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IRS Outlines Guidance on Internal Use Software Research. Activities.

In e-mailed advice, the IRS addressed the current legal standard for the internal use software exception under section 41, outlining the applicable internal use software guidance and recent case law.

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From: * * *
Sent: Thursday, May 29, 2014 9:22:23 AM
To: * * *
Cc: * * *
Bcc:
Subject: RE: CCA Request — IUS Legal Standard

Hello * * *

This is in response to your request regarding the current legal standard for the internal use software exception under section 41. Presently, the only published internal use software guidance is in the ANPRM, issued on December 31, 2003. The ANPRM provides, in relevant part, that 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 provisions of the 2001 proposed regulations, or all provisions of TD 8930 with respect to their internal use software research activities. For example, the ANPRM requires taxpayers relying upon the internal use software rules of TD 8930 to also apply the "discovery" test as set forth in TD 8930. Concurrent with the publication of the ANPRM, the Treasury Department and the IRS finalized the 2001 proposed regulations in the Federal Register as TD 9104 on December 31, 2003. TD 9104 retained the "discovery" test in the same manner as the 2001 proposed regulations but removed the internal use software provisions and marked § 1.41-4(c)(6) as "Reserved." TD 9104 applied to taxable years ending on or after December 31, 2003; however, TD 9104 stated that the IRS would not challenge return positions that are consistent with its rules for taxable years ending before December 31, 2003.

Since publication of the ANPRM, its enforceability was questioned by the court in FedEx Corporation v. United States of America, 108 AFTR 2d 2011-5669 (W.D.Tenn Mar 28, 2011), denying reconsideration of 103 AFTR 2d 2009-2722, 2009-1 USTC ¶ 50,435 (W.D.Tenn 2009). The court questioned the authority to require taxpayers to comply with the ANPRM that may partly conflict with TD 9104 and allowed the taxpayer to apply the internal use software rules of TD 8930 while applying the general eligibility rules under TD 9104. Please note, however, that the taxable years at issue in FedEx were prior to the issuance of the ANPRM.

TD 9104 clearly states that the IRS would not challenge return positions that are consistent with its rules for prior years; therefore, it is inappropriate for the IRS to challenge taxpayers who apply the general eligibility provisions of TD 9104. Since the ANPRM is the only internal use software guidance available, taxpayers may continue to follow the ANPRM in its entirety. However, we should not challenge taxpayers that choose instead to follow only the internal use software provisions of § 1.41-4(c)(6) in either TD 8930 or the 2001 proposed regulations, and follow TD 9104 for the general eligibility rules for qualified research.

I hope this answers your question. Please let me know if you want to discuss further.

Thank you

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