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IRS issues guidance on amortization of specified research or experimental expenditures under section 174 (Notice 2023-63)

Tax Alert

Overview

On September 8, 2023, the Treasury Department ("Treasury") and the IRS published Notice 2023-63 ("the Notice") to provide interim guidance intended to clarify the application of section 174 for expenditures paid or incurred for tax years beginning on or after January 1, 2022, as well as announce their intent to issue proposed regulations consistent with the interim guidance provided in the Notice.

Issue

The 2017 Tax Act (P.L. 115-97, the "Tax Cuts and Jobs Act" or "TCJA") requires taxpayers to capitalize specified research or experimental (SRE) expenditures effective for taxable years beginning after December 31, 2021. More specifically, SRE expenditures attributable to US-based research (including software development) must be amortized over a period of 5 years and SRE expenditures attributable to research conducted outside of the US must be amortized over a period of 15 years, beginning with the mid-point of the tax year in which SRE expenditures are paid or incurred. The Notice provides that the government intends to issue proposed regulations addressing various issues arising under section 174 mandatory capitalization.

Overview

The Notice provides interim guidance and gives notice that Treasury and IRS plan to address the following topics in forthcoming proposed regulations:

- Capitalization and amortization of SRE expenditures
- Scope of costs considered SRE expenditures
- Software development
- Research performed under contract
- Disposition, retirement, or abandonment of property resulting from SRE expenditures
- Treatment of SRE expenditures under section 460

- Treatment of SRE expenditures incurred as part of a qualified cost sharing arrangement under Treas. Reg. § 1.482-7

The Notice is not intended to change the rules for determining eligibility for or computation of the research credit under section 41 or for any expenditures paid or incurred in taxable years beginning before January 1, 2022 under former section 174 as in effect prior to the TCJA amendments.

Applicability

Taxpayers generally may choose to rely on the Notice for SRE expenditures paid or incurred in taxable years beginning after December 31, 2021, provided that the taxpayer consistently applies all provisions of the Notice. However, partnerships and partners may not rely on the proposed rules for the disposition, retirement, or abandonment of property with respect to property that is contributed to, distributed from, or transferred from a partnership. The government anticipates that the forthcoming proposed regulations would be applicable to tax years ending after September 8, 2023.

The government intends to issue guidance to provide procedures for taxpayers to obtain automatic consent to change methods of accounting to comply with the Notice. In the meantime, taxpayers may rely on section 7.02 of Rev. Proc. 2023-24 to change their methods of accounting under section 174 to comply with the Notice.

> ***Observation:*** Taxpayers have the *option* but are not required to follow the rules described in the Notice. Thus, taxpayers that choose not to rely on the Notice may take supportable positions that differ from the rules in the Notice. The government intends to provide procedures for taxpayer to comply with the Notice in cases where the taxpayer has changed methods of accounting to comply with section 174 as amended by TCJA, but whose treatment of SRE expenditures is not entirely consistent with the Notice (e.g., in cases where a return applying mandatory capitalization has already been filed).

Capitalization and amortization of SRE expenditures

Taxpayers are required to capitalize SRE expenditures and amortize such expenditures ratably over the applicable amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred. The Notice provides that the "midpoint" of the taxable year is determined as the first day of the seventh month of the taxable year in which the SRE expenditures are paid or incurred for tax years of 12 months.

For purposes of determining the applicable amortization period, the Notice confirms that the determination of US or foreign research is made based on where the SRE activities are performed.

Short taxable years

The Notice provides that the amortization deduction for a short taxable year is based on the number of months in the short taxable year and provides a series of simplifying conventions to determine the midpoint of a short taxable year, depending on whether there is an odd or even number of months in a short taxable year. The Notice includes a numerical example of amortization deductions allowed over an amortization period that includes a short taxable year.

