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Deducting Year 2000 Costs

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by Jeffrey Hodges Kahn

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The cost of curing the Year 2000 problem for computer software systems will be substantial. In most cases, Kahn concludes, for tax purposes, costs incurred in developing a cure can be expensed; but, if not, they can be amortized over a period of no more than five years. If, instead, the taxpayer purchases software to cure the Year 2000 problem, the Service has ruled that the purchase price must be amortized over a period of no more than five years. Contrary to that ruling, Kahn explains, it is possible to make a case for expensing the purchase price (or development costs) as a repair of the existing system.

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I. Introduction

As the new millenium approaches, more and more is reported about the "Year 2000" computer crisis. Most computer software, processors, and other electronic devices use only the last two digits when viewing or using dates that contain years. For example, a non-Year 2000 compliant software program will read 1998 as only 98. These programs will view data involving 2000 as 00, which it is programmed to regard as 1900 causing, at least, calculation problems and, at worst, a complete crash of the system.

The Year 2000 problem could cause malfunctions ranging in severity from elevators not working to a banking industry shutdown. The obvious solution of reprogramming the systems to recognize more than two digits for date computations and data is not so simple to accomplish. There is, in fact, no universal fix and no inexpensive one. Making systems Year 2000 compliant will cost most businesses dearly.[1] The Stamford, Connecticut-based Gartner Group, an international information technology consulting firm, estimates that the cost to fix the Year 2000 problem worldwide will be around $600 billion.

Making systems Year 2000 compliant will cost most businesses dearly.

With that much money at stake, the question of how the tax law will treat Year 2000 expenses is a major issue. The tax treatment will have a large impact on the bottom line of many companies. The Internal Revenue Service is painfully aware of the enormity of the anticipated expenses since the Service itself plans to spend approximately $1 billion attempting to fix the Year 2000 problem in its own systems.

Fixing the Year 2000 system problem may not be the only significant Year 2000 expense that businesses will face.[2] Failures caused by the Year 2000 problem will trigger lawsuits that will cause litigants to incur substantial legal expenses and, for defendants, possible adverse judgments. Indeed, there already has been litigation involving the Year 2000 problem,[3] and it's just 1998. Shareholders, directors, and fiduciaries could be at risk if they do not take adequate steps to deal with the Year 2000 problem.

[1]It should be noted that current software for some businesses will have problems when Europe converts to the euro. Therefore, businesses will incur expenses to make their software "euro-compliant." The same tax issues that attend Year 2000 expenses arise with euro expenditures.

[2]Even if a business is completely Year 2000 compliant, if a customer or supplier is not, it will cause disruption.

[3]For example, Richard Capellan has filed a class action suit against Symantec Corporation (the maker of Norton AntiVirus) for breach of implied warranty of merchantability and related claims. See *The Wall Street Journal*, June 17, 1998, p. B80.

II. Fixing the Problem

In 1969, the Service issued Revenue Procedure 69-21,[4] described below, providing guidelines for the tax treatment of the costs of acquiring computer software. In it, the Service divided software expenses into three categories: (1) developed software, (2) purchased software, and (3) leased software.

A. Developed Software

1. Definition of 'developed.' While the Revenue Procedure prescribed different tax treatment for the three categories of software expenses that it listed, it did not define those categories. In TAM 8614004, *86 TNT 70-53*, the IRS addressed the issue of distinguishing developed software expenses from purchased software expenses.

In that TAM, Corporation X hired Corporation A to develop a new software system that could be used by X. Under the terms of the original contract, A was paid weekly for the services of its personnel plus payments for expenses incurred in developing the new software system. However, there was a cap on the amount X was required to pay A. Should the system fail, the contract made A liable for damages to X, subject to a ceiling of the amount that X had paid for A's services.

In response to the extensive publicity the Year 2000 problem has received, the Service issued Revenue Procedure 97-50.

This original contract was never fulfilled. Instead, A and X negotiated a replacement contract whereby A's compensation for producing the software system was based on an open end job order with no cap on the amount to be paid to A.

One of the issues in the TAM was whether the payments made to A were developed software expenses. The Service stated:

> The determination of whether X's payments to A are software development costs or costs of purchased software depends on which party bore the risk of developing the new software system. Therefore, the agreements between X and A must be examined.

The Service specifically noted that, under the original contract, the fees paid to A could not exceed a specified amount. The Service also noted that the original contract required A to make refunds to X if the software system did not work properly. The Service determined that, under the original contract, A bore that risk of developing the software system. Since A bore the risk, the Service ruled that any payments paid under the original contract were purchased software expenses.

