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INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, AREA 3 (RFP)
CC:LM:RFP

FROM: Associate Chief Counsel CC:PSI

SUBJECT: In-Process Research and Development Expenses

This Chief Counsel Advice responds to your memorandum dated July 20, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Petitioner

Target 1
Target 2

Seller

Software Package 1
Software Package 2
Software Package 3
Software Package 4

Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:
Date 7:
Date 8:
Date 9:
Date 10:
Date 11:

ISSUE

What is the appropriate tax treatment of the costs of acquiring assets that Petitioner has called "in-process research and development."

CONCLUSIONS

(1) The amounts designated as "IPR&D" by Petitioner must be capitalized and may not be deducted under section 162.

(2) Although Petitioner may have used the Software Packages 1-4 in research or experimental activities, the costs allocated to Software Packages 1-4 are not eligible for the election to expense research or experimental expenditures under section 174.

(3) The costs allocable to Software Packages 1-4 are not deductible under section 3 of Rev. Proc. 69-21, 1969-2 C.B. 303.¹

(4) Because Software Packages 1 and 4 are amortizable section 197 intangibles, section 4 of Rev. Proc. 69-21 does not apply to Software Packages 1 and 4.

(5) Software Packages 2 and 3 are purchased software and, as a result, fall under section 4 of Rev. Proc. 69-21. Because the costs for Software Packages 2 and 3 are separately stated, they are recoverable using the straight-line method of depreciation over a period of five years or such shorter period as can be established by Petitioner as appropriate if the useful life of Software Packages 2 and 3 will be less than five years. In no case, however, may Software Packages 2 and 3 be depreciated over a period less than 36 months.

(6) The costs attributable to Software Packages 1-4 are not eligible for a loss deduction based on abandonment or worthlessness of the acquired assets under section 165.

FACTS

Petitioner provides client/server software development tools and application products and services to customers.

¹Rev. Proc. 69-21 has been superseded by Rev. Proc. 2000-50, 2000-2 C.B. 601, which, among other things, reflects the enactment of sections 167(f) and 197. Rev. Proc. 2000-50 states that for taxable years ending prior to December 1, 2000, the Service will not disturb the taxpayer's treatment of costs of computer software except to the extent that the taxpayer's treatment is markedly inconsistent with the practices described in Rev. Proc. 2000-50.

Petitioner was incorporated and elected to be treated as a subchapter S corporation in Date 1. On Date 2, as part of an initial public offering, Petitioner terminated its subchapter S election and filed a final Form 1120-S for the short taxable period beginning Date 3 and ending Date 4.

On its tax returns for the short taxable period beginning Date 2 and ending Date 5, and the taxable year ending Date 6, Petitioner deducted amounts that Petitioner has called “in-process research and development” (IPR&D). The amounts deducted as IPR&D are amounts allocated to IPR&D that were paid or incurred in three separate acquisition transactions.

Acquisition 1

On Date 7, Petitioner and Target 1 entered into an Asset Purchase Agreement. Under this agreement, Petitioner agreed to purchase from Target 1, and Target 1 agreed to sell to Petitioner, all right, title, and interest in and to all of Target 1’s assets in exchange for a purchase price of \$ _____ and \$ _____ of net liabilities assumed.

Under the agreement, Petitioner acquired all of Target 1’s real property, leaseholds, improvements, fixtures, and fittings thereon and easements, and rights-appurtenant thereto, and all of Target 1’s tangible personal property. In addition, Petitioner acquired all of Target 1’s intellectual property, goodwill associated therewith, licenses and sublicenses granted and obtained with respect thereto, and rights thereunder, remedies against infringements thereof, and rights to protection of interests therein under the laws of all jurisdictions. Further, Petitioner acquired all of Target 1’s books, records, ledgers, files, documents, correspondence, lists, architectural plans, drawings, specifications, creative materials, advertising and promotional materials, studies, reports, and other printed or written materials.

Petitioner allocated the purchase price among the assets as follows:

Purchase Price (\$ _____ Cash and _____ shares of Petitioner’s stock valued at \$ _____ per share)	_____
Net Liabilities Assumed	_____
Net Purchase Premium	_____

Software Technology

Assembled Workforce

Customer Base

In-Process Research and Development

Goodwill and other nonidentifiable
intangible assets

Total

The amount allocated to IPR&D in the Target 1 acquisition reflects amounts allocated to Petitioner's acquisition of Software Package 1. At the time of the acquisition, Software Package 1 was a stand-alone product that Target 1 offered for sale. Software Package 1 consisted of general ledger, accounts receivable, purchasing, accounts payable, and projects accounting modules.

Petitioner represents that, at the time of the acquisition, Software Package 1 was not complete for Petitioner's purposes. Petitioner intended to integrate Software Package 1 into its existing product line. Petitioner also represents that prior to the acquisition, Petitioner invested about one man-week on technical evaluation of Software Package 1. Petitioner has not located any documentation regarding this evaluation.

Petitioner alleges that it spent a large amount of time, effort, and money to create a common infrastructure for Software Package 1 and Petitioner's existing product that Petitioner planned to integrate with Software Package 1. Software Package 1 was integrated into Petitioner's product and the new product was released to the public in Date 8.

Acquisition 2

During Date 9, Petitioner and Seller entered into a Distribution, Marketing and Licensing Agreement. Pursuant to this agreement, Petitioner acquired from Seller exclusive marketing and distribution rights for two software products known as Software Package 2 and Software Package 3.

