Internal Revenue Service

memorandum

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JLHeinkel

date: September 5, 2000

to: LMSB-CTM , **Attn. Saul Ruiz**, MS 1N-4503 956-3867/291-7031

from: District Counsel
Central California

subject: I.R.C. § 174/Rev. Proc. 69-21
[redacted] TL-N-6898-97

Pursuant to the August 23, 2000, memorandum and request of Saul Ruiz, we provide this advice.

ISSUES

1) Whether pursuant to I.R.C. § 174 and Revenue Procedure 69-21, [redacted] must capitalize or may expense consulting fees associated with software development.

2) If capitalized, whether the software was "placed in service" during the audit years enabling [redacted] to take depreciation deductions.

BACKGROUND

[redacted] is on a fiscal year ending [redacted]. In [redacted] entered into a Software License and Support Agreement ("**License Agreement**"), for a new accounting system with [redacted], for $[redacted]. [redacted] capitalized and amortized this cost over a [redacted] year period. In connection with the License Agreement, [redacted] and [redacted] entered into a "Professional Services Agreement" ("**Agreement**"), in [redacted] of [redacted], to customize for [redacted]'s own purposes, the software [redacted] obtained under the License Agreement. There is a document entitled "Addendum Number One To Professional Services Agreement" ("**Addendum**"), which amends the Agreement and that has a footnote date of "[redacted]".

Pertinent parts of the Agreement include paragraphs:

5.1 [redacted] will pay [redacted] on a time and materials basis;

6.1 [redacted] will own all software customizations;

6.2 [redacted] will license the software customizations to [redacted];

8.1 [redacted] warrants that the customizations will conform to the functional specifications for 90 days from [redacted]'s completion. If [redacted] is unable to make the customization conform to the functional specification, [redacted] will terminate the Agreement and refund to [redacted] the fees [redacted] paid for the customization under the Agreement.

The Addendum extended the 90 day warranty period to one year.

In [redacted]'s [redacted] and [redacted] taxable years, [redacted] expensed $[redacted] and $[redacted], respectively, relating to fees it paid [redacted] under the Agreement for customization of the License Agreement accounting software. [redacted] relies on Revenue Procedure 69-21 as authority for expensing the software customization fees. LMSB questions whether the at risk requirements of I.R.C. § 174 are applicable in conjunction with Revenue Procedure 69-21. If yes, LMSB believes that [redacted] was not at risk for the outcome of the software customization services with [redacted]. Therefore, LMSB believes the software development costs at issue must be capitalized.

LMSB notes that [redacted] continues to work on the accounting software. LMSB is seeking to determine how many of [redacted]'s divisions are using the software. To that end, LMSB questions if the customized software has been "placed in service" such as to allow [redacted] to take depreciation deductions.

DISCUSSION

Revenue Procedure 69-21 provides guidelines for examining Federal income tax returns involving the costs incurred to develop, purchase, or lease computer software. "Computer software" includes all programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs. *Rev. Proc.* 69-21 § 2. We believe the software [redacted] is customizing/developing for [redacted] under the Agreement is software within the purview of Revenue Procedure 69-21.

The costs of <u>developing</u> software in many respects closely resembles the kind of research and experimental expenditures that fall within the purview of I.R.C. § 174. *Rev. Proc.* 69-21 § 3.

Therefore, accounting treatment similar to that accorded section 174 expenditures is given to software development costs. *Id.*

A taxpayer may treat research or experimental expenditures which are paid or incurred by it during the taxable year in connection with its trade or business as expenses which are not chargeable to a capital account. I.R.C. § 174; Treas. Reg. § 1.174-3(a). Under this section, a taxpayer can elect to either expense its research and experimental expenditures or amortize them over a period of not less than 60 months[1]. The provisions of I.R.C. § 174 apply to costs paid or incurred by a taxpayer for research or experimentation undertaken directly by it, as well as to expenditures paid or incurred for research or experimentation carried on in its behalf by another person or organization. Treas. Reg. § 1.174-2(a)(2). Additionally, if expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at its risk. Treas. Reg. § 1.174-2(b)(3). *See also,* Letter Rulings: 8614004, November 25, 1985; 9449003, August 25, 1994; FSA 199930016, July 30, 1999.

