Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201650012**
Release Date: 12/9/2016

CC:PSI:B06:JARecords
POSTF-102328-16

UILC: 41.00-00

date: August 22, 2016

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subject: Applicable High Threshold of Innovation Test For Taxable Years Ending Prior to the Issuance of the 2015 NPRM

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Date 1 =

Date 2 =

ISSUES

1. Is § 41(d)(4)(E) of the Internal Revenue Code self-executing for purposes of determining whether research with respect to computer software developed primarily for internal use (IUS) is qualified research?

2. Given that § 41(d)(4)(E) is not self-executing for purposes of determining whether research with respect to IUS is qualified research, what may Taxpayer rely on to determine the three-part high threshold of innovation test for taxable years ending prior

to the issuance of the 2015 proposed IUS regulations (2015 NPRM) and for which there are no final regulations in effect?

3. If Taxpayer chooses to apply the 2001 final IUS regulations (T.D. 8930), is the common knowledge of skilled professionals standard under § 1.41-4(c)(6)(vii) applicable to Taxpayer?

CONCLUSIONS

1. Section 41(d)(4)(E) is not self-executing for purposes of determining whether research with respect to IUS is qualified research. In the absence of final regulations, research with respect to IUS is not qualified research (except for the limited exceptions provided in the statute that do not apply to Taxpayer).

2. As provided in the 2004 advance notice of proposed rulemaking (2004 ANPRM) and 2015 NPRM, Taxpayer may choose to apply either *all* of the IUS provision in T.D. 8930 or *all* of the IUS provisions in the 2001 proposed IUS regulations (2001 NPRM) for purposes of the three-part high threshold of innovation test with respect to taxable years ending prior to the issuance of the 2015 NPRM and for which there are no final regulations in effect.

3. If Taxpayer chooses to apply T.D. 8930, the common knowledge of skilled professionals standard under § 1.41-4(c)(6)(vii) in those final regulations is applicable.

FACTS

Taxpayer claimed research credits under § 41 for the taxable years ended Date 1 and Date 2, which include qualified research expenses (QREs) related to research with respect to IUS. Taxpayer's position is that if Taxpayer chooses to apply the IUS provisions of T.D. 8930, the "common knowledge of skilled professionals" standard in § 1.41-4(c)(6)(vii) of those regulations does not apply. Alternatively, Taxpayer argues that it may apply the 1986 legislative history, which does not reference the "common knowledge of skilled professionals" standard as part of the three-part high threshold of innovation test. Conversely, your office asserts that Taxpayer must either choose to apply either *all* of the IUS provision of T.D. 8930 or *all* of the IUS provisions of the 2001 NPRM. If Taxpayer chooses to apply the IUS provisions provided in T.D. 8930, it must apply *all* of those provisions, including the common knowledge of skilled professionals standard. You have asked whether we concur with your office's conclusion.

LAW AND LEGISLATIVE HISTORY

Section 41(d)(4)(E) provides that "[*e]xcept to the extent provided in regulations*, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" is excluded from the definition of qualified research under § 41(d), other than for use in -- (i) an activity which constitutes

qualified research (determined with regard to this subparagraph), or (ii) a production process with respect to which the requirements of § 41(d)(1) are met. (emphasis added).

Generally, research with respect to IUS may be eligible for the research credit under § 41 only if it satisfies certain criteria provided in regulations, including the requirements collectively referred to as the three-part high threshold of innovation test.

Regulations under § 41(d)(4)(E)

On January 2, 1997, the Treasury Department and the Service published a notice of proposed rulemaking (1997 NPRM) to provide guidance on IUS under § 41(d)(4)(E). T.D. 8930 (66 FR 280) finalized and substantially modified the 1997 NPRM and was published on January 3, 2001.

Section 1.41-4(c)(6)(vi) of T.D. 8930 provides that software satisfies the high threshold of innovation test only if the taxpayer can establish that: (A) The software is innovative in that the software is intended to result in a reduction in cost, improvement in speed, or other improvement, that is substantial and economically significant; (B) The software development involves significant economic risk in that the taxpayer commits substantial resources to the development and there is a substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period; and (C) The software is not commercially available for use by the taxpayer in that the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the requirements of (A) and (B).

T.D. 8930 also includes, as part of the three-part high threshold of innovation test, a requirement to compare the intended result with software that is within the common knowledge of skilled professionals in the relevant field. Section 1.41-4(c)(6)(vii) of T.D. 8930 provides:

> The determination of whether the software is intended to result in an improvement or cost reduction that is substantial and economically significant is based on a comparison of the intended result with software that is within the common knowledge of skilled professionals in the relevant field of science or engineering, see §1.41-4(a)(3)(ii).

