Sprint Corp. v. Commissioner, 108 T. C. 384 (1997)

Custom software integral to digital switches qualifies as tangible property for investment tax credit and accelerated depreciation under ACRS.

Summary

Sprint Corporation purchased digital switches and the necessary software for its telephone services, claiming investment tax credits (ITC) and accelerated cost recovery system (ACRS) deductions for the total cost. The IRS disallowed the portion related to software costs, arguing the software was not tangible property and Sprint did not own it. The Tax Court, relying on Norwest Corp. v. Commissioner, held that the software was tangible property and Sprint owned it, entitling Sprint to the claimed tax benefits. Additionally, the court ruled that 'drop and block' telecommunications equipment was 5-year property under ACRS, despite a change in FCC accounting rules.

Facts

Sprint Corporation, a telephone service provider, purchased digital switches from various manufacturers to replace electromechanical switches. The digital switches required specific software to operate, which was custom-designed by the manufacturers for each switch. Sprint claimed ITC and ACRS deductions for the total cost of each digital switch, including the software. The IRS disallowed the deductions related to software costs, asserting that Sprint did not own the software and it was not tangible property. Sprint also treated 'drop and block' telecommunications equipment as 5-year property for tax purposes, while the IRS classified it as 15-year public utility property following a change in FCC accounting rules.

Procedural History

The IRS issued a notice of deficiency to Sprint for the tax years 1982-1985, disallowing the portion of ITC and ACRS deductions related to software costs. Sprint petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court held that the software was tangible property and Sprint owned it, entitling Sprint to the claimed tax benefits. Additionally, the court ruled that 'drop and block' equipment was 5-year property under ACRS, despite the change in FCC accounting rules.

Issue(s)

1. Whether Sprint's expenditures allocable to the software used in digital switches qualify for the ITC and depreciation under the ACRS.
2. Whether 'drop and block' telecommunications equipment is classified as 5-year property or 15-year public utility property under ACRS.

Holding

1. Yes, because the software was tangible property and Sprint owned it, as established in Norwest Corp. v. Commissioner.
2. Yes, because as of January 1, 1981, 'drop and block' equipment was classified in FCC account No. 232, which had a 5-year property classification under ACRS.

Court's Reasoning

The court followed the precedent set in Norwest Corp. v. Commissioner, which held that software subject to license agreements qualifies as tangible personal property for ITC purposes. The court found that Sprint owned the software because it possessed all significant benefits and burdens of ownership, including exclusive use for the switch's useful life and the right to transfer the software with the switch. The court rejected the IRS's argument that Sprint did not own the software, emphasizing that the restrictions on Sprint's use protected the manufacturer's intellectual property rights, not the software itself. For the 'drop and block' issue, the court applied the ACRS classification as it existed on January 1, 1981, and found that the equipment was classified in FCC account No. 232, making it 5-year property.

Practical Implications

This decision clarifies that custom software integral to hardware can be treated as tangible property for tax purposes, allowing businesses to claim ITC and accelerated depreciation for the total cost of such integrated systems. It underscores the importance of ownership rights in software, even when subject to license agreements. The ruling also emphasizes that ACRS classifications are fixed as of January 1, 1981, and not subject to subsequent changes in regulatory accounting rules, providing certainty for tax planning. This case has been cited in later decisions, such as Comshare, Inc. v. United States, which also dealt with the tangibility of software for tax purposes.