On Date 10, Petitioner and Seller entered into a Software Purchase Agreement. Pursuant to this agreement, Petitioner acquired all copyright, trade secret, and other ownership rights to Software Package 2 and Software Package 3 and Seller and its affiliates retained a perpetual non-exclusive, world-wide and non-transferable unlimited license to use Software Package 2 and Software Package 3. Under the agreement, the base purchase price for the systems was reduced by (1) all payments made through the closing date by Petitioner pursuant to the distribution, marketing and licensing agreement with Seller and (2) to reflect the perpetual non-exclusive, world-wide and non-transferable unlimited license retained by Seller.

Petitioner allocated the final purchase price among the assets as follows:

Software Technology	
In-Process Research and Development	
Total	<hr/>

Both Software Package 2 and Software Package 3 were marketed and sold by Seller prior to selling the systems to Petitioner. Further, it is believed that Petitioner marketed and sold these systems without modification after the acquisition.

Petitioner represents that, at the time of the acquisition, both systems consisted of approximately one million lines of code each. Further, Petitioner represents that neither system was ready to be marketed by Petitioner as a stand-alone application or as part of a larger suite of projects. Petitioner indicates that it needed to rewrite and add functionality to both systems so that they could be integrated into a suite of products.

Acquisition 3

On Date 11, Petitioner and Target 2 entered into an Agreement and Plan of Reorganization. Pursuant to this agreement, Petitioner agreed to acquire from Target 2 and Target 2 agreed to transfer to Petitioner all right, title, and interest in and to all of the assets of Target 2 in exchange for _____ shares of Petitioner's common stock. Petitioner and Target 2 agreed that Petitioner's common stock had a fair market value of \$ _____ a share, resulting in consideration valued at \$ _____.

Petitioner and Target 2 agreed that they would (1) treat the transaction as a tax-free reorganization under section 368(a)(1)(C), (2) report the transaction in a manner consistent with that treatment, (3) take all reasonable action required to cause the transaction to be treated as a reorganization under section 368(a)(1)(C), and (4) not take any action that would disqualify the transaction from treatment under section 368(a)(1)(C).

The assets Petitioner acquired pursuant to the agreement included all of Target 2's leaseholds and subleasehold improvements, fixtures, and fittings thereon, and easements, and rights-appurtenant thereto, and all of Target 2's tangible personal property including machinery, equipment, computer software but excluding the name Target 2 and any derivation thereof and other Target 2 trade names, trademarks, service marks and logos using the Target 2 mark. In addition, Petitioner acquired all of Target 2's intellectual property, goodwill associated therewith, licenses and sublicenses granted and obtained with respect thereto, and rights thereunder, remedies against infringements thereof, and rights to protection of interests therein under the laws of all jurisdictions. Further, Petitioner acquired

all of Target 2's books, records, ledgers, files, documents, correspondence, lists, plats, architectural plans, drawings, specifications, creative materials, advertising and promotional materials, studies, reports, and other printed or written materials.

Under the agreement, the term "Intellectual Property" is defined to include all inventions (whether patentable or unpatentable and whether or not reduced to practice), all improvements thereto, and all patents, patent applications, and patent disclosures, together with all reissuances, continuations, continuations-in-part, revisions, extensions, and reexaminations thereof, all trademarks (but specifically excluding the Target 2 name), service marks, trade dress, logos, trade names, together with all translations, adaptations, derivations, and combinations thereof and including all goodwill associated therewith, and all applications, registrations, and renewals in connection therewith, all mask works and all applications, registrations, and renewals in connection therewith, all trade secrets and confidential business information (including ideas, research and development, know-how, formulas, compositions, manufacturing and production processes and techniques, technical data, designs, drawings, specifications, customer and supplier lists, pricing and cost information, and business and marketing plans and proposals), all computer software (including data related documentation), all other proprietary rights and all copies and tangible embodiments thereof (in whatever form or medium).

Petitioner allocated the purchase price among the assets as follows:

Purchase Price (shares of
Petitioner's stock valued at \$ per
share)

Net Assets Acquired

Net Purchase Premium

Software Technology

Assembled Workforce

Customer Base

In-Process Research and Development

Other nonidentifiable intangible assets

Total

The amount allocated to IPR&D in the Target 2 acquisition reflects amounts allocated to Petitioner's acquisition of Software Package 4 for financial accounting purposes. On its federal income tax return for the taxable year ended Date 6, Petitioner reclassified \$ _____ of the amount allocated to IPR&D as Goodwill and expensed \$ _____ as IPR&D.

At the time of the acquisition, Software Package 4 was in the early stages of development. After the acquisition, Petitioner tried to complete the Software Package 4 program. Petitioner determined that too much time and effort was required to bring Software Package 4 to market and still be competitive with other products. Petitioner maintains that the Software Package 4 program was abandoned in the year of acquisition.

According to Petitioner's response to informal discovery, Software Package 4 provided Petitioner with additional standard coding algorithms to expedite program development or it provided a series of methodologies and class libraries that could potentially complement a product of Petitioner. Petitioner completed its application integration during Date 8. At that time, Petitioner looked at the Software Package 4 know-how and began a plan to integrate the concepts into some of its current products. Petitioner ultimately decided not to proceed with the integration of the Software Package 4 know-how into its current products.

Informal discovery also indicates that Software Package 4 was not the objective of Petitioner's acquisition of Target 2. Rather, Target 2, a holding company for U.S. and _____ subsidiary sales offices, had a sales distribution system that was attractive to Petitioner.

