



DIVISION OF  
MARKET REGULATION

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

October 25, 1999

Mr. Steven L. Scheid  
Executive Vice President  
Chief Financial Officer  
Charles Schwab & Co., Inc.  
101 Montgomery Street  
San Francisco, CA 94104

**Re: Net Capital Treatment of Deferred Tax Liabilities Directly Related to Capitalized Costs Associated with Internal Software Development**

Dear Mr. Scheid:

This responds to your letter dated December 8, 1998, on behalf of Charles Schwab & Co., Inc. (the "Firm"), regarding the net capital treatment under Rule 15c3-1<sup>1</sup> under the Securities Exchange Act of 1934 ("Exchange Act") of its deferred tax liability directly related to certain capitalized costs associated with internal software development.

Based on your letter and conversations with the staff of the Division of Market Regulation ("Division"), I understand the following facts to be pertinent to your request. Paragraph (c)(2)(iv) of Rule 15c3-1 requires a broker-dealer when computing net capital to deduct from its net worth certain illiquid or nonallowable assets. In addition, paragraph (c)(2)(i)(C) of Rule 15c3-1 provides that a broker-dealer may add back to its net worth when computing net capital certain deferred tax liabilities which directly relate to: (1) income derived from nonallowable assets; (2) unrealized gains on assets subject to haircuts under paragraph (c)(2)(vi) and Appendices A and B of Rule 15c3-1 at the applicable tax rates; or (3) unrealized gains on assets otherwise deducted from net worth.

---

<sup>1</sup> 17 C.F.R. § 240.15c3-1 (1999).

You request that the Firm be allowed to add back to its net worth the amount of its deferred tax liability which relates to capitalized costs associated with internal software development, as determined under Generally Accepted Accounting Principles ("GAAP") under AICPA Statement of Position 98-1 ("SOP 98-1").<sup>2</sup> You state that SOP 98-1 requires the Firm to capitalize portions of its employee compensation and professional service costs incurred in the application development stage of internal use software projects. These capitalized costs must be amortized over the estimated useful life of the software. You further state that the Internal Revenue Code permits the deduction of these costs in the period in which they are paid. The Firm accounts for the resulting tax-to-book discrepancy by recognizing a deferred tax liability and a related nonallowable asset entitled "software assets."

You contend that the net capital treatment of the deferred tax liability should be similar to the treatment under paragraph (c)(2)(i)(C) of Rule 15c3-1 because it is directly related to a nonallowable asset. You further contend that the deferred tax liability does not affect the Firm's cash flows, income tax liability or overall operating risk profile and that the journal entry "merely alters the timing under which software development costs are recognized in book net income." However, you assert that the accounting treatment for the software development costs result in an inappropriate double charge to net capital because software assets are nonallowable and the deferred tax liability also reduces the Firm's net worth.<sup>3</sup>

---

<sup>2</sup> ACCOUNTING FOR THE COSTS OF COMPUTER SOFTWARE DEVELOPED OR OBTAINED FOR INTERNAL USE, Statement of Position 98-1 (American Inst. of Certified Pub. Accountants, April 1998).

<sup>3</sup> Exchange Act Release No. 18737 (May 13, 1982), 47 FR 23919 (June 2, 1982) specifically requires a broker-dealer to adopt the accrual method of accounting under GAAP for its financial reporting.

Mr. Steven L. Scheid

October 25, 1999

Page 3

Based on the foregoing, the Division will not recommend enforcement action if, when computing net capital, the Firm adds back to its net worth the amount of its deferred tax liability which directly relates to the nonallowable asset entitled software assets capitalizing certain costs associated with internal software development under SOP 98-1. You should be aware that this is a staff position with respect to enforcement only and does not purport to express any legal conclusions. This position is based solely on the foregoing description. Factual variations could warrant a different response, and any material change in the facts must be brought to the Division's attention. This position may be withdrawn or modified if the staff determines that such action is necessary for the protection of investors, in the public interest, or otherwise in furtherance of the purposes of the securities laws.

Sincerely,



Michael A. Macchiaroli  
Associate Director

cc: Raymond J. Hennessy, NYSE  
Thomas R. Cassella, NASD