DEDUCTING THE COST OF COMPUTER SOFTWARE

In response to the relentless advance of technology, many business owners regularly acquire new computer software. Although the learning curve associated with using the new software may be painful, business owners may find the pain somewhat diminished when they hear that the cost of acquiring their new software is tax deductible. As discussed below, several basic rules govern the deductions for computer software. First, your software must meet the definition of computer software as prescribed by the Internal Revenue Service (IRS). Next, you must use the software in your trade or business. Finally, you will have to determine whether your software falls within the purchase rules or the development rules.

Is It Software?

When formulating the deduction rules for computer software, the Internal Revenue Service (IRS) could not resist issuing a complicated definition of software. According to the IRS, computer software consists of all programs or routines used to cause a computer to perform a desired task or set of tasks. It also consists of the documentation required to describe and maintain those programs. Computer programs of all classes, including operating systems, executive systems, monitors, compilers, translators, assembly routines, utility programs, and application programs are included. However, computer software does not include procedures external to computer operations, such as instructions to transcription operators and external control procedures.

When Can You Deduct the Cost of Software?

The Internal Revenue Code (IRC) contains two sets of rules that govern deductions for the cost of acquiring computer software--the purchase rules and the development rules. These rules determine when you can take your deductions.

The first set, the purchase rules, apply if you simply purchase software from a store and use it without making any modifications. In this case, you have a choice. Your purchase could qualify for either the three year or the lump sum depreciation rules. Under these rules, business owners may depreciate the cost of their software over three years. In other words, you can deduct one-third of the cost in each of three years. Or, as an alternative, the IRC allows business owners to deduct the acquisition costs for depreciable business assets, including software, each year in a lump sum. (For more information regarding deductions for the purchase of business assets, see the article on this site entitled Deductions For Business Equipment Purchases.)

The second set of rules, the development rules, may apply instead if you hire someone to either modify "off the shelf" software or develop a custom-made program. The development rules require business owners who have had software developed specifically for their needs to depreciate the cost of the software over five years. Further, software that falls under the development rules does not qualify for the lump sum deduction mentioned above.

Software Development Rules

Developing custom software can be a complicated undertaking. Many rewrites and much "debugging" may be required before a custom program performs its intended functions. Whether your software falls under the purchase or development rules depends on who bears the expense to make the rewrites and debugging.

If the software developers are responsible for correcting problems with the software at their expense, your software acquisition should fall within the purchase rules and should qualify for the three year or lump sum depreciation. This situation would occur when you are paying a developer a flat fee. However, if you are responsible for correcting the problems, then your software acquisition will probably fall within the development rules, and will require five year depreciation. This situation would occur when you pay a developer on an hourly basis.

Whether you can take a deduction as a lump sum, during three years, or during five years can significantly affect the amount of your business income taxes. If you are purchasing software that will be modified or custom made for your particular needs, you should consult an attorney. The attorney can prepare a contract to maximize your remedies if the developer fails to write the software properly. Doing so can also maximize your tax deductions.