

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

N o t i c e

┌ N(35)000-161 ┐
└ ──────────── ┘

May 14, 1999

Internal Use Computer Software
Subject: Research Credit Cases **Cancel Date:** November 10, 1999

The purpose of this Notice is to assist district and regional counsel attorneys in the development and coordination of nondocketed and docketed cases involving research credit claims under I.R.C. § 41 for internal use computer software and to request notification of the National Office coordinator of all cases and issues involving such claims.

The internal use computer software research credit issue is a significant compliance issue for the Service, involving many Coordinated Examination Program taxpayers in a wide variety of industries. The issue is usually raised either late in the audit through claims for refunds or at the time the petition is filed. There are currently twelve groups of cases in the Tax Court and more than 200 cases in Examination with this issue. The claims for internal use software credit exceed 2 billion dollars.

The Service recently issued proposed regulations concerning the research credit provisions. 63 F.R. 66503 (December 2, 1998), 1998-50 I.R.B. 10. The Service has been successful in two cases in litigation: Norwest v. Commissioner, 110 T.C. 454 (1998); and United Stationers v. United States, 982 F. Supp. 1279 (N.D. Ill. 1997), aff'd, 99-1 U.S.T.C. ¶ 50, 136 (7th Cir. 1999).

A taxpayer is allowed a credit against taxes for increasing research activities. In general, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's "qualified research expenses" for the taxable year over the base amount, and 20 percent of the taxpayer's basic research payments. Section 41(a). To constitute qualified research expenses, the expenses must be paid or incurred by the taxpayer in carrying on any trade or business of the taxpayer. Further, eligible expenditures are limited to in-house research expenses and contract research expenses. Section 41(b)(1).

"Qualified research" is research with respect to which expenditures may be treated as expenses under section 174. In addition, the research must be undertaken for the purpose of discovering information which is technological in nature and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer. Substantially all of the activities of such research must constitute elements of a process of experimentation for a purpose that relates to a new

Filing Instructions: Binder Part (35) Master Sets: NO X RO X
NO: Circulate Distribute X to: All Personnel Attorneys X In: all divisions
RO: Circulate Distribute X to: All Personnel Attorneys X In: CC:DOM:FS, CC:INTL, CC:ESEO
Other National and Regional FOIA Reading Rooms
Electronic Filename: software.pdf Original signed copy in: CC:F&M:PA

or improved function; performance; or reliability or quality. Section 41(d)(1), (d)(3). Research will not be treated as conducted for a qualified purpose if it relates to style, taste, cosmetic, or seasonal design factors. Section 41(d)(3)(B).

In Norwest, the Tax Court largely sustained the Service except with respect to a contract research issue. A contract research credit expense is incurred when amounts are paid or incurred for the performance of research by an unrelated party for the benefit of another. Both parties are not entitled to the credit on the same research. Only the taxpayer that has a right to the research results and that bears the ultimate responsibility for paying for the research can claim the research. Many taxpayers are now claiming that the research in question was done as contract research as they seek to distinguish their respective cases from the major portion of the Norwest opinion and the United Stationers opinions. Taxpayers' claims concerning contract research should be closely scrutinized to determine: 1) whether the contractor also took the credit on the same activities, 2) whether the taxpayer has a right to the research results, and 3) whether the taxpayer bore the risk of loss if the research was not successful. In addition to the contract research issues, it should be noted that the computations of the credit and the base period amount are complex and should not be agreed to without a thorough examination and coordination.

Following the opinions in United Stationers and Norwest, we are developing other cases in order to establish additional precedent in the Tax Court, not only on the issues that were sustained in United Stationers and Norwest, but also on the contract research issue. In addition to developing and defending the docketed cases, the Service has developed both generalized and industry specific examination techniques, training and coordinated issue papers. Cases that include the research credit for internal use software should be brought to the attention of the National Office for advice regarding factual development and the appropriate legal conclusions to be drawn based on the particular facts of individual cases.

The internal use software research credit issue is significant and thus is subject to the notification procedures described in Chief Counsel Notice N(35) 000-139(a), issued September 24, 1996.

If you have a docketed case or are assisting a revenue agent or appeals officer with a case involving the research credit for internal use software, please notify National Office attorney, Joni Larson, CC:DOM:FS:P&SI, at (202) 622-7840, who is coordinating the Office's efforts on this issue.

/s/ Daniel J. Wiles

for JUDITH C. DUNN
Associate Chief Counsel
(Domestic)