LAW AND ANALYSIS

The issues raised by this case involve the interplay of several different provisions of the Internal Revenue Code. Petitioner supports its deduction of amounts allocated to IPR&D primarily by reference to the treatment of research and experimental expenditures under section 174, the "similar treatment" of software expenses under Rev. Proc. 69-21, and the treatment of IPR&D for financial accounting purposes.

Capitalization vs. business expense

Section 162 of the Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property.²

In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the Supreme Court clarified that its earlier decision in Commissioner v. Lincoln Savings and Loan Assn., 403 U.S. 345 (1971), should not be interpreted as holding that capitalization is appropriate only for expenditures that "create or enhance a separate and distinct asset":

Although the mere presence of an incidental future benefit -- "*some future aspect*" -- may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.

503 U.S. at 87 (emphasis in original).

Based on the facts provided in this case, the costs associated with the software packages identified as "IPR&D" in all three transactions are clearly capital expenditures, not deductible under section 162. Petitioner paid specific amounts in order to acquire all the copyright, trade secret, and other ownership rights, title and interests in specific software programs.³

In Acquisition 1 and Acquisition 2, the software products were being marketed by the sellers (Target 1 and Seller, respectively) before they were acquired by Petitioner. In all three acquisitions, Petitioner asserted that the software products had significant value, and either paid or allocated substantial sums of money to what Petitioner termed "IPR&D." It is our understanding that in arriving at this value, at least for Software Packages 1-3, Petitioner employed a

²There is an argument that, at least in certain circumstances, software-related costs are potentially subject to capitalization under section 263A, especially to the extent they are embodied in, or allocable to tangible property. However, this issue is generally moot because of the specific provisions dealing with software in sections 167 and 197, and the fact that the Service has not invoked section 263A to change the treatment of software-related costs under Rev. Procs. 69-21 and 2000-50. In this discussion, we will assume that for our purposes the software rights at issue are intangible assets subject to section 263.

³We understand that valuation of the software may be an issue, and that the field attorney may retain an expert to advise the Service. For purposes of this discussion, we assume that the taxpayer's valuation of the software is correct; if it turns out that it is not, our conclusions still apply pro tanto.

"capitalization of earnings" valuation method in which income flows are projected over several years and then discounted to present value. Software Packages 1-3 may have been marketed without modification after they were acquired (the facts are unclear), but in any case all three were integrated by Petitioner into a line of software products, thus providing long-term benefits that were more than incidental. Petitioner apparently had similar plans for Software Package 4 -- although, as discussed later in connection with the possibility of a loss deduction, it may have abandoned those plans at some point.

Given these and other factors described in the memorandum from the field attorney, it is clear that Software Packages 1-3, and probably Software Package 4 as well, were "separate and distinct assets" that would qualify even under the narrower definition of a capital expenditure identified with the Supreme Court's opinion in Lincoln Savings. Moreover, the expenditures did not merely "serve to create or enhance" the assets; rather, they were the direct costs of acquiring the assets from a third party. The cost of acquiring property, whether tangible or intangible, is perhaps the archetype of a capitalized cost.⁴

This conclusion applies without regard to whether the assets identified by Petitioner as "IPR&D" were "software" —strictly defined or as defined for some particular purpose—or were instead, in whole or in part, some other form of technical know-how. While we believe that the assets qualify under the narrower "separate and distinct asset" test, the "significant future benefits" test of INDOPCO would clearly encompass the costs of acquiring such assets from a third party.

In a series of administrative rulings following the INDOPCO decision, the Service has ruled that certain costs generally remain deductible despite the fact that they may have an incidental future benefit. See, e.g., Rev. Rul. 92-80, 1992-2 C.B. 57 (advertising costs); Rev. Rul. 94-12, 1994-1 C.B. 36 (incidental repair costs); Rev. Rul. 94-38, 1994-1 C.B. 35 (environmental cleanup costs; but not costs of groundwater treatment facilities); Rev. Rul. 94-77 (severance costs in connection with business downsizing); Rev. Rul. 95-32, 1995-1 C.B. 8 (energy conservation expenditures); Rev. Rul. 96-62, 1996-2 C.B. 9 (training costs); Rev. Rul. 98-25, 1998-1 C.B. 998 (cost of replacing underground waste storage tanks); Rev. Rul.

⁴The regulations under section 263 specifically address acquisition costs as examples of capital expenditures. Under Treas. Reg. § 1.263(a)-2(a), for example, the cost of acquisition of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year is a capital expenditure. With respect to intangible assets, Treas. Reg. § 1.263(a)-2(h) provides that the cost of goodwill in connection with the acquisition of the assets of a going concern is a capital expenditure. See also sections 1012 (basis of property is generally its cost) and 1060 (purchase price of trade or business allocated as basis of acquired assets).

2000-4, 2000-1 C.B. 331 (ISO 9000 certification costs). The present case is distinguishable from the situations described in these rulings. Unlike the present case, most of these situations did not involve the acquisition cost of an asset, and all of them involved expenditures yielding only incidental future benefits.⁵

Petitioner asserts, at least in the context of the section 174/Rev. Proc. 69-21 argument, that the expenditures could be expensed because the software packages were "incomplete," or because they were not useful—at least for its purposes—without substantial modification. This may have some bearing on the treatment of the software for financial accounting purposes, discussed below. However, as a matter of general tax law we are aware of no authority to the effect that a taxpayer who purchases an asset can expense the cost of acquisition because the asset is "incomplete" or because the taxpayer intends to further modify it, improve it, or incorporate it into some other product (although such factors may affect valuation).

