alleges that the IRS did not follow. For purposes of this paragraph (c)(3)(i)(B), the term *applicable published guidance* means final or temporary regulations, revenue rulings, revenue procedures, information releases, notices, announcements, and, if issued to the taxpayer, private letter rulings, technical advice memoranda, and determination letters. Also, for purposes of this paragraph (c)(3)(i)(B), the term *administrative proceeding* includes only those administrative proceedings or portions of administrative proceedings occurring on or after the administrative proceeding date as defined in § 301.7430–3(c).

* * * * *

Par. 12. Section 301.7430–4 is amended by:

1. Removing the language ''$75'' from paragraph (b)(3)(i) and adding '', in the case of proceedings commenced after July 30, 1996, $110'' in its place.
2. Revising paragraph (b)(3)(ii).
3. Removing the language ''$75'' from the first, second, and third sentences of paragraph (b)(3)(iii)(B) and adding ''$110'' in its place.
4. Removing the language ''$75'' from paragraph (b)(3)(iii)(C) and adding ''$110'' in its place.
5. Removing the language ''$75'' from the third sentence of the example in paragraph (b)(3)(iii)(D) and adding ''$110'' in its place.
6. Removing the language ''$75'' from the second and third sentences of paragraph (c)(2)(ii) and adding ''$110'' in its place.

The revision reads as follows:

§ 301.7430–4 Reasonable administrative costs.

* * * * *

(b) * * *

(3) * * *

(ii) *Cost of living adjustment.* The IRS will make a cost of living adjustment to the $110 per hour limitation for fees incurred in any calendar year beginning after December 31, 1996. The cost of living adjustment will be an amount equal to $110 multiplied by the cost-of-living adjustment determined under section 1(f)(3) for the calendar year (substituting ''calendar year 1995'' for ''calendar year 1992'' in section 1(f)(3)(B)). If the dollar limitation as adjusted by this cost-of-living increase is not a multiple of $10, the dollar amount will be rounded to the nearest multiple of $10 (rounding up if the amount is a multiple of $5).

* * * * *

Par. 13. Section 301.7430–5 is amended by:

1. Revising paragraph (a).
2. Adding paragraph (c)(3).

The addition and revision read as follows:

§ 301.7430–5 Prevailing party.

(a) *In general.* For purposes of an award of reasonable administrative costs under section 7430 in the case of administrative proceedings commenced after July 30, 1996, a taxpayer is a prevailing party only if—

(1) The position of the IRS was not substantially justified;

(2) The taxpayer substantially prevails as to the amount in controversy or with respect to the most significant issue or set of issues presented; and

(3) The taxpayer satisfies the net worth and size limitations referenced in paragraph (f) of this section.

* * * * *

(c) * * *

(3) *Presumption.* If the IRS did not follow any applicable published guidance in an administrative proceeding commenced after July 30, 1996, the position of the IRS, on those issues to which the guidance applies and for all periods during which the guidance was not followed, will be presumed not to be substantially justified. This presumption may be rebutted. For purposes of this paragraph (c)(3), the term *applicable published guidance* means final or temporary regulations, revenue rulings, revenue procedures, information releases, notices, announcements, and, if issued to the taxpayer, private letter rulings, technical advice memoranda, and determination letters. Also, for purposes of this paragraph (c)(3), the term *administrative proceeding* includes only those administrative proceedings or portions of administrative proceedings occurring on or after the administrative proceeding date as defined in § 301.7430–3(c).

* * * * *

Par. 14. Section 301.7430–6 is revised to read as follows:

§ 301.7430–6 Effective date.

Sections 301.7430–2 through 301.7430–6, other than §§ 301.7430–2 (b)(2), (c)(3)(i)(B), (c)(3)(ii)(C), and (c)(5); §§ 301.7430–4 (b)(3)(i), (b)(3)(ii), (b)(3)(iii)(B), (b)(3)(iii)(C), (b)(3)(iii)(D), and (c)(2)(ii); and §§ 301.7430–5 (a) and (c)(3)(i)(B), apply to claims for reasonable administrative costs filed with the IRS after December 23, 1992, with respect to costs incurred in administrative proceedings commenced after November 10, 1988. Section 301.7430–2(c)(5) is applicable March 23, 1993. Section 301.7430–0, §§ 301.7430–2 (b)(2), (c)(3)(i)(B), and (c)(3)(ii)(C); §§ 301.7430–4 (b)(3)(i), (b)(3)(ii), (b)(3)(iii)(B), (b)(3)(iii)(C), (b)(3)(iii)(D), and (c)(2)(ii); and §§ 301.7430–5 (a) and (c)(3) are applicable for administrative proceedings commenced after July 30, 1996.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 96–32380 Filed 12–31–96; 8:45 am]

