

Recovery of Technology Expenditures Under the Tax Code

by Paul P. Psota

This article discusses mechanisms for the recovery of technology based expenditures under the federal income tax code (hereinafter the "Code"). Items covered include computer software, computer hardware and website development and maintenance.

Code Section 162 sets forth the basic criteria for successfully claiming a trade or business deduction for most business related expenditures. An expenditure is deductible under Section 162 only if:

1. It is paid or incurred in an active trade or business carried on by the taxpayer;
2. It is "ordinary and necessary;"
3. It is not capital in nature; and
4. The taxpayer has proof of the expenditure.

An "ordinary" expense is one that is common and acceptable in the taxpayer's trade or business. A "necessary" expense is one that is appropriate for, and helpful to, the trade or business. Such expenses are distinguishable from the taxpayer's personal expenditures. Ordinary and necessary expenses must also be reasonable, under the circumstances, in order to be deductible.

Currently deductible expenditures are also distinguished from capital expenditures. The latter must generally be capitalized and recovered through depreciation or amortization or recovered as basis when the asset is disposed of. There is no bright line distinction between currently deductible and capital expenditures. The general rule, however, is that an expenditure must be capitalized if it acquires is for an asset with a useful life of more than one year, or creates a benefit that lasts beyond the current tax year. See, eg., *INDOPCO Inc. v. Commissioner of Internal Revenue*, 503 U.S. 79 (1992).

Treasury Reg. Section 1.263(a)-1 provides that capital expenditures include amounts paid or incurred:

1. To add to the 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.

The regulation states that amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures.

Applying these rules, taxpayer expenditures to maintain or repair computer hardware, software or a website, and related expenses that do not have a useful life of more than one year may be currently deductible.

Some expenditures are expressly identified as currently deductible or capital in nature by the Code and underlying regulations. Code Section 162(a)(3), for example, allows a current deduction for ordinary and necessary expenses paid or incurred during the taxable year in the nature of "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken, or is not taking, title or in which he has no equity." Current lease and license expenditures for computer hardware, software and websites may be deductible pursuant to this provision.

It is most advantageous to classify an expense as one incurred in the taxpayer's "trade or business" because such an expense is generally deductible from gross income. Code Section 212 provides an additional avenue of current deductibility for individuals who cannot meet the trade or business standard. Section 212 allows individuals to deduct all ordinary and necessary expenses paid or incurred during the taxable year:

1. For the production or collection of income;
2. For the management, conservation or maintenance of property held for the production of income; or
3. In connection with the determination, collection or refund of any tax.

A deduction under Section 212 is an itemized deduction from adjusted gross income and is generally subject to the 2 percent floor on miscellaneous itemized deductions. That is, the deduction is allowed only to the extent that aggregate miscellaneous itemized deductions exceed 2 percent of the individual's adjusted gross income.

Pursuant to Section 212, an individual taxpayer may be able to obtain a deduction for current expenditures attrib-

utable to computer hardware, software and website leases, licenses, maintenance and repair activities, and other related ordinary and necessary expenses that do not have a useful life of more than one year.

It must be noted that there are many caveats to deductibility under the tax law. One example is the Code's passive activity loss rules. Pursuant thereto, deductions from passive trade or business activities or activities for which a Section 212 deduction is allowed generally may not be applied to reduce other types of nonpassive income, such as compensation from services, portfolio income and income from a trade or business in which the taxpayer materially participates.

As noted, a taxpayer who acquires an asset with a useful life of more than one year, such as a machine or equipment, is generally not permitted to deduct the full cost of the item in the year acquired. Instead, the cost must be recovered over the asset's life. Such an asset is depreciable if it:

1. Is used for business or held for the production of income;
2. Has a determinable life exceeding one year; and
3. Wears out, becomes obsolete, or otherwise is exhausted. See, Code Section 167.

