

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC::PSI:6-PLR-166142-01
Date:
June 4, 2002

Re: Request for Private Letter Ruling Regarding Computer Software

Legend:

P =

Taxpayer =

K =

L =

M =

Year 1 =

Year 2 =

\$a =

\$b =

\$c =

\$d =

\$e =

\$f =

\$g =

\$h =

\$i =

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\$j =

\$k =

\$m =

Dear

This letter responds to a letter dated November 28, 2001, submitted on behalf of Taxpayer requesting a ruling concerning the income tax consequences on the purchase, development, and implementation of a customized computer software database. Additional material was submitted on May 8, and May 17, 2002.

FACTS

Taxpayer represents that the facts relating to its request are as follows:

Taxpayer is a wholly owned subsidiary of P, a foreign corporation. Taxpayer is engaged in the business of marketing and distributing products related to the music industry. Taxpayer purchases its most significant product line from P and is a distributor of other products manufactured by third parties. Taxpayer is an accrual basis taxpayer with a March 31 year end.

In Year 1, Taxpayer acquired Enterprise Resource Planning (ERP) software from K and acquired computer hardware. ERP software is a shell that integrates different software modules for financial accounting, inventory control, production, sales and distribution, and human resources. Usually consultants are hired to implement the ERP package by customizing the software programs and routines within the shell to fit a taxpayer's specific needs. This implementation is accomplished by using internal ERP templates and pre-set programs and by writing additional machine readable code. The ERP software is not usable until the implementation is completed. Taxpayer entered into a consulting agreement with K for additional software development and employee training for the newly developed software. In addition, Taxpayer entered into an agreement with L to act as project manager for the implementation and design modifications of the ERP system. In Year 2, Taxpayer entered into an agreement with M for additional training, software design enhancements, and technical issue resolution.

Taxpayer's expenditures for the software project during Year 1 and Year 2 were as follows:

Computer hardware	\$b
ERP software fee and sales tax	\$c
Functional Consulting Costs paid to K	\$d
Maintenance	\$e
Prepaid outside training	\$f
Functional Consulting Costs paid to L	\$g

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Technical Consulting Costs:	
Model/Design Software	\$h
Write Machine readable code	\$i
Option/Implement Templates	\$j
Miscellaneous	\$k
Project Total	\$m

The functional consulting costs represent training, troubleshooting, maintenance, and running reports during the training. Such costs did not include any reorganization expenditures. The technical consulting costs represent the modeling and design of additional software, the writing of machine readable code, and the option selection and implementation of existing imbedded ERP templates.

The original budget for the software and the consulting combined from K was \$a (including the ERP software fee). The actual cost, excluding the computer hardware, was almost 3.9 times higher than anticipated. Pursuant to the consulting contracts, Taxpayer was responsible for the costs of completing the project, including correcting, at its own expense, any problems relating to the software systems operability or functionality. The contracts provided no guarantees or warranties of the operability of the systems whose development the consultants were aiding. The consultants were to be paid regardless of their success or failure. For example, the Consulting Services Agreement with K specifically provides, in part “No specific result from provision of the Services is assured or guaranteed. [K] disclaims all other warranties, express or implied, including but not limited to the warranties of merchantability, and fitness for a particular purpose.”

RULINGS REQUESTED

Taxpayer requests rulings that:

- (1) The cost of the acquired ERP software is amortized ratably over a 36 month period upon the system being placed in service, pursuant to § 167(f)(1) of the Internal Revenue Code.
- (2) Employee training costs are deductible as current expenses, pursuant to Rev. Rul. 96-62, 1996-2 C.B. 9, and § 162.
- (3) The self-developed software costs are treated as current expenses, not capital expenditures, pursuant to section 5.01(1) of Rev. Proc. 2000-50, 2000-2 C.B. 601.
- (4) The separately stated cost of computer hardware is depreciated over a 5-year recovery period pursuant to § 168.

LAW AND ANALYSIS

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

However, § 263 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.

In addition, § 1.263(a)-1(b) of the Income Tax Regulations indicates that in general, capital expenditures include amounts paid or incurred (1) to add value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. However, amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.

Section 167(a) provides, in part, that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, or obsolescence of property used in a trade or business.

If a depreciation deduction is allowable under § 167(a) for computer software, § 167(f)(1)(A) provides that such depreciation deduction shall be computed by using the straight line method and a useful life of 36 months. Section 1.167(a)-14(b)(1) provides that the amount of the deduction for computer software described in § 167(f)(1) and § 1.197-2(c)(4) is determined by amortizing the cost or other basis of the computer software using the straight line method described in § 1.167(b)-1 (except that its salvage value is treated as zero) and an amortization period of 36 months beginning on the first day of the month that the computer software is placed in service.

