

software. In addition, the Treasury Department and the IRS request comments on whether final rules relating to internal-use software should have retroactive effect.

Background

Section 41(d)(4)(E) provides that, except to the extent provided by regulations, research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer (internal-use software) is excluded from the definition of qualified research under section 41(d). (Software that is developed for use in an activity which constitutes qualified research and software that is developed for use in a production process with respect to which the general credit eligibility requirements are satisfied are not excluded as internal-use software under the provisions of section 41(d)(4)(E).) The statutory exclusion for internal-use software and the regulatory exceptions to this exclusion have been the subject of a series of proposed and final regulations.

Legislative History

The legislative history to the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) (1986 Act), states that "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." See H.R. Conf. Rep. No. 841, at II-73 (1986 legislative history). The 1986 legislative history further states that Congress intended that regulations would make the costs of new or improved internal-use software eligible for the credit only if the research satisfies, in addition to the general requirements for credit eligibility, an additional, three-part high threshold of innovation test (*i.e.*, that the software was innovative, that the software development involved significant economic risk, and that the software was not commercially available for use by the taxpayer).

Congress has extended the research credit a number of times since the 1986 Act but has not made any changes to the statutory definition of qualified research or to the statutory exclusion for internal-use software in section 41(d)(4)(E). When Congress extended the research credit in the Tax Relief Extension Act of 1999, Public Law 106-170 (113 Stat. 1860) (1999 Act), however, the

legislative history stated the following with respect to internal-use software:

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 wish to 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.

H.R. Conf. Rep. No. 106-478, at 132 (1999).

1997 Proposed Regulations

On January 2, 1997, the Treasury Department and the IRS published proposed regulations (REG-209494-90, 1997-1 C.B. 723) in the **Federal Register** (62 FR 81) under section 41 relating to internal-use software (1997 proposed regulations). In relevant part, the 1997 proposed regulations stated:

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).

Prop. § 1.41-4(e)(1) (1997).

The 1997 proposed regulations contained an exception to the internal-use software rules 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. Such software would not be subject to the high threshold of innovation requirements for internal-use software under the 1997 proposed regulations. The 1997 proposed regulations, however, did not contain a specific definition of internal-use software. Instead, the 1997 proposed regulations provided that the determination of whether software was internal-use software would depend on the facts and circumstances of each case:

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.

Prop. § 1.41-4(e)(4) (1997).

2001 Final Regulations (TD 8930)

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 280) final regulations (TD 8930) relating, in relevant part, to the definition of internal-use software for purposes of section 41(d)(4)(E). With respect to the general definition of internal-use software, TD 8930 provided:

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). If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph (c)(6) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

§ 1.41-4(c)(6)(iv). TD 8930, therefore, did not provide a specific definition of internal-use software but instead identified two general categories of software as examples of internal-use software: software "used internally" and software used "in providing noncomputer services." TD 8930 eliminated the general facts and circumstances standard contained in the 1997 proposed regulations.

The preamble to TD 8930 addressed the requests made by some commentators that the definition of internal-use software exclude software used to deliver a service to customers and software that includes an interface with customers or the public. The preamble stated that after careful analysis of the legislative history, the Treasury Department and the IRS had concluded that such broad exclusions would be inconsistent with the statutory mandate, because the exclusion would extend to some software that Congress clearly intended to treat as internal-use software. The preamble, however, continued by highlighting changes that had been made in TD 8930 to take into account the commentators' concerns as well as the legislative history to the 1999 Act.

First, TD 8930 provided that the high threshold of innovation test applicable to internal-use software does not apply to software used to provide computer services (defined in TD 8930 generally as a service offered by a taxpayer to customers who conduct business with the taxpayer primarily for the use of the taxpayer's computer or software technology). In contrast, software used