The modified accelerated cost recovery system (MACRS) depreciation rules apply to such property placed in service after 1986. Pursuant to MACRS rules, qualified technological equipment, including computers and peripheral equipment, is classified as five-year property. The cost of such property is recovered over a five-year period using the 200 percent declining balance method switching to the straight line method in the first tax year that the straight line rate exceeds the declining balance rate. Code Section 168. If the cost of acquiring an interest in software is included, without being separately stated, in the cost of acquired hardware, the software cost is treated as a part of the hardware cost and is capitalized and depreciated with the hardware.

The IRS has recently issued final regulations that provide rules for the capitalization of amounts paid to separately acquire or create intangibles. Treasury Reg., Section 1.263(a)-4. The regulations apply to amounts paid or incurred on or after Dec.31, 2003. Pursuant thereto, a

taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Intangibles, under the regulations, include computer software, even readily available software which has not been substantially modified.

Because of its expressed capital nature, expenditures incurred to acquire computer software are generally recoverable, if at all, through depreciation deductions in accordance with Section 167. Section 167(f)(1)(a) provides that, if a depreciation deduction is allowable under the statute with respect to any computer software, the deduction shall be computed by using the straight line method and a useful life of 36 months. Effective for leases entered into after Oct. 3, 2004, however, computer software leased to a tax exempt entity cannot be depreciated over a time period less than 125 percent of the lease term. Section 167(f).

The Explanation and Summary of Comments to the final regulations explains that the regulations do not address issues relating to the development and implementation of computer software (as opposed to its acquisition in a purchase). The Explanation states that, until separate guidance is issued on development and implementation issues, taxpayers may continue to rely on Rev. Proc. 2000-50 (2000-2 C.B. 601). See, 68 FR 436-01.

That Revenue Procedure, which has been modified by Rev. Proc. 2004-II, sets forth three alternatives for recovering software development costs, either for the taxpayer's own trade or business use, or to be held by the taxpayer for sale or lease to others. The Revenue Procedure explains that software development costs in many respects resemble research and experimental expenditures within the meaning of Section 174 and, therefore, warrant similar accounting treatment.

Accordingly, the Revenue Procedure states that the Service will not disturb a taxpayer's treatment of costs paid or incurred in developing software for trade or business purposes, where:

1. All of the costs are consistently treated as current expenses and deducted in full in the year paid or incurred in accordance with Code Section 174(a);
2. All of the costs are consistently treated as capital expenditures recoverable through deductions for ratable amortization over a period of sixty (60) months from the date of the completion of the development in accordance with Section 174(b); or
3. All of the costs are consistently treated as capital expenditures recoverable ratably over 36 months from the date the software is placed in service in accordance with Section 167(f)(1).

Interestingly, and despite the Revenue Procedure, the Service has, in its unofficial publication, Industry Specialization Program, taken the position that a website should be primarily viewed as software amortizable

over three years once placed in service pursuant to Section 167(f).

Rev. Proc. 2000-50 states that it does not apply to computer software that is subject to amortization as an "amortizable Section 197 intangible," or to costs that a taxpayer has treated as a research and experimentation expenditure under Section 174. Section 174 allows taxpayers to amortize research and experimental expenses over 10 years beginning in the year paid or incurred in addition to the recovery mechanisms thereunder previously discussed.

Computer software is a Section 197 intangible only if it is acquired in a transaction or series of related transactions involving the acquisition of assets constituting a trade or business, or a substantial portion of a trade or business. Code Section 197(e)(3)(A). In that event, the taxpayer generally deducts the cost of the software only ratably over a 15 year period beginning in the month of acquisition.

The 15-year amortization period applies regardless of the actual useful life of the software. No other depreciation or amortization deduction may be claimed on software that is amortizable under Section 197.

Under final regulations published in 2000, the costs incurred to lease computer software are also governed by Section 197, and may not be deducted as rent under Section 162, if acquired as part of a transaction involving the acquisition of a trade or business. Treasury Reg., Section 1.197-2(a)(3).

Excluded from the definition of a Section 197 intangible is computer software that is readily available for purchase by the general public, is subject to a non-exclusive license, and has not been substantially modified.

