accounting, disbursements, economic analysis and forecasting, financial reporting, finance, fixed asset accounting, general ledger bookkeeping, internal audit, management accounting, risk management, strategic business planning, and tax.
>
> (2) Human resources management. Human resources management functions are functions that manage the taxpayer's workforce. Human resources management functions include, but are not limited to, functions such as recruiting, hiring, training, assigning personnel, and maintaining personnel records, payroll, and benefits.
>
> (3) Support services. Support services are other functions that support the day-to-day operations of the taxpayer. Support services include, but are not limited to, functions such as data processing, facility services

[16] Prop. Treas. Reg. § 1.41-4(c)(6)(vi)(A) (2001).

[17] Announcement 2004-9, 2004-6 IRB 441 (Feb. 9, 2004).

[18] Prop. Treas. Reg. § 1.41-4(c)(6) Preamble, 80 Fed. Reg. at 2626 (2015).

[19] Id.

[20] Prop. Treas. Reg. § 1.41-4(c)(6)(iii), 80 Fed. Reg. at 2631 (2015) (emphasis added).

[21] Id. A related party is any corporation, trade or business, or other person that is treated as a single taxpayer with the taxpayer pursuant to IRC § 41(f).

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

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(for example, grounds keeping, housekeeping, janitorial, and logistics), graphic services, marketing, legal services, government compliance services, printing and publication services, and security services (for example, video surveillance and physical asset protection from fire and theft).[23]

As noted in the Preamble, this list is intended to target back-office functions, which, regardless of their industry, most taxpayers would have. However, the pertinent function must also be analyzed in light of the industry that the taxpayer operates in. For example, tax software may not be used in a general and administrative function for a taxpayer in the tax services industry, while in other industries it will.

Not-Internal-Use Software Defined. Computer software will not be considered IUS if it is developed either:

- To be commercially sold, leased, licensed, or otherwise marketed to third parties; or
- To enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system.[24]

The purpose for which the software is intended will be determined at the outset of the software development. The determination will take into account the relevant facts and circumstances, and may change over time if the intended function changes.

The first part of this non-IUS definition is a partial carryover from the 2001 proposed regulations' "presumption of IUS" definition, but it eliminates the requirement of a separately stated consideration for the software. The pared down definition of non-IUS purposes is clearly a favorable change, offering certainty for a large category of software.

The second part of the definition is brand new to the regulations in this area, and will significantly benefit financial institutions and taxpayers in many other industries. It would be reasonable to assume that the development of online portals, online banking systems, mobile banking applications, online product application systems, product quoting systems, and customer searchable databases will all now be non-internal software under these regulations. In addition, the related development of security systems, fraud detection applications, and legacy system interfaces would arguably fall under this definition as well, as they allow for the third-party interaction to take place in a secure and controlled environment.

[23] Prop. Treas. Reg. § 1.41-4(c)(6)(iii), 80 Fed. Reg. at 2631 (2015).

[24] See Id.

Dual-Function Computer Software. The regulation drafters astutely recognized that developed software may certainly include both internal-use and non-internal-use elements, and therefore provided guidance on how to properly treat these situations for credit-calculation purposes. The regulations provide that dual-function software is presumed to be internal-use.[25] However, to the extent a subset of not-for-internal-use software can be identified, the presumption will not apply. To assist in the administration of situations where dual-function software is being developed, the regulations include a safe harbor method for calculating qualifying expenses of the subset.

To utilize the safe harbor, taxpayers must use an objective reasonable method to show that at least 10 percent of the dual-function software's use is reasonably estimated to be for third-party use or to allow the taxpayer to interact with third parties.

The pared down definition of non-IUS purposes is clearly a favorable change, offering certainty for a large category of software.

This estimate must take place at the beginning of the software development, and be based on an objective and reasonable method. If this minimum usage can be shown, then the taxpayer may claim 25 percent of the dual-function subset's qualified research expenditures in its credit calculation.

