NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Final Internal Use Software Regulations Create Opportunities for Taxpayers

Final Treasury Regulations were published on October 4, 2016 that make it easier for taxpayers to claim the federal research credit for software development.

These regulations reverse IRS' long-standing objections to the eligibility of certain software development activities for the research credit. The final regulations closely follow the proposed internal use software regulations that were published on January 20, 2015, which remains the effective date for the new rules.

Software developed for third parties must generally satisfy the same requirements as other research and development activities that qualify for the research credit. However, software developed for *internal use* is subject to an additional *high threshold of innovation test*. Prior to the new regulations this test required internal use software to be *unique and novel* from other types of software in order to qualify for the research credit. IRS has long argued that all software is developed for internal use, *except* software that is developed exclusively for sale, lease or license to third parties. The new regulations provide a narrow definition of internal use software, as well as create a new category of *dual function computer software* that will allow more software development activities to qualify for the research credit without applying the high threshold of innovation test. When the test does apply, the new regulations significantly lower the level of innovation required to qualify for the research credit. The regulations also create a new safe harbor for software developed for both internal and external use, and provide guidance on when software implementation activities can qualify for the research credit.

Revised Definitions

The new regulations define internal use software as software developed by the taxpayer (or a related party) for use in general administrative functions that facilitate or support the conduct of the taxpayer's trade or business. Only three categories of general administrative functions are identified as *per se* internal use. They are software developed for the taxpayer's own:

1. Financial management functions
2. Human resource management functions; and
3. Support services functions.

By narrowing the definition of internal use software, the new regulations eliminate controversy with taxpayers over the need to qualify certain software development activities through application of the high threshold of innovation test. This change opens the door for taxpayers to claim a broader range of development activities. When the high threshold of innovation test does apply, the new regulations eliminate the language in the prior obsolete regulations that required *unique or novel* features or functionality for the software in order to qualify for the credit. The final regulations dramatically lower the level of software innovation required to qualify for the credit. The new high threshold of innovation test has three parts:

1. The software must be intended to reduce cost, improve speed, or make some other measurable improvement in the taxpayer's business;
2. Development must involve significant economic risk, which only exists if there is technical uncertainty at the outset of the software development effort; and
3. There can be no commercially available alternatives to self-development.

Dual Function Computer Software and a New Safe Harbor

Under the new regulations, most software is *dual function computer software* that may include some functionality developed for the taxpayer's internal use, but also allows third parties to access the taxpayer's systems to review data or initiate functions. Mobile apps, cloud- or web-based software and software-as-a-service platforms fall into this category. For these development efforts, taxpayers are allowed to carve out the development expense for the *third-party subset* and qualify that portion of the research activity without applying the high threshold of innovation test. If the taxpayer cannot segregate the expense related to the third-party subset, the regulations create a new *dual function computer software safe harbor,* in which 25% of the cost associated with development of the software will be allowed as qualified research expense. To qualify for the safe harbor, the taxpayer must reasonably anticipate that at least 10% of the software's use will come from third parties if successfully developed.

Enterprise Resource Planning Software

IRS has long held that enterprise resource planning (ERP) systems implementation is not a qualified research activity because it is the configuration of canned software. The new regulations provide two examples illustrating when software implementation expenses do not qualify for the credit and when they do. In the first example, the cost of an ERP implementation is not a qualified research expense because the taxpayer is configuring the software by selecting options from a variety of menu driven reporting capabilities that are pre-programmed in the software. In the second example, the taxpayer has qualified research expense related to its ERP implementation because the software lacks certain reporting capabilities and the taxpayer must engage in new and original coding to develop the desired functionality. The so called *shrinking back rule* is applied to isolate the qualified portion of the implementation expense.

