

Do you buy or lease computer software for use in your business? Do you develop computer software for use in your business, or for sale or lease to others? Then you should be aware of the complex rules that apply to determine the tax treatment of the expenses of buying, leasing or developing computer software.

*Purchased software.* Generally, the way to account for the cost of purchased software is to amortize (ratably deduct) the cost over the three-year period beginning with the month in which you placed the software in service. Also, off-the-shelf computer software placed in service in a tax year beginning in 2003 through 2010 qualifies as "section 179 property" eligible for an elective current expense deduction of up to \$125,000 a year (for 2007), annually adjusted for inflation. There are two other exceptions to the three-year amortization rule. One exception requires that, if you buy the software as part of a hardware purchase in which the price of the software isn't separately stated, you must treat the cost of the software as part of the cost of the hardware. Thus, you must depreciate the software under the same method and over the same period of years that you depreciate the hardware. The other exception requires that if you buy the software as part of your purchase of all or a substantial part of a business, the software must be amortized over 15 years (unless the software is readily available for purchase by the public, is subject to a nonexclusive license and hasn't been substantially modified).

*Leased software.* You must deduct the amounts you pay to rent leased software in the tax year in which paid, if you are a cash-method taxpayer, or the tax year for which the rentals are accrued, if you are an accrual-method taxpayer. Generally, however, deductions aren't permitted before the years to which the rentals are allocable. Also, if a lease involves total rentals of more than \$250,000, special rules may apply.

*Software you develop.* Costs for developing computer software may be accounted for using any of the following methods:

- (1) amortizing the costs over a three-year period beginning with the month that the software was placed in service;
- (2) deducting the costs in the tax year in which the costs are paid (if you are a cash-method taxpayer) or in the tax year in which the costs are accrued (if you are an accrual-method taxpayer), but only if all of your costs of developing the software are deducted this way;
- (3) amortizing the costs over a five-year period beginning with the completion of the development, but only if all of your costs of developing software are amortized this way;
- (4) amortizing the costs over a period longer than five years, but only if the costs are Code Sec. 174 "research or experimental expenditures."

You should also be aware that if following any of the above rules requires you to change your treatment of software costs, it will usually be necessary for you to obtain IRS consent to the change by following prescribed procedures.