With respect to the treatment of costs paid or incurred to purchase software, the Service will not disturb the taxpayer's treatment of purchased software costs if the following practices are consistently followed:

a. Where purchased software costs are included, without being separately stated, in the cost of the hardware and such costs are treated as a part of the cost of the hardware that is capitalized and depreciated; or

b. Where purchased software costs are separately stated, and the software is treated by the taxpayer as an intangible

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[1]A taxpayer's treatment of the costs of development of software in accordance with the above procedures is treated as a method of accounting. Any change in the treatment of such costs is a change in method of accounting subject to the provisions of sections 446 and 481 of the Code and the Income Tax Regulations thereunder. Rev. Proc. 69-21, § 6, *see also*, Rev. Rul. 71-248, 1971-1 C.B. 55 - the capitalization of software development costs with respect to a new computer where such costs incurred in connection with another computer had previously been expensed is a change in method of accounting requiring the Commissioner's consent.

asset the cost of which is to be recovered by amortization deductions ratably over a period of five years, or such shorter period as can be established by the taxpayer as appropriate in any particular case if the useful life of the software in its hands will be less than five years. Rev. Proc. 69-21 § 4.

Therefore, to determine if [redacted] can expense its consulting fees associated with its software customization, we must first determine whether [redacted]'s payments to [redacted] to customize the new software system for it constitute costs of:

a. developing software under section 3 of Rev. Proc. 69-21. If yes, [redacted] may expense the customization costs if [redacted] has consistently expensed such costs (Rev. Proc. 69-21 § 3.01(1)); or

b. costs of purchased software under section 4 Revenue Procedure 69-21 requiring [redacted] to capitalize and amortize the customization costs.

The determination of whether [redacted]'s payments to [redacted] are software development costs or costs of purchased software depends on which party bore the risk of developing the new software system. Therefore, the agreements between [redacted] and [redacted] must be examined.

Under the Agreement and Addendum which appear to have been entered into fairly contemporaneously, (LMSB should verify when the Addendum was entered into), [redacted] agreed to customize [redacted]'s software on a time and materials basis. This is indicative of [redacted]'s payments to [redacted] being software development costs.

However, [redacted] warranted that the customizations would conform to [redacted]'s functional specifications for one year from [redacted]'s completion of the customization. In the event [redacted] was ultimately unable to make the software customization conform to [redacted]'s functional specification, [redacted] would be required to refund to [redacted] the fees [redacted] paid under the Agreement. This is indicative that [redacted]'s payments to [redacted] under the Agreement were for the purchase of software, much like the original [redacted] software [redacted] received under the License Agreement (*see Rev. Proc.* 69-21 § 3, Treas. Reg. § 1.174-2(b)(3)).

Therefore, it is our opinion, that the [redacted] software [redacted] received under the Agreement must be capitalized as was the [redacted] software [redacted] received under the License Agreement.

LMSB further questioned whether the cost of the customized software at issue would qualify for depreciation deductions in the audit years since its questionable whether the customized software was ever "placed in service" during the audit years. "[T]he period for depreciation of an asset shall begin when the asset is placed in service . . ." Treas. Reg. § 1.167(a)-10(b). Generally, an asset is placed in service for depreciation purposes when it is acquired and available for use in the business, even if it is not actually used. *See Sears Oil Co. v. Commissioner*, 359 F.2d 191, 198 (2d Cir. 1966), *aff'g* in part, *rev'g* in part, and remanding T.C. Memo. 1965-39; *P. Dougherty Co. v. Commissioner*, 159 F.2d 269 (4th Cir. 1946), *aff'g* 5 T.C. 791 (1945). *Sandoval v. Commissioner* T.C. Memo. 2000-189.

Depreciation may be taken when depreciable property is available for use "should the occasion arise," even if the property is not in fact in use. *P. Dougherty v. Commissioner*, 159 F. 2d 269 (4th Cir. 1946); *Kittredge v. Commissioner*, 88 F. 2d 632 (2d Cir. 1937); *Otis Beall Kent*, 12 CCH Tax Ct. Mem. 1491 (1953) (farm structures completed but not used in the year for which depreciation deduction taken); *George S. Jephson*, 37 B. T. A. 1117 (1938) (rental property ready for rent but not rented in the year for which depreciation deduction taken). The key fact that LMSB needs to uncover is what year did the customized software become available for use. We also encourage LMSB to determine if various versions of the software have been available for use. LMSB will need to determine if there was operable software available for use that [redacted] continued to improve. If yes, [redacted] is entitled to depreciation deductions. However, if the accounting software was incapable of performing the required function and thus not available for use, [redacted] is not entitled to depreciation deductions. To that end, a good indicator of whether the software was available for use, was the extent that [redacted] used it.

If you have any further questions, please contact Jeffrey L. Heinkel at 408-817-4679.

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