

Checkpoint Contents

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Practical Tax Strategies

DERIVE THE BEST TAX TREATMENT FOR COMPUTERS AND SOFTWARE, Practical Tax Strategies

COMPUTER DEDUCTIONS

DERIVE THE BEST TAX TREATMENT FOR COMPUTERS AND SOFTWARE

A variety of tax rules—some presenting choices—apply to computer and software purchases made for business (by employers or employees), investment, and other purposes

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The use of computers has become more widespread in both our business and personal lives. When computers are used for business, their costs—like the costs of other types of business equipment—are deductible. The precise deduction rules for computers and computer software, however, can be more complex in some situations than the rules governing other business equipment. Some of these complexities arise when computers are used only partly for business or purely for other purposes. With proper planning and record keeping, taxpayers can maximize their tax deductions for computer and software purchases.

Education credits

To qualify for the Hope or Lifetime Learning credits, the taxpayer must generally pay for “qualified tuition and related expenses” of a post-high school educational program. The term “qualified tuition and related expenses” means *tuition and fees* (emphasis added) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a qualified dependent of the taxpayer. ¹ This wording would seem to disallow the purchase of a computer for the student as a qualifying expense for purposes of these credits. However, fees that must be paid to the educational institution as a condition of the student's enrollment or attendance at the institution do qualify as educational expenses. ² As a result, such fees that entitle the student to use computer facilities owned by the school would then qualify for the credits.

Computers used for medical care

Generally, a taxpayer may deduct medical expenses paid “for the diagnosis, cure, mitigation, treatment, or prevention of disease or for the purpose of affecting any structure of function of the body....” ³ Capital expenditures are generally not deductible for federal income tax purposes. ⁴ However Reg. 1.213-1(e)(1)(iii) provides that an expenditure otherwise qualifying as a medical expense under Section 213 is not disqualified as a medical expense merely because it is capital in nature. Rev. Rul. 2003-58 ⁵ also provides that amounts paid for equipment, as well as supplies or diagnostic services, may qualify as medical expenses for purposes of the medical expense deduction.

However the expense must be incurred primarily to prevent or alleviate a physical or mental defect or illness. ⁶ As a result, if the taxpayer incurs the expense primarily for a non-medical reason, the expense is not deductible as a medical expense even though it may provide an indirect medical benefit. ⁷ This rule is illustrated by *Keating*, ⁸ a Tax Court memorandum decision, in which the taxpayer's wife was denied a depreciation deduction for a computer she used partly to help with her recovery from brain surgery. She used the computer for other purposes, including helping her professor husband in his work and typing documents for her Ph.D. program. The court was not persuaded that she purchased the computer primarily to help her rehabilitation from brain surgery.

The Code and regulations indicate it may be possible for a taxpayer to deduct the cost of a computer as a medical expense. However, the taxpayer must be able to demonstrate that the computer is used primarily for medical purposes.

Medical expenses are deductible only by taxpayers who itemize their deductions, and only to the extent total medical expenses exceed 7.5% of adjusted gross income. An expenditure that qualifies as a deductible medical expense, however, can be eligible for reimbursement under a health care flexible spending account arrangement that a taxpayer has established with his or her employer.

Expensing computer used for business

Computers and related peripheral equipment used in a trade or business are classified as five-year property (as qualified technological equipment)⁹ and are expensed under MACRS over six years (allowing only half a year's depreciation for the first and last years). Related peripheral equipment is defined as any auxiliary machine designed to be placed under the control of the central processing unit (CPU) of a computer,¹⁰ including printers and scanners.

Expensing in year of purchase. Like other business property, the purchase price of a computer used in a trade or business may be expensed under the Section 179 rules in the year it is acquired and placed in service.¹¹ The business must be actively conducted, and it must be the taxpayer's trade or business.¹² Only personal property (i.e., not real estate) qualifies for the election. The taxpayer must make a yearly election to expense such property.

For tax years beginning in 2006, the maximum amount each taxpayer may expense is \$108,000.¹³ The \$108,000 maximum deduction is phased out dollar for dollar if qualified purchases for 2006 exceed \$430,000. These amounts are adjusted for inflation through tax years beginning before 2010. For tax years beginning in 2010 or later, they are scheduled to drop to their pre-2003 level of \$25,000 and \$200,000, respectively.

Example 1. Nina's Pottery, an unincorporated business operated by Nina, purchases and places in service during 2006 \$103,000 worth of qualifying Section 179 property. Because her purchases do not exceed the \$430,000 limit, Nina may elect to expense the full purchase price of \$103,000 on her 2006 tax return.