Exhibit 1 illustrates the application of the safe harbor; it is based on the example provided in the proposed regulation.

High Threshold of Innovation Test. As noted earlier, the high threshold of innovation test contains three separate requirements, which are applicable only to activities classified as IUS development. For IUS development to qualify for the research credit, all three of these requirements must be met, along with the general four requirements that all research and development is subject to for purposes of the credit.[26] Therefore, it is clear that a higher standard of eligibility exists for internal-use software than for other business components. However, the Preamble states:

> . . . it is clear that Congress intended that some software developed primarily for internal use would

[25] Prop. Treas. Reg. § 1.41-4(c)(6)(iv)(C), 80 Fed. Reg. at 2631 (2015).

[26] Per IRC § 41(d)(1) and generally referred to as the four-part test, all of which must be met to qualify for the credit. The requirements are:

1. Expenditures must be deductible under IRC § 174;

Exhibit 1: Application of Dual-Application Software Safe Harbor Rules

Facts:

Taxpayer develops computer software that Taxpayer uses in general and administrative functions that facilitate or support the conduct of Taxpayer's trade or business and that allows third parties to initiate functions. Taxpayer is unable to identify the third-party subset. Taxpayer incurs $50,000 of research expenditures for the computer software.

Taxpayer uses an objective, reasonable method at the beginning of the computer software development to determine that the use by third parties of the dual-function computer software to initiate functions is reasonably anticipated to constitute 75 percent of the software's total use.

Conclusion:

The computer software developed by Taxpayer is dual-function computer software and is presumed to be developed primarily for internal use under Proposed Treasury Regulation Section 1.41-4(c)(6)(iv)(C)(1). Although unable to identify a specific third-party subset, Taxpayer reasonably anticipates that the dual-function computer software's use by third parties is at least 10 percent of the software's total use. If Taxpayer's research activities related to the development or improvement of the dual-function computer software (1) constitute qualified research under Section 41(d), without regard to Section 41(d)(4)(E), and (2) the allocable expenditures are qualified research expenditures under Section 41(b), Taxpayer may include $12,500 (i.e., $50,000 x 25%) of the research expenditures related to the dual-function computer software in computing the amount of Taxpayer's credit pursuant to Proposed Treasury Regulation Section 1.41-4(c)(6)(iv)(C)(3).[a]

[a] See Prop. Treas. Reg. § 1.41-4(c)(6)(iv)(C), 80 Fed. Reg. at 2632 Example 2 (2015). Note, the facts were modified as instructed in the regulations.

> meet the high threshold of innovation test. Accordingly, the requirements should not be so restrictive as to make the test impossible to meet. The proposed regulations provide rules of application with respect to the high threshold of innovation test that reflect this purpose.[27]

Although it should be simply assumed by the presence of eligibility tests that IUS can qualify for the research credit, it is encouraging to see that Treasury and the IRS make this affirmation. In practice, it is not unusual for the IRS and its associates to take a different view. Hopefully, with this clear direction being provided to the IRS and practitioners alike, present and future controversy can be resolved in a more appropriate and timely fashion.

Innovation. The regulations do an excellent job of clarifying this component of the high threshold of innovation test, which recently has caused considerable controversy due to the multiple definitions of the test provided for in earlier regulations.[28] The definition follows the 1986 legislative history, and confirms the development need not be successful to pass this test. The regulations provide:

> Software is innovative if the software would result in a reduction in cost or improvement in speed or other measurable improvement, that is substantial and economically significant, if the development is or would have been successful.[29]

The proposed definition of innovation provides taxpayers with an approach that is measurable and objective, and generally could be satisfied using documentation which has already been prepared for other business purposes. For example, to justify the need (or more likely, the budget) for a new development project, the benefits expected to be enjoyed by such development are generally documented for

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; and,

4. Substantially all of the research activities constitute elements of a process of experimentation.

[27] Prop. Treas. Reg. § 1.41-4(c)(6) Preamble, 80 Fed. Reg. at 2628 (2015).

