Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Capitalization of Software Development Costs
POSTN-124481-15

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether the principles and conclusions of PLR 200236028 continue to apply to the treatment of acquired and developed software costs?

CONCLUSION

The principles and conclusions of PLR 200236028 continue to apply to the treatment of acquired and developed software costs.

FACTS

In PLR 200236028 (June 4, 2002), the Internal Revenue Service addressed the income tax consequences on the purchase, development, and implementation of

Enterprise Resource Planning (ERP) software acquired by a taxpayer from a third party as well as acquired computer hardware. ERP software is a database software system that integrates different business functions such as financial accounting, sales and distribution, materials management, and production planning. Implementation of the ERP system generally involves various categories of costs, including (1) costs to acquire the ERP software package from the vendor, (2) costs to install the acquired ERP software on the taxpayer's computer hardware and to configure the software to the taxpayer's needs through the use of options and templates embedded in the software, (3) software development costs, and (4) costs to train employees in the use of the new software. The ERP software is not usable until the implementation is completed. The Service concluded the following:

       (1) The cost of the purchased ERP software (including the sales tax) is to be capitalized under § 263(a) of the Internal Revenue Code and amortized under § 167(f) ratably over 36 months, beginning with the month the software is placed in service by the taxpayer;

       (2) The employee training and related costs (maintenance, troubleshooting, and running reports during the training; such costs did not include any reorganizational expenditures) are deductible as current expenses under § 162. However, the pre-paid training expenses are deductible as a current expense in the year in which incurred under the requirements of § 461;

       (3) The separately stated computer hardware cost is to be capitalized under § 263(a) and depreciated under § 168 over a 5-year recovery period;

       (4) If the taxpayer is solely responsible for the creation and performance of the software project covered by the consulting contracts, the costs of writing machine readable code software (and its allocable portion of the costs of modeling and design of additional software) under the taxpayer's consulting contracts are self-developed computer software and are allowed to be deductible as current expenses pursuant to section 5.01(1) of Rev. Proc. 2000-50, 2000-2 C.B. 601; and

       (5) The costs of option selection and implementation of templates (and its allocable portion of the costs of modeling and design of additional software) under the taxpayer's consulting contracts are installation/modification costs that are to be capitalized and amortized as part of the purchased ERP software ratably over 36 months, beginning with the later of the month the purchased software is placed in service by the taxpayer or the month the template work is available for use by the taxpayer. The undefined miscellaneous costs under the taxpayer's consulting contracts are also capitalized as a part of the underlying purchased ERP software and amortized over the same 36 month period described in the preceding sentence.

       On December 19, 2002, the Service and Treasury Department issued proposed regulations that explained how § 263(a) applies to amounts paid to acquire, create, or

enhance intangible assets (the "proposed intangible regulations"). 67 Fed. Reg. 77701.
The proposed intangible regulations did not specifically address the treatment of ERP
implementation costs. Instead, the preamble to the proposed intangible regulations
provided that the Service and Treasury Department expected that the final regulations
would address these costs and, subject to the simplifying conventions provided in the
proposed intangible regulations for employee compensation, overhead, and de minimis
transaction costs, will treat such costs in a manner consistent with the treatment
prescribed in PLR 200236028.

On January 5, 2004, the Service and Treasury Department issued final
regulations that explained how § 263(a) applies to amounts paid to acquire, create, or
enhance intangible assets (the "final intangible regulations"). T.D. 9107, 69 Fed. Reg.
436. The final intangible regulations also did not specifically address the treatment of
ERP implementation costs. The preamble to the final intangible regulations stated that
issues relating to the development and implementation of computer software were more
appropriately addressed in separate guidance, and not in the final intangible
regulations. The preamble further provided that, while the final intangible regulations
require a taxpayer to capitalize an amount paid to another party to acquire computer
software from that party in a purchase or similar transaction (*see* § 1.263(a)-4(c) of the
Income Tax Regulations), nothing in the final intangible regulations was intended to
affect the determination of whether computer software is acquired from another party in
a purchase or similar transaction, or whether computer software is developed or
otherwise self-created (including amounts paid to implement ERP software). The
preamble indicated that the issue of the treatment of ERP implementation costs was
more appropriately addressed in separate guidance dedicated exclusively to computer
software issues and, until such separate guidance was issued, that taxpayers may
continue to rely on Rev. Proc. 2000-50. The preamble to the final intangible regulations
did not cite to PLR 200236028. To date, no separate guidance has been issued.

LAW AND ANALYSIS

Some taxpayers are taking the position that the conclusions set forth in PLR
200236028 no longer apply following the promulgation of § 1.263(a)-4. We disagree.

Section 162(a) provides, in part, that there shall be allowed as a deduction all the
ordinary and necessary expenses paid or incurred during the taxable year in carrying on
any trade or business.

However, section 263(a) provides, in part, that no deduction shall be allowed for
any amount paid out for new buildings or for permanent improvements or betterments
made to increase the value of any property or estate. Section 1.263(a)-4 provides rules
for requiring the capitalization of costs associated with the acquisition or creation of an
intangible asset.

Section 1.263(a)-4(c)(1) requires a taxpayer to capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Section 1.263(a)-4(c)(1) also provides a nonexclusive list of examples of the types of intangibles taxpayers must capitalize including, in relevant part, computer software. Section 1.263(a)-4(c)(1)(xiv).

Section 1.263(a)-4 did not render PLR 200236028 obsolete. The cost of the purchased ERP software (including the sales tax) are capital expenditures pursuant to § 263(a) and § 1.263(a)-4(c)(1)(xiv). Because the ERP software is not usable to the taxpayer without the option selection and implementation of templates, the costs of option selection and implementation of templates (and its allocable portion of the costs of modeling and design of additional software) are capitalized as part of the purchased ERP software. *See* § 1.263(a)-4(g)(1).

Some taxpayers are taking the position that Rev. Proc. 2000-50 allows the deduction of all software costs. We disagree.

Rev. Proc. 2000-50 provides guidelines on the treatment of the costs of computer software. Section 2 of Rev. Proc. 2000-50 defines the term "computer software" as 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.

Section 5.01 of Rev. Proc. 2000-50 provides, in part, that the cost of developing computer software in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of § 174 as to warrant similar accounting treatment. Accordingly, the Service will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project 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 § 174.

Section 6.01(2) of Rev. Proc. 2000-50 provides that with respect to the costs of acquired computer software, the Service will not disturb the taxpayer's treatment of costs that are separately stated if the costs are consistently treated as capital expenditures for an intangible asset the cost of which is to be recovered by amortization deductions ratably over a period of 36 months beginning with the month the software is placed in service, in accordance with the rules under § 167(f)(1). See § 1.167(a)-14(b)(1).

Section 4 of Rev. Proc. 2000-50 provides that this revenue procedure applies to all costs of computer software as defined in section 2 of Rev. Proc. 2000-50. Accordingly, Rev. Proc. 2000-50 applies only to the costs for computer software as that term is defined in section 2 of Rev. Proc. 2000-50.

Accordingly, the principles and conclusions contained in PLR 200236028 continue to apply. However, PLR 200236028 may not be used or cited as precedent. *See* § 6110(k)(3).

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