Example 2. The facts are the same as in Example 1, except Nina's Pottery purchases and places in service qualifying property costing \$110,000. Nina may elect to expense only \$108,000 of the purchase price. She may depreciate the remaining \$2,000 under MACRS.

Example 3. The facts are the same as in Example 1, except Nina's Pottery purchases \$450,000 of qualifying property. Because her purchases exceed the \$430,000 threshold, she may expense only \$88,000 (\$108,000 - (\$450,000 - 430,000)) of the purchase price. The remaining \$20,000 cost may be depreciated under MACRS.

Depreciation limits on listed property. A computer used for both business and personal use qualifies as "listed property,"¹⁴ and the depreciation deductions for the business use of such property are limited. A computer used exclusively at a regular business establishment is not listed property and, therefore, is not subject to the limited depreciation rules.¹⁵

If the listed property (i.e., computer) is used primarily in a trade or business on a predominantly (i.e., more than 50%) annual basis,¹⁶ the computer may be expensed quickly using the statutory percentages from the MACRS table or even more quickly using the election to expense under Section 179.¹⁷ However, only the business-use percentage may be so expensed.

Example 4. In 2006, Lisa purchases a new computer for \$2,000 to use 70% in her business, Designs in Glass, and 30% for personal use. Because Designs in Glass uses the computer (based on hours of use) more than half the time, she may use the statutory percentage and deduct \$280 ($\$2,000 \times .20 \times .7$) of the cost of the computer as a business expense for 2006. The personal-use portion of 30% is not deductible.

The taxpayer may not use the statutory percentage if the business-use percentage is 50% or less. Rather, the straight-line method must be used over a longer recovery period under the alternative depreciation system (ADS).¹⁸

Example 5. The facts are the same as in Example 4, except that Lisa uses the computer only 40% of the time in her business. Thus, the computer is not predominantly used in a trade or business. In this situation, Lisa's 2006 business expense for the computer is only \$80 ($\$2,000 \times .10 \times .4$). Because she did not use the listed property more than 50% of the time for business purposes in its first year of use (2006), Lisa must continue to depreciate the computer using the straight-line method for all subsequent years.¹⁹ She may not switch to the regular, accelerated MACRS deduction method for the computer in any later year that its business use exceeds 50%.

Taxable income limitation. The expense deduction allowed under Section 179 is further limited to the taxpayer's taxable income from active trades or businesses for that year. ²⁰ Any allowable amount in excess of the taxable income may be carried over to later years until it is deducted. ²¹ For purposes of this limitation, taxable income is computed without regard to the following items:

- (1) The expense deduction itself. ²²
- (2) The deduction for one-half of self-employment tax under Section 164(f).
- (3) Any net operating loss carryback or carryforward.
- (4) Any deduction suspended under other Code sections. ²³

For an individual, partnership, or S corporation, taxable income equals net income or loss from all active (non-passive) trades or businesses conducted by that entity. ²⁴ Taxable income for a C corporation is its total taxable income before deducting a net operating loss and certain other deductions, adjusted to reflect items of income and deduction that are not from the active conduct of a business. ²⁵

One result of the aggregating rule for taxable income is that the taxpayer may be denied the expense deduction in situations where it would be expected to be allowed, and vice versa. To deduct the expense, the taxpayer does not have to show a taxable income in the specific business activity in which property is used, as long as all of the taxpayer's business activities result in a positive taxable income when combined. Conversely, the specific business activity in which the property is used may have a loss for the year, but the expense deduction is allowed as long as the taxpayer's business activities, in total, produce a net income.

Example 6. During 2006, Marie buys for \$3,000 and places in service a new computer for her hair styling salon, Simply Stunning. The salon generates \$20,000 of net income for the year, not counting the purchase of the equipment. However, Marie's other business activity, Roller Derby Heaven, has a net loss of \$22,000. Because her two business activities generate an aggregate \$2,000 net loss, Marie may not expense any of the cost of the new computer for Simply Stunning.

Example 7. The facts are the same as in Example 6, except Simply Stunning generated a net loss of \$4,000 and Roller Derby Heaven had a net income of \$6,500 for 2006. Because Marie's two businesses generated a combined positive net income of \$2,500, she may expense up to \$2,500 of the cost of the new computer. It does not matter that the business in which the computer was used had a net loss for the year.

