



FedEx Has Done IUS Developers a Huge Favor

If your company uses software to manage your business, FedEx may have done you a huge favor

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The research and development tax credit is a federal incentive that has been around for more than three decades and is designed to reward businesses for their own internal innovation. If a company makes improvements to any products, processes or techniques, they could be eligible for valuable tax credits – credits that can potentially save a business hundreds of thousands on their bottom line.

Thanks to FedEx, eligibility for this incentive has never been more generous and internal-use software developers have the most to gain.

As you probably already know, FedEx is a package delivery company and in order to grow its business, they invested in computer software that manages and controls its package delivery system. When Congress originally passed the R&D tax credit, computer software development was specifically singled out as an activity Congress sought to reward.

After the legislation passed however, additional standards were put in place for companies, like FedEx, that used internal software systems to manage their business. For these software systems, also known as “internal-use software” (or “IUS”), an extra layer of standards were added to qualify for R&D, regulations commonly referred to as the “High Threshold of Innovation” test.

After spending millions of dollars on its IUS and going through an Internal Revenue Service examination, FedEx and the IRS disagreed on the legal standard that should apply, ultimately leading the company to file a lawsuit in federal court. Both FedEx and the IRS sought a court’s interpretation of the appropriate High Threshold of Innovation test that applied to the company’s IUS.

Looking at the history of the R&D tax credit, it is understandable that FedEx and the IRS were at odds on the correct standards to apply. In 2001, the U.S. Treasury Department issued a ruling interpreting the R&D tax credit

(known as T.D. 8930), which included the definition of what qualifies as research and development activities and specifically referenced the development of computer software. This decision created the original High Threshold of Innovation test, the same law that FedEx contended was the correct applicable standard.

After T.D. 8930 came into law however, Congress became concerned that a portion of the law misinterpreted their intention, making the R&D credit more inclusive than originally intended.

Specifically, Congress and tax professionals alike became alarmed at the so-called “Discovery Rule” and, acknowledging the need to make changes, the Treasury Department issued new proposed regulations in January 2003, eliminating the “Discovery Rule” and rewriting the High Threshold of Innovation test (the new law known as Proposed T.D. 9104).

After the Treasury Department received comments on the proposed legislation, the law was finalized, but with the new High Threshold of Innovation test eliminated from the law.

In January 2004, the IRS issued an announcement allowing taxpayers to rely on the standard (either T.D. 8930 or T.D. 9104) of their choosing with a catch – if taxpayers used the prior standard, the “Discovery Rule” would also be applied to their firm’s eligibility.

In the federal court case, FedEx contended that the 2001 regulation was the correct precedent, while the government argued in favor of the more stringent 2004 standards. Ultimately, the court found in favor of FedEx, ruling that the IRS did not have the legal authority to create an enforceable law through the use of an announcement, a decision that effectively eliminated the “Discovery Rule” for good.

As the FedEx case was the first federal court ruling directly interpreting the appropriate legal standard for IUS, the case is of great importance. While the decision has the potential to help taxpayers across the country understand how to traverse a complicated legal area, taxpayers must be cautious. The decision was issued by a federal district court, not an appellate court or by the United States Tax Court. The case’s precedent can be extremely limited.

After the court reached its ruling, the government gave notice that it intended to appeal the decision. In late August of last year however, the government abandoned the appeal and reached a settlement with FedEx. This action does not change the precedent of the case, but the IRS generally attempts to treat similar taxpayers the same way across the nation. While only time will tell how this case will influence or set IRS policy, the court approved that the High Threshold of Innovation Test is as follows:

(1) 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;

(2) 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

(3) 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 paragraphs (c)(6)(vi)(A) and (B) of this section.

While the FedEx case has reached finality without fireworks, FedEx has delivered the first direct case interpreting the standards to apply to internal-use software. Taxpayers should be cautious when evaluating and applying this standard and they should seek the advice of their tax consultant.

Overall, the High Threshold of Innovation test stated above should be one that gets taxpayers excited – if you think this test applies to the software your company or your client has developed, it is time to dig in and see if you too, are entitled to the R&D tax credit.



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