Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CLE:PIT:TL-N-2384-01
MAYost

date: AUG 1 2001

to: Dennis Sorel, Team Coordinator, [redacted] Audit

thru: Shirley Hoops, Sr. Team Coordinator, [redacted] Audit

from: Associate Area Counsel, LM:MCT:CLE:PIT

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subject: [redacted] - **Capitalized Software Costs**
[redacted]
U.I.L. Nos. 174.01-01, 174.05-02 and 446.04-03

Our National Office has modified the advice that we previously issued in our prior memorandum dated June 14, 2001. As previously indicated, our memorandum was subject to 10-day post review in the National Office and, therefore, was subject to modification.

The National Office takes the position that the taxpayer's actions with respect to the [redacted] project did not give rise to a change in method of accounting. We previously advised that it could be argued that there was a change in method, but indicated that such argument was subject to substantial hazards. The National Office maintains that in order for a change in method of accounting to have occurred in this case, the taxpayer had to either (a) obtain consent of the Commissioner to capitalization of the [redacted] costs, or (b) consistently capitalize/amortize the costs of the [redacted] project on two consecutive returns (capitalization of the costs of a project without consent would constitute an improper method of accounting for a taxpayer that expenses software development costs under Rev. Proc. 69-21). Since the taxpayer did not treat the costs of the project in a consistent manner in [redacted] and [redacted], the taxpayer never adopted capitalization as its method of accounting for these costs. The National Office concluded, therefore, that because there was no change in method of accounting in the treatment of the costs of the [redacted] project, the taxpayer does not need the Commissioner's consent to revert back to its old method of expensing all software development costs.

If you have any questions, please call Attorney Michael A. Yost, Jr. at (412) 644-3441.

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Office of Chief Counsel
Internal Revenue Service

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from: Associate Area Counsel, LM-MCT:CLE:PIT

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subject: [redacted] **- Capitalized Software Costs**
[redacted]
U.I.L. Nos. 174.01-00, 174.05-02 and 446.04-03

This memorandum responds to your request to assistance dated April 5, 2001. This memorandum should not be cited as precedent. It is also subject to 10-day post review in the National Office and, therefore, is subject to modification.

ISSUES

1. What is the proper tax treatment for software development costs claimed by the taxpayer with respect to a particular project associated with a specific long-term service contract?

2. Did the taxpayer change its method of accounting for software development costs when it capitalized such costs relating to the project and, if so, whether the taxpayer can revert back to its old method of expensing such costs without securing the consent of the Commissioner pursuant to I.R.C. § 446(e)?

CONCLUSIONS

1. The taxpayer's tax treatment of the software development costs at issue is governed by the guidelines set forth in Rev. Proc. 69-21, 1969-2 C.B. 303 and Rev. Proc. 2000-50, 2000-52 I.R.B. 601, which updated and superseded Rev. Proc. 69-21. These revenue procedures indicate that software development costs are so similar to I.R.C. § 174 research and exploration expenditures as to be treated in the same manner. The revenue procedures allow the taxpayer here to either deduct the costs or to capitalize and amortize them. This alternative treatment is

available even where, as here, the costs are related to a specific long-term service contract.

2. It can be argued that the taxpayer changed its method of accounting for software development costs when it capitalized such costs in [redacted] and the taxpayer can not revert back to its old method of expensing such costs without first securing the consent of the Commissioner pursuant to I.R.C. § 446(e), but, as discussed below, such position is subject to substantial litigating hazards.

FACTS

On [redacted], a [redacted] affiliate, entered into a service contract with [redacted], [redacted], Louisiana. [redacted] contracted with [redacted] to provide services with respect to the safekeeping and processing of securities and other assets and for related record keeping and accounting activities. The contract was effective from [redacted] and continued for a period of [redacted] years from the date [redacted] actually began to provide services, which was expressly not to begin until the later of [redacted] or the date on which [redacted] first became capable of providing the services, but no later than [redacted]. The term of the contract was subject to automatic renewal for successive [redacted]-year periods.