Enhanced Opportunities for Software Start-Ups

The *Protecting Americans from Tax Hikes Act* (the PATH Act) that was signed into law on December 18, 2015, expanded research credit benefits to qualified small businesses that receive less than $5 million in gross receipts in 2016 and have no greater than a five-year history of gross receipts ending with 2016 (meaning they did not receive gross receipts prior to 2012). These benefits include allowing taxpayers to designate up to $250,000 of their research credit to offset a portion of the taxpayer's FICA payroll tax liability in the subsequent tax year (the payroll tax credit). This election can be made each year for up to five years if the taxpayer remains qualified, which could result in a same-as-cash benefit of up to $1.25 million. When combined with the new favorable regulations governing qualified software development, many small software and technology start-ups are now empowered to reap significant cash benefits from the research credit, even if they are in an overall loss position.

The New Software Regulations and 2016 Year-End Tax Planning

The new regulations are a welcomed improvement over prior regulations governing the eligibility of software development activities for the federal research credit. However, the full benefits of the regulations can only be realized with proper analysis of prior-year activities and some current-year planning for research credits that will be claimed on future tax returns. This is especially true for qualified small businesses that may be eligible to receive the same-as-cash payroll tax credit as soon 2017.

• Edit this entry

NEWS YOU CAN USE FROM ANDERSEN TAX
for the RECORD

Coming to America – Helpful Guides to What You Need to KnowIn addition, those planning to do busines

People moving to the United States (U.S.), especially those with substantial wealth, need to organize their financial affairs before landing here.

In addition, those planning to do business in the U.S. need to insure they consider key tax issues relating to the organization, operation, repatriation of profits and exit of a foreign-owned U.S. business. For those who plan ahead, there can be significant tax savings.

Pre-Immigration Tax Planning

The U.S. tax system is complex. U.S. citizens and residents are subject to income taxes on worldwide income and, typically, transfer taxes on their worldwide assets. Non-residents on the other hand, are generally only subject to tax on income that is effectively connected with a U.S. trade or business (including gains on the sale of real property) and dividend payments from U.S. corporations (through withholding tax). In addition, non-residents are generally subject to U.S. gift and estate tax only on certain U.S. situs assets, real or tangible personal property.

An individual who is not a U.S. citizen (*an alien*) is treated as a U.S. tax resident (also known as a *resident alien*) during a particular taxable year, and therefore subject to U.S. federal income tax on a worldwide basis (unless an applicable treaty provides otherwise), if such individual (1) is a *lawful permanent resident of the U.S.* at any time during such calendar year (the *green card test*), (2) satisfies the *substantial presence test* or (3) makes an election to be treated as a U.S. tax *resident*. In general, an individual is treated as a lawful permanent resident of the U.S. at any time if, (1) such individual has the status of having been lawfully accorded the privilege of residing permanently in the U.S. as an immigrant in accordance with the immigration laws (*i.e.*, a green card), and (2) such status has not been revoked (and has not been administratively or judicially determined to have been abandoned). Further, in general an individual who is not a U.S. citizen or a green card holder will also be treated as a U.S. tax resident during a particular calendar year if he is physically present in the U.S. for 183 days or more during that calendar year or at least 31 days during that calendar year and satisfies the physical presence test under the three-year look-back rule (the *substantial presence* test). Knowing your residency status and planning accordingly can help minimize first-year taxes and provide a window to take action prior to actually becoming a resident. It is also important to understand how residency status impacts your estate and gift tax position. Our guide, Coming to America – U.S. Tax Planning for Foreign Individuals, provides helpful information regarding residency, pre-residency income tax planning and pre-domicile transfer tax planning.