Financial Accounting vs. Tax Accounting

Petitioner argues that its treatment of its costs is consistent with the treatment of "in-process research and development" costs for financial accounting purposes. This treatment is reflected in several documents issued by the Financial Accounting Standards Board.

Generally, under ¶ 11.a of FASB Statement No. 2, *Accounting for Research and Development Costs*, the costs of tangible materials, equipment, or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) must be capitalized as tangible assets; only the costs of the materials as they are consumed, or the depreciation of the equipment or facilities as they are used, are expensed as research and development costs. Paragraph 11.a continues (emphasis added):

However, the costs of materials, equipment, or facilities that are *acquired or constructed for a particular research and development project and that have no alternative future uses* (in other research and development projects or

⁵In Rev. Rul. 98-25, the costs at issue include the acquisition costs of the replacement storage tanks. Noting that "[t]he useful life of asset for section 263 purposes is its useful life to the taxpayer, not its inherent useful life," Rev. Rul. 98-25 reasons that since the storage tanks are only used once, and have no remaining useful life to the taxpayer once they have been filled with waste and sealed, the acquisition costs are deductible. In the present case, by contrast, the software packages, with the possible exception of Software Package 4, provided significant benefits *to this taxpayer* substantially beyond the year of acquisition.

otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

In ¶ 11.c. of FASB Statement No. 2, this treatment is extended to intangibles purchased from others.⁶ FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, clarifies that this treatment applies not only when the tangible or intangible assets are purchased separately, but also when they are acquired in a business combination in which the overall purchase price is allocated among the acquired assets. Finally, FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, ¶ 7, applies this "no alternative use" standard to purchased software.⁷

As a general matter, it is true that consistency with generally accepted accounting principles and conformity between a taxpayer's tax and financial accounting methods is one factor in determining whether the treatment of an item for tax purposes is appropriate. See Treas. Reg. § 1.446-1(a)(2). For several reasons, however, we do not believe that in the present case Petitioner's treatment of the acquisition costs for tax purposes is supported by this financial accounting practice.

First, there is some question whether the taxpayer's treatment is entirely correct, even as a matter of financial accounting, under FASB Statement No. 2 and

⁶Presumably, the costs of *self-created* R&D intangibles are expensed for financial accounting purposes whether they have an alternative future use or not.

⁷Appendix B to FASB Statement No. 2, ¶ 33, explains the underlying reasoning behind the "no alternative future use" rule:

Consideration was given to the alternative that the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development project or otherwise) be apportioned over the life of the project rather than treated as research and development costs when incurred. The Board reasons, however, that if materials, equipment, or facilities are of such a specialized nature that they have no alternative future uses, even in another research and development project, those materials, equipment, or facilities have no separate economic values to distinguish them from other types of costs such as salaries and wages incurred in a particular project. Accordingly, all costs of these materials, equipment, and facilities should be treated as research and development costs when incurred.

See also ¶ 34 (same treatment for purchased intangibles).

FASB Interpretation No. 4. Functioning software products are arguably "assets *resulting from* the research and development activities of the acquired enterprise," rather than assets "*to be used in*" research and development activities of the combined enterprise. Moreover, to the extent the assets *were* intended to be used by Petitioner in creating its own software products (that is, instead of continuing projects begun by the acquired companies), that would appear to be an "alternative future use."

Second, the treatment of purchased IPR&D has come under increasing criticism even in the context of financial accounting where the general concern is to prevent the overstatement of income. In two 1998 letters to the American Institute of Certified Public Accountants, the Chief Accountant's Office of the Securities and Exchange Commission expressed concern over the treatment of purchased IPR&D. While the SEC did not challenge the practice itself, it noted that the treatment of IPR&D is "unique among purchased assets," and described a number of abuses of the rule, including overvaluation of IPR&D in general, and the bifurcation of purchase price into the immediate value of a presently completed product, which is capitalized, and the future value of the right to enhance or embellish that product, which is expensed. With respect to the latter practice, for example, the SEC observed:

The SEC staff believes that the value of the right to enhance or embellish an existing product, or the right to enhance or embellish an existing technology that has alternative future uses, is not separable from the value of ownership of the intellectual rights to the technology itself. If the technology itself meets the criteria for capitalization, the fair value of that asset necessarily includes the value of the right to enhance or embellish the asset.⁸

Third—and most important for present purposes—regardless of the correctness of Petitioner's accounting treatment for financial purposes, and regardless of the general status of the IPR&D exception in that context, it is well settled that for purposes of federal income tax accounting, financial accounting practices are neither controlling, nor even presumptively correct. First, of course,

⁸This comment may have specific relevance to the present case – for example, in Petitioner's treatment of Software Packages 2 and 3, where the acquisition costs of apparently completed products were bifurcated between "software" and "IPR&D."

While a reevaluation of the treatment of purchased IPR&D has been considered by the FASB, it appears that any such reevaluation has been postponed, perhaps until it can be addressed in the context of an overall reassessment of the treatment of research and development costs. See Exposure Draft: Proposed Statement of Financial Accounting Standards. *Business Combinations and Intangible Assets* (1999), ¶¶ 20, 252, 485

when the tax treatment is established by provisions of the Code, those provisions take precedence. Second, however, the correctness of any tax accounting method is subject to the overall requirement that it clearly reflect income, pursuant to section 446. As the Supreme Court stated in Thor Power Tool v. Commissioner, 439 U.S. 522, 540 (1979):

[T]he Code and Regulations give the Commissioner broad discretion to set aside the taxpayer's method if, "in [his] opinion," it does not reflect income clearly.... The Regulations embody no presumption; they say merely that, in most cases, generally accepted accounting practices will pass muster for tax purposes. And in most cases they will. But if the Commissioner, in the exercise of his discretion, determines that they do not, he may prescribe a different practice without having to revive any presumption running against the Treasury.

In support of this principle, the Thor Power opinion cited a long line of judicial precedent, as well as the "vastly different objectives" that financial and tax accounting have:

Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors and measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light.

439 U.S. at 541-43. Thus, no accounting method is acceptable for tax purposes to the extent it conflicts with statutory principles or with the clear reflection of income, as expressed in the Service's regulations or otherwise.

Viewed in this light, the anomalous practice of expensing purchased IPR&D—still sanctioned for financial accounting purposes by FASB Statement No. 2 and Interpretation No. 4, but increasingly suspect even in that context—is clearly unacceptable for tax purposes. Capitalization of expenditures that provide future benefits that are more than incidental, so that those expenditures may be more accurately matched with the income to which they relate, is a cardinal principle of the clear reflection standard, required for accrual-basis and cash-basis taxpayers alike. Clearly this is true when those expenditures represent the direct acquisition costs of an asset.

For financial accounting purposes, the treatment of purchased IPR&D hinges on a distinction between assets that are acquired only for their original use, and assets that are acquired, or also acquired, for an alternative use. Regardless of the function this "original use/alternative use," project-by-project standard may serve in the financial accounting context, it is clear that neither section 263 (or

section 263A), nor any of the related regulations, administrative pronouncements, or case law, make any such distinction. Under section 263, an expenditure must be capitalized if it has *any* significant future use or benefit. In fact, it is probably safe to say that the vast majority of capitalized expenditures are capitalized precisely because they are useful for their original purpose, not for an alternative use.

Assume two scenarios. In both, S has been developing software Program X, which it intends to use in creating a marketable product, Product X. In both scenarios, B acquires Program X for \$100x (for purposes of this example, it does not matter whether Program X is acquired separately or as part of a business acquisition).

In Scenario 1, B intends to and does in fact continue to develop and use Program X for several years to create Product X, after which Program X is no longer useful to B. In Scenario 2, the facts are the same except that, in addition to using Program X in the Product X project, B also intends to use Program X in a future project intended to develop Product Y.

For purposes of accounting for research and development costs under FASB Statement No. 2 and Interpretation No. 4, B expenses the \$100x acquisition cost immediately in Scenario 1, because for B, Program X is only suitable for its original use, the project to develop Product X. In Scenario 2, B would capitalize the \$100x, since B also has an alternative use for Program X.

For federal income tax purposes, however, under section 263, B must capitalize the \$100x in *both* scenarios. Whether the program is useful for its original purpose or for an "alternative use" is irrelevant.

Finally, please note that for financial accounting purposes, IPR&D costs that may be expensed because they have no alternative future use are not limited to "materials and supplies," which are items that might be expensed, at least in some circumstances, in any case. Items that may be expensed as IPR&D also include the costs of, for example, equipment and facilities, costs that would generally be capitalized in any other context. Petitioner's attempt to characterize its acquired software as a form of intangible "supplies" thus tends to soften the full force of Petitioner's argument: If we were to accept the proposition that the financial treatment of purchased IPR&D dictates its treatment for income tax purposes, then taxpayers could deduct not just the acquisition costs of "supplies," but also of equipment, buildings, and similar assets—so long as those assets had "no alternative future use."

Accordingly, we conclude that the amounts designated as "IPR&D" by

Petitioner must be capitalized and may not be deducted under section 162.⁹ It follows that the acquired software and software-related assets are "property" with a basis under section 1012 and/or section 1060, with whatever consequences flow from that determination under sections 167, 174, and 197.

Section 174 and/or Rev. Proc. 69-21

Petitioner argues that the amounts allocated to IPR&D are deductible for federal income tax purposes under section 174 and/or Rev. Proc. 69-21.

Under section 174, taxpayers may elect one of two methods to account for research or experimental expenditures paid or incurred in connection with the taxpayer's trade or business. Taxpayers may deduct, under section 174(a), their research or experimental expenditures in the tax year in which they are paid or incurred, or they may elect, under section 174(b), to amortize such expenditures over a period of not less than 60 months. Taxpayers not electing to treat research and experimental expenditures under section 174 may continue to capitalize research and experimental expenditures and will continue to receive the same treatment as under pre-1954 law. The extent to which a taxpayer pays or incurs research or experimental expenditures is a factual question.

Expenditures represent research and development costs in the experimental or laboratory sense if the expenditures are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Treas. Reg. § 1.174-2(a)(1).

⁹This conclusion clearly applies to Software Packages 1-3. With respect to Software Package 4, while our discussion of financial accounting practices and the "no alternative use" rule still applies, there is some evidence that, within the year of acquisition, Petitioner attempted to complete or integrate Software Package 4 into its product line and abandoned the project. Although this fact, if true, would not appear to support the deduction for the cost of Software Package 4 under section 162, a case might be made for a loss deduction under section 165. However, if section 197 applies, a loss deduction could be barred by section 197(f)(1). Alternatively, if, in fact, Software Package 4 was not the primary focus of Acquisition 3, the value assigned to Software Package 4 may have been overstated. Pending additional factual and legal development regarding Software Package 4 specifically and Acquisition 3 in general, the treatment of Software Package 4 is uncertain.

Treas. Reg. § 1.174-2(a)(2) provides that the term "product" includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. However, Treas. Reg. § 1.174-2(a)(3)(vi) provides that the term research or experimental expenditures does not include expenditures for the acquisition of another's patent, model, production or process.

Treas. Reg. § 1.174-2(a)(8) provides that the provisions of Treas. Reg. § 1.174-2 apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by the taxpayer but also to expenditures paid or incurred for research or experimentation carried on in the taxpayer's behalf by another person or organization. However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

Treas. Reg. § 1.174-2(b) contains rules relating to certain expenditures with respect to land and other property. Under Treas. Reg. § 1.174-2(b)(1), expenditures for the acquisition or improvement of land or for the acquisition or improvement of other property which is subject to the allowances for depreciation or depletion are not eligible for treatment under section 174. The annual allowances for depreciation or depletion, however, may be considered research and experimental expenditures eligible for section 174 treatment.

Treas. Reg. § 1.174-2(b)(2) provides, in relevant part, that expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of Treas. Reg. § 1.174-2(b)(4), be allowable as a current expense deduction under section 174(a).

Under Treas. Reg. § 1.174-2(b)(3), expenditures for research and experimentation that are incurred in connection with the construction or manufacture of depreciable property by another are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction is allowed if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account.

Finally, Treas. Reg. § 1.174-2(b)(4) provides that the deductions referred to in Treas. Reg. § 1.174-2(b)(2) and (3) for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation.

Thus, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property.

In each of the transactions, Petitioner acquired assets that included software and know-how. The purchase price attributable to the acquisition of another's patent, model, production or process is ineligible for the expense election under section 174. Similarly, section 174 does not apply to any expenditure for the acquisition of depreciable or amortizable "property" to be used in connection with research or experimentation. Sections 174(c); 197(f)(7); and Treas. Reg. § 1.174 - 2(b).

Although Petitioner may have used the acquired assets in research or experimental activities, the costs allocated to these acquired assets are not eligible for the election to expense research or experimental expenditures under section 174. Instead, under section 174 and Rev. Proc. 69-21, such property is depreciated or amortized under sections 167 or 197. To the extent that these assets are used in research or experimental activities, the annual depreciation deductions attributable to these assets, may be deductible as research or experimental expenditures under section 174.

In Rev. Proc. 69-21, the Service provides guidelines on the treatment of the costs of computer software. The revenue procedure addresses the tax accounting treatment of the costs of developing software, the costs of acquired software, and the costs of leased software. Although the revenue procedure specifies that the development costs refer to self-developed costs incurred by the taxpayer, the revenue procedure does not enumerate these software development activities. The extent to which a taxpayer incurs software development costs is also a factual question subject to rules similar to the rules of section 174.

In the case of developed software, the revenue procedure provides that the costs of developing computer software (whether or not the particular software is patented or copyrighted) in many respects so closely resembles the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant accounting treatment similar to the accounting treatment accorded research or experimental expenditures under section 174. Rev. Proc. 69-21 provides two alternative methods that taxpayers may use to account for computer software self-development costs. A taxpayer may either deduct the expenditures in the year in which they are paid or incurred, or treat the expenditures as capital expenditures. If the taxpayer treats its costs of developing software as capital expenditures, the taxpayer may recover the software development costs through deductions for ratable amortization, in accordance with rules similar to those provided by section 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development.

In the case of purchased software, the revenue procedure provides that the costs that are included, without being separately stated, in the cost of the computer hardware may be treated as part of the cost of the hardware that is capitalized and depreciated. Otherwise, the software is treated as an intangible asset and the cost is recovered by amortization deductions ratably over a period of five years or such shorter period as can be established by the taxpayer as appropriate if the useful life of the software will be less than five years.

Petitioner contends that the costs allocated to IPR&D are deductible under Rev. Proc. 69-21. However, software costs are only deductible under Rev. Proc. 69-21 if they are self-development costs pursuant to section 3 of that revenue procedure. In the present case, acquired Software Packages 1 - 4 are purchased software instead of self-developed software. Thus, section 3 of Rev. Proc. 69-21 does not apply to these software packages. Further, since Software Packages 1 and 4 constitute amortizable section 197 intangibles, Rev. Proc. 69-21 does not apply to Software Packages 1 and 4. With respect to acquired Software Packages 2 and 3, these software packages are, as previously stated, purchased software and, as a result, fall under section 4 of Rev. Proc. 69-21. Since the costs for Software Packages 2 and 3 are separately stated, they are recoverable using the straight-line method of depreciation over a period of 5 years or such shorter period as can be established by Petitioner as appropriate if the useful life of Software Packages 2 and 3 will be less than five years. In no case, however, may Software Packages 2 and 3 be depreciated over a period less than 36 months. See section 167(f)(1).

Amortization under section 197

Section 197(a) provides for an amortization deduction with respect to any amortizable section 197 intangible ratably over the fifteen year period beginning with the month of acquisition of the intangible.

Section 197(c)(1) provides, in general, that the term "amortizable section 197 intangible" means any section 197 intangible (A) which is acquired after August 10, 1993, and (B) which is held in connection with the conduct of a trade or business.

Section 197(d)(1) provides, in general, that the term "section 197 intangible" means:

(A) goodwill;

(B) going concern value;

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and

conditions (contractual or otherwise) of its employment;

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers);

(iii) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item;

(iv) any customer-based intangible;

(v) any supplier-based intangible; and

(vi) any other similar item;

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof;

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition of an interest in a trade or business or substantial portion thereof; and

(F) any franchise, trademark, or trade name.

Section 197(e)(3)(A) provides that a "section 197 intangible" does not include: i) any computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified; and ii) other computer software which is not acquired in a transaction involving the acquisition of assets constituting a trade or business.

Section 197(e)(3)(B) provides that the term "computer software" means any program designed to cause a computer to perform a desired function, but does not include any data base or similar item unless the data base or item is in the public domain and is incidental to the operation of otherwise qualifying computer software.

Section 167(f)(1) provides that if a depreciation deduction is allowable under the general rule of section 167(a) with respect to any computer software, such deduction shall be computed by using the straight line method and a useful life of 36 months. For purposes of section 167(f), computer software has the same meaning as in section 197(e)(3)(B), but does not include any such software which is an amortizable section 197 intangible.

Section 197(f)(1)(A) provides that if there is a disposition of any amortizable section 197 intangible acquired in a transaction or series of related transactions (or

any such intangible becomes worthless) and one or more other amortizable section 197 intangibles acquired in such transaction or series of related transactions are retained—

(i) no loss shall be recognized by reason of such disposition (or such worthlessness), and

(ii) appropriate adjustments to the adjusted bases of such retained intangibles shall be made for any loss not recognized under section 197(f)(1)(A)(i).

In the present case, in each of the transactions, Petitioner allocated part of the cost of an acquired software package to IPR&D. The acquired Software Packages 1 - 4 are included in the term “section 197 intangible” as know-how under section 197(d)(1)(C)(iii). The legislative history includes an expanded definition of know-how and provides that “the term ‘section 197 intangible’ includes any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item. For this purpose, the term ‘section 197 intangible’ is to include package designs, computer software, and any interest in a film, sound recording, video tape, book, or other similar property, except as specifically provided otherwise in the bill.” H.R. Conf. Rep. No. 103-213, 672, 675 (1993). There is no requirement that the software be complete. Other items listed in the definition of know-how (i.e., process, design, pattern, format) do not describe finished products, rather they constitute works in progress.

Section 197(e)(3)(A) provides two exceptions where computer software is not a section 197 intangible. The first exception involves any computer software which is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified. This exception does not apply in the present case to any of the acquired Software Packages 1 - 4. In Acquisitions 1 and 3, Petitioner purchased all right, title, and interest in and to all of the respective Target’s assets, including Software Packages 1 and 4 later characterized as IPR&D. Consequently, Petitioner acquired all rights and exclusive license to Software Packages 1 and 4 such that they fail to meet the exception. In Acquisition 2, Petitioner purchased all copyright, trade secret, and other ownership rights to Software Packages 2 and 3. Petitioner did not acquire a nonexclusive license to use Software Packages 2 and 3 (as was sold by Seller to the general public), instead Petitioner acquired all rights and exclusive use of the software and gave back to Seller a nonexclusive license to use the software. Petitioner then made Software Packages 2 and 3 again available for purchase by the general public such that each purchaser would be subject to a nonexclusive license. Thus, Software Packages 2 and 3 also fail to meet the first exception.

The second exception to section 197(e)(3)(A) involves computer software which is not acquired in a transaction involving the acquisition of assets constituting a trade or business. It is clear that Software Packages 1 and 4, purchased

pursuant to Acquisitions 1 and 3, respectively, do not meet this exception because Petitioner purchased all of the assets of Targets 1 and 2, respectively. In Acquisition 2, Petitioner purchased all copyright, trade secret, and other ownership rights to Software Packages 2 and 3. The legislative history indicates that computer software includes any incidental and ancillary rights with respect to computer software that are necessary to effect the legal acquisition of the title to, and ownership of, the computer software. H.R. Conf. Rep. No. 103-213, 672, 681 (1993). Since Petitioner did not acquire Software Packages 2 and 3 in a transaction involving the acquisition of assets constituting a trade or business (*i.e.*, workforce, business books and records, etc.), this software meets the exception of the definition of a section 197 intangible found in section 197(e)(3)(A)(ii). Therefore, Software Packages 2 and 3 would not be considered section 197 intangibles.

Software Packages 2 and 3, since they do not constitute section 197 intangibles, are depreciated pursuant to section 167(f)(1). Consequently, they are depreciated using the straight line method of depreciation and a useful life of 36 months. Software Packages 1 and 4 (including the portion allocated to IPR&D) do not qualify for exclusion from section 197, thus they constitute amortizable section 197 intangibles and are amortized over a period of 15 years.

Loss deduction under section 165

Although Petitioner's primary argument rests on section 174 and Rev. Proc. 69-21, and Petitioner may raise the issue of whether it can claim a loss under section 165 on the worthlessness of the acquired software assets, the memorandum from the field alludes to this possibility. As the field memorandum discusses, section 197(f)(1)(A) would prevent any loss deduction to the extent that the IPR&D assets are characterized as section 197 intangibles.

Section 165 provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Treas. Reg. § 1.165-2(c) of the regulations provides that for the allowance under section 165(a) of losses from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see Treas. Reg. § 1.167(a)-8.

Treas. Reg. § 1.167(a)-8(a)(4) provides, in part, that in order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

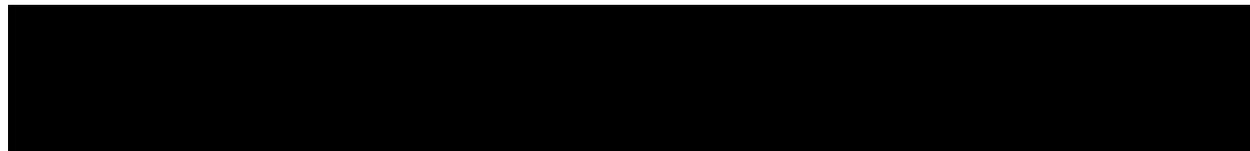
Even if, or to the extent that, section 197 does not apply, it would seem that

the factual predicate for a section 165 deduction (or similar treatment, such as an "obsolescence" deduction under the section 167 regulations) does not exist. At least with respect to Software Packages 1-3, these were items with a substantial value, as reflected in the taxpayer's basis allocation and attempted deduction, which were either sold separately or integrated into the petitioner's product line.¹⁰ It would clearly be inconsistent for Petitioner to claim that these products were abandoned or worthless in 1995.¹¹

In this connection, it is worth noting that the purchased IPR&D exception under FASB Statement No. 2 and Interpretation No. 4 is not based on a finding that the acquired assets are worthless or abandoned, at least not as the exception is interpreted by the FASB. As discussed earlier, when the purchaser of IPR&D writes off the costs because it is determined that the acquired assets have no *alternative* future use, this does not mean that the assets have *no* use; it simply means that the assets have no use outside the particular research and development project with respect to which they were originally created or acquired. See n. 7, above. In the context of *that project*, the assets may have considerable value, as reflected in the buyer's purchase price or purchase price allocation. The rationale for the purchased IPR&D exception is not that the acquired assets have no value—either in general or for the particular purchaser. Instead, the exception appears to be based on the idea that a company that acquires a research and development project "in midstream" should be placed in the same position, to the extent possible, as though it had initiated the project to begin with, and had been required for financial accounting purposes to expense the costs of materials, supplies, equipment, and facilities with no alternative future use as they were incurred.

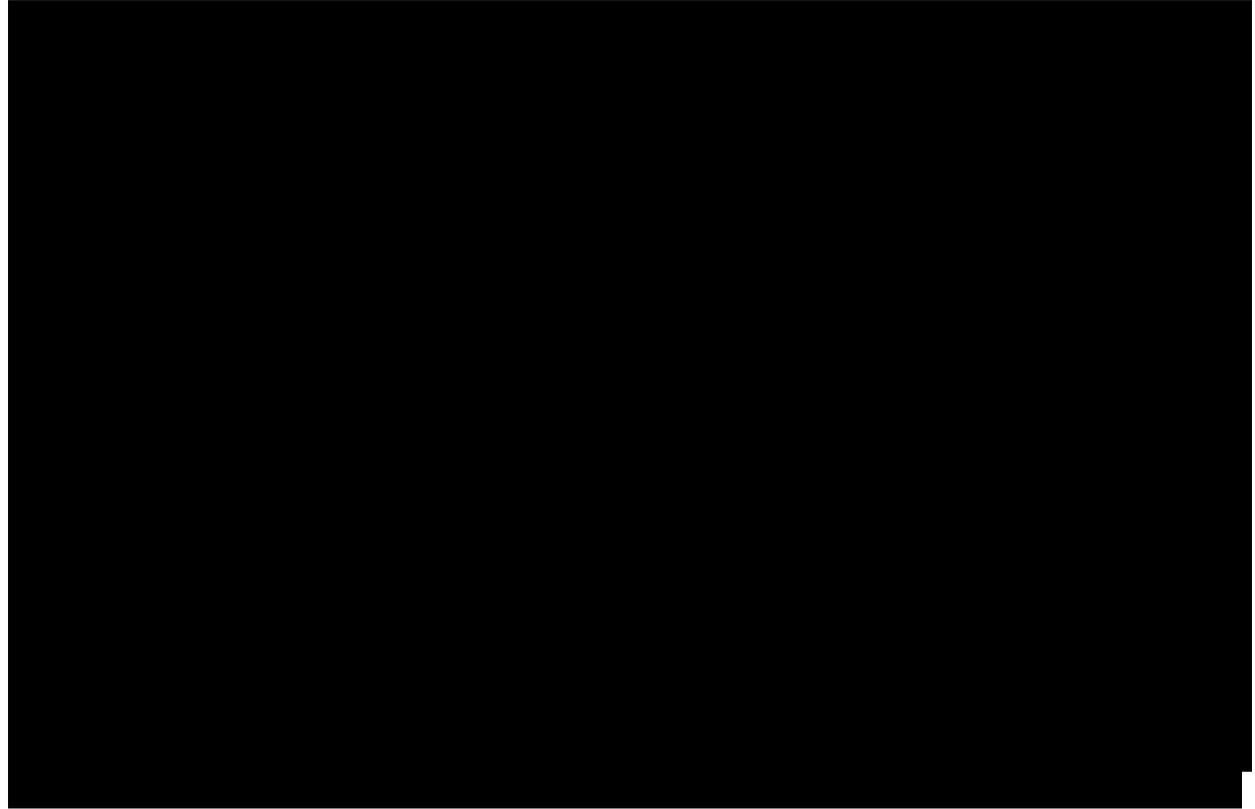
Accordingly, just as Petitioner's use of the purchased IPR&D exception for financial purposes does not indicate that the acquired assets have no useful life beyond the tax year, for purposes of sections 162 and 263, so too the use of the exception for financial purposes would not support a loss deduction based on abandonment or worthlessness of the acquired assets, under section 165.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



¹⁰ Petitioner's 1996 Form 10K, for example, refers to three components of its integrated software product line as "formerly" Software Packages 1-3.

¹¹ As discussed above, different treatment might be appropriate for Software Package 4, depending on further factual and legal development.



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