Limits for married couples. Whether they file jointly or separately, a married couple is treated as one taxpayer for purposes of applying the dollar limitations above. ²⁶ This rule applies even if each bought separate properties to be used in separate businesses. If the couple files separately, the dollar limitation is allocated equally between them, unless they elect otherwise. ²⁷

Making the election. Generally, a taxpayer must make the election to expense qualifying property under Section 179 on the income tax return for the year to which the election applies ²⁸ (i.e., the first year the property is placed in service by the business) using Form 4562. A taxpayer may also make the election on an amended return for that tax year, as long as the amended return is filed in a timely manner. ²⁹ If the entity placing the property in service is a partnership or an S corporation, the partnership or S corporation would make the election to expense the property, not the individual partner or shareholder. ³⁰

The election must specify the items of Section 179 property to which the election applies and the portion of the cost of each item that is to be expensed for the tax year. ³¹ Also, the taxpayer must show as a separate item on the taxpayer's income tax return:

- (1) The total Section 179 expense deduction claimed for all Section 179 property.
- (2) The portion of that deduction allocable to each specific item. ³²

In addition, the taxpayer must keep records that:

- (1) Enable the specific identification of each piece of Section 179 property.
- (2) Reflect how and from whom the property was acquired.
- (3) Indicate when the property was placed in service.

Recapturing depreciation for listed property. If the business use of listed property (including computers) falls to

50% or less in any year before the property is fully depreciated, the "excess depreciation" must be recaptured as ordinary income in that year. ³³ Excess depreciation is defined as the excess of:

- (1) The depreciation deductions allowable (including any amounts expensed under Section 179) for the property for tax years before the first tax year in which the property was not predominantly used in a qualified business use, over—
- (2) The depreciation deductions which would have been allowable for those years if the property had not been predominantly used in a qualified business use for the year it was acquired and no election had been made to expense part or all of the cost of the property under Section 179. ³⁴

Example 8. During 2006, Allison purchased a new computer to use exclusively in her business, Creative Designs. She elected to expense 100% of the \$2,000 cost of the computer. During 2007, she needed to use the computer 60% of the time in her college coursework. Because the business use of her computer dropped to 50% or less during 2007, she must recapture excess depreciation on the computer on her 2007 tax return.

Computer used in the home

A computer used at home is generally considered to be listed property, unless the computer is used exclusively in the taxpayer's trade or business (discussed later). Listed property used in the home by an employee for business purposes can be expensed or depreciated *only* if the employee can prove that the computer is used for the convenience of the employer and is required as a condition of employment. ³⁵ This means the employee must clearly demonstrate that the employee cannot perform his or her job without the computer or peripheral equipment. ³⁶

Whether the computer is used for the convenience of the employer and is required as a condition of employment is determined by the facts and circumstances of each situation. Further, a statement by the employer that the computer is required as a condition of employment is not, by itself, sufficient documentation. ³⁷ However, the employer need not explicitly require the employee to use the home computer.

The IRS views both the "convenience of the employer" and the "condition of employment" requirements as meaning that it would be virtually impossible for the employee to perform his or her job without the computer and peripherals ³⁸ Thus, the employee would also need to demonstrate that this equipment is a required condition for continued employment, as shown in the examples below.

Example 9. Derek is an accountant who works for Celebrity Accounting in Hollywood. His employer provided him with an office and a computer to use there. Although Derek's employer did not require him to purchase a computer to use at home as a condition of being hired for the job, he occasionally works on his computer at home in the evening to keep up with his workload. Because Derek has access to a computer at the office, the requirement that his home computer be used for the convenience of his employer and is required as a condition of his employment was *not* met. ³⁹ Further, he cannot show evidence that his colleagues who do not own and use a computer at home are professionally disadvantaged.

Example 10. Romeo is a professor whose college encouraged him to purchase a computer to enhance his professional and teaching activities by doing some scholarly work, grading exams, etc. at home because there are not enough computers in the office for everyone to use at any given time. The requirement that a computer be used for the convenience of the employer and be required as a condition of employment was not met because the college did not make the purchase a required condition of his employment. ⁴⁰ The fact it was inconvenient for Romeo to use the computers provided by the college did not make a home computer a required condition of employment. ⁴¹

Example 11. Sara is an electric company utility sales manager. She purchased a computer and printer for her home office and used it exclusively to write reports required by the utility company to maintain her required workload. She would have been unable otherwise to maintain this required workload because the company office was closed after the normal business hours. Therefore, Sara *does* meet the requirement that her home computer is used for the convenience of her employer and is required as a condition of her employment; she may deduct the cost of the computer and printer. ⁴²

Deductions for an employee's business use of a computer are characterized as miscellaneous itemized deductions. As such, they are deductible only if the employee itemizes his or her deductions and, even then, only to the extent the employee's total miscellaneous itemized deductions exceed 2% of adjusted gross income.