BILLING CODE 4830–01–U

26 CFR Parts 1 and 602

[REG–209494–90]

RIN 1545–A051

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 41 of the Internal Revenue Code of 1986 describing when computer software which is developed by (or for the benefit of) a taxpayer primarily for the taxpayer's internal use can qualify for the credit for increasing research activities. The proposed regulations reflect a change to section 41 made by the Tax Reform Act of 1986. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of topics to be discussed at the public hearing scheduled for May 13, 1997 must be received by April 22, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–209494–90), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209494–90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax__regs/comments.html. The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Lisa J. Shuman or Robert B. Hanson, 202–622–3120; concerning submissions and the hearing, Christina Vasquez, 202–622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 41 of the Internal Revenue Code provides a credit against tax for increasing research activities. Eligibility for the credit is determined in part on the definition of *qualified research* under section 41(d)(1). Section 231 of the Tax Reform Act of 1986 (the 1986 Act), 1986–3 C.B. 1, 87, established a new definition of *qualified research* for purposes of the research credit. Qualified research was narrowed to require that research be undertaken for the purpose of discovering information that is technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer. In addition, research is eligible for the credit only if substantially all of the activities of the research constitute elements of a process of experimentation for a new or improved function, performance, or reliability or quality. Treasury and the IRS request comments on the appropriate explanation of the terms used in the definition of qualified research under the 1986 Act, in particular, the term *process of experimentation*.

Section 231 of the 1986 Act also specified that expenditures incurred in certain research, research-related, and non-research activities are to be excluded from eligibility for the credit without reference to the general requirements for credit eligibility. Under section 41(d)(4)(E) of the Code, except to the extent provided in regulations, qualified research does not include research with respect to computer software developed by (or for the benefit of) the taxpayer primarily for the taxpayer's own use (internal-use software), other than for use in (1) an activity which constitutes qualified research, or (2) a production process whose development meets the requirements in section 41(d)(1) for qualified research (as where the taxpayer is developing robotics and software for the robotics for use in operating a manufacturing process, and the taxpayer's research costs of developing the robotics are eligible for the credit).

The legislative history indicates that Congress intended to limit the credit for the costs of developing internal-use software to software meeting a high threshold of innovation. In particular, Congress intended that regulations would permit internal-use software to qualify for the credit only if, in addition to satisfying the general requirements for credit eligibility, the taxpayer can establish that the following three-part test is satisfied: the software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant); the software development involves significant 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 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). See H.R. Rep. No. 841, 99th Cong., 2d Sess. II–73. Thus, Congress did not intend that the three-part test in the legislative history would apply in lieu of the general requirements for credit eligibility but, rather, intended that the general requirements for credit eligibility of section 41(d) also would have to be satisfied. See H.R. Rep. No. 841 at II–73.

The legislative history indicates, however, that Congress did not intend the internal-use software exclusion in section 41(d)(4)(E) to apply to research related to the development of a new or improved package of software and hardware developed as a single product of which the software is an integral part, and that is used directly by the taxpayer in providing technological services to customers in its trade or business (as where a taxpayer develops together a new or improved high technology medical or industrial instrument containing software that processes and displays data received by the instrument, or where a telecommunications company develops a package of new or improved switching equipment plus software to operate the switches). See H.R. Rep. No. 841 at II–74.

Congress intended that regulations incorporating the three-part test in the legislative history as an exception to the exclusion from the definition of qualified research under section 41(d)(4)(E) would be effective on the same date section 41(d)(4)(E) became effective. In Notice 87–12 (1987–1 C.B. 432), the IRS stated that regulations to be issued under section 41(d)(4)(E) would be effective for taxable years beginning after December 31, 1985.

