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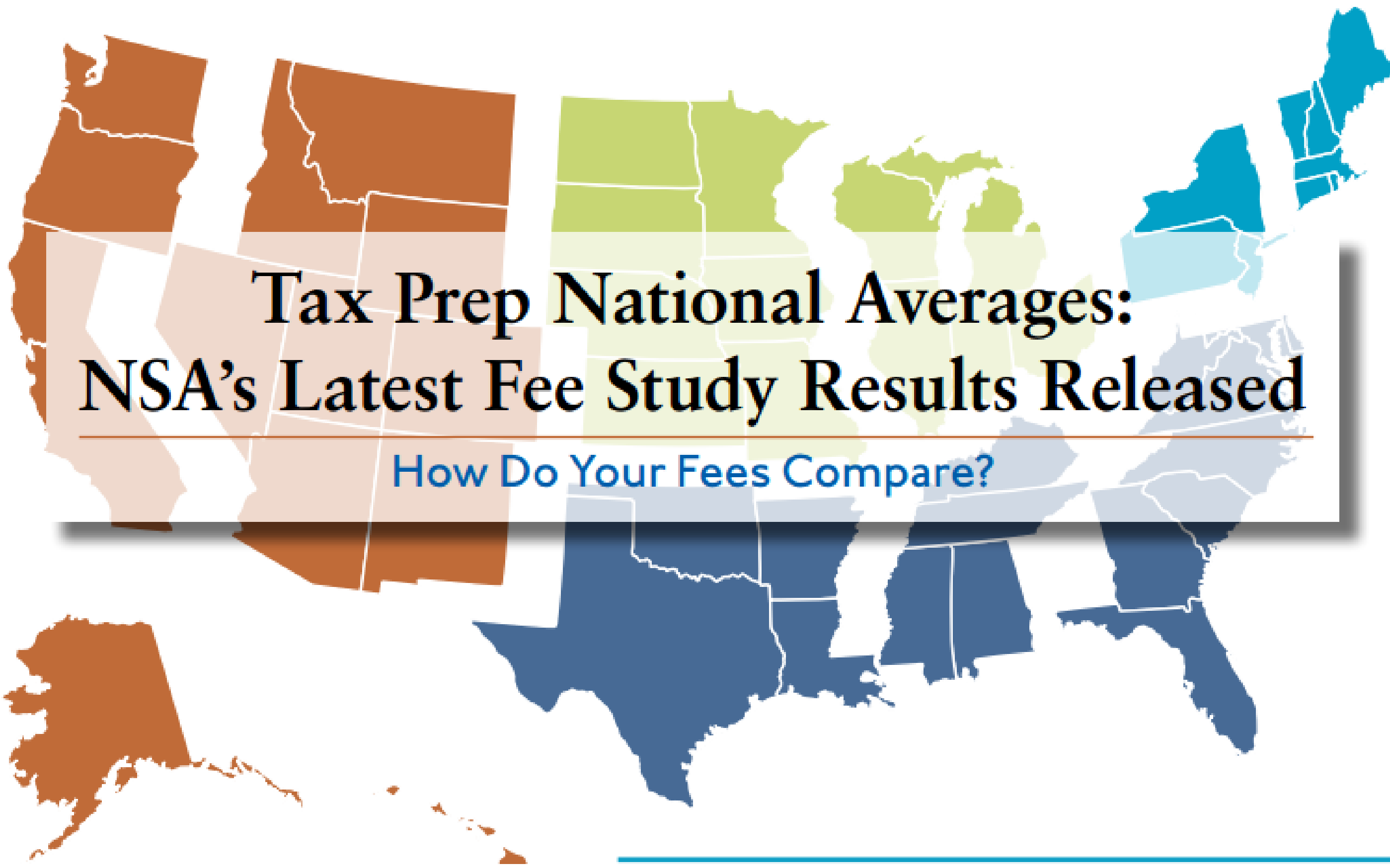

Tax Prep National Averages: NSA's Latest Fee Study Results Released

How Do Your Fees Compare?

Tax Consequences of Distributions from S Corporations

The Annual Tax Meeting is Dead

New Economy to Benefit as IRS Clarifies Key R&D Standards

Michael Silvio

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These days, the solutions often mean investing in software; the guidelines for such research and development tax credits have been too vague to utilize effectively – until now.

