

to provide a noncomputer service (defined in TD 8930 generally as a service other than a computer service, even if such other service is enabled, supported, or facilitated by computer or software technology) would be subject to the high threshold of innovation test under TD 8930.

Second, TD 8930 contained a new exception to the high threshold of innovation test for internal-use software for software used to provide a noncomputer service if the software, among other things, contained features or improvements not yet offered by a taxpayer's competitors. In describing this exception, the preamble to TD 8930 stated:

This exercise of regulatory authority [to create the exception for certain software used to provide non-computer services] is based on a determination that the development of software containing features or improvements that are not available from a taxpayer's competitors and that provide a demonstrable competitive advantage is more likely to increase the innovative qualities and efficiency of the U.S. economy (by generating knowledge that can be used by other service providers) than is the development of software used to provide noncomputer services containing features or improvements that are already offered by others. IRS and Treasury believe that drawing such a line is an appropriate way to administer the credit with a view to identifying and facilitating the credit availability for software with the greatest potential for benefiting the U.S. economy, an important rationale for the research credit.

In response to taxpayer concerns, on January 31, 2001, the Treasury Department and the IRS published Notice 2001-19 (2001-10 I.R.B. 784), announcing that the Treasury Department and the IRS would review TD 8930 and reconsider comments previously submitted in connection with the finalization of TD 8930.

### 2001 Proposed Regulations

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 66362) a notice of proposed rulemaking (REG-112991-01) reflecting their review of TD 8930 (2001 proposed regulations). The 2001 proposed regulations revised the definition of internal-use software as compared to the definitions contained in the 1997 proposed regulations and TD 8930. The definition in the 2001 proposed regulations was based on a presumption that turns on whether the software is developed to be commercially sold, leased, licensed, or otherwise marketed for separately stated consideration:

*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. For example, the computer software may serve general and administrative functions of the taxpayer, or may be used in providing a noncomputer service. General and administrative functions include, but are not limited to, functions such as payroll, bookkeeping, financial management, financial reporting, personnel management, sales and marketing, fixed asset accounting, inventory management and cost accounting. Computer software that is developed to be commercially sold, leased, licensed or otherwise marketed, for separately stated consideration to unrelated third parties is not developed primarily for the taxpayer's internal use. The requirements of this paragraph (c)(6) apply to computer software that is developed primarily for the taxpayer's internal use even though the taxpayer subsequently sells, leases, licenses, or otherwise markets the computer software for separately stated consideration to unrelated third parties.*

Prop. § 1.41-4(c)(6)(iv) (2001) (emphasis added).

As explained in the preamble to the 2001 proposed regulations, this "separately stated consideration" standard reflected the Treasury Department and the IRS' determination that software that is sold, leased, licensed, or otherwise marketed, for separately stated consideration to unrelated third parties is software that is intended to be used primarily by the customers of the taxpayer, whereas software that does not satisfy this requirement is software that is intended to be used primarily by the taxpayer for its internal use or in connection with a noncomputer service provided by the taxpayer. The 2001 proposed regulations modified the hardware-software exception and continued to provide that software used to provide computer services was not required to satisfy the additional qualification requirements imposed on internal-use software. The new proposed regulations, however, eliminated the special rule in TD 8930 for certain software used to provide noncomputer services. The preamble to the 2001 proposed regulations explained that "[d]ue to other revisions contained in these proposed regulations, Treasury and the IRS believe that the computer software targeted by this rule generally would be credit eligible without this rule."

The preamble to the 2001 proposed regulations also addressed the continued concerns expressed by some commentators that the definition of internal-use software should not include software used to deliver a service to customers and software that includes an interface with customers or the public.

In addition to repeating the Treasury Department and IRS' concern that such exclusions may conflict with Congress' intent regarding software used in the provision of noncomputer services, the preamble stated that an exclusion for software that includes an interface with customers or the public would entail substantial administrative difficulties and "may inappropriately permit certain categories of costs (e.g., certain web site development costs) to constitute qualified research expenses without having to satisfy the high threshold of innovation test."

### Discussion

Prior regulatory guidance generally reflects three approaches to the definition of internal-use software. First, the 1997 proposed regulations closely mirrored the language contained in the legislative history but did not provide a specific definition of internal-use. Instead, the 1997 proposed regulations used the "general and administrative functions" and "noncomputer services" language from the legislative history as examples of internal-use software and provided that the determination of whether particular software was internal-use software required an evaluation of "all relevant facts and circumstances."

TD 8930 then attempted to provide greater specificity regarding the definition of internal-use software. Although TD 8930 eliminated the facts and circumstances test in the 1997 proposed regulations, TD 8930 continued to provide a general definition of internal-use software that incorporated the legislative history's examples of general and administrative functions and non-computer services. Additionally, TD 8930 provided that software used by the taxpayer to provide "computer services" was not subject to the high threshold of innovation test applicable to internal-use software, and provided definitions of *computer services* and *noncomputer services*. The exception for computer services software, however, required a determination of the primary reason why a taxpayer's customers conduct business with the taxpayer. TD 8930 also applied this exception to certain software used to provide "noncomputer services" provided that the software satisfied additional requirements intended to identify software containing new features or improvements that provide a competitive advantage to the taxpayer.

Finally, the 2001 proposed regulations prescribed a bright-line, separately-stated consideration rule for determining which software is treated as