However, under the renegotiated contract, there was no ceiling on the amount of fees payable to A. The Service determined that the risk of developing the software system had been switched to X and any expenses paid under the renegotiated contract were software development expenses.

This TAM is very helpful because it contrasts the two most commonly encountered categories in the Year 2000 solutions and explains how to differentiate them. The determinative element is which party bears the risk of development. If a business hires a consulting company to fix software systems, the placement of the risk of development will determine whether the fees are development expenses. When the owner of the system bears the risk, the expenses will be developed software expenses. Conversely, if the developer of the program bears the risk, the software will be deemed to have been purchased.

2. Revenue Procedure 69-21. In this revenue procedure, the IRS determined that the costs of developing software closely resemble section 174 research and experimental expenditures. While such costs typically will not qualify as research and experimental expenditures, the Service deemed them to be sufficiently analogous to the latter expenditures that the considerations that induced Congress to provide liberal cost recovery provisions for research and experimental expenditures should apply also to software development costs. Therefore, the Service determined that the cost recovery accounting for the two types of expenditures should be the same. In the revenue procedure, the Service stated that it will not challenge a taxpayer's developed software expense treatment where the taxpayer either: (1) consistently treats such costs as a current expense and deducts them in full under rules similar to those established in section 174(a) or (2) consistently treats all of such costs as capital expenditures that are recoverable either over a five-year period from the completion of such development or over a shorter period if the taxpayer can show that the software has a useful life of less than five years.

Note that a taxpayer must be consistent in its treatment of developed software expenses. If a taxpayer chooses one method, it cannot use a different method for subsequent software expenses unless it gets permission from the Service to change accounting methods. However, as discussed in Part B below, a taxpayer that has previously capitalized such costs may be able to deduct subsequent expenses as a repair without obtaining the Service's approval.

3. Revenue Procedure 97-50. In response to the extensive publicity the Year 2000 problem has received, the Service issued Revenue Procedure 97-50,[5] which specifically addressed the tax treatment for Year 2000 expenses. The 1997 revenue procedure did not adopt radically new tax treatment for Year 2000 expenses. Instead, the IRS determined that Year 2000 expenses fall within the purview of Rev. Proc. 69-21; Rev. Proc. 97-50 merely amplified the guidelines provided by the 1969 revenue procedure by applying them to Year 2000

[4] 1969-2 C.B. 303.

[5] 1997-45 IRB 8, *Doc 97-29050 (4 pages), 97 TNT 204-9.*

expenses. The 1997 revenue procedure recognized five different types of approaches that could be used to solve the Year 2000 problem. A taxpayer could either: (1) convert its existing software, (2) purchase new software to replace its existing software, (3) purchase software tools that would assist the taxpayer in converting its existing software, (4) develop software tools which would assist in converting the software, or (5) lease new software to replace its existing software. The 1997 revenue procedure placed each of those five types into one of the three categories of expenses that Rev. Proc. 69-21 discussed: developed software (which includes conversion expenses); purchased software; and leased software. The 1997 revenue procedure confirms that a taxpayer's costs in developing software to cure a Year 2000 problem can be expensed or depreciated over a period of no more than five years, depending on the taxpayer's prior treatment of software development costs.

4. Uniform capitalization rules. Generally, a taxpayer must capitalize the costs incurred in producing real or tangible property.[6] Although software is generally considered intangible property, it is likely that it will be treated as tangible for purposes of section 263A since the code states "the term 'tangible personal property' shall include a film, sound recording, video tape, book or similar property."[7] The Service likely would conclude that software is "similar property" and, therefore, qualifies as tangible property for purposes of section 263A.

Nevertheless, section 263A does not pose a threat to a taxpayer's claim to expense development software costs. For two independent reasons that section will not apply and so will not interfere with the taxpayer's treatment of such costs. Section 263A establishes several exceptions to its application, one of which is for research and experimental expenditures allowable as a deduction under section 174.[8] Although development software expenses do not normally meet the standard for research and experimental expenditures, the 1969 revenue procedure states that development software expenses are similar enough to such expenditures to warrant the same cost recovery treatment. It is likely, therefore, that the research and experimental expense exception to the section 263A uniform capitalization rules will be extended to incorporate development software costs. In addition, the 1997 revenue procedure does not even mention section 263A and that provision is too visible for the Service to have overlooked it. The omission must have been deliberate and shows that the Service does not deem section 263A to be apposite. Therefore, taxpayers need not worry about the uniform capitalization rules for this purpose.

