

In looking at software developers and game designers, it is clear that many of the standard processes they are engaged in can be very R&D tax credit friendly. However, within the software development umbrella there are several different types of software development activities, each with their own nuances related to the credit:



## 1. Proprietary Software Product Development

Companies, such as Microsoft or Oracle, which develop their own proprietary products that are held for sale or lease by the taxpayer are the most straight-forward candidates for qualified software development, as it relates to the research tax credit. The basic requirement is that the qualified research activities meet the "4-part test" requirements.

### 1. Permitted Purpose

The activity must result in a new or improved process, function, product, performance, reliability, quality, or significant reduction in cost. Probably the most common type of activity overlooked by companies regarding these specific criteria involves significant improvements made to production-line operations. A very common example of this sort of improvement would be the updating of production-line capabilities by a manufacturer that ultimately improved efficiency, increased production capacity, and eventually yielded an overall reduction in costs. An example of this type of activity would be a company that manufactures heavy equipment, and relied upon a labor-intensive approach to production. If that company were to implement improvements in its manufacturing process, by way of automation or some other means that required investment in new equipment for the plant floor, then it's very possible that the costs associated with the implementation of the new production process could be eligible for the R&D tax credit.

### 2. Elimination of Uncertainty

Were the activities conducted and intended to eliminate uncertainty concerning the development or improvement of a product? This criterion specifically involves the identification of information that is uncertain at the onset of the project or activity. Such uncertainty can relate to the capability of the product, the method used to produce it, or the appropriate design of the product. The examples that we typically encounter when consulting with clients in this arena deal with issues such as: Will the new or improved manufacturing process integrate with our current system, on any level? Will our new product development meet the customer specifications? Will the potential benefits outweigh the potential risks? Or will the new or improved product or activity even work?

### 3. Technical in Nature

Does the research fundamentally rely on the principals of, engineering, physical or biological science, or computer science? This criterion is usually a fairly easy one to deal with. What it really does is eliminate the soft sciences from the formal definition of technology. In other words, products or activities that are predicated upon literary, historical or social sciences do not qualify for the R&D Tax Credit. In all of our experiences, this technology criterion has never been an issue when performing an R&D study for a manufacturing company.

### 4. Process of Experimentation

Does the activity involve developing one or more hypotheses for specific design decisions, testing and analyzing those hypotheses, and refining and discarding the hypotheses? A key factor regarding the Process of Experimentation hurdle was recently crystallized, when Treasury Regulations changed the wording to evaluation of one or more alternatives. Previous language defined the process as evaluation of more than one alternative.



## 2. Custom Software Development

Custom software development (i.e. software that is developed under contract as a service for a third-party) can potentially qualify for the credit, assuming the 4-part test is again met for the research activities.

However, an important consideration for custom software development to qualify is whether the contract the work is performed under passes the exclusion for "funded research" found in IRC §41(d)(4)(H). For the contract to be eligible, two conditions must both be met. First, the payments must be contingent on the development activities being successful. Second, the developer must retain rights to the intellectual property that is developed.



### 3. Mobile Apps

A relatively new trend in the software development market is the emergence and rise of developers focusing on applications for mobile devices (such as phones, tablets, etc.). As a large percentage of these mobile app developers are early stage companies, the potentially limiting factor here is their profitability and ability to benefit from the credit by reducing taxes due.



### 4. Web Developers (Website Development)

In general, standard web development (i.e. building a website) is not likely to qualify for the research tax credit. A significant portion of the work is generally related to the aesthetic design, which is specifically excluded from qualified activities, and HTML coding is not likely to rise to the level of technical uncertainty and experimentation required to qualify.

However, there are research activities performed by web developers that may qualify. Specifically, the back-end development of new software applications and platforms such as CRM applications and ecommerce engines utilizing source code developed in a programming language such as C++ or Java, which ties in to a web-based front end may qualify.



### 5. Internal Use Software

Software that is developed for internal use (meaning software that is not intended to be sold as a product) is generally excluded from qualified research activities under IRC §41(d)(4)(E).

As with anything, there are exceptions for when internal use software development can still qualify for the research credit. If the software satisfies the following three additional tests, then it could still be eligible:

#### 1: Innovation Test

The software must be intended to be unique or novel and to differ in a significant and inventive way from prior software.

#### 2: Economic Risk Test

The taxpayer must commit substantial resources and there is substantial uncertainty whether the investment will be recovered within a reasonable time.

#### 3: Commercial Availability Test

No commercially available software could be used for the intended purpose without modifications that meet the first two requirements.

Clearly, many of the fundamental areas related to software development can provide meaningful opportunities to explore R&D tax credits. Whether the software development activities are intended to result in a new product, internal-use software, or something else, it is clearly an area of tax savings that should be fully explored. A significant portion of the activities performed by a company's employees such as the software programmers, software architects, software analysts, QA testers, and other supporting team members may qualify, which could translate into meaningful tax savings.

Some general examples of software development activities that may qualify for the credit include:

- Development of specifications and requirements
- Concept development and ideation
- Alpha and beta prototype development and testing
- Design of software architectures
- Database design
- Regression and unit testing
- Developing test cases for functionality and performance analysis

If you have any questions about software R&D credit and how it may affect your business, please contact:

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