

internal-use software for purposes of the research credit. (The 2001 proposed regulations retained the exception for software used to provide computer services, but removed the special rule for noncomputer services. Additionally, the 2001 proposed regulations expanded upon the list of general and administrative functions contained in the legislative history and expanded the exception for integrated software-hardware products.) The purpose of this rule was to provide a clear definition of internal-use software that could be readily applied by taxpayers and more readily administered by the IRS.

Numerous comments were received in response to the 1997 proposed regulations, TD 8930 and Notice 2001-19, and the 2001 proposed regulations regarding the provisions relating to internal-use software. Although commentators addressed virtually all aspects of the internal-use software provisions in the various iterations of regulations, most of the comments focused on the definition of internal-use software. As previously stated, many commentators believed that the definition of internal-use software should exclude any software used to deliver a service to customers and any software that includes an interface with customers or the public. Some commentators suggested, as an alternative, that the statutory production process exception be extended to software used in connection with the provision of services.

With respect to the definition of internal-use software in the 2001 proposed regulations, commentators stated that the separately-stated consideration test was a poor indication of when computer software was developed “primarily for internal use by the taxpayer” and directly conflicted with the legislative history to the 1999 Act. In support of a narrower definition of internal-use software, these commentators pointed to technological advancements and changes to the role of computer software in business activities since the exclusion for internal-use software was enacted in 1986, including the increased development of computer software by taxpayers, the increased use of computer software in all aspects of business activity, and the role of computer software (often integrated across a business) in providing goods and services in addition to the internal operations of a business. Commentators further argued that the definition should be based on the underlying functionality of the software (*i.e.*, whether the software, in light of the facts and circumstances, is used to deliver services or goods to a taxpayer’s

customers). Commentators urged that a functionality rule is preferable to a bright-line rule (such as the separately-stated consideration rule in TD 8930) even though a bright-line rule provided a clearer rule for identifying internal-use software for purposes of the research credit.

The Treasury Department and the IRS are continuing to consider the concerns raised by commentators in response to the definition of internal-use software contained in the 2001 proposed regulations, including the concern that the separately-stated consideration test is over-inclusive. Nevertheless, the Treasury Department and the IRS are concerned that the alternatives, including expanded or modified exceptions, proposed by commentators generally would make the definition of internal-use software more complex without providing additional clarity. Several commentators suggested similar definitions that would exclude software that, for example, is “integral and essential” to the provision of services with integral defined as software that directly “enables, supports, or facilitates” a service. Some commentators suggested a definition that would exclude software that is “primarily used” by customers, suppliers, or other third parties. Other commentators suggested a definition that would limit internal-use software to software that is developed primarily for use in general and administrative functions that enable, facilitate, or support the taxpayer’s conduct of the taxpayer’s trade or business, but would exclude certain customer interface software. These suggestions would introduce many terms (including *enable, support, facilitate, primarily*) that, due to their subjective nature, the Treasury Department and the IRS believe would be prone to controversy and could not be readily applied by taxpayers or administered by the IRS. Another commentator suggested limiting the definition of internal-use software to software used to perform a specifically enumerated list of general and administrative functions. Some commentators, however, have noted that the often highly integrated nature of software development today makes it difficult, if not impossible, to divide software development projects into separate components, and thus a list approach may not be administrable. Finally, as part of their review of these comments, the Treasury Department and the IRS also reviewed the possibility of using definitions of internal-use software contained in prior guidance.

In light of the statute, the legislative history, the history of the regulations regarding internal-use software, and the comments received, the Treasury Department and the IRS have decided not to finalize in TD 9104 the provisions in the 2001 proposed regulations relating to internal-use software. Instead, the Treasury Department and the IRS are issuing this ANPRM to solicit further comments regarding the definition of internal-use software as well as other provisions affecting the qualification of internal-use software for the research credit. The Treasury Department and the IRS are mindful that Congress specifically intended that computer software “developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer” be subject to additional requirements before the software could qualify for the research credit. At the same time, the Treasury Department and the IRS recognize that there have been changes in computer software, and its role in business activity, since the mid-1980s. In light of these changes, the Treasury Department and the IRS are concerned about the difficulty of effecting Congressional intent behind the exclusion for internal-use software with respect to computer software being developed today. Despite Congress’ broad grant of regulatory authority in section 41(d)(4)(E), the Treasury Department and the IRS believe that this authority may not be broad enough to resolve those difficulties.

Accordingly, the Treasury Department and the IRS request comments regarding a definition of internal-use software that appropriately reflects the statute and legislative history, can be readily applied by taxpayers and readily administered by the IRS, and is flexible enough to provide continuing application into the future. In submitting comments, commentators are invited to address any of the definitions included in prior guidance as well as other definitions that have been proposed to the Treasury Department and the IRS by commentators.

In addressing these alternatives, commentators also are invited to discuss how software development efforts that encompass both internal-use software and non-internal use software should be addressed under any particular definition. The Treasury Department and the IRS are concerned that the tendency toward the integration of software across many functions of a taxpayer’s business activities may make it difficult for both taxpayers and the IRS to separate internal-use software from non-internal use software (or software not subject to additional