For purposes of § 167, the term “computer software” is defined in § 167(f)(1)(B) as having the meaning given to such term by § 197(e)(3)(B), except that such term shall not include any computer software that is an amortizable section 197 intangible.

Except as otherwise provided in § 197, § 197(c) defines the term “amortizable section 197 intangible” as meaning, in general, any section 197 intangible that is acquired by the taxpayer after August 10, 1993, and that is held in connection with the conduct of a trade or business or an activity described in § 212. Section 197(e)(3)(A) provides, in part, that the term “section 197 intangible” shall not include computer software that is not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

Section 197(e)(3)(B) provides that the term “computer software” means any program designed to cause a computer to perform a desired function. Such term shall not include any data base or similar item unless the data base or item is in the public

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domain and is incidental to the operation of otherwise qualifying computer software. See also § 1.197-2(c)(4)(iv).

Rev. Proc. 2000-50 provides guidelines on the treatment of the costs of computer software. Section 2 of this revenue procedure defines 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 Internal Revenue 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).

The depreciation deduction provided by § 167(a) for tangible property placed in service after 1986 generally is determined under § 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system in § 168(a); and (2) the alternative depreciation system in § 168(g). Under either depreciation system, the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either § 168(a) or § 168(g), the applicable recovery period is determined by reference to class life or by statute. Section 168(e)(3)(B)(iv) provides that any qualified technological equipment is 5-year property. Pursuant to § 168(c), 5-year property has a recovery period of 5 years for purposes of the general depreciation system in § 168(a). For purposes of the alternative depreciation system in § 168(g), § 168(g)(3)(C) provides that in the case of any qualified technological equipment, the recovery period shall be 5 years.

The term "qualified technological equipment" is defined in § 168(i)(2)(A) as meaning, in part, any computer or peripheral equipment. Section 168(i)(2)(B)(ii) defines the term "computer" as meaning a programmable electronically activated device that (I) is capable of accepting information, applying prescribed processes to the information,

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and supplying the results of these processes with or without human intervention, and (II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. Section 168(i)(2)(B)(iii) defines the term “related peripheral equipment” as meaning any auxiliary machine (whether on-line or off-line) that is designed to be placed under the control of the central processing unit of the computer. However, pursuant to § 168(i)(2)(B)(iv)(A), the term “computer or peripheral equipment” shall not include any equipment that is an integral part of other property that is not a computer.

The computer software expenditures addressed herein were not incurred in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Therefore, in this case, the computer software is not subject to amortization under § 197.

The cost of the purchased ERP software, along with the sales tax on the software, and the cost of the computer hardware are capital expenditures pursuant to § 263(a). The amortization of the purchased software is computed by using the straight line method over 36 months, beginning with the month the software is placed in service by Taxpayer, pursuant to § 167(f)(1) and § 1.167(a)-14(b)(1). See also section 6.01(2) of Rev. Proc. 2000-50.

For purposes of § 168, the computer hardware is qualified technological equipment. Consequently, the depreciation of the computer hardware is determined under § 168(a) or § 168(g) by using a 5-year recovery period, beginning in the year the computer hardware is placed in service by Taxpayer.

The functional consulting costs paid to K and L, and the separately incurred maintenance and training expenses, represent maintenance and training related expenses of Taxpayer’s business. Such consulting costs did not include any reorganization expenditures. In Rev. Rul. 96-62, the Service reiterated that amounts paid or incurred for training, including the costs of trainers and routine updates of training materials, are generally deductible as business expenses under § 162, even though such costs may have some future benefit. However, the pre-paid training expenses are deductible as a business expense in the year in which incurred under the requirements of § 461.

Rev. Proc. 2000-50 provides guidelines on the treatment of the costs of computer software. For purposes of Rev. Proc. 2000-50, section 2 of this revenue procedure defines the term “computer software” as meaning 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(1) of Rev. Proc. 2000-50 provides that the costs properly attributable to the development of computer software by the taxpayer are allowed to be treated as current expenses and deducted in full. Section 6.01(2) of the revenue procedure provides that the costs of purchased

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computer software are to be 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.