U.S. Tax Planning for Foreign-Owned U.S. Operations

In additional to individual considerations, there are also key U.S. tax issues that should be considered in establishing a foreign-owned U.S. business enterprise in the U.S. Of course, foreign is a relative notion. Used herein, it means a non-U.S. business entity (assumedly a corporation) owned by non-U.S. shareholders. Our guide, Coming to America – U.S. Tax Planning for Foreign-Owned U.S Operations, is intended to outline the key tax issues relating to the organization, operation, repatriation of profits and exit of a foreign-owned U.S. business. It describes the three organizational forms (subsidiary, branch and partnership), highlighting their pros and cons. The guide further describes the considerations involved in deciding whether to capitalize the venture with debt or equity financing, including a discussion on the limits of interest deductibility. It also discusses the tax issues involved in staffing the U.S. business with either U.S. or foreign nationals. The guide further considers the various means to repatriate the profits of the U.S. business, including interest, royalties, and in-bound sales as well as methods for exiting the investment. There are, of course, a number of home country legal and tax issues that must also be considered in structuring an outbound investment (i.e., from a non-U.S. jurisdiction into the U.S.) which is outside the scope of this guide.

Final Thoughts

It is important to weigh any planning ideas against your personal and business objectives. Paying careful attention to how U.S. tax planning interacts with tax treaties and the tax and property laws in other countries is a critical part of this planning.

• Edit this entry

BALTIMORE BOSTON CHICAGO DALLAS GREENWICH HARRISBURG
HOUSTON LONG ISLAND LOS ANGELES NEW JERSEY NEW YORK CITY ORANGE COUNTY
PHILADELPHIA SAN FRANCISCO SEATTLE SILICON VALLEY WASHINGTON, D.C. WEST PALM BEACH
WOODLAND HILLS

ANDERSEN TAX

100 First Street, Suite 1600, San Francisco, CA 94105
AndersenTax.com | Privacy Policy | Terms & Conditions | Disclaimer

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Narrowed Scope of Final and Temporary Sec. 385 Regulations Provide Relief for Some but Not All Taxpayers

On October 13, 2016, IRS and Treasury Department released final and temporary regulations under Sec. 385, (collectively, the Final 385 Regulations), concerning the treatment of certain related-party interests in corporations as stock or indebtedness for federal income tax purposes.

The Final 385 Regulations adopt portions of the proposed regulations issued on April 4, 2016, but are significantly narrower in scope. As a result, the Final 385 Regulations limit the number of taxpayers and transactions affected by the regulations and are a welcome result for many taxpayers and tax professionals who provided comment letters to IRS outlining the added burden the proposed regulations would have caused. For those taxpayers still subject to the Final 385 Regulations, the consequences can be quite serious and the compliance burdens remain heavy.

The Final 385 Regulations treat as stock certain related-party interests that otherwise would be treated as indebtedness and establish threshold documentation requirements that ordinarily must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness.

Application of the Final 385 Regulations is dependent on the relationship and the aggregate amount of debt outstanding between related-party members. Members of a U.S. consolidated group are treated as a single entity, and thus the Final 385 Regulations do not apply to debt between consolidated group members. Below is a discussion of some of the key changes in the scope and application of the Final 385 Regulations.

Removal of Bifurcation Rule:

The Final 385 Regulations do not include a general bifurcation rule, which would have provided IRS, upon audit, with the authority to bifurcate certain interests between related-parties into part debt and part equity. Many taxpayers commented that the rule did not provide specific guidance or articulate clear standards for its application by revenue agents. As a result, the Treasury Department and IRS reserved on this issue but will continue to study the treatment of an instrument as part debt and part stock. In the meantime, with the removal of the bifurcation rule, the debt versus equity classification for U.S. federal income tax purposes remains an all-or-nothing determination.

S Corp Exclusion:

One of the main concerns for S corporations after the release of the proposed regulations was the potential to invalidate an S Election if related-party debt was re-characterized as equity and deemed to create a prohibited second class of stock. To address this issue, the Final 385 Regulations exclude S corporations, along with non-controlled RICs and REITs from the definition of an expanded group, thereby exempting these entities from application of the regulations.

Foreign Issuer Exclusion:

The Final 385 Regulations reserve on all aspects of their application to foreign issuers but will continue to review this issue. The Final 385 Regulations apply only to expanded group instruments (EGIs) and debt instruments issued by a covered member, meaning a member of the expanded group that is a domestic corporation. As a result, all debt issued by foreign corporations, including both controlled foreign corporations (CFCs) and other foreign affiliates is excluded. Excluding debt issued by foreign corporations from the scope of the Final 385 Regulations eliminates the issue under the proposed regulations that the re-characterization of foreign debt could potentially result in the loss of foreign tax credits.