Notwithstanding MACRS rules regarding depreciation of assets of a capital nature, Code Section 179 allows certain taxpayers to deduct the cost of such property in the year in which it is placed in service. Taxpayers (other than estates, trusts and certain non-corporate lessors) may be eligible if they purchase qualifying depreciable property. Such purchased property includes computer hardware and peripheral equipment, and off the shelf computer software. Qualifying software must be placed in service in a taxable year beginning after 2002 and before 2008. All qualifying property must be used by the taxpayer predominantly in the active conduct of a trade or business.

The maximum annual deduction under Section 179 is \$100,000 (adjusted annually for inflation) for property placed in service in tax years beginning in 2003, 2004 and 2005. The American Jobs Creation Act of 2004 extends the maximum annual deduction two years to tax years beginning in 2006 and 2007. The maximum deduction is reduced to \$25,000 per year thereafter.

The maximum annual deduction is also reduced to the extent the cost of all qualifying property placed in service during the tax year exceeds \$400,000 (adjusted annually for inflation) in tax years beginning in 2003 through 2007. Thereafter, the investment limit is reduced to \$200,000.

The Section 179 deduction may not exceed the taxpayer's taxable income from the active conduct of his trade or business. Deductions disallowed on this ground may be carried forward.

A further limit on a taxpayer's ability to utilize a Section 179 deduction for purchased computers and peripheral equipment applies if those assets are not used exclusively at a regular business establishment or are not owned or leased by the taxpayer operating the establishment. In that event, the computer equipment constitutes "listed property."

Listed property does not qualify for the Section 179 deduction unless it is predominantly used, i.e., more than 50 percent, in a trade or business of the taxpayer (but not an activity conducted for the production of income within the meaning of Section 212) in the year in which it is placed in service. See, Code Section 280F. If the equipment fails to meet the predominant business use requirement during any year, furthermore, the amount otherwise depreciable will be subject to straight line depreciation recoverable over 12 years. Treasury Reg., Section I-280F-3T. A taxpayer's failure at any time to meet the predominant business use requirement will trigger recapture of all excess depreciation previously claimed.

Taxpayers who lease computers and peripheral equipment are subject to comparable limits if the assets constitute listed property. This is accomplished by reducing the Lessee's rental deductions by adding amounts in income in the first year in which qualified business use does not exceed 50 percent. See, Section 280F and regulations thereunder.

In addition to the potential Section 179 deduction, computers and peripheral equipment and off the shelf software may be eligible for a first year "bonus" depreciation deduction. The Job Creation and Workers Assistance Act of 2002 created an additional 30 percent depreciation allowance for new MACRS property (original use must begin with the taxpayer) with a recovery period of 20 years or less (such as qualifying computer equipment), and off the shelf software depreciable over three years under Section 167. Section 168(k). The Jobs and Growth Tax Relief Reconciliation Act of 2003 increased the bonus depreciation allowance to 50 percent. Section 168(k)(4).

The applicable rate depends upon the property acquisition date. Generally, the 30 percent rate applies to property acquired after Sept. 11, 2001, and before May 6, 2003. The 50 percent rate applies to property acquired after May 5, 2003, and before Jan. 1, 2005. In

either event, the property must be placed in service before Jan. 1, 2005.

Software amortized over 15 years under Section 197 does not qualify for the bonus allowance. Nor does computer equipment used 50 percent or less for business, i.e., listed property. If the business use of listed property falls to impermissible levels, the bonus depreciation must be recaptured.

Bonus depreciation is generally claimed on the property's cost after being reduced to reflect any personal use and by any amount expensed under Section 179. Regular MACRS deductions are computed on the property's remaining depreciable basis.

This article has highlighted several potential paths for maximizing the recovery of technology based expenditures through the tax code. As a by-product, it has exemplified the complexities of our current system of federal income taxation. The advice of competent tax counsel, therefore, remains paramount. ⁱⁱⁱ



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