



Indiana Research Expense Credit

Internal Use Software

While research related to the development of computer software generally meets the definition of “qualified research” under Internal Revenue Code (IRC §41(d)(4), research related to the development of computer software for internal use by the taxpayer generally does not. However, there are exceptions to this general rule.

Internal use software means software developed by (or for the benefit of) the taxpayer primarily for the taxpayer’s internal use. In addition to meeting the definition of “qualified research” under IRC §41(d)(4), internal use software must meet a three part “high-threshold-of-innovation test.” A taxpayer can satisfy the test if they establish that the software meets the criteria in each of the following three parts:

1. **Innovative.** Software is innovative if the software results in a reduction in cost or improvement in speed or other measurable improvement, that is substantial and economically significant, if the development is or would have been successful.
2. **Significant economic risk.** The software development involves significant economic risk if the taxpayer commits substantial resources to the development and if there is substantial uncertainty, because of technical risk, that such resources would be recovered within a reasonable period.
3. **Not commercially available.** The software is not commercially available, meaning that it cannot be purchased, leased, or licensed and used for the intended purpose without modifications that would satisfy the innovation and significant economic risk requirements.

The high-threshold-of-innovation test **does not apply** to the following:

1. Software for use in an activity that constitutes qualified research (other than the development of the internal use software itself)
2. Software for use in a production process
3. A new or improved software and hardware package developed together by the taxpayer as a single product (or the costs to modify an acquired software and hardware package), of which the software is an integral part, used directly by the taxpayer in providing services in its trade or business

Determining Whether Software is Internal Use or Non-Internal Use

Whether software is developed primarily for internal use or not depends on the intent of the taxpayer and the facts and circumstances at the beginning of software development.

Software is developed by (or for the benefit of) the taxpayer primarily for internal use if the software is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer’s trade or business. General and administrative functions are limited to:

1. Financial management functions
2. Human resource management functions
3. Service functions that support day-to-day operations such as data processing or facilities services

Software is not developed primarily for the taxpayer's internal use if it is not developed for use in general and administrative functions that facilitate or support the conduct of a taxpayer's trade or business, such as:

- Software developed to be commercially sold, leased, licensed or otherwise marketed to third parties
- Software developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system

The development of this type of non-internal use software may be eligible for the research expense credit.

Dual-function software

Regarding dual-function software (developed for internal use and for interaction with third parties), there is a presumption that such software is developed primarily for a taxpayer's internal-use. However, if a subset of elements can be identified that only enables the taxpayer to interact with third parties or allows third parties to initiate functions or review data on the taxpayer's system (third party subset), this subset of the software may be treated as non-internal-use software.

If after applying that exception there remains dual-function software or a subset of elements of dual-function software (dual-function subset), a taxpayer may include 25% of the qualified research expenditures of the remaining dual-function software or dual-function subset in computing the research expense credit. However, this is only permitted if the third-party functions are reasonably anticipated to account for at least 10% of the software's use.

Enterprise Resource Planning systems

Taxpayers may qualify for the research expense credit for developing and integrating an Enterprise Resource Planning (ERP) system depending on whether it is developed primarily for internal or external use.