To be capable of performing its agreed accounting and reporting responsibilities under the [redacted] contract, [redacted] incurred substantial costs in [redacted] and [redacted] for internal software development done in accord with [redacted]'s specifications to permit [redacted]'s computerized system to track [redacted]'s securities and investments in a manner which would readily transfer data to [redacted]'s own computer system.[1] [redacted] was apparently the first customer for which [redacted] established a direct computer link or interface. Under the contract, [redacted] was also obligated to furnish [redacted] with systems documentation and written operating procedures.

For book purposes, [redacted] capitalized the [redacted] software development costs in [redacted] and then amortized the costs over [redacted] months, starting in [redacted] of [redacted]. On its [redacted] income tax return, [redacted] showed no Schedule M adjustment with respect to these costs, indicating that the costs were capitalized for tax purposes. [redacted] contends, however, that the capitalization was

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[1] There is no indication that the taxpayer utilized any purchased or leased software in the interface project.

erroneous and the costs should have been deducted in [redacted]. It was [redacted]'s policy for tax to expense all internally developed software pursuant to Rev. Proc. 69-21, 1969-2 C.B. 303, which it had done with respect to other such costs in [redacted], as well as in prior and subsequent years. [redacted] alleges that the tax department was not aware that the [redacted] project costs had been capitalized and followed the book treatment for [redacted]. [redacted] is requesting a [redacted] audit adjustment allowing a deduction for the [redacted] development costs in the amount of $ [redacted]. In [redacted], [redacted] took a deduction for the development costs incurred on the [redacted] project in that year. Additionally, [redacted] showed a Schedule M reversal in [redacted] with respect to the book expense taken for the [redacted] capitalized costs. The same was done for [redacted] and [redacted], which means that [redacted] did not claim any amortization for the capitalized [redacted] software development costs in subsequent years.

DISCUSSION

Tax Treatment of Software Costs

The Service issued initial guidelines for use in examining the tax treatment of internally developed computer software in Rev. Proc. 69-21, 1969-2 C.B. 303, which was later superseded by Rev. Proc. 2000-50, 2000-52 I.R.B. 601.

For purposes of Rev. Proc. 69-21, "computer software" broadly included 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. This definition of computer software encompassed all classes of programs, including operating systems, executive systems, monitors, compilers and translators, assembly routines and utility programs, as well as application programs. See § 2 of Rev. Proc. 69-21.

Section 3.01-1 of Rev. Proc. 69-21 states that the costs of developing software by a taxpayer in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of I.R.C. § 174 as to warrant accounting treatment similar to that provided such costs under that section.[2] Accordingly, the Service indicated that it would not disturb a taxpayer's treatment of costs incurred in developing software where all of the costs properly attributable to the

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[2] In Rev. Proc. 69-21, the Service did not take the position that software development costs are, in fact, research and experimental expenditures within the meaning of I.R.C. § 174.

development of software by the taxpayer are consistently treated as current expenses and deducted in full under rules similar to those applicable under I.R.C. § 174(a). Likewise, under § 3.01-2 of Rev. Proc. 69-21, the Service would not disturb a taxpayer's consistent treatment of software development costs as capital expenditures that are recoverable through deductions for ratable amortization, in accord with rules similar to those provided by I.R.C. § 174(b) and the regulations thereunder, over a period of five years from the date of completion of such development or over a shorter period where the taxpayer clearly establishes that such costs have a useful life of less than five years.

In Rev. Proc. 2000-50, the Service reaffirms much of the guidance issued in Rev. Proc. 69-21. The definition of "computer software" covered by Rev. Proc. 2000-50 is as broad as that in Rev. Proc. 69-21, and includes "any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine." The definition embraces computer programs of all classes. See § 2 of Rev. Proc. 2000-50.

The Service again states in Rev. Proc. 2000-50 that it will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where all of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under I.R.C. § 174(a). Rev. Proc. 2000-50 also indicates that the Service will not disturb the taxpayer's treatment of development costs which are consistently capitalized and amortized, but does, however, update the old guidelines under Rev. Proc. 69-21 to comport with the regulations under I.R.C. § 167 to provide for capitalized software costs to be amortized over 60 months from the date of completion of the development or, in accord with rules under § 167(f), over 36 months from the date the software is placed in service.

