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IRS issues procedural guidance for method changes to comply with section 174

Tax Alert

Overview

On December 12, 2022, Treasury and IRS released Rev. Proc. 2023-8, which provides procedural guidance for taxpayers to make an automatic change in method of accounting for research and experimental (R&E) expenditures in order to comply with the mandatory capitalization requirement under section 174, effective for tax years beginning after December 31, 2021. Rev. Proc. 2023-8 only provides accounting method procedural guidance and does not address any substantive issues in complying with the section 174 mandatory capitalization requirement.

Issue

The 2017 Tax Act (P.L. 115-97, the "Tax Cuts and Jobs Act" or "TCJA") requires taxpayers to capitalize specified R&E expenditures paid or incurred in connection with the taxpayer's trade or business in taxable years beginning after December 31, 2021. Specified R&E expenditures attributable to US-based research must be amortized over a period of 5 years and specified R&E expenditures attributable to research conducted outside of the US must be amortized over a period of 15 years. Further, the statute provides that the definition of specified R&E expenditures includes amounts paid or incurred in connection with the development of any software.

Except as otherwise expressly provided in the Code or regulations, taxpayers are generally required under section 446 and the regulations thereunder to secure the consent of the Commissioner before changing a method of accounting. Section 13206(b) of the TCJA provides that a change in the treatment of specified R&E expenditures to comply with the mandatory capitalization provision of section 174 ("Required Section 174 Method") is treated as a change in method of accounting made on a cut-off basis (i.e., without a section 481(a) adjustment).

Rev. Proc. 2023-8 – Overview

Rev. Proc. 2023-8 provides that a change to comply with section 174 as modified by the TCJA generally has automatic consent. Rev. Proc. 2023-8

provides procedures for obtaining automatic consent based on when the taxpayer first makes a change to the Required Section 174 Method:

- Change to Required Section 174 Method in the taxpayer's first taxable year beginning after December 31, 2021: The requirement to file a Form 3115, *Application for Change in Accounting Method*, is waived. Instead, taxpayers must include a statement that provides certain information, including, a description of the type of expenditures included as specified research or experimental expenditures; the amount of specified research or experimental expenditures paid or incurred by the taxpayer during the year of change; and a declaration that the taxpayer is changing the method of accounting for specified research or experimental expenditures to capitalize such expenditures and amortize such amount over either 5 years (domestic research) or 15 years research (foreign research) (as applicable) in accordance with the method permitted under section 174; and a statement that the applicant is making the change on a cut-off basis.
- Change to the Required Section 174 Method in a tax year later than the taxpayer's first taxable year beginning after December 31, 2021: Taxpayers are required to file a Form 3115. The change is made with a modified section 481(a) adjustment that takes into account only specified R&E expenditures paid or incurred in taxable years beginning after December 31, 2021. The taxpayer must provide the same information as required for a taxpayer changing to the Required Section 174 Method in its first tax year.
- Taxpayer filed a federal tax return prior to January 9, 2023 for a taxable year beginning after December 31, 2021: Under this "transition rule," taxpayers will be deemed to have complied with method change procedures to change to the Required Section 174 Method in the first taxable year beginning after December 31, 2021 *if* the taxpayer properly capitalized and amortized such specified R&E expenditures in accordance with the Required Section 174 Method on its return, *and* reported the amount of specified R&E expenditures paid or incurred on Form 4562, *Depreciation and Amortization.*

Eligibility for Automatic Consent/Audit Protection

A taxpayer is generally precluded from obtaining automatic consent for a change in method of accounting if it has made or requested a change for the same item in the prior 5 taxable years ending with the year of change. However, Rev. Proc. 2023-8 waives this requirement for a change to the Required Section 174 Method for a taxpayer's first taxable year beginning after December 31, 2021.

Rev. Proc. 2023-8 also provides that no audit protection is granted with respect to expenditures paid or incurred in taxable years beginning on or before December 31, 2021. Additionally, section 2.03(7) of Rev. Proc. 2023-8 provides that the audit protection granted for this method change does not preclude the IRS from changing the characterization or classification of expenditures as specified R&E expenditures to apply section 174 to the proper amount of expenditures paid or incurred in tax years beginning after December 31, 2021.

Rev. Proc. 2023-8 further notes that no inference should be drawn with respect to the treatment of R&E expenditures paid or incurred in or accounting method changes for tax years to which the changes made by the TCJA to section 174 are not applicable.

Other Considerations

The state tax impact of federal accounting method changes may require recalculation to report the correct state cumulative change amount or other impact. For example, federal accounting method changes related to provisions enacted or modified by the TCJA may need to be reversed in states that either generally do not conform to a version of the Code that includes the TCJA, or that specifically decouple from one or more specific provisions of the TCJA.

Further, the mere filing of the federal Form 3115 may not satisfy state reporting requirements. Failure to properly account for state differences may potentially result in penalties, such as California's 20% strict liability penalty, and interest.

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