PLANNING TIP

Surpassing the 50% business-use level is an important threshold for taxpayers who use a computer partly for business and partly for other purposes. The cost of only computers used predominantly (i.e., more than 50%) for business are eligible for Section 179 expensing deductions and accelerated depreciation. If this threshold is met in the first year a computer is placed in service, but not in a later year, a recapture of excess tax benefits may be required. On the other hand, if business use of a computer first rises above the 50% level after the first year it is placed in service, the taxpayer is not permitted to switch to a more favorable depreciation method.

Self-employed taxpayers

A computer and related equipment purchased by a self-employed taxpayer and used exclusively in the taxpayer's business is *not* listed property. ⁴³ Taxpayers in this situation have several options. The self-employed taxpayer can elect the Section 179 deduction for the full cost of the property (subject to limitations previously discussed), he or she can depreciate the full cost of the property, or the self-employed taxpayer can take part of the cost as a Section 179 deduction and depreciate the balance. However, if the taxpayer does *not* use the computer and peripheral equipment exclusively in his or her business, but the taxpayer uses it more than 50% for business, the taxpayer can claim a Section 179 deduction or an accelerated depreciation deduction for the percent used for business purposes.

Example 12. Gloria uses her computer at home 40% of the time for her home business. She also uses that computer 50% of the time to manage her personal investments. Her computer is considered to be "listed property," and Gloria does not qualify for the Section 179 deduction because she does not use the computer more than 50% of the time for business purposes. However, she can use her combined business/investment use (90%) to figure her depreciation deduction using the alternative depreciation system (ADS).

Example 13. If Gloria uses her computer 60% of the time for business use and only 30% of the time for personal investment use, she can claim the Section 179 deduction because her business use of the computer would pass the more-than-50% use test. In addition, she can use her combined business/investment use (90%) to figure her depreciation deduction using the general depreciation system (GDS).

Computer software

Computer software can qualify as depreciable property ⁴⁴ as long as it meets the following requirements:

- (1) It is used in a trade or business or held for the production of income. ⁴⁵
- (2) It is not inventory or stock in trade. ⁴⁶

Another requirement for computer software to be depreciated is that it must have a useful life that can be determined with some degree of reasonable accuracy.

Example 14. Richard purchased software to use in his financial investments business. He used it for database functions relating to his client's transactions, as well as stock valuations and other investment analyses. Because Richard used the software in his business, he was able to deduct depreciation on the software. ⁴⁷

Expensing computer software costs. Different and potentially complex rules apply for expensing the cost of software depending on whether the software was purchased, leased, or developed by the taxpayer.

Purchased software. In general, the cost of software purchased can be ratably amortized (using the straight-line method) over a 36-month period beginning with the month in which the software is placed in service. ⁴⁸ Three exceptions apply to this general rule:

- (1) "Off-the-shelf" software purchased between 2003 and 2009 qualifies as Section 179 property (discussed above), and is eligible for immediate expensing.
- (2) If software is purchased together with computer hardware and the cost of the software cannot be separated from the cost of the hardware, the software is depreciated under the same method and over the same period of years that the hardware is depreciated. ⁴⁹
- (3) If software is purchased as part of an overall purchase of all or a substantial part of a business, the software must be amortized as an intangible asset over a 15-year period under Section 197, unless the software is readily available for purchase by the public, is subject to a nonexclusive license, and has not been substantially

modified. [50](#)

Leased software. The costs of leased software must be deducted in the year they are paid if the taxpayer uses the cash method. Otherwise, the amount would be deducted in the year the lease costs are accrued if the taxpayer uses the accrual method. [51](#)

Self-developed software. Several methods are available for deducting the costs of software developed by the taxpayer as follows: [52](#)

- (1) The software costs can be amortized over a three-year period beginning with the month the software is placed in service.
- (2) If the taxpayer uses the cash method, he or she can deduct the costs in the tax year in which the costs are paid. A taxpayer who uses the accrual method can deduct the costs in the tax year in which the costs are accrued. However, these methods can be used only if all of the costs of developing the software are deducted this way.
- (3) The costs can be amortized over a five-year period that begins with the completion of the software development, but only if all of the costs of developing the software are amortized this way.
- (4) The costs can be amortized over a period longer than five years if the costs qualify under Section 174 as research or experimental expenditures.

Essentially, in Rev. Proc. 2000-50 [53](#) the Service states that when the taxpayer has consistently used the same method of expensing or of capitalizing and amortizing software costs, the Service will allow the taxpayer to continue to use that method.

