

Tax Implications of Incurring Website Development Costs

February 23, 2009

The business use of websites is widespread and increasing rapidly as many organizations move away from a traditional brick-and-mortar business model and turn to an online presence for ongoing business activities. This trend combined with the fact that IRS has not issued formal guidance as to the deductibility of website development costs has resulted in confusion. The long-established rules applicable to the deductibility of business costs in general, and existing IRS guidance applicable to software development costs in particular, provide limited guidance as to the proper tax treatment of these costs. As businesses compile their tax information and make decisions regarding the deductibility of these costs incurred or paid in 2008, or enter into contracts for website development activities, care should be exercised so that desired deductibility is achieved.

The determination of the proper time period for deducting website design costs (*i.e.*, costs of the website's overall structure, functionality and appearance) depends on whether the costs are "software costs" within the meaning of the "software guidelines." Generally, the portions of the website's design that are produced from sophisticated programming language typically used in website design will qualify as "software." Website design costs that qualify as "software" costs are deductible under the following "safe-harbor" rules.

Generally, if the individual or company launching the website acquires the design from a contractor who is at economic risk should the software not perform, the design costs are amortized by that individual or company over the three-year period beginning with the month in which the website is placed in service. It is important to note in this context that off-the-shelf computer software placed in service in a tax year beginning in 2003 and before calendar year 2010 qualifies as "section 179 property" eligible for an elective current expense deduction in 2008 of up to \$250,000.

If, on the other hand, the design is "developed" (designed in-house by the individual or company launching the website or designed by an independent contractor who is not at risk should the software not perform), the individual or company launching the website can choose among the following alternative tax treatments:

- Amortizing the costs over a three-year period beginning with the month that the software was placed in service;
- Deducting the costs in the tax year in which the costs are paid (if taxpayer is a cash-basis taxpayer) or in the tax year in which the costs are accrued (if taxpayer is an accrual-basis taxpayer), but only if all of costs of developing the software are deducted this way;
- Amortizing the costs over a five-year period beginning with the completion of the development, but only if all costs of developing software are amortized this way; or
- Amortizing the costs over a period longer than five years, but only if the costs are Code Sec. 174 research or experimental expenditures.

Website design costs not considered "software" costs are deductible in accordance with their useful life. Thus, these costs must be amortized over the number of years that it is expected that the non-software portions of the design will be used in the business. If it is expected that these non-software portions of the design will have a useful life of no more than a year, the costs can be currently deducted.

Website content associated with advertising is generally deductible in the year incurred or paid and is consistent with the treatment of advertising costs in general. Website content other than advertising will be currently deductible or amortized over a multi-year period, depending on the useful life of the content.

The deductibility of some website costs related to the startup of a business is limited. When website costs that would otherwise be currently deductible are paid or accrued before a business activity begins, the costs are deductible only upon the termination or disposition of the business, unless the individual or company launching the website elects to amortize these costs over a period of 60 months or more beginning with the actual start of the business. Generally, business activity is deemed to have commenced upon the business' engaging in activity for which it was organized, such as recording sales or revenue.

The above rules provide ways in which an individual or company launching a website can take advantage of the most profitable tax treatment when planning and incurring website development costs. For instance, an individual or company seeking to contract for a website design can structure the contract so that the website development costs qualify as software costs and also include in the written agreement with the developer/contractor terms that will put the risk that the software fails to perform on the individual or company, which is likely to result in more favorable tax treatment.

Appropriate tax treatment of website development costs can be supported by detailed, descriptive allocations of costs, both in contracts and in internal records.

Conclusion

While the costs of purchased hardware and software should be capitalized, many of the costs involved in the development of a website may be appropriately classified as software development costs and are thus currently deductible as an expense under the various provisions of the Internal Revenue Code. Companies incurring significant website development costs should consult with their tax advisors to perform a detailed analysis of the tasks undertaken and the related costs to ensure maximum deductibility.

For Further Information

If you have any questions regarding this Alert, please contact Michael A. Gillen, Director of the Tax Accounting Group, or Steven M. Packer, Manager in the Tax Accounting Group, or the practitioner with whom you are regularly in contact.

As required by United States Treasury Regulations, you should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under United States federal tax laws.