SRE expenditures

The Notice provides that SRE expenditures are expenditures paid or incurred in taxable years beginning on or after January 1, 2022, that either 1) satisfy the

requirements in Treas. Reg. § 1.174-2, or 2) are paid or incurred in connection with the development of any computer software regardless of whether such expenditures meet the requirements of Treas. Reg. § 1.174-2.

The Notice includes a non-exhaustive list of examples of the types of costs that are *incident to* research and experimental activities paid or incurred in connection with software development activities, including: labor costs, materials and supplies, cost recovery allowances, cost of obtaining patents, overhead costs with respect to facilities and other assets used in research, and travel costs.

> ***Observation:*** Taxpayers should be aware that cost recovery allowances that meet the definition of SRE expenditures may be related to property placed in service in taxable years beginning before January 1, 2022.

The Notice also includes a non-exhaustive list of examples of types of costs that are *not* SRE expenditures (even if incident to research or software development activities), including: costs paid or incurred by general and administrative service departments or functions that only indirectly support or benefit SRE activities (e.g., services of payroll, human resources, or accounting departments), interest expense on debt used to finance SRE activities, costs attributable to ordinary testing or inspection of materials for quality control, and amortization of SRE expenditures or research and experimental expenditures paid or incurred in taxable years beginning before January 1, 2022 (e.g., section 174(b) election or section 59(e) elections under former section 174).

> ***Observation:*** The examples provided in the Notice provide guidance on an area of significant uncertainty and narrows the scope of indirect costs that could be considered SRE expenditures.

The Notice requires taxpayers to treat SRE expenditures consistently in applying all provisions of the Code. SRE expenditures may not be treated as section 162 expenses or capitalized under sections 195, 263(a), 263A, or 471. Additionally, amortization of SRE expenditures must be allocated and apportioned consistent with the rules under Treas. Reg. §§ 1.861-8 and 1.861-17.

Allocation method

To determine total SRE expenditures, taxpayers must allocate costs to SRE activities on the basis of a cause-and-effect relationship (or other reasonable relationship) between the costs and SRE activities. The allocation method used for one type of cost may be different from that used for another type of cost; however, the allocation method for each type of cost must be applied consistently.

For example, a taxpayer may consistently allocate labor costs to SRE activities based on the ratio of total time the person spent performing, supervising, or directly supporting SRE activities or allocate facility cost recovery allowances by the ratio of square footage of area used to conduct or directly support SRE activities to the total square footage of the facility. The Notice provides a detailed example of reasonable allocation methods to determine SRE expenditures from costs incurred by various departments.

Software development

The Notice defines computer software as any computer program or routine (that is, any sequence of code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine including system software, programming software, application software, embedded software, and all

forms and media in which the software is contained. Computer software includes "upgrades and enhancements," which means modifications to existing computer software that result in additional functionality or that materially increase speed or efficiency of the software.

The Notice provides a non-exclusive list of activities that are treated as software development including: planning development, designing, building models, writing source code, testing, addressing certain defects identified during testing, and production of master copies of software.

Further, amounts paid or incurred in connection with the development of any computer software are considered as SRE expenditures regardless of whether such expenditures meet the requirements of Treas. Reg. § 1.174-2. In other words, the Notice apparently does not require software development activities to discover information to eliminate uncertainty with respect to the development or improvement of a product to be considered an SRE expenditure.

The Notice includes the following non-exclusive list of activities that are not treated as software development including: employee training, maintenance, data conversion, and installation. Additionally, in the case of computer software developed for sale or licensing to others, activities that occur after such software is ready for sale or licensing to others is not consider software development (e.g., marketing and promotional activities, distribution activities, customer support activities, and maintenance activities that do not give rise to "upgrade and enhancements").

Notably, the guidance provides that corrective maintenance to debug, diagnose, and fix programming errors are not considered software development activities where they do not give rise to "upgrades and enhancements" (i.e., don't result in additional functionality or materially increase speed or efficiency).

The Notice separately addresses software development activities with respect to purchased software. In the case of "upgrades and enhancements" to purchased software, the principles described above apply. However, the purchase and installation of purchased software, including configuration to make software compatible with the business or reengineering the business to make it compatible with the software, and any planning, designing, modeling, testing, or deployment activities with respect to the purchase and installation of such software are not treated as software development.

Research performed under contract

The Notice addresses treatment of expenditures incurred under agreements between a "Research Provider" and "Research Recipient" with respect to an "SRE Product." An SRE Product is any pilot model, process, formula, invention, technique, patent, computer software, or similar property (or a component) that is subject to protection under applicable law. A Research Recipient is a party that contracts with a Research Provider to either perform research services for the Research Recipient with respect to an SRE Product or develop an SRE Product that the Research Recipient acquires from the Research Provider.

The treatment of costs paid or incurred by the **Research Recipient** continue to be governed by the principles of Treas. Reg. §§ 1.174-2(a)(10) and (b)(3), which provide generally that that SRE expenditures incurred in connection with the development, construction or manufacture of depreciable property by another party are SRE expenditures only if made upon the taxpayer's order and at his risk.

However, the Notice introduces new guidance which addresses the treatment of costs paid or incurred by the **Research Provider**:

- **If the Research Provider bears financial risk** under the terms of the contract, research costs paid or incurred pursuant to the contract **are** SRE expenditures; the Research Provider bears financial risk if it may suffer a financial loss related to the failure of the research to produce the desired SRE Product
- **However, even if the Research Provider does not bear financial risk** under the terms of the contract, if the Research Provider has the **right to use any resulting SRE product** in its trade or business or otherwise exploit any resulting SRE Product through sale, lease, or license, then research costs paid or incurred pursuant to the contract **are** SRE expenditures
- An example provided in section 6.05 of Notice 2023-63 makes clear that where **the Research Provider does not bear financial risk** *AND* **does not have the right to use any resulting SRE product** in its trade or business, the research provider's expenditures incurred **are not** SRE expenditures

> ***Observations:*** The Notice does not eliminate the possibility that both parties in a contract research arrangement may have to treat costs incurred as SRE expenditures (so-called "double capitalization"), but it does provide a framework for taxpayers to analyze the issue. Taxpayers should continue to carefully review the terms of the legal agreements governing contract research arrangements to determine whether research costs incurred pursuant to such contracts should be treated as SRE expenditures.
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> The government also has requested comments whether the rules for determining whether a party to a research contract has SRE expenditures under section 174 should be similar to the funded research rules under section 41(d)(4)(H). Those rules only permit a single taxpayer to claim the research credit. The government also has requested whether special rules are needed for contracts with the government or with related foreign research providers and recipients.

Disposition, retirement, or abandonment of property

Statutory section 174(d) provides that, if any property with respect to which SRE expenditures are paid or incurred is disposed of, retired, or abandoned during the applicable section 174 amortization period, *no deduction shall be allowed* with respect to the unamortized SRE expenditures on account of such disposition, retirement, or abandonment, and such amortization shall continue with respect to the SRE expenditures over the remainder of the applicable amortization period. In this regard, the Notice equates "*no deduction*" with "*no recovery*" and contains an example illustrating this point (where a seller does not include unamortized SRE expenditures as basis when computing gain or loss on a taxable sale transaction (e.g., section 1001 or section 1060 transaction) or as basis transferred in a section 351 transaction.

However, the Notice provides special rules for the treatment of unamortized SRE expenditures in transactions in which a *corporation* ceases to exist:

- If it is a transaction to which section 381(a) applies, the acquiring corporation will continue to amortize the distributor or transferor corporation's unamortized SRE expenditures over the remainder of the transferor's applicable amortization period beginning with the month of transfer
- If a corporation ceases to exist for federal income tax purposes in a transaction or series of transactions to which section 381(a) does not apply, the corporation is allowed a deduction equal to the unamortized SRE expenditures in its final taxable year, subject to an anti-abuse exception

The Notice does not address (and requests comments regarding) the application of section 174(d) to SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership.

> ***Observation:*** The guidance provided in the Notice somewhat narrows the applicable scope of section 174(d) by providing for the deduction of unamortized section 174 expenditures for a corporation that ceases to exist. Because the government had previously determined that mandatory capitalization and amortization was a method of accounting, the carryover provision for section 381(a) transactions is unsurprising. Uncertainty remains with respect to how section 174(d) applies in the context of transfers to or from a partnership.

Long-term contracts under section 460

The Notice states that Treasury and IRS anticipate issuing proposed regulations to amend the existing section 460 regulations.

Section 460 generally requires use of the percentage of completion method (PCM) to account for taxable income from a long-term contract. Treas. Reg. § 1.460-4(b)(2)(i) provides that under the PCM the portion of contract price to be recognized into income corresponds to the ratio of incurred allocable contract costs to total estimated allocable contract costs. This ratio represents the portion of a contract considered completed for purpose of the PCM.

The section 460 regulations provide that allocable contract costs include research or development expenses other than independent research and development expenses. Thus, when these expenses are incurred, they increase the portion of a contract considered completed and the percentage of the contract price required to be reported.

The government interprets the regulations as providing that allocable contract costs include research and development expenses paid or incurred even if such research and development expenses are not currently deductible in that taxable year. As a result, SRE expenditures subject to capitalization under section 174 would increase the percentage of contract price required to be reported without a matching deduction for such expenditures.

The proposed revisions to the section 460 regulations would provide that allocable contract costs include amortization of SRE expenditures (rather than total SRE expenditures incurred), and that such amortization is treated as incurred for purposes of determining the percentage of contract completion as it is deducted. However, the Notice does not address the amount to be included in the denominator of the PCM fraction (i.e., should the denominator be the total SRE Expenditures allocable to the contract or only the amortization of the allocable SRE Expenditures during the expected contract term).

Cost sharing regulations at Treas. Reg. § 1.482-7

In general, Treas. Reg. § 1.482-7(j)(3)(i) addresses cost sharing transaction payments (CST Payments) between controlled participants in a cost sharing arrangement (CSA). In general, under current law, CST Payments received by a controlled participant reduce its otherwise deductible intangible development costs (IDCs). CST Payments are made between controlled participants to ensure that each controlled participant's share of IDCs is proportional to its share of reasonably anticipated benefits (RAB share) from exploitation of the developed intangibles. Under the current regulations, there was uncertainty as to the treatment of CST payments where the amount paid exceeded the currently deductible amount. Under the current regulations, CST Payments in excess of the deductible IDCs of the recipient are treated as in consideration for the use of land and tangible property furnished for purposes of the CSA. Some

taxpayers were concerned that, under the current regulations, CST payments for capitalized IDCs (such as section 174 expenses included in IDCs) could give rise to deemed rental income to the recipient of the CST payment.

The forthcoming proposed regulations will eliminate certain provisions in Treas. Reg. § 1.482-7(j)(3)(i) and will ensure that CST Payments that reimburse capitalized IDCs (such as section 174 expenses) no longer risk being characterized as rental income to the recipient of the CST Payment. To this end, the proposed CST Payments rule provides that CST Payments will reduce IDCs that are required to be capitalized and deductible IDCs of the recipient. (This new rule is illustrated in Example 1, explained in detail below.) However, the proposed CST Payments rule explicitly states that the amount of a CST Payment that is in excess of the payor's RAB share of the recipient's capitalizable and deductible IDCs constitutes income to the recipient of the CST payment. As a result, CST Payments that reimburse non-deductible non-capitalizable IDCs may result in income to the recipient. (This new rule is illustrated in Example 2, explained in detail below.)

In Example 1, U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) form a CSA to develop a miniature widget, the Small R. Based on RAB shares, USP agrees to bear 40% and FS agrees to bear 60% of the IDCs incurred during the term of the agreement. USP incurs $100,000 of IDCs to perform research in the United States annually and FS incurs $100,000 of IDCs to perform research in country X annually. USP's IDCs are required under U.S. Federal income tax rules to be capitalized and amortized ratably over the 5-year applicable section 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred, and FS's IDCs incurred in country X are required under U.S. Federal income tax rules to be capitalized and amortized ratably over the 15-year applicable section 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred. Of the total IDCs of $200,000, USP's share is $80,000 ($200,000 × 40%) and FS's share is $120,000 ($200,000 × 60%) so that FS must make a payment to USP of $20,000 ($120,000 – $100,000). The CST Payment reduces USP's IDCs in the United States that are required to be capitalized by $20,000. Accordingly, USP is required to capitalize $80,000, all of which is required to be amortized over 5 years, while FS is required to capitalize $120,000, $100,000 of which is required to be amortized over 15 years, and $20,000 of which is required to be amortized over 5 years.

In Example 2, the facts are the same as in Example 1, except that the $100,000 of IDCs borne by USP consist of (1) $5,000 of IDCs incurred by USP in the United States that are required to be capitalized and amortized ratably over the 5-year applicable section 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred, (2) $5,000 of deductible IDCs, and (3) $90,000 of arm's length rental charge, as described in § 1.482-7(d)(1)(iii), for the use of USP's facility in the United States. As in Example 1, of the total IDCs of $200,000, USP's share is $80,000 and FS's share is $120,000, so that FS must make a payment to USP of $20,000. The $20,000 CST Payment from FS to USP will first be treated as reducing the $5,000 of IDCs that are required to be capitalized and the $5,000 of deductible IDCs pro rata to the extent of FS's RAB share of such IDCs. Because the IDCs required to be capitalized make up 50% of the combined amount of capitalized IDCs and deductible IDCs directly borne by USP (i.e., $5,000 = 50% × $10,000), and because FS's RAB share of the total amount of IDCs in both categories is $6,000 (i.e., 60% × $10,000), $3,000 of the $20,000 CST Payment reduces USP's capitalized IDCs, $3,000 of the CST Payment reduces USP's deductible IDCs, and the remaining $14,000 ($20,000 – $6,000) of the CST Payment is treated as income.

Additional future guidance

As noted, the Notice states the government's intent to issue proposed regulations consistent with the guidance in the Notice for the items covered by the Notice. The government also requested comments with respect to certain items covered in the Notice as well as items not addressed by the Notice, including the application of sections 56(b)(2), 59(e), and 280C(c)(1) and whether special rules apply for small taxpayers. Comments were also requested for the treatment of SRE expenditures when property is contributed to, distributed from, or transferred to a partnership and the treatment of SRE expenditures of a partnership that is party to a merger, consolidation, division, or liquidation, or otherwise terminates under section 708.

State tax considerations

Some states do not conform to the changes to sections 174 and 280C(c). See this Tax Alert dated June 1, 2023 for guidance in select states. Consultation with multistate tax specialists on the potential state implications is recommended.

Accounting considerations

For financial reporting purposes, the Notice represents new information that generally should be ***considered in the reporting period that includes the issuance date (i.e., September 8, 2023)***. In determining the implications, an entity should consider, in the reporting period the Notice was issued, whether or not it intends to follow the proposed rules described in the Notice for SRE expenditures. If an entity intends to follow the proposed rules described in the Notice, and is permitted to rely on the Notice then in the reporting period the Notice was issued, the impact on deferred tax assets and deferred tax liabilities and any impact on taxes refundable or payable for a prior year would generally be recognized as a discrete item, while the impact on taxes payable for the current year would generally be recognized as an adjustment to the annual effective tax rate (AETR).

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