[28] See generally Michael A. Krajcer, "Favorable Ruling in FedEx Case Provides Opportunity for Financial Institutions Developing Internal-Use Software to Claim the Research Tax Credit," 25(4) J. Tax'n & Reg. Fin. Insts. 57 (Mar./Apr. 2012).

[29] Prop. Treas. Reg. § 1.41-4(c)(6)(v)(B), 80 Fed. Reg. at 2633 (2015).

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purposes of presentation to an approval committee. This documentation generally would also include an estimated amount of such benefit (or would note the cost of not going forward with the project). *Practice pointer:* If this information is not presently being prepared, it will be necessary, going forward, for such analysis to be completed and documented for credit eligibility purposes.

Significant Economic Risk. Per the Preamble, in order to be consistent with legislative history, the significant economic risk requirement of the high threshold of innovation test requires that "substantial uncertainty" exist that substantial resources invested in the development will not be recovered within a reasonable time period.[30] In order to create the higher threshold for eligibility that was intended by Congress for IUS, the regulations define "substantial uncertainty" to mean that information does not exist at the outset of a project to establish the capability or method for developing the new or improved software.[31] This definition of the significant economic risk requirement thus incorporates an economic and technical risk, which will not be satisfied if the only technical uncertainty that exists at the outset of the development surrounds the appropriate design of the software.

By removing the "appropriate design" as an eligible technical uncertainty, Treasury has created new challenges for both the taxpayer and the IRS:

- *For the taxpayer*: The taxpayer now must try to separately document the uncertainties of capability, methodology, and appropriate design—and this may be impossible, since one uncertainty may be creating the others or may eventually lead to additional uncertainties as development proceeds. Since the determination has to be made at the outset of the development, this interplay of uncertainties is subjective at best. This effort will require a significant investment in resources to generate the documentation, an investment which has no business purpose or other benefit to the taxpayer. Imposing significant additional recordkeeping requirements will only add to the already overwhelming burden forced on taxpayers to claim the research credit.

- *For the IRS:* The IRS will have to deal with the bifurcation of uncertainties as well, and possibly will be forced to make judgement calls in a very subjective area.

These situations can only lead to an increase in controversy, a situation that the regulations should be drafted to avoid. One can expect that this provision of the proposed regulations will receive significant attention during the comment period, and at the scheduled public hearing on the regulations.

Commercially Available. The proposed regulations are consistent with prior regulations regarding the commercially available standard, which state:

> 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.[32]

By removing the "appropriate design" as an eligible technical uncertainty, Treasury has created new challenges for both the taxpayer and the IRS.

Applying the High Threshold of Innovation Test to IUS. To provide further guidance and reduce potential controversy, the regulations provide a series of 13 examples relating to the definition of IUS and application of the high threshold of innovation test. One of the more favorable changes to the test's application that is reflected in these examples is the elimination of a "common knowledge of skilled professionals" comparative assessment for uncertainty and technical risk that had been incorporated in earlier regulations. In addition, as the example in Exhibit 2 clearly demonstrates, the significant economic risk test (described above) is applied to the uncertainty level in existence at the outset of development, not to the degree of innovation ultimately achieved by the development.

The example in Exhibit 2 will likely have broad applicability, including to financial institutions. The is fact pattern in the example—specifically, having a significant need and desire to redesign a multitude of disparate software applications into a single system, but not having the luxury of being able to purchase a system with the requisite functionality—is quite common to financial institutions. In many instances,

[30] Prop. Treas. Reg. § 1.41-4(c)(6) Preamble, 80 Fed. Reg. at 2628 (2015).

[31] Prop. Treas. Reg. § 1.41-4(c)(6)(v)(C), 80 Fed. Reg. at 2633 (2015).