Moreover, even if the Service changed its view and contended that the exception to section 263A for research and experimental expenditures does not extend to developed software expenses, section 263A does not apply to "repairs"[9] and, as will be explained in Part B below, expenditures to develop software to cure the Year 2000 problem may qualify as a repair.

Section 263A does not pose a threat to a taxpayer's claim to expense development software costs.

5. Research credit. Under section 38, businesses are allowed a credit against taxes imposed for certain listed items.[10] One of the items listed is the "research credit,"[11] described in section 41. Section 41 provides the operational rules for qualified research credits. Section 41(d)(1) indicates that "qualified research" means research:

> (A) with respect to which expenditures may be treated as expenses under section 174;
>
> (B) which is undertaken for the purpose of discovering information —
>
> (i) which is technological in nature, and
>
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
>
> (C) substantially all the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

Paragraph (d)(3) lists the following qualified purposes: (i) a new or improved function; (ii) performance; or (iii) reliability or quality.

The 1997 revenue procedure states that only in extraordinary circumstances will Year 2000 expenses satisfy the definition of "qualified research" under section 41.

> [Y]ear 2000 costs generally do not involve research undertaken for the purpose of discovering information that is technological in nature where substantially all of the research activities constitute elements of a process of experimentation.

It will be an uphill battle for taxpayers to receive a research credit for their Year 2000 expenses. The Service's position is a reasonable interpretation of the statute and is likely to be upheld by the courts.

6. FASB and SEC rules. Finally, both the FASB rules and the SEC rules require Year 2000 modification expenses to be charged against earnings (i.e. expensed) as they are incurred.[12] Although taxpayers do not have

[6]Section 263A(b)(1).

[7]Section 263A(b)(2) and Treas. reg. section 1.263A-2(a)(2)(ii).

[8]Section 263A(c)(2).

[9]The Committee Reports on P.L. 99-514 (Tax Reform Act of 1996) state, "The uniform capitalization rules are not intended to apply to expenditures properly treated as repair costs under present law that do not relate to manufacture, remanufacture, or production of property."

[10]Section 38(a).

[11]Section 38(b).

[12]Emerging Issues Task Force of the Financial Accounting Standards Board Issue No. 96-14: Accounting for the Costs Associated With Modifying Computer Software for the Year 2000, July 18, 1996.

to follow the FASB or SEC rules for tax accounting purposes, taxpayers may want to coordinate their treatment of these expenses. It is interesting that the FASB and SEC rules require expensing treatment even though most businesses would rather capitalize such expenses for accounting purposes since current deductions translate to lower earnings. While tax accounting need not conform to general accounting treatment, the FASB and SEC rules do show that expensing such items is considered by several independent authorities to be the most accurate representation of a taxpayer's income.[13]

B. Purchased Software

The most obvious example of purchased software is a business simply buying software from a dealer. However, in most cases, fixing the Year 2000 problem will require individualized tailoring of the cure to the taxpayer's problems and needs. This will require the employment of specialized services, such as computer consultants. As discussed above in Part A, the Service has ruled that consulting fees can be classified as either purchased software expenses or developed software expenses depending on which party bears the risk of development. If the consulting firm bears the risk of loss and of incurring excessive costs in creating the Year 2000 solution, the Service will rule that the fees paid to the consulting firms are purchased software rather than developed software expenses.

In the case of Year 2000 expenses, the tests point in conflicting directions, but a strong case can be made for treating many such expenses as repairs.

The importance of this distinction is that the Service has determined that the two types of expenditures have different tax cost recovery treatments.

1. Service's position. Rev. Proc. 97-50 looks to Rev. Proc. 69-21 for the tax treatment of Year 2000 expenses for purchased software expenses. Rev. Proc. 69-21 provides that if software was purchased as part of a package with hardware (i.e., actual computers), the software expense must be included as part of the cost of the hardware and capitalized and depreciated as such. However, it is unlikely that many businesses will purchase entirely new hardware to solve the Year 2000 problem. The revenue procedure provides that if software is purchased separately the software expense should be treated by the taxpayer as an intangible asset. The Service determined that the cost of the software should be recovered by amortization deductions over a five-year period (or a shorter period if the taxpayer can show a shorter useful life). Contrary to its treatment of developed software costs, the Service does not permit the cost of such purchases to be expensed. We will next consider whether such purchases can be expensed as a repair, despite the Service's position.