Section 1.41-4(c)(6)(vii) of T.D. 8930 further provides:

> The extent of uncertainty and technical risk is determined with respect to the common knowledge of skilled professionals in the relevant field of science or engineering.

In response to taxpayer concerns regarding T.D. 8930, the Treasury Department and the Service published Notice 2001-19, 2001-1 C.B. 784, announcing that the Treasury

Department and the Service would review T.D. 8930 and reconsider comments previously submitted. Notice 2001-19 also provides that, upon the completion of this review, the Treasury Department and the Service would announce changes to the regulations, if any, in the form of new proposed regulations.

On December 26, 2001, the Treasury Department and the Service published the 2001 NPRM (66 FR 66362) relating to IUS. With respect to the high threshold of innovation test, the 2001 NPRM clarifies the first requirement of the test and provides that IUS is innovative if the software is intended to be unique or novel and is intended to differ in a significant and inventive way from prior software implementations or methods. However, the second and third requirements of the high threshold of innovation test are the same as under T.D. 8930. The 2001 NPRM also removed explicit references to the common knowledge of skilled professional standard for application of the high threshold of innovation test.

On January 2, 2004, the Treasury Department and the Service published final regulations (T.D. 9104). T.D. 9104 (69 FR 22) finalized the 2001 NPRM's rules relating to the definition of qualified research under § 41(d) but removed the IUS provisions and marked § 1.41-4(c)(6) as "Reserved." T.D. 9104 applies to taxable years ending on or after December 31, 2003.

Concurrently with T.D. 9104, the Treasury Department and the Service issued the 2004 ANPRM (69 FR 43). The 2004 ANPRM requested comments concerning the definition of IUS. Recognizing that taxpayers needed guidance with respect to IUS while the Service worked on new regulations, the 2004 ANPRM provides 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 NPRM, or *all* provisions of T.D. 8930 with respect to their IUS research activities. The 2015 NPRM similarly provides that for taxable years ending prior to publication of the 2015 NPRM, taxpayers may choose to follow either *all* of the IUS provisions of § 1.41–4(c)(6) under T.D. 8930 or under the 2001 NPRM. However, the 2015 NPRM provides that the proposed rules, when finalized, will be prospective only.

Legislative History

The legislative history of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085 (1986)) (1986 legislative history), provides that "[a]ny other research activities [other than narrow activities provided in the statute] with respect to internal-use software are *ineligible* for the credit *except to the extent provided in Treasury regulations*. Accordingly, the costs of developing software are not eligible for the credit where the software is used internally . . . *except to the extent permitted by Treasury regulations*." H.R. Conf. Rep. No. 99-841, at II-73 (emphasis added).

Congress intended that regulations would make the costs of new or improved IUS eligible for the credit only if the research satisfies, in addition to the general

requirements for credit eligibility, an additional three-part high threshold of innovation test:

> (1) the software must be innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant);
>
> (2) the software development involves significant economic risk (as where the taxpayer commits substantial resources to the development of the software and there is substantial uncertainty, because of technical risk, that such resources would not be recovered in a reasonable period of time); and
>
> (3) the software is not commercially available for use by the taxpayer (as where the software cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the first two requirements).

Id.

The 1986 legislative history also provided that "these regulations are to apply as of the effective date of the new specific rule relating to internal-use software; i.e., internal-use computer software costs that qualify under the three-part test . . . are eligible for the research credit even if incurred prior to issuance of such final regulations." *Id.* at II-73-74.

Self-executing Statute Jurisprudence

Where the Code grants the Service regulatory authority, courts have frequently determined whether the statutory provision is self-executing or, in other words, whether the statutory provision at issue is operative in the absence of regulations. *See, e.g.*, *Int'l Multifoods Corp v. Commissioner*, 108 T.C. 579 (1997); *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996); *Occidental Petroleum Corp. v. Commissioner*, 82 T.C. 819 (1984). In making this determination, courts draw a distinction between a "how" statute and a "whether" statute. *See, e.g.*, *Sundance Helicopters, Inc. v. United States*, 104 Fed. Cl. 1, 11 (2012); *Neumann* 106 T.C. at 219-21.