Under Rev. Proc. 2000-50, for tax years ending prior to December 1, 2000, the Service will challenge only those taxpayers who have treated software development costs in a way "markedly inconsistent" with the practices described in the revenue procedure. It appears that those taxpayers who in prior years followed Rev. Proc. 69-21 in their handling of software costs will generally have acted consistently with Rev. Proc. 2000-50.

Clearly, [redacted]'s software development expenses at issue here

fall within the scope of Rev. Procs. 69-21 and 2000-50. The programming in question was done by [redacted] to enable [redacted]'s computer system to interface directly with its own system and, thus, involved programs or routines causing its computers to perform a set of tasks or functions. Moreover, the software developed by [redacted] represented either an utility or application program, both of which are among the classes of covered software specifically mentioned. Further, [redacted] had established a tax policy to expense such software costs, as permitted under Rev. Proc. 69-21, and consistent therewith, [redacted] expensed all of its development costs in prior and subsequent years other than the costs incurred in [redacted] in connection with the [redacted] project.

The bottom line is that if [redacted] had adhered to its existing practice and expensed the [redacted] development costs, Rev. Procs. 69-21 and 2000-50 would apply, and in accord with the Service's administrative position set forth therein, [redacted]'s deduction would not be subject to adjustment on audit, provided the costs claimed were reasonable. The Service's administrative position does not draw an exception for software development costs that are associated with a long-term asset such as the [redacted] service contract. Therefore, as with its other internally developed software, [redacted] could have deducted the [redacted] development costs when incurred.

Change in Method of Accounting

Although [redacted] could have deducted the software development costs, the fact remains that [redacted], in effect, capitalized the costs that it incurred in the [redacted] project during the taxable year [redacted]. The issues, therefore, arise whether [redacted] changed its prior method of accounting for such costs and, if so, whether it needs the consent of the Commissioner before changing its method of accounting back to deducting the software costs, pursuant to I.R.C. § 446(e).

Treas. Reg. § 1.446-1(e)(2)(i) requires that consent to change a method of accounting must be secured whether or not such method is proper or permitted. See, Commissioner v. O Liquidating Corp., 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961). Thus, if [redacted]'s capitalization of the [redacted] project costs in [redacted] was a change in its method of accounting, [redacted] would need the consent of the Commissioner to change back to expensing such costs, even though the capitalization of such costs in [redacted] was unauthorized, since it was made without first getting the Commissioner's consent. See, TAM 9421003 (February 4, 1994)(A similar position was taken where the taxpayer deducted software costs for 16 years after which it capitalized a portion of such costs for 5 years).

While the Commissioner is authorized under I.R.C. § 446(e) to consent to [redacted]'s request for a retroactive change to [redacted], Barber v. Commissioner, 64 T.C. 314 (1975), [redacted] does not have the right to demand that a change in a method of accounting be made retroactively. See, Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989), cert. denied, 498 U.S. 823 (1990). But, we do have some concern that a court may find a lack of consent on our part to be arbitrary, in light of [redacted]'s quick action in [redacted] to correct its alleged "mistake".

An argument can be made that [redacted] changed its method of accounting for software development costs for the [redacted] project when it capitalized such costs in [redacted]. Under Treas. Reg. § 1.446-1(e)(2)(ii)(a), a change in method of accounting includes not only a change in the overall plan of accounting for gross income or deductions, but also a change in the treatment of any material item used in such overall plan. A material item is any item which involves the proper time for the inclusion of an item in income or the taking of a deduction. The change from deducting to capitalizing the [redacted] project costs implicates the timing of the deduction for such costs. Thus, the treatment of such costs would seem to qualify as a material item.