2. Year 2000 expenses as a 'repair.' The tax rules have always treated expenses for "repairs" differently from "improvements" or "replacements." Section 162 generally allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 263 generally prohibits deductions for capital expenditures. Therefore, repairs are allowed the more tax beneficial current deduction while improvements must be capitalized and often can be amortized over a period of years.

The Treasury regulations provide:

> The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.[14]

The test for whether an expense is a repair rather than a capital expenditure is not clear cut. The Supreme Court has stated that expenses that keep items in good condition are repairs while expenses that enlarge or improve an item are capital expenditures.[15] The Board of Tax Appeals (now the Tax Court) has stated that repairs restore to a sound state or mend while a replacement or capital expenditure is similar to a substitution.[16] Note that the Service has stated that the Supreme Court's decision in *INDOPCO, Inc. v. Commis-*

[13] *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 99 S. Ct. 773, 58 L.Ed.2d 785 (1979) (financial accounting tilts toward understating earnings while tax accounting tilts the other way).

[14] Treas. reg. section 1.162-4.

[15] *Union Pacific Railroad Company*, 99 U.S. 402 (1878).

[16] *Illinois Merchants Trust Co.*, 4 BTA 103 (1926). The court stated: "In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an ordinarily efficient operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings."

sioner[17] does not affect the treatment of incidental repair costs as business expenses.[18]

In the case of Year 2000 expenses, the tests point in conflicting directions, but a strong case can be made for treating many such expenses as repairs. Making a software system Year 2000 compliant will prolong the life of the system; i.e., the system will function past 2000. However, fixing the Year 2000 problem will merely keep the system in an operating condition for the uses for which it was acquired. Taxpayers purchased systems on the understanding that they would operate past 2000. The fact that an error in programming renders the system defective beginning in 2000 (or earlier) shows that the system is in need of repair. Correction of that flaw does not expand the ordinary useful life of the system, nor does it enhance the quality of the system over the quality it would have if the flaw in the program had not existed. Correction of the Year 2000 flaw merely places the software program in the condition which the developer and the owner originally expected it to have.

Although one test for an improvement is whether the expenditure extends the life of the property, the courts have noted that all repairs extend the life of the property in some manner. See *Illinois Merchants Trust Co.* ("There is no question but that by this expenditure the life of the building was prolonged over what it would have been after the sudden lowering of the water level in the river, but any repair increases the useful life of the property over what it would have had without the repair.") The test is whether the expenditure extends the asset's useful life beyond that which it would have had if the repair had not become necessary. Therefore, allowing systems to perform beyond 2000 in the same manner they performed before the correction was made will not necessarily make the expenditures capital in nature.

Another of the repair tests is whether the expenditure adds value to the property. It is again clear that all repairs make an item more valuable than it was before the repair was made. The courts have also noted this fact. The Tax Court has stated:

> [A]ny properly performed repair adds value as compared with the situation existing immediately prior to the repair, but the proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure.[19]

The Service itself has noted that this is the proper test.[20]

The Service may argue that this test does not apply to Year 2000 expenses because there never was a status of the asset prior to the time necessitating the repair, i.e. the software never was free from the Year 2000 problem. For example, in TAM 9627002, *Doc 96-19322 (8 pages), 96 TNT 132-16*, the Service ruled on the deductibility of expenditures made to clean up contaminated land. In the ruling, the Service suggests that current deductions can be made only for expenditures that "restore contaminated property to what was its uncontaminated condition at the time it was acquired by the taxpayer."[21]

However, there is nothing in the Treasury regulation that suggests that repairs should be so limited.

Prior to the time that it became recognized that the arrival of the year 2000 will cause unanticipated problems, taxpayers believed that their programs would operate adequately for their useful lives, which extended beyond 2000.[22] The Year 2000 situation is not one where a taxpayer purchased an asset with either a known defect or with knowledge that there existed a risk that was more than minimal. Therefore, in the Year 2000 area, the test should compare the quality and useful life that the asset was thought to possess when originally purchased. The fact that the item is flawed merely shows that it needs repairing to operate properly. However, the Service may well use this argument to deny repair treatment for Year 2000 purchased software expenses.

Although capital expenditures are sometimes termed as a 'replacement,' the fact that parts of a computer system are replaced does not necessarily make the expenses capital expenditures.