[32] Prop. Treas. Reg. § 1.41-4(c)(6)(v)(A)(3), 80 Fed. Reg. at 2632 (2015).

there will also be legacy-system interfacing limitations that make purchasing a complete prepackaged system impossible. The need to use older technology is also quite common when an institution has to build systems internally which must have the ability to interface with unique legacy systems. As noted in the example, the use of older technology can create substantial uncertainty in its own right. Finally, uncertainty would not be uncommon at the outset of a development project relating to a brand new system. Whether the proposed software could in fact be developed within a reasonable timeframe, given the functionality, database architecture, and technology uncertainties that will generally exist, will more likely than not be in question.

REGULATION EFFECTIVE DATE

Generally, proposed regulations are not effective until the "notice and comment" process has been completed, and the Treasury Decision is published in the Federal Register adopting the rules as final regulations. However, the IRS has stated that it will not challenge return positions consistent with these proposed regulations for taxable years ending on or after the date the proposed regulations are published. Treasury and the IRS have also said that the regulations are intended to be prospective only. For taxable years ending prior to the date that the proposed regulations are published in the Federal Register, taxpayers may choose to follow either all of the internal use software provisions of Treasury Regulations

Exhibit 2: Application of the High Threshold of Innovation Test to IUS

Facts:

X maintained separate software applications for tracking a variety of human resource (HR) functions, including employee reviews, salary information, location within the hierarchy and physical location of employees, 401(k) plans, and insurance coverage information. X determined that improved HR efficiency could be achieved by redesigning its disparate software applications into one employee-centric system, and worked to develop that system. X also determined that commercially available database-management systems did not meet all of the requirements of the proposed system. Rather than waiting several years for vendor offerings to mature and become viable for its purpose, X embarked upon the project utilizing older technology that was severely challenged with respect to data-modeling capabilities. The improvements, if successful, would provide a substantial and economically significant reduction in cost and improvement in speed. For example, having one employee-centric system would eliminate the need to manually enter basic employee information separately in each application (a costly and time-consuming task); the information would have to be entered only once, and would then be available across all applications. The limitations of the technology X was attempting to utilize required that X attempt to develop a new database architecture. X committed substantial resources to the project, but was not certain it could successfully develop the database software in the timeframe necessary so that X could recover its resources in a reasonable period.

Specifically, X was uncertain whether it could develop, within a reasonable period, a new database architecture using the old technology that would resolve its technological issues regarding the data modeling capabilities and the integration of the disparate systems into one system. At the beginning of the development process, X did not intend to develop the software for sale. The software did not enable X to interact with third parties or allow third parties to initiate functions or review data.

Conclusion:

The software is IUS because it is developed primarily for use in a general and administrative function. However, the software satisfies the high threshold of innovation test set forth in Proposed Treasury Regulation Section 1.41-4(c)(6)(v). The software was intended to be innovative in that it would provide a reduction in cost or improvement in speed that is substantial and economically significant. In addition, X's development activities involved significant economic risk in that (1) X committed substantial resources to the development and (2) there was substantial uncertainty, because of technical risk, that the resources would be recovered within a reasonable period. Finally, at the time X undertook the development of the system, software meeting X's requirements was not commercially available for use by X.[a]

[a] See Prop. Treas. Reg. § 1.41-4(c)(6)(vi) Example 10, 80 Fed. Reg. at 2634 (2015).

Section 1.41-4(c)(6) in Treasury Decision 8930 *or* all of the internal use software provisions in the 2001 proposed regulations.

CONCLUSION

The proposed regulations provide a significant opportunity for financial institutions conducting customer-facing software development to claim the research credit. No longer will these activities be subject to the heightened requirements mandated for internal-use software, and thus they are more likely to qualify for the credit.

In addition, these regulations provide taxpayers with clarity as to (1) the definition of the three requirements that make up the high threshold of innovation test for IUS and (2) the process of experimentation test that all software development is subject to. Given this clarity and, now, the ability to plan the preparation of requisite supporting documentation, taxpayers should have a better chance in the future of sustaining credits claimed for software development, whether it is for internal use or not. ■

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