A statute is self-executing when regulations are not necessary to determine "whether" the statute applies in the first instance, but Congress leaves the mechanics or details affecting the application of the statute to the Secretary. See *Id.* In such case, the promulgation of regulations only constitutes a means of arriving at "how," not whether the provision applies. See *Id.*

Conversely, a statute is not self-executing if the statue requires a "whether" regulation. *See, e.g.*, *Neumann*, 106 T.C. at 219-21. That is, the promulgation of regulations is a necessary condition precedent to determining "whether" the statutory provision applies. *See id*. For example, the statute at issue in *Alexander v. Commissioner* is illustrative of

a "whether" provision. *See* 95 T.C. 467, 473 (1990), *affd. without published opinion sub nom. Stell v. Commissioner*, 999 F.2d 544 (9th Cir. 1993). In *Alexander*, the Tax Court analyzed the language in § 465(c)(3)(D) that provided that § 465(b)(3) "shall only apply to the extent provided in regulations prescribed by the Secretary." 95 T.C. at 473-74. The Tax Court found that because regulations had not been prescribed, § 465(b)(3) did not apply. *Id.* at 473.

Courts will look to the text of the regulations and the legislative history to determine if regulations are a precondition to applying the statute. *See*, *e.g.*, *Temsco Helicopters, Inc. v. United States*, 409 F. App'x 64, 67 (9th Cir. 2010); *Francisco v. Commissioner*, 119 T.C. 317, 322-23 (2002), *aff'd on other grounds*, 370 F.3d 1228, 1230 n.1 (D.C. Cir. 2004). If a court finds a statue to be self-executing, and the Service has failed to provide guidance, courts may nevertheless apply the statute as they determine reflects Congressional intent. *See, e.g.*, *Int'l Multifoods*, 108 T.C. at 587 ("the absence of regulations is not an acceptable basis for refusing to apply the substantive provisions of a section"); *Occidental*, *82 T.C. at* 829 (determining that in the absence of regulations 8 years after the issuance of § 58(h), the court must "do the best [it] can" with the provision).

ANALYSIS

Like the statute at issue in *Alexander*, the issuance of regulations under § 41(d)(4)(E) determines *whether*, rather than *how*, research with respect to IUS qualifies for the research credit. Both the statutory provision at issue in *Alexander* and § 41(d)(4)(E) contain language that provides that the provision will be operative only to the extent provided in regulations. *Compare* § 41(d)(4)(E) (providing that "[e]xcept to the extent provided in regulations" research with respect to IUS is not qualified research) *with Alexander*, 95 T.C. at 473 (considering § 465(c)(3)(D), which provided that § 465(b)(3) "shall only apply to the extent provided in regulations"). The delegation of authority from Congress to the Secretary to provide regulations under § 41(d)(4)(E) involves a policy call to be made by the Treasury Department concerning whether, and under what circumstances, IUS should be eligible for the credit. Thus, the issuance of regulations is a precondition to the determination of whether research with respect to IUS is qualified research.

In addition to the statutory text itself, the legislative history to § 41(d)(4)(E) also supports the view that Congress intended for the Treasury Department and the Service to issue regulations under § 41(d)(4)(E) with respect to the three-part high threshold of innovation test to make the provision operative. *See* H.R. Conf. Rep. No. 99-841, at II-73 ("the costs of developing software are *not eligible* for the credit where the software is used internally . . . *except to the extent permitted by Treasury regulations*.") (emphasis added). Regulations are, therefore, required to determine whether research with respect to IUS qualifies for the research credit.

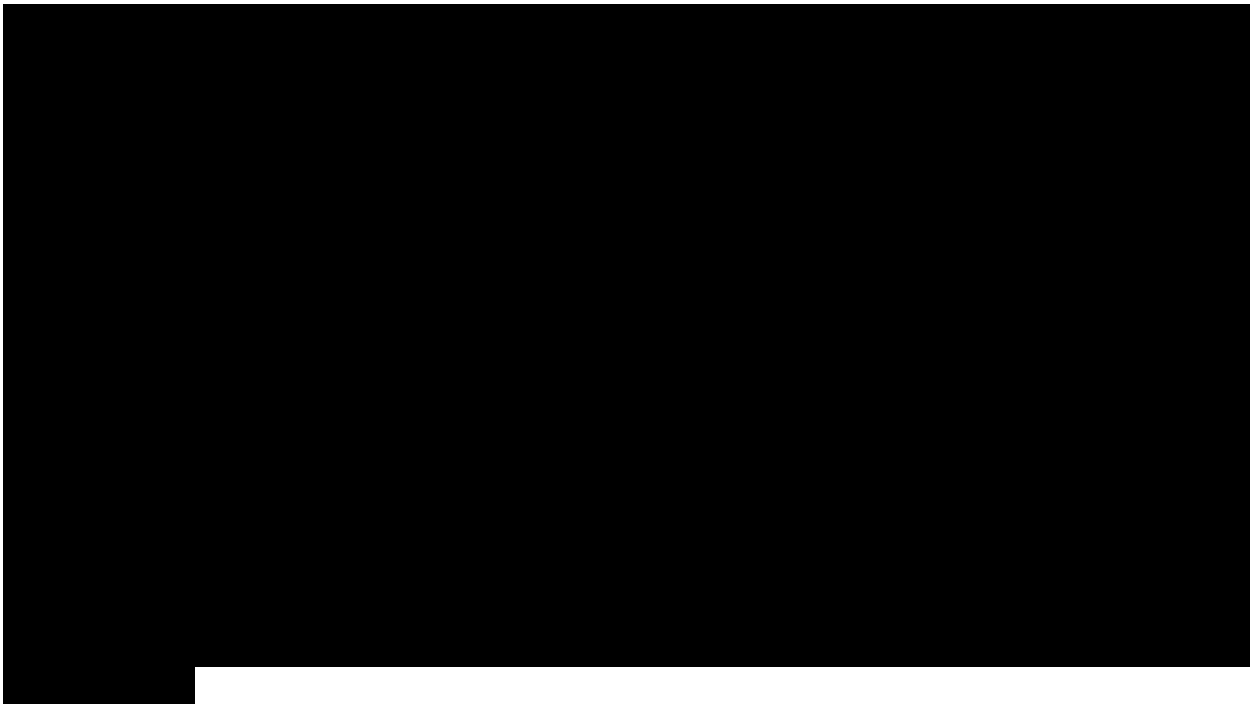
Although courts have been willing to exercise broad discretion to find statutes that grant authority to the Treasury Department to issue regulations to be self-executing, this exercise appears contrary to statutory construction principles. These principles provide that the plain meaning of a statute must control. *See United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989); *Caminetti v. United States*, 242 U.S. 470, 485 (1917) (If the statutory text is not ambiguous, "the rules which are to aid doubtful meanings need no discussion"). Thus, if the statutory text plainly requires the issuance of regulations to be operative, courts are not free to ignore that language. Moreover, courts have employed more restraint in other areas of the law relying on these principles. *See, e.g.*, *Gholston v. Hous. Auth. of Montgomery*, 818 F.2d 776, 785-86 (11th Cir. 1987) ("The express language of [the statute] simply indicates that local housing authorities shall comply with such procedures and requirements as the Secretary *may* prescribe.") (internal quotations omitted). *See also Dunlap v. United States*, 173 U.S. 65, 72 (1899) (in a case involving alcohol tax rebates decided prior to the Administrative Procedure Act finding that the "plain words" of the statute required regulations and because none had been issued the claimant had no rights under the statute).

Moreover, unlike the statutory provisions at issue in cases like *Occidental* and *Int'l Multifoods*, the Treasury Department and the Service have not left taxpayers without guidance. Although T.D. 9104 reserved the IUS regulations as of December 31, 2003, the Treasury Department and the Service provided taxpayers with interim guidance. To provide relief to taxpayers while the Department of Treasury and Service worked to issue further guidance, the Service has consistently provided that taxpayers could choose to follow either *all* of the IUS provisions of T.D. 8930 or *all* of the IUS provisions of the 2001 NPRM. *See* the 2004 ANPRM and the 2015 NPRM. This guidance applies to taxable years ending prior to the issuance of the 2015 NPRM and for which there are no final regulations in effect. *Id.* However, because § 41(d)(4)(E) is not self-executing for purposes of determining whether research with respect to IUS is qualified research, choosing to apply either *all* of the IUS provisions of T.D. 8930 or *all* of the IUS provisions of the 2001 NPRM for purposes of the three-part high threshold of innovation test is the only way research with respect to IUS can be qualified research during this period.

Thus, in this case, Taxpayer can choose to apply either *all* of the IUS provisions of T.D. 8930 or *all* of the IUS provisions of the 2001 NPRM for purposes of the three-part high threshold of innovation test, but cannot apply the legislative history to create rules in the absence of regulations. Accordingly, if Taxpayer chooses to apply T.D. 8930, it must apply *all* of T.D. 8930 for purposes of the three-part high threshold of innovation test, including the common knowledge of skilled professionals standard.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]



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