Although capital expenditures are sometimes termed as a "replacement," the fact that parts of a computer system are replaced does not necessarily make the expenses capital expenditures. One district court has stated:

> It is, of course, true that the distinction between the terms used in the regulations "repair" and "replacement" is one of degree rather than of kind. We must draw the line without too much help from the definition of the two terms. Most repair would necessarily involve substitution of new parts or ingredients for old. If the substitution is of a major unit or structural part of the

[17]503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226, *92 TNT 44-1* (1992).

[18]Rev. Rul. 94-12, 1994-1 C.B. 36, *94 TNT 25-12*.

[19]*Oberman Manufacturing Co. v. Commissioner*, 47 T.C. 471 (1967), *acq.* 1967-3 C.B. 3.

[20]*See* Rev. Rul. 94-38, 1994-1 C.B. 35, *94 TNT 107-12*.

[21]*See also Transport Manufacturing & Equipment Company v. Commissioner, 434 F.2d 373 (8th Cir. 1970)* ("Both terminals had been built upon unstable ground and required extensive replacement and rebuilding within one year of their completion. The evidence is undisputed that the resultant deterioration was not the effect of normal wear and tear but rather the consequence of faulty construction. . . . Upon a review of the record, we affirm the Tax Court decision that these expenditures constituted a part of the original construction and as such must be capitalized.").

[22]Taxpayers who own systems whose useful life does not extend to 2000 (and do not use future date calculations) do not have a Year 2000 problem since their system will cease to be useful before that date arrives.

> nature of the floor, wall or roof, or large part thereof, so that the building as a whole may be considered to have gained appreciably in expectancy of useful life, it is a substitution so great in degree that we may well place it on the "replacement" side of the line.
>
> Where the substitutions, though numerous, are of relatively minor proportions of the physical structure and of any of its major parts, *even though high in cost, where the building as a whole may not be considered to have gained appreciably in expectancy of useful life over its expectancy when built,* it falls more naturally on the "repair" side of the line. Emphasis added.[23]

The emphasized section unequivocally applies to Year 2000 expenses. Although the cost to fix the Year 2000 problem will be very high for some taxpayers, that fact alone should not make those costs capital expenditures.

Again and again, courts note that a key determination is whether the expenditure returns the property to the original or expected condition of use.

Again and again, courts note that a key determination is whether the expenditure returns the property to the original or expected condition of use. Fixing the Year 2000 problem merely gives the software the same life expectancy it was thought to have had when it was purchased. It is returning the software to its expected operational ability. See *Gopcevic v. Commissioner*,[24] ("The work done by Tassi merely restored the warehouse to its former operating condition. The restoration to plumb of the roof supports did not increase the value of the property or make it adaptable to a different use. It prolonged the life of the building only in the negative sense that if the repairs had not been made the roof might have collapsed and the warehouse would have been ruined. The estimated useful life of the property was not increased by the treatment of the roof supports — it was only brought back to its original span.").

The Year 2000 expenditures do not improve or extend the life of software or systems beyond what was originally expected. Accordingly, the expenses to bring systems back to the original expected condition should be repairs.

The fact that some of these repairs will occur very soon after the systems were purchased also does not make the expenditures capital. For example, the Board of Tax Appeals has noted that expenditures can still be repairs even if made immediately after the acquisition of the property.[25]

As we are discussing purchased software, distinctions need to be made. As the 1997 revenue procedure noted, there are four types of purchased software that could be used to make systems Year 2000 compliant: (1) purchased software that is a separate program that fixes the Year 2000 problem (i.e., a software tool used to fix another system); (2) purchased software that replaces a part of the taxpayer's system (but does not replace the whole software system); (3) purchased software that replaces the entire software system with a similar, although Year 2000 compliant, system; and (4) purchased software that replaces the software system with an improved system.

Purchased software that does no more than fix a flaw in other software is a repair. No system is being replaced, and the original software is being altered to bring it into conformity with the performance and useful life it was expected to have. Purchased software that replaces the entire system or only a part of the system and is similar to the previous software except for the fact that it is Year 2000 compliant should also be treated as a repair. Even though, there is a nominal substitution, there is no improvement or an extension of the anticipated life of the software.