For decades, companies have hesitated to invest in new software because the cost of developing it would throw off the bottom line.

Ideally, such a program would pay for itself over time either as a back-office tool that streamlines critical functions or as an asset tracker that ensures efficiencies and prevents the loss of expensive equipment. But this takes time, and for many businesses in competitive industries, the upfront investment can be too much to absorb while executives and investors wait to see how things "play out."

This is where research and development tax credits can be most valuable – when business leaders need to innovate their way to a customized solution. These days, the solutions often mean software; however, the guidelines for such research and development tax credits have been too vague to utilize effectively – until now.

The final software regulations recently issued by the IRS under Regulation 1.41-4 provide much needed clarity for businesses in this situation. If the software being created is for internal use (such as general and administrative functions) and there is a subset of the software intended for use by third parties (such as an online client portal), the company may qualify for research and development tax credits offsetting some of the upfront expense.

This is established in the final reg's dual-function test, which serves as a safe harbor for companies that develop software for internal use that has additional functionality for customers that is not internal use. If 10 percent of the dual function is used by the customer, the company may be eligible for a 25 percent research and development tax credit for the cost of developing the program. Depending on the size of the organization and the relative cost of the research and development investment, these credits can have a big impact on the bottom line.

In many ways, this is the clarity that tax professionals have been patiently awaiting since the proposed software regulations were issued. Prior to these final regulations, internal use software could only be qualified for research and development purposes using the "High Threshold of Innovation Test." This unclear test created more problems than it

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solved. Business leaders were rightfully skeptical of pursuing credits because they faced too many burdens under these tests and often were not certain whether their claims would hold up to IRS scrutiny.

Under these proposed regulations, three criteria were established:

1. The software had to be "innovative"
2. The company needed to incur a "significant" economic risk
3. The program could not be commercially available

While the definition of "significant" is still debatable, certain areas are coming into focus. For instance, generally, software designed solely for internal use that does not meet the "High Threshold of Innovation Test" is not qualified if it is of a general or administrative function, such as payroll or bookkeeping.

If a company's intention at the outset is to develop software that enables customers or third parties to interact with it and initiate functions in the company's system, the software has a good chance of qualifying for the research and development credit. For example, a client-facing component, such as an online portal for customers to access their accounts and initiate transactions, should qualify. The software would not be seen as internal use software as it was not developed for use in a general and administrative capacity and it allows customers and third parties to access it and initiate functions using it.

For the right company, this could generate millions of dollars in savings for much needed research and development. Since the standard is now known ahead of time, companies can plan accordingly and develop software with the purpose of having such a qualified dual function without having to meet the "High Threshold of Innovation Test."

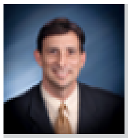
However, it is important to note that the IRS has left some portions of the code open to interpretation. In reviewing the reg for the "High Threshold of Innovation Test," there is no bright-line test defining what a "significant" economic risk is for this type of research and development. Accountants, tax professionals and CFOs will have to use their best judgment to determine how much money can be put into the project in order to qualify as taking a significant economic risk.

One standard is to compare the qualified research expenses to the company's revenue. Showing that the qualified expenses are a significant percentage of revenue may support that this portion of the "High Threshold of Innovation Test" has been met.

Hopefully, this area of the code will be clarified in the near future so business owners can have more knowledge to make better-informed decisions on investment strategies and the future of their companies. Other areas of the tax code would benefit from more clarity as well, but this final reg is an excellent start.

While many industries can benefit from this clarification of the tax code, the software developers are probably the clearest winners. They should expect a nice windfall as cloud-based service providers look to revamp their proprietary platforms and pay a premium for the developers' coding skills knowing that they can likely recoup a sizeable portion of the investment through the research and development tax credit.

Tax professionals will be called upon to guide companies through this decision-making process. It is critical that all figures are projected in the most accurate manner possible, and accountants with the deepest tax credit-claiming experience will be best positioned to consult on this type of research and development strategy. After all, it would be a tremendous waste for a company to invest in a new software program with the expectation of receiving a tax credit only to find out after paying the bill that the credit will not be coming.



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