

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:ITA:2 PLR-105767-02

Date:

April 23, 2002

Attn:

X =

Y =

Dear :

This refers to a request filed by X (the taxpayer) for consent to adopt the current expense method of deducting all computer software development costs pursuant to the provisions of Rev. Proc. 69-21, 1969-2 C.B. 303, for the tax year beginning January 1, 1999 (year of adoption/year of change).

The taxpayer represents that it currently capitalizes and amortizes ratably all computer software development costs pursuant to an election under Rev. Proc. 69-21. The taxpayer represents that its software development costs are incurred for projects developed by the taxpayer and for projects developed by third parties for the taxpayer. Where projects are developed by third parties, the taxpayer bears the risks incurred. As of the first day of the year of change, the total amount of capitalized (but unamortized) software development costs was Y.

Section 3.01-1 of Rev. Proc. 69-21 states that the costs of developing software by a taxpayer (whether or not the software is patented or copy-righted) in many respects so closely resembles the kind of research and experimental expenditures that fall within the purview of section 174 of the Internal Revenue Code as to warrant accounting treatment similar to that accorded such costs under that section. Accordingly, it was stated that the Service would not disturb a taxpayer's treatment of costs incurred in developing software 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 section 174(a) of the Code.

Likewise, section 3.01-2 of Rev. Proc. 69-21 states that the Service will not

disturb a taxpayer's treatment of costs incurred in its developing software where all of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by section 174(b) of the Code.

Rev. Rul. 68-144, 1968-1 C.B. 85, holds that where a taxpayer had elected to currently expense all research and experimental expenditures (with the exception of those on particular projects to which the deferred expense method was elected), it cannot in a later year elect the deferred expense method on new projects unless permission is granted by the Commissioner. Rev. Rul. 71-248, 1971-1 C.B. 55, adopts this requirement -- permission to change to a different method must be approved by the Commissioner -- to software development costs. Once permission is granted, such method must be used consistently unless permission is granted to change to another method with respect to part or all software development costs. Rev. Rul. 71-248 further requires that any change to a different method shall only be authorized by a letter ruling.¹

Based on the facts presented here, consent is hereby granted the taxpayer to adopt the current expense method for software development costs pursuant to section 3.01-1 of Rev. Proc. 69-21 for costs paid or incurred on or after the first day of the year of adoption provided:

- (1) the taxpayer keeps its books and records for the year of change and for subsequent taxable years on the method of accounting granted in this letter. This condition is considered satisfied if the taxpayer reconciles the results obtained under the method used in keeping its books and records and the method used for federal income tax purposes and maintains sufficient records to support such reconciliation;
- (2) the taxpayer currently deducts all software development costs, whether incurred by the taxpayer or by third parties (where the taxpayer bears the risks incurred), as determined under section 3.01-1 of Rev. Proc. 69-21, paid or incurred during the year of adoption and later tax years unless permission is granted to change to another method with respect to part or all of the costs; and
- (3) the taxpayer deducts the balance of the software development costs

¹ Rev. Proc. 2000-50, 2000-52 I.R.B. 601 (Dec. 26, 2000), which permits changes in treatment of software development costs pursuant to the automatic change of accounting rules (and which supercedes Rev. Proc. 69-21) is not applicable to the year of change in this ruling.

capitalized prior to the first day of the year of change, in accordance with its present methods of amortizing such costs.

In connection with the consent granted in this letter, it is understood that the responsibility for making determinations as to whether costs paid or incurred by the taxpayer constitute software development as defined in section 2 of Rev. Proc. 69-21 is a matter to be considered upon examination of the taxpayer's return.

The taxpayer should attach a copy of this letter to its tax return for the year of adoption as evidence of its authority for adopting the current expense method.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,
Associate Chief Counsel
Income Tax and Accounting

By:

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