



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

Overview

On December 29, 2022, Treasury and IRS released [Rev. Proc. 2023-11](#), which modifies and supersedes [Rev. Proc. 2023-8](#), the recently released 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. 2023-11 removes audit protection for taxpayers that delay making the change to the tax year immediately subsequent to the taxpayer's first tax year beginning after December 31, 2021.

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. 2023-11 supersedes Rev. Proc. 2023-8 but continues to provide three procedures for obtaining automatic consent based on when the taxpayer first makes a change to the Required Section 174 Method (see previously released [Tax Alert](#) for additional details):

- 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 and effectuate 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.
- Taxpayer filed a federal tax return prior to January 17, 2023 (modified from 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

Rev. Proc. 2023-11 modifies Rev. Proc. 2023-8 by providing that a taxpayer will not be granted audit protection if a change in method is made for the taxable year immediately subsequent to the first taxable year in which section 174 becomes effective. In other words, a calendar year taxpayer that does not file its 2022 taxable year tax return applying the Required Section 174 Method would not obtain audit protection by filing a Form 3115 effective for taxable year 2023.

Rev. Proc. 2023-11 otherwise retains the same eligibility and audit protection terms as Rev. Proc. 2023-8.

ASC 740 Considerations

An entity should properly account for the impact of the Required Section 174 Method in the interim and annual financial statements for its tax years beginning after December 31, 2021 as Rev. Proc. 2023-11 does not change the currently enacted tax law. Entities should, however, determine their intended filing position¹ with respect to effectuating the Required Section 174 Method.

If an entity intends to change its method of accounting (for income tax reporting purposes) for its first tax year beginning after December 31, 2021 as required by enacted law, the entity would record a deferred tax asset for the amounts capitalized for income tax reporting purposes but expensed for financial reporting purposes and the corresponding impact on current taxes payable. If, however, an entity does not intend to change its income tax method of accounting in its first taxable year beginning after December 31, 2021, but instead intends to file a Form 3115 in 2023 or later, the entity would be on an impermissible method for the tax year beginning on or after December 31, 2021 and should consider the ASC 740 recognition and measurement guidance in assessing the uncertainty of its tax position as of the reporting date. In this case, the entity would still recognize a deferred tax asset for the section 174 costs required to be capitalized, but instead of recognizing an increase in current taxes payable, the entity would now have an unrecognized tax benefit liability for the difference between the income tax

payable determined pursuant to the impermissible method and that which would be due if the proper method was adopted for the first taxable year beginning after December 31, 2021. Entities should not consider new information that is received after the balance sheet date when evaluating an uncertain tax position as of the balance sheet date.



Footnotes

¹ See Deloitte Roadmap: *Income Taxes* (Dec. 2022) sections 4.1.2 *Consideration of Tax Positions Under ASC 740* and 4.6.1 *Accounting for the Tax Effects of Tax Positions Expected to Be Taken in an Amended Tax Return or Refund Claim or to Be Self-Reported Upon Examination*, for a discussion of intended filing position.

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