Moreover, Rev. Procs. 69-21 and 2000-50 state that any change in the treatment of software costs is a change in method of accounting to which I.R.C. §§ 446 and 481 apply. Further, Treas. Reg. § 1.174-3(a) permits research and experimental expenditures to be treated on a project-by-project basis. And, since the costs of developing software are said to closely resemble research and experimental expenses and are afforded similar tax treatment under Rev. Procs. 69-21 and 2000-50, software development costs may be treated on a project-by-project basis. See Rev. Rul. 71-248, 1971-1 C.B. 55. Thus, [redacted]'s change in method could involve only the software costs related to the [redacted] project.

Based on the facts of the case, however, this argument would appear to be subject to some litigating hazards. Treas. Reg. § 446-1(e)(2)(ii)(a) provides that in most instances a method of accounting for an item is established by a pattern of consistent treatment, although a method of accounting may exist without the necessity of such a pattern. The question here is whether there was sufficient consistency of treatment of the software costs associated with the [redacted] project to establish that [redacted] adopted a new method of accounting with respect to these costs in [redacted]. As indicated above, [redacted] did not account for the development costs incurred in [redacted] on the project in the same manner that it did in [redacted]. The [redacted] costs were deducted by [redacted], which was in line with its overall plan of accounting for

other developed software. In addition, starting in [redacted], [redacted] reversed all Schedule M adjustments for book amortization relating to the [redacted] capitalized costs, thus not claiming any ratable deductions for such costs in subsequent years.

Plainly, under these facts, the Service can not point to a pattern of consistent treatment of the [redacted] software costs spanning multiple tax years. See, Rev. Rul. 90-38, 1990-1 C.B. 57, citing Diebold, Inc. v. United States, supra., which notes that treatment of an item in the same way in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of Treas. Reg. § 1.446-1(e)(2)(ii)(a).[3] A change in a method of accounting presupposes that the method from which the taxpayer is changing was adopted at some point in the past. The Service's countervailing argument here is that [redacted] elected to follow book treatment to capitalize and amortize the [redacted] project costs in the first return (ie., for the tax year [redacted]) that reflected these project costs and this choice of method was permissible under Rev. Procs. 69-21 and 2000-50. Under these circumstances, it would not be necessary for [redacted] to treat the item consistently in two or more consecutive tax returns before it can be deemed to have adopted a new method of accounting for the item. See Treas. Reg. § 1.446-1(e)(1); Pacific National Co. v. Welch, 304 U.S. 191 (1938).

Additionally, the lack of consistency between tax years in the accounting treatment for the [redacted] costs would also appear to strengthen [redacted]'s claim that its corrective action in [redacted] demonstrates that it was merely fixing an error in [redacted] in the application of its general method of accounting for developed software, and does not involve a method change to which the Commissioner's consent is required. See, Northern States Power Co. v. Commissioner, 151 F.3d 876 (8th Cir. 1998)(taxpayer allowed to expense previously capitalized costs, since capitalization was unintentional, resulting from a "posting" error); but compare, Cargill Inc. v. United States, 91 F.Supp.2d 1293 (D.C. Minn. 2000)(method used and from which taxpayer sought to change was a deliberate choice, rather than an inadvertent mistake). See also, Standard Oil Co. (Indiana) v. Commissioner, 77 T.C. 349, 382-83 (1981), appeal dismissed,(7th Cir. 1982), acq. in result only, 1989-2 C.B. 1; Gimbel Bros., Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1976), non-acq., A.O.D. CC-1976-345 (Aug. 6, 1976). Finally, Rev. Rul. 58-74, 1958-1 C.B. 148, holds

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[3] There is also some authority that indicates that a taxpayer can correct an erroneous accounting treatment by filing an amended return before the following year's return is filed. See, Rev. Rul. 72-491, 1972-2 C.B. 104.

that where a taxpayer who adopted the I.R.C. § 174(a) expense method for all its research expenses in its first taxable year, but failed to deduct some of its costs, was able to file refund claims for all open years to deduct the omitted costs. The Service has indicated, however, that Rev. Rul. 58-74 should not be extended beyond its I.R.C. § 174 situation and is limited to the relief provided to specific taxpayers in that setting. See, TAM 9421003 (February 4, 1994).

This writing may contain privileged information. Any authorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions, please call Attorney Michael A. Yost, Jr. at (412) 644-3441.

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