The characterization will be different, however, if the purchased software replaces a part or the entire original software and is better than the original software in a manner other than the Year 2000 flaw. In such a case, the taxpayer is using the Year 2000 problem as an excuse to claim that an upgrade of its current system is a repair. The Service has a strong case that this is a capital expenditure because the system is improved beyond what was originally purchased. The courts have consistently held that expenditures which are part of a general plan to improve the property, rather than merely maintain the property, are capital expenditures.[26]

How large an improvement of quality or useful life must be to transform what would otherwise be a repair into a capital expenditure is a question of degree. Virtually all software programs are better today than they were yesterday because they run more quickly or smoothly. Whether the difference between the upgraded version and the original version is great enough to make the replacement a capital expenditure will be a question of fact. A taxpayer may have better prospects if it had no choice but to upgrade slightly because the old version is no longer available and the taxpayer purchased the least improved version that could be acquired. For example, if the taxpayer has to replace a word processor that would crash in 2000, the taxpayer may have no choice but to get a more recent version of the word processor because the original version is not available. This might still be a repair.

[23] *Buckland v. U.S.*, 366 F.Supp. 681 (D. Conn. 1946) (emphasis added).

[24] 3 TCM 1216 (1944).

[25] *Appeal of Osage Steamship Co., Ltd*, 3 B.T.A. 141 (1925).

[26] There is a question of whether a taxpayer could allocate the costs between repairs and improvements. However, it is unlikely that the Service would allow such an allocation unless it is very clear which expenses were made for the Year 2000 fix and which were made for improvements. Otherwise, the Service will disallow any repair deduction. *See Ruttenberg v. Commissioner*, 52 T.C. Memo. 1986-414, *86 TNT 177-29* (1986).

Note that if expenditures to fix a program are repairs, it is likely that they can be expensed without the commissioner's approval even if the taxpayer had previously amortized software expenses. The requirement that permission of the commissioner is needed for a change of accounting methods applies to deductions taken pursuant to Rev. Proc. 69-21. On the other hand, if the expense is a repair, its proper treatment is to expense it, and no permission need be obtained to report an item accurately.[27]

3. Uniform capitalization rules. The uniform capitalization rules of section 263A do not apply. The uniform capitalization rules apply to property that is produced by the taxpayer or that is acquired by the taxpayer for resale.[28] In the circumstances under discussion, the software was neither produced by the taxpayer nor was it acquired for resale.

4. Section 41 credit. As already noted, 1997 revenue procedure states that only in extraordinary circumstances will a taxpayer be able to take a section 41 research credit for purchased software.

5. Conclusion. Contrary to the Service's position, the cost of purchased software that fixes the Year 2000 problem or is a new program that is similar in quality and useful life to the existing noncompliant software should qualify as a "repair," and if so it can be deducted. Greatly improved systems will likely have to be capitalized.

C. Leased Software

Finally, Rev. Proc. 97-50 also states that leased software may be used to correct the Year 2000 problem. It provides that taxpayers should look to Rev. Proc. 69-21 for the tax treatment of leased software. Rev. Proc. 69-21 states that the Service will not disturb a taxpayer's treatment of such costs if they are deducted under Treasury regulation section 1.162-11 as rentals. The revenue procedure essentially states the obvious. Rental payments connected with business activities typically are deductible under section 162. However, it is unlikely that businesses will look to leased software for their Year 2000 solutions.

III. Liability for Year 2000 Problems

As noted, businesses may find themselves liable for problems that are caused by Year 2000 problems. Even if the business itself is Year 2000 compliant, other Year 2000 shutdowns may cause disruptions that harm one party or another. While an examination of the tax treatment of such expenses is for another article, it is likely that they are deductible as ordinary business expenses.

IV. Final Summary

The Service has stated its position in two revenue procedures. Despite the Service's contrary assertion, some purchased software should qualify as a repair, in which case the cost thereof will be deductible. In most cases, the cost of software developed by the owner to cure the Year 2000 problem can be deducted.

WANT TO COMMENT?

Your views regarding the tax treatment of Year 2000 problem correction costs would be welcome by our editors and participants in Tax Analysts' Internet discussion groups. We invite you to comment by accessing our Business Tax Issues Discussion Group, which will be dealing with the issue in the coming weeks. To access the group and join the discussion, and to view a list of all our discussion groups, log on to our Web site at http://www.tax.org

[27] *But see Commissioner v. O. Liquidating Corp.*, 292 F.2d 225 (3d Cir. 1961), and *Wright Contracting Company v. Comissioner*, 316 F.2d 249 (5th Cir. 1963).

[28] Section 263A(b).