Re-characterization Rules:

Besides a few additional exceptions, most of the re-characterization rules in the proposed regulations were retained in the Final 385 Regulations. Subject to certain exceptions, the General Rule and Funding Rule still apply and related-party debt instruments will be re-characterized as equity if issued (i) as a distribution, (ii) in exchange for related-party stock, (iii) as consideration in an internal asset reorganization, or (iv) to fund a distribution, acquisition of related-party stock or boot in an internal asset reorganization.

Among the new exceptions, the Final 385 Regulations (i) exclude instruments issued by regulated financial groups and insurance entities, (ii) exclude cash pools and short-term loans, (iii) expand the exception for distributions of E&P, (iv) allow netting of distributions against certain capital contributions, (v) exclude stock acquisitions related to employee compensation plans, (vi) limit certain cascading re-characterizations, and (vii) provide modified rules for instruments issued by disregarded entities and controlled partnerships.

Documentation Requirements:

The Final 385 Regulations also eliminate the proposed regulations' 30-day timely preparation requirement and instead treat documentation and financial analysis as timely prepared if it is prepared by the time that the issuer's federal income tax return is filed (taking into account all applicable extensions).

In addition, the Final 385 Regulations provide that, if an expanded group is otherwise generally compliant with the documentation requirements, then a rebuttable presumption, rather than a per se re-characterization as stock, applies in the event of a documentation failure with respect to a purported debt instrument. Under the proposed regulations, failure to satisfy the documentation requirements automatically recast the debt instrument into stock.

Effective Dates:

The general effective date of the Final 385 Regulations is January 19, 2017. However, IRS has provided some relief regarding application of the re-characterization rule through a final transition period and delayed implementation of the documentation requirements. Taxpayers also have the option to apply the proposed regulations for debt instruments issued after April 4, 2016, and before October 13, 2016.

The Final 385 Regulations provide a final transition period that generally exempts debt from re-characterization if it is settled on or prior to January 19, 2017. The final transition period covers debt issued between April 4, 2016 and January 19, 2017, that otherwise would have been recast under the re-characterization rules. Any debt that is not settled during this final transition period will be automatically re-characterized as equity on January 20, 2017.

The documentation requirements apply only to debt instruments issued on or after January 1, 2018.

In Summary

While fewer taxpayers are affected by the Final 385 Regulations, those that remain within the scope of the regulations will find the consequences are quite serious and the documentation requirements, once effective, are quite burdensome.

The general effective date of January 19, 2017 provides taxpayers with three months from the date the regulations were finalized to clean up their related-party group obligations to remove the risk of re-characterization. Taxpayers should take an immediate inventory of their related-party debt obligations to determine those debt instruments impacted by the regulations and assess instruments subject to the re-characterization rules. If there are debt instruments that are subject to re-characterization taxpayers should take advantage of the delay in automatic re-characterization prior to January 19, 2017 to remediate these impacted debt instruments by paying off debt. In addition, taxpayers should work with their tax professionals to establish policies and procedures for complying with the re-characterization rules and documentation requirements on a go-forward basis.

- Edit this entry

BALTIMORE BOSTON CHICAGO DALLAS GREENWICH HARRISBURG
HOUSTON LONG ISLAND LOS ANGELES NEW JERSEY NEW YORK CITY ORANGE COUNTY
PHILADELPHIA SAN FRANCISCO SEATTLE SILICON VALLEY WASHINGTON, D.C. WEST PALM BEACH
WOODLAND HILLS

ANDERSEN TAX

100 First Street, Suite 1600, San Francisco, CA 94105
AndersenTax.com | Privacy Policy | Terms & Conditions | Disclaimer