The technical consulting costs incurred by Taxpayer include three different activities: the modeling and design of additional software, the writing of machine readable code, and option selection and implementation of existing imbedded ERP software templates. In order to properly prepare for either writing additional machine readable code or selecting options and implementing imbedded software templates, the additional needs of the software project are identified and modeled. Therefore, the costs for the modeling and design of additional software (\$h) are to be allocated to the activities of writing machine readable code and the option selection and implementation of existing imbedded ERP software templates.

The determination of whether Taxpayer's expenditures for technical consulting costs are software development costs under section 5 of Rev. Proc. 2000-50 or costs associated with purchased software under section 6 of Rev. Proc. 2000-50 depends on the nature of the work performed by the consultants and on which party was responsible for developing the new software. In this case, Taxpayer was solely responsible for adapting and customizing the purchased ERP software. Under the consulting contracts, the consultants performed the technical activities for Taxpayer under a time-plus expense, open-end job order. Pursuant to the consulting contracts, Taxpayer was responsible for the costs of completing the project, including correcting, at its own expense, any problems relating to the software systems operability or functionality. The contracts provided no guarantees or warranties of the operability of the systems by the consultants. The consultants were to be paid regardless of their success or failure. These facts are material representations. If Taxpayer is the sole responsible party for the creation and performance of the software project covered by the consulting contracts and Taxpayer's technical consulting costs meet the definition of computer software in Rev. Proc. 2000-50, such costs will constitute Taxpayer developed software under section 5.01 of Rev. Proc. 2000-50.

Consequently, the portion of the technical consulting costs incurred by Taxpayer for the writing of machine readable code, as well as the allocable portion of the costs for the modeling and design of additional software activity, meet the definition of computer software in Rev. Proc. 2000-50. Accordingly, such costs are currently deductible under section 5.01(1) of Rev. Proc. 2000-50.

On the other hand, the portion of the technical consulting costs incurred by Taxpayer for the option selection and implementation of imbedded templates, including any allocable portion of the costs for the modeling and design of additional software activity, is a part of Taxpayer specific installation/modification costs of the ERP software necessary to make it compatible with Taxpayer's business. The ERP software cannot be operated without such option selection and implementation. These costs do not meet the machine readable code requirements of Rev. Proc. 2000-50. Therefore, such

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costs are to be capitalized as part of the underlying purchased ERP software and amortized ratably over a 36 month period, beginning with the later of the month the purchased software is placed in service by Taxpayer or the month the template work is available for use by Taxpayer.

Lastly, as the category of project costs identified by Taxpayer as miscellaneous is undefined and has not been identified by Taxpayer as being for the writing of machine readable code or for training, such costs are also capitalized as a part of the underlying purchased ERP software and amortized over the same 36 month period, as discussed in the preceding paragraph.

CONCLUSIONS

Accordingly, based solely on the representations submitted by Taxpayer and the applicable law discussed above, we rule as follows:

- (1) The cost of the purchased ERP software (including the sales tax) ($\$c$) is to be capitalized under § 263(a) and amortized ratably over 36 months, beginning with the month the software is placed in service by Taxpayer.
- (2) The employee training and related costs ($\$d+\$e+\$f+\g) are deductible as current expenses under § 162. However, the pre-paid training expenses are deductible as a current expense in the year in which incurred under the requirements of § 461.
- (3) The separately stated computer hardware cost ($\$b$) is to be capitalized under § 263(a) and depreciated under § 168 over a 5-year recovery period.
- (4) If Taxpayer is solely responsible for the creation and performance of the software project covered by the consulting contracts, the costs of writing machine readable code software ($\$i$) (and its allocable portion of the costs of modeling and design of additional software) under Taxpayer's consulting contracts are self-developed computer software and are allowed to be deductible as current expenses pursuant to section 5.01(1) of Rev. Proc. 2000-50.
- (5) The costs of option selection and implementation of templates ($\$j$) (and its allocable portion of the costs of modeling and design of additional software) under 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 Taxpayer or the month the template work is available for use by Taxpayer. The undefined miscellaneous costs under 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.

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Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of the transaction described above under any other provision of the Code or regulations. Specifically, we express no opinion on whether § 174 or the regulations thereunder apply to Taxpayer's expenditures at issue.

This ruling is directed only to the taxpayer on whose behalf it was requested. Section 6110(k)(3) provides that it may not be cited or used as precedent.

In accordance with the power of attorney, we are sending a copy of this letter ruling to Taxpayer's authorized representatives. We also are sending a copy of the letter ruling to the appropriate Industry Director, LMSB.

Sincerely yours,
KATHLEEN REED
Senior Technician Reviewer, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):
Copy of this letter
Copy for § 6110 purposes

cc: