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IRS Releases Initial Guidance on Section 174 SRE Expenditures

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On September 8, 2023, Treasury and the IRS issued Notice 2023-63 (the "Notice") to provide initial guidance expected to be reflected in proposed regulations for applying the mandatory capitalization and amortization rules under section 174 to costs paid or incurred after December 31, 2021. The Notice addresses many of the topics that were a source of existing uncertainty and controversy for taxpayers and practitioners, such as the types of costs includible as specified research or experimental ("SRE") expenditures, treatment of costs of research service providers, software development activities, and qualified cost sharing agreements. Taxpayers may rely on the Notice for tax years beginning after December 31, 2021, or choose not to apply the Notice for those years until final regulations are effective, subject to the taxpayer consistently applying all provisions in the Notice.

Background of section 174

Section 174[1] was enacted in 1954 to eliminate uncertainty about the treatment of research or experimental ("RE") expenditures and encourage taxpayers to engage in speculative developmental activities in connection with a present or future trade or business by providing an election to currently deduct all R&E expenditures as paid or incurred. Public Law 115-97,[2] commonly referred to as the "Tax Cuts and Jobs Act" ("TCJA"), amended section 174 in several ways with the intent of raising revenues to offset tax cuts made by TCJA in other areas. The key amendments were:

- Removing the election to currently deduct SRE expenditures and requiring taxpayers to capitalize such costs;[3]

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[2] December 22, 2017.

[3] SRE expenditures are defined as RE expenditures paid or incurred during the taxable year, so practically, there is little difference between pre-TCJA RE expenditures and post-TCJA SRE expenditures with the exception of costs related to software development activities.

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- Requiring SRE expenditures be recovered through amortization over 5 years for expenditures incurred in the United States and over 15 years for expenditures incurred outside of the United States;[4]
- Including expenditures for software development as SRE expenditures; and
- Disallowing a deduction for unamortized SRE expenditures upon a disposition.

Needless to say, these amendments have created many headaches and uncertainty for taxpayers who previously had little reason to care about the intricacies of SRE expenditures. Under former section 174, there was no difference in the recovery of a cost whether it was characterized as an ordinary and necessary business expense under section 162(a) or an RE expenditure under former section 174(a). As such, other than for the smaller population of research credit eligible expenses, little thought was put into which of a taxpayer's U.S. and non-U.S. expenses are properly required to be reported as RE expenditures and now subject to the mandatory amortization regime. Compounding this problem is that there was little in the way of guidance from the IRS. Regulations were first promulgated under section 174 in 1957 and they remain largely unchanged today. This has left taxpayers and practitioners scrambling to develop reasonable positions with regards to identifying the types of costs includible as SRE expenditures, how to define software development, the extent to which indirect costs and overhead are allocable to and includible as SRE expenditures, how to treat contracts for research services from the service provider's perspective, and a host of other issues.

Overview of Notice 2023-63

On September 8, 2023, the IRS issued the Notice, announcing its intent to issue proposed regulations addressing issues related to section 174 as amended by TCJA. Given the lack of a deferral of the effective date[5] or repeal of the requirement to capitalize and amortize SRE expenditures, this Notice was welcome guidance for taxpayers working to prepare their current year tax returns. The Notice covers several areas that have been unclear in previous guidance and for which there has been much debate over the past two years as taxpayers have sought to apply the section 174 requirements. Specifically, the Notice addresses issues related to short taxable years and the definition of the midpoint of the taxable year, the types of costs that constitute SRE expenditures including allocation methods, software development, research performed under contract, dispositions of property, and how to apply the long-term contract rules under section 460 to allocable contract costs that include SRE expenditures. Further, the Notice expresses an intent to issue procedural guidance that will allow taxpayers to follow automatic consent procedures to change accounting methods to comply with the Notice after the first effective year.

Effective Dates

The Notice states that the IRS intends to apply the rules described in the Notice and the forthcoming proposed regulations to taxable years ending after September 8, 2023. A taxpayer may choose to rely on the rules described in the Notice for SRE expenditures paid or incurred in taxable years beginning after December 31, 2021, provided the taxpayer relies on and consistently applies all of the rules in the Notice. As of September 8, 2023, many taxpayers already filed tax returns for taxable years beginning after December 31, 2021, and those taxpayers may have taken positions contrary to the Notice. This delayed effective date should provide protection for such taxpayers provided their positions were reasonable. Further, the Notice makes clear that the IRS intends to issue procedural guidance to address situations in which taxpayers have taken positions contrary to the Notice

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[4] Former section 174(b) provided an election to capitalize and amortize over a period of no less than 60 months from the date RE expenditures were paid or incurred, but there was no distinction between domestic and foreign RE expenditures.

[5] Section 174, as amended by TCJA, applies to amounts paid or incurred in taxable years beginning after December 31, 2021.

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and makes clear that, unless specifically authorized by the IRS or by statute, a retroactive change in method of accounting via the filing of an amended return is not permissible.[6]

KPMG Observation

As a notice and not a binding final regulation, taxpayers may rely on the rules set forth in the Notice where the existing rules might be less favorable but are not required to apply other positions in the Notice that might be less favorable than an interpretation of existing law. However, taxpayers who choose to rely on the Notice for 2022 are required to apply all provisions in the Notice consistently, so both good (if needed relative to current law) and bad (in the case of less favorable positions that may not be required under an interpretation of existing law). Also, taxpayers should anticipate being able to file an automatic accounting method change for 2023 and being provided a temporary waiver of the 5-year same item scope restriction currently in effect for this change in order to change their treatment to comply with the Notice (or proposed or final regulations, when issued), with a section 481(a) adjustment.

Short Taxable Years

Section 174(a) requires taxpayers to charge their SRE expenditures to a capital account and allows a deduction of such expenditures ratably over the 5-year period (15-year period for foreign research) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred. There has been debate over the terms 5-year period and 15-year period and whether they refer to taxable years (e.g., whether short taxable years could accelerate the recovery period) or whether the period is based on 60 or 180 months (such that a short taxable year does not impact the length of the recovery period). The Notice makes clear that the amortization period is based on either 60 months or 180 months. The Notice accomplishes this by first defining the midpoint of a taxable year and then providing illustrations for short taxable years.

Section 3.05 of the Notice defines the midpoint as the first day of the seventh month of the taxable year in which the SRE expenditures are paid or incurred. For short taxable years, section 3.06(2) of the Notice states that the midpoint of a short taxable year is the first day of the midpoint month. For short taxable years with an even number of months, the midpoint month is determined by dividing the number of months in the short taxable year by two and then adding one. For short taxable years with an odd number of months, the midpoint month is the month in which there are an equal number of months before and after such month. When determining the number of months, section 3.06(1) of the Notice provides that if a short taxable year includes part of a month, the entire month is included in the number of months in the short taxable year, but the same month may not be counted more than once. For example, if a taxpayer has two consecutive short taxable years and the first short taxable year ends in the same month that the second short taxable year begins, the ending month of the first short taxable year is not included as the beginning month of the second short taxable year.

KPMG Observation

The following examples illustrate the application of this rule:

Example 1. Taxpayer has a short taxable year of January 1 to June 15. Since part of June is included in the short taxable year, the entire month is included, and this taxable year is considered six months for application of the midpoint convention. As a taxable year with six months, the midpoint is calculated as 6 divided by 2 plus 1 and the midpoint month is determined to be April (the fourth month of the short taxable year). Since the midpoint must be the first day of a month the midpoint of this taxable year is considered to be April 1. Thus, a 60-month amortization period begins on April 1 and will end on March 31 five years later.

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[6] Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Rul. 2023-8, 2023-18 I.R.B. 801.

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Example 2. Taxpayer has two successive short taxable years. The first taxable year ends on July 14 and the next short taxable year is July 15 to February 10. Since the first taxable year ends in the same month that the short taxable year begins, July is included in the first taxable year and February is included in the second taxable year. The taxable year is considered to be seven months for application of the midpoint convention. The fourth month will be the midpoint month as that means there are both three months before and after the midpoint month. Thus, the midpoint of this short taxable year is November 1.

KPMG Observation

Some taxpayers may have already filed tax returns following a different methodology for determining the midpoint of a short taxable year. Provided the methodology was reasonable, taxpayers may not need to make any changes as the Notice applies to taxable years ending after September 8, 2023. Optionally, taxpayers could consider an update on their next tax return following procedural guidance to address situations where taxpayers have taken positions contrary to the Notice. Until further guidance is provided, an amended return is not required but a method change on a Form 3115 may be considered if a future short year return is filed.

Scope of SRE Expenditures

Section 174 focuses on what types of activities qualify as SRE activities and not on what types of costs are generally includible. Specifically, Treas. Reg. § 1.174-2(a)(1) only provides that, "[t]he term generally includes all [RE] costs incident to the development or improvement of a product. . . Whether expenditures qualify as [RE] expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents." It was therefore a matter of reasonable interpretation to determine exactly what costs were includible as SRE expenditures. Did taxpayers need to include only "direct" costs (such as labor of scientists and engineers and supplies consumed in laboratory testing), or is a full-absorption costing methodology implied by the phrase "incident to"?