Explanation of Provisions

The proposed regulations follow the legislative history and provide that internal-use software that meets the general requirements of section 41(d), is innovative, involves significant economic risk, and is not commercially available for use by the taxpayer is not excluded from eligibility for the research credit under section 41(d)(4)(E). Under the proposed regulations, this is a facts and circumstances test. Treasury and the IRS request comments on facts and circumstances, other than those factors enumerated in the legislative history, to be considered in determining whether internal-use software satisfies the three-part test.

Proposed Effective Dates

The amendments are proposed to be effective for taxable years beginning after December 31, 1985.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described in the **ADDRESSES** portion of this preamble) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 13, 1997, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit (in the manner described in the **ADDRESSES** portion of this preamble) comments and an outline of the topics to be discussed and the time to be devoted to each topic by April 22, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.41–4 also issued under 26 U.S.C. 41(d)(4)(E). * * *

Par. 2. Section 1.41–0 is amended by revising the entry for § 1.41–4 to read as follows:

§ 1.41–0 Table of contents.

* * * * *

§ 1.41–4 Qualified research for taxable years beginning after December 31, 1985.

(a) through (d) [Reserved].
(e) Internal-use computer software.
(1) General rule.
(2) Requirements.
(3) Computer software and hardware developed as a single product.
(4) Primarily for internal use.
(5) Special rule.
(6) Application of special rule.
(7) Effective date.

* * * * *

Par. 3. Section 1.41–4 is revised to read as follows:

§ 1.41–4 Qualified research for taxable years beginning after December 31, 1985.

(a) through (d) [Reserved].

(e) *Internal-use computer software*—(1) *General rule.* Research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if the software satisfies the requirements of paragraph (e)(2) of this section. Generally, research with respect to computer software is not eligible for the research credit where software is used internally, for example, in general and administrative functions (such as payroll, bookkeeping, or personnel management) or in providing noncomputer services (such as accounting, consulting, or banking services).

(2) *Requirements.* The requirements of this paragraph (e)(2) are—

(i) The software satisfies the requirements of section 41(d)(1);

(ii) The software is not otherwise excluded under section 41(d)(4) (other than section 41(d)(4)(E)); and

(iii) One of the following conditions is met—

(A) The taxpayer uses the software in an activity that constitutes qualified research (other than the development of the internal-use software itself);

(B) The taxpayer uses the software in a production process that meets the requirements of section 41(d)(1); or

(C) The software satisfies the special rule of paragraph (e)(5) of this section.

(3) *Computer software and hardware developed as a single product.* This paragraph (e) does not apply to the development costs of a new or improved package of computer software and hardware developed together by the taxpayer as a single product, of which the software is an integral part, that is used directly by the taxpayer in providing technological services in its trade or business to customers. In these cases, eligibility for the research credit is to be determined by examining the combined hardware-software product as a single product.

(4) *Primarily for internal use.* All relevant facts and circumstances are to be considered in determining if computer software is developed primarily for the taxpayer's internal use. If computer software is developed primarily for the taxpayer's internal use, the requirements of this paragraph (e) apply even though the taxpayer intends to, or subsequently does, sell, lease, or license the computer software.

(5) *Special rule.* Computer software satisfies the special rule of this paragraph (e)(5) only if the taxpayer can establish that—

(i) The software is innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant);

(ii) The software development involves significant economic risk (as where 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

(iii) 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 requirements of paragraphs (e)(5) (i) and (ii) of this section).

(6) *Application of special rule.* In determining if the special rule of paragraph (e)(5) of this section is satisfied all of the facts and circumstances are considered. The special rule allows the costs of developing internal-use software to be eligible for the research credit only if the software meets a high threshold of innovation. The facts and circumstances analysis takes into account only the results attributable to the development of the new or improved software independent of the effect of any modifications to related hardware or other software. The weight given to any fact or circumstance will depend on the particular case.

(7) *Effective date.* This paragraph (e) is applicable for taxable years beginning after December 31, 1985.

§§ 1.41–0A through 1.41–8A [Removed]

Par. 4. Sections 1.41–0A through 1.41–8A and the undesignated centerheading preceding these sections are removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. In § 602.101, paragraph (c) is amended by removing the following entries from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * *	*
1.41–4A	1545–0074
1.41–4 (b) and (c)	1545–0074
* * * *	*

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 96–32671 Filed 12–31–96; 8:45 am]

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