Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:MAN:2:TL-N-703-01
PLDarcy

date:

to: Territory Manager, Communications, Technology and Media
(Kansas City-Mo)
Attn: Revenue Agent Kimberly A. Hendricks
Revenue Agent Patricia M. Valentine

Director, Pre-Filing and Technical Guidance
Attn: Research Credit Technical Advisor David Bernard

from: Area Counsel (Financial Services & Healthcare) (Area 1 - Manhattan)

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subject: [redacted]
Taxable Years Ended [redacted] and [redacted]
U.I.L. No. 174.05-01

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This memorandum responds to your request for advice on whether [redacted] ("[redacted]") can now elect to amortize, pursuant to section 174(b),[1] software development expenses incurred during the taxable years ended [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted]. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us, and is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice. We have discussed this case with National Office attorney Jolene Shiraishi (CC:PSI:B7).

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[1] All references to "section" are to the Internal Revenue Code of 1986, as amended.

ISSUE

1. Whether [redacted] can now elect to amortize software development expenses, pursuant to section 174(b), that it incurred during the taxable years ended [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted].

CONCLUSION

[redacted] cannot now elect to amortize software development expenses, pursuant to section 174(b), incurred during the taxable years ended [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted].

FACTS

The Communications, Technology and Media Operating Division (LMSB) is currently examining [redacted]'s taxable years ended [redacted], and [redacted]. [redacted]'s taxable years ended [redacted] and [redacted] are currently under consideration by the Appeals Division. The statutes of limitations for [redacted]'s taxable years ended [redacted], [redacted], [redacted], and [redacted] are open pursuant to consents executed by the parties. The statute of limitations bars [redacted] from filing a claim for refund for its taxable year ended [redacted].[2]

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[2] We have not been asked to opine on whether the statute of limitations bars [redacted] from filing a claim for refund for its taxable years ended [redacted] and [redacted]. For these taxable years, [redacted] previously filed claims for refund, which were unrelated to the section 174 treatment of the software development expenses at issue in this case. The Service erroneously allowed a portion of these claims and authorized the Department of Justice to bring an erroneous refund suit against [redacted]. Prior to commencing suit, the Department of Justice and [redacted] settled the matter. Documents provided to us show that [redacted] believes the statutes of limitations for its taxable years ended [redacted] and [redacted] remain open. If the statute of limitations issue arises for these periods, we have advised the examiners to seek the assistance of local counsel. Currently, we do not have enough facts to opine on this issue.

In [redacted], [redacted] began incurring costs on a specific software development project (hereinafter the "software development expenses"). The software development expenses included direct labor expenses, overhead expenses, and consultants' fees. [redacted] continued to incur these software development expenses each year until the project ended in [redacted]. The software development expenses may constitute section 174 research or experimental expenditures as defined in section 1.174-2 of the Regulations.[3]

The examiners assigned to this case have advised us that prior to [redacted], [redacted] made a valid election to currently deduct research expenses pursuant to section 174(a). This analysis assumes that [redacted] properly elected to currently deduct research expenses.

On its returns for taxable years ended [redacted] through [redacted], [redacted] did not claim any tax attributes from the software development expenses in question.[4] That is, [redacted] did not deduct, amortize, or capitalize the software development expenses. Instead, [redacted] simply accumulated these software development expenses on its books.

On its return for the taxable year ended [redacted], [redacted] claimed a deduction for the software development expenses it incurred during [redacted]. In [redacted], [redacted] discovered that it never claimed any tax benefits from the software development expenses it incurred during [redacted], [redacted], [redacted], [redacted], [redacted], and [redacted]. [redacted] has now proposed that the examiners permit it to amortize the software development expenses incurred in each year over a 60-month period commencing in the year that it incurred the software development expenses. The following chart summaries [redacted]'s amortization proposal:

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[3] The examiners have not requested advice on whether any of the software development expenses meet the requirements of section 174 research or experimental expenditures as defined in section 1.174-2 of the Regulations. Thus, this memorandum is limited to the procedural issue set forth herein.

[4] We have been advised that [redacted] claimed a section 41 credit for a small portion of the software development expenses in question on its original returns. This memorandum does not address these software expenses.

Year the Software Expense is Incurred	Proposed Amortization Period
[redacted]	[redacted] through [redacted]
	through
	through
	through
	through
	through
	through
	through [redacted].[5]

DISCUSSION

Section 174 applies to a taxpayer's method of accounting for software developing costs. Rev. Proc. 2000-50, 2000-52 I.R.B. 601, § 5.01; Rev. Proc. 69-21, 1969-2 C.B. 303. Section 174 provides two methods for treating research or experimental expenditures paid or incurred by the taxpayer in connection with its trade or business. The taxpayer may elect to claim a current deduction pursuant to section 174(a), or may elect to defer and amortize the expenses pursuant to section 174(b). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. Treas. Reg. § 1.174-1.

[redacted] previously made a valid election to currently deduct its research or experimental expenses pursuant to section 174(a). Therefore, [redacted] cannot now elect to defer and amortize the software development expenses under section 174(b) without first obtaining the approval and authorization of the Secretary. I.R.C. § 174(a)(3). Section 1.174-3(b)(3) of the Regulations provides rules that [redacted] must follow to obtain the Secretary's approval to defer and amortize the software development expenses.

Section 1.174-3(b)(3) of the Regulations specifically requires that a taxpayer must file its application to change its section 174 election no later than the last day of the first taxable year for which the change in method is to apply. [redacted]

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[5] [redacted] proposes that it be allowed to amortize the software development expenses incurred in each year over a [redacted] month period commencing in the year the software development expenses were incurred. However, section 174(b) does not permit such treatment. Section 174(b) would only permit [redacted] to claim amortization deductions beginning "<u>with the month in which the taxpayer first realizes benefits from such expenditures</u>". (emphasis added).

now seeks to amortize its software development expenses incurred between the taxable years ended [redacted] through [redacted]. However, pursuant to section 1.174-3(b)(3) of the Regulations, [redacted] is now time barred from obtaining the Secretary's approval to change its method for accounting for the software development expenses for these years.

The Service addressed similar facts in Revenue Ruling 58-74, 1958-1 C.B. 148. In this Revenue Ruling, the taxpayer adopted the expense method of treating research or experimental expenditures, pursuant to section 174(a), but failed to include certain expenses relative to the cost of obtaining a patent on its returns. The taxpayer requested permission to defer and amortize (or capitalize) the unclaimed expenses. The Service held that the taxpayer's expense method of treating research or experimental expenditures was binding for the taxable year adopted and for all subsequent taxable years, until a change to another method is properly effected. The Service stated that the taxpayer's sole recourse was to file a timely claim or amended return and to deduct the unclaimed research or experimental expenses for the year or years in which they were omitted. However, any deduction in taxable years closed by the statute of limitations is lost. Thus, [redacted] is now permitted to file a timely claim or an amended return to deduct the software development expenses. However, [redacted] may not claim any software development expenses for any period closed by the statute of limitations. Id.

If you have any questions regarding the above, please contact the undersigned at (212) 264-5473, extension 256.

ROLAND BARRAL
Area Counsel

By: _____
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(LMSB)