Conclusion

Generally, few tax benefits are available for the personal (nonbusiness) use of computers by taxpayers. Computer costs might (if used solely for medical purposes) qualify for the medical expense deduction, if the taxpayer itemizes, but making a case for such a deduction may be difficult to do and, furthermore, medical expenses must be reduced by 7.5% of the taxpayer's AGI. An employee who uses a computer at home for business purposes generally will not qualify to deduct part of the cost of the computer unless the employee can demonstrate the computer was used for the convenience of his or her employer and using the computer at home was a condition of his or her employment. Most employees who have an employer-provided computer at a regular workplace outside the home will have a difficult time making the case for deducting any of their home computer costs.

Business entities and self-employed persons should have no difficulty depreciating or expensing the cost of computers, peripherals, and software used exclusively in their businesses. However, a self-employed person who also uses the computer for personal purposes must be sure to use the computer more than 50% of the time for business purposes to gain the maximum deduction and to avoid recapture of prior deductions.

[1](#)

Sections 25A(f)(1)(A)(i) through (iii).

[2](#)

Reg. 1.25A-2(d)(2)(i).

[3](#)

Section 213(d)(1)(A).

[4](#)

Reg. 1.213-1(e)(1)(iii).

[5](#)

2003-1 IRB 959.

[6](#)

Reg. 1.213-1(e)(1)(ii).

[7](#)

Brown, 62 TC 551 (1974).

[8](#)

TC Memo 1995-101, RIA TC Memo ¶95101, 69 CCH TCM 2052 .

[9](#)

Sections 168(e)(3)(B)(iv) and 168(i)(2).

[10](#)

Section 168(i)(2)(B)(iii).

[11](#)

Section 179(a).

[12](#)

Section 179(d)(1)(C); Reg. 1.179-4(a).

[13](#)

Rev. Proc. 2005-70, 2005-47 IRB 979, section 3.18.

[14](#)

Section 280F(d)(4)(A)(iv).

[15](#)

Section 280F(d)(4)(B); Reg. 1.280F-6(b)(5).

[16](#)

Section 280F(b)(4); Reg. 1.280F-6(d)(4)(i).

[17](#)

Section 168(a).

[18](#)

Section 280F(b)(1).

[19](#)

Id.

[20](#)

Section 179(b)(3)(A); Reg. 1.179-2(c)(1).

[21](#)

Section 179(b)(3)(B).

[22](#)

Section 179(b)(3)(C).

[23](#)

Reg. 1.179-2(c)(1).

[24](#)

Reg. 1.179-2(c).

[25](#)

Reg. 1.179-2(c)(4).

[26](#)

Regs. 1.179-2(b)(5)(i) and 1.179-2(b)(6)(i).

[27](#)

Section 179(b)(4).

[28](#)

Section 179(c)(1)(B).

[29](#)

Reg. 1.179-5(a).

[30](#)

Reg. 1.179-1(h)(1).

[31](#)

Sections 179(c)(1)(A) and (B).

[32](#)

Regs. 1.179-5(a)(1) and (2).

[33](#)

Section 280F(b)(2)(A); Temp. Reg. 1.280F-3T(d)(1).

[34](#)

Section 280F(b)(2)(B).

[35](#)

Section 280F(d)(3); Reg 1.280F-6(a).

[36](#)

Rev. Rul. 86-129, 1986-2 CB 48.

[37](#)

Reg. 1.280F-6(a)(2)(ii).

[38](#)

Reg. 1.280F-6(a)(2); Rev. Rul. 86-129, *supra* note 36.

[39](#)

Reg. 1.280F-6(a)(4), Example 5.

[40](#)

Rev. Rul. 86-129, *supra* note 36; Ltr. Rul. 8710009.

[41](#)

Bryant, 74 AFTR 2d 94-6388, 39 F3d 1168 (CA-3, 1994), *aff'g* TC Memo 1993-597, RIA TC Memo ¶93597, 66 CCH TCM 1594 .

[42](#)

Mulne, TC Memo 1996-320, RIA TC Memo ¶96320, 72 CCH TCM 111 .

[43](#)

Section 280(d)(4)(B); Reg. 1.280F-6(b)(5).

[44](#)

Hirahara, TC Memo 1997-16, RIA TC Memo ¶97016, 73 CCH TCM 1699 ; Ltr. Rul. 8226063.

[45](#)

Section 167(a).

[46](#)

Reg. 1.167(a)-2.

[47](#)

Note 44, *supra*.

[48](#)

Section 167(f)(1)(A).

49

Reg. 1.167(a)-14(b)(2); H Rep't No. 93-111 (PL 103-66) p. 767.

50

Section 197(e)(3)(A).

51

Rev. Proc. 2000-50, 2000-2 CB 601, section 8.03.

52

Id. at section 5

53

Note 51 *supra*.

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