Includible and Excludible Costs as SRE Expenditures

Section 4 of the Notice is meant to provide clarity to taxpayers when determining if costs are SRE expenditures by clarifying exactly what types of costs are "incident to" RE activities, including software development. Section 4.03(1) of the Notice gives a nonexclusive list of costs that are SRE expenditures, while section 4.03(2) provides a list of costs that are not permitted or required to be treated as SRE expenditures. Costs that are SRE expenditures include:

- Labor costs, excluding severance, of full-time, part-time, and contract employees and independent contractors who perform, supervise, or directly support SRE activities;
- Costs of materials and supplies that are used or consumed in the performance of SRE activities or in the direct support of SRE activities;
- Cost recovery allowances with respect to property used in the performance of SRE activities or in the direct support of SRE activities including property placed in service prior to January 1, 2022;
- Costs of obtaining a patent;
- Costs with respect to operating and managing facilities, equipment and other assets used in the performance of SRE activities or in the direct support of SRE activities (e.g., rent, utilities, insurance); and
- Travel costs for the performance of SRE activities or the direct support of SRE activities.

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KPMG Observation

Section 41, which contains the rules for computing the credit for increasing research activities (the "R&D Credit"), generally provides as a threshold requirement that an expense be a SRE expenditure in order to be a qualified research expense ("QRE"). Under Treas. Reg. § 1.41-4(a)(2)(i), research is only qualified research if the expenditures may be treated as SRE expenditures. However, qualified wages are determined based on Box 1, Schedule W-2 wages, which includes severance. In light of the consistency requirement discussed below, taxpayers may need to reconsider whether to include severance in the computation of their R&D Credit.

KPMG Observation

Labor costs include the costs of employees who supervise SRE activities whereas section 41 refers to employees who *directly* supervise qualified research activities. The IRS has historically interpreted this requirement under section 41 to mean only first-line managers, those who directly supervise employees performing the qualified research activities, could have wages treated as QREs. Therefore, the wording in the Notice would seem to indicate that more than first-line managers must be considered when identifying labor costs includible as SRE expenditures, even though not included for purposes of the R&D Credit. Note, however, the LB&I ASC 730 Directive[7] does allow taxpayers to include wages of upper-level managers (i.e., a manager who directly supervises a first-line manager) in the computation of the credit as long as those wages are treated as an R&D cost under ASC 730. Another interpretation of the language in the Notice is to conform the definition of labor costs includible in SRE expenditures with the expanded definition of qualifying wages under the Directive.

Costs that are not permitted or required to be included in SRE expenditures are:

- Costs paid or incurred by general and administrative service departments that only indirectly support or benefit SRE activities;
- Interest on debt to finance SRE activities;
- Costs paid or incurred for activities not treated as software development under the Notice;
- Costs to input content into a website;
- Costs for website hosting that involve the payment of a specified, periodic fee to an Internet service provider in return for hosting a website on its server(s) connected to the Internet;
- Costs to register an Internet domain name or trademark;
- Costs previously identified as exclusions from the definition of R&E expenditures in Treas. Reg. § 1.174-2(a)(6);
- Amounts representing amortization of SRE expenditures; and
- Amounts representing amortization of R&E expenditures paid or incurred in taxable years beginning before January 1, 2022.

KPMG Observation

The exclusion of general and administrative service departments that only indirectly support SRE activities resolves uncertainty around whether or not taxpayers needed to adopt a full-absorption costing regime similar to the one provided in section 263A for the costs of producing or acquiring inventory for resale. Taxpayers who took

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[7] See LB&I-04-0820-0016, "Guidance for Allowance of the Credit for Increasing Research Activities Under I.R.C. Section 41 for Taxpayers That Expense Research and Development Costs on Their Financial Statements Pursuant to ASC 730" (September 10, 2020), the "LB&I ASC 730 Directive" or "Directive", available at: https://www.irs.gov/businesses/corporations/irc-41-asc-730-research-and-development-costs (last accessed September 12, 2023).

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a conservative position with regards to these costs should revisit their calculations and consider whether to pull these costs out of SRE expenditures. These taxpayers will also be required to file an accounting method change to remove these excess costs when regulations are effective, or prior to that time given that capitalization under the Notice is not an elective option.

Some costs of general and administrative service departments may still be includible as SRE expenditures to the extent that personnel in those departments provide direct support to SRE activities. As an example, during the implementation of a new ERP system, members of service departments will sometimes be directly involved in the planning and design meetings where they will collaborate with employees directly performing software development activities. In such a situation, a portion of the labor costs for those employees would likely be an SRE expenditure.

Allocation of Costs to SRE Activities

Section 4.03(3) of the Notice goes on to provide guidance regarding the allocation of costs when a cost relates to SRE activities and non-SRE activities such as depreciation on a building that houses both research facilities and administrative offices. An allocation method must be made on the basis of a cause-and-effect relationship between the costs and the SRE activities or another relationship that reasonably relates the costs to benefits provided to the SRE activities. Different allocation methods may be used for different types of costs (e.g., labor costs versus facility costs), but costs of the same type must be allocated on a consistent basis. For example, if depreciation is allocated by square footage, other facility costs like rent, utilities, and insurance should also be allocated on the same basis, but compensation costs could be allocated based on the portion of total time an employee spent on performing, supervising, or directly supporting SRE activities.

Section 4.03(4) provides a useful example of how to apply these rules. The example involves a taxpayer that manufactures chemical products. The taxpayer has Manufacturing, Research, Engineering, Legal, Personnel, and Accounting Departments. The Legal Department provides direct support by preparing patent applications, and the Engineering Department provides direct support by collaborating with the Research Department on development. The other Departments either do not support or only indirectly support SRE activities. From this example, one sees that legal departments may often be an exception to the rule of excluding general and administrative service departments because of patent-related activities. Finally, the example indicates the following allocation methods are reasonable allocation methods in regard to the types of costs considered:

- Depreciation, utilities other than electricity, and other facility overhead costs are allocated to each Department based on the ratio of square footage occupied by the Department to total square footage occupied by the taxpayer;
- Electricity is allocated to each Department based on the ratio of kilowatt hours used by the Department to total kilowatt hours used by the taxpayer because the Research Department is known to consume a disproportionate amount of electricity;
- Direct costs and allocated overhead costs of the Research Department are included at 100%, (presumably because employees in the Research Department spent 100% of their time on SRE activities during the year); and
- Direct costs and allocated overhead costs of the supporting Departments are included based on the percentage of time the employees in each department spent on SRE activities during the year.

Consistency Requirement

Finally, section 4.04 of the Notice requires SRE expenditures to be treated consistently for all federal income tax purposes. This means an SRE expenditure may only be capitalized and amortized under the rules of section 174. No deduction of SRE expenditures is allowed under section 162(a), and no SRE expenditure may be capitalized as a start-up expense under section 195 or as a cost of creating or acquiring tangible or intangible property under sections 263(a), 263A, or 471. The amortization allowance for SRE expenditures must be

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allocated and apportioned consistent with the rules of Treas. Reg. §§ 1.861-8 and 1.861-17 when computing taxable income from U.S. sources.

Software Development

SRE expenditures subject to capitalization include expenditures for software development.[8] Section 5 of the Notice provides welcome clarity in determining the types of activities that constitute software development for purposes of section 174. The Notice defines the term "computer software" itself consistent with the long-standing definitions in Rev. Proc. 2000-50[9] and Treas. Reg. § 1.197-2(c)(4)(iv).

Software Development Activities

Under the Notice, software development activities generally include those that are performed before the developed computer software (or the upgrades and enhancements to such software[10]) is placed in service or ready for sale or licensing to others. A non-exhaustive list of software development activities includes planning the development of, designing, and building a model of the computer software (or the upgrades and enhancements to such software); writing source code and converting it to machine-readable code; testing and making necessary modifications to address defects up until the point in time that the computer software is placed in service (if internal-use software) or ready for sale or licensing to others; and production of the product master(s) (in the case of computer software developed for sale or licensing to others).

KPMG Observation

The inclusion of these types of activities within the meaning of software development is consistent with prior IRS guidance under former section 174 and Rev. Proc. 2000-50.[11]

Non-Software Development Activities

The Notice excludes various types of activities from the meaning of software development for purposes of section 174. Specifically, in the case of purchased computer software, software development activities do not include any of the activities mentioned above, unless the activities relate to upgrades and enhancements to purchased computer software.

In the case of internal-use computer software (or upgrades and enhancements to such software), software development activities exclude training activities, maintenance activities after the software is placed in service that do not give rise to upgrades and enhancements (e.g., corrective maintenance to debug, diagnose, and fix programming errors) ("routine maintenance"), data conversion activities (except for activities to develop computer software that facilitate access to existing data or data conversion), and installation and other activities relating to placing the computer software in service.

In the case of computer software developed for sale or licensing to others (or upgrades and enhancements to such software), software development activities exclude activities that occur after such software (or upgrades and enhancements to such software) is ready for sale or licensing to others (e.g., marketing, routine maintenance, distribution, and customer support activities).

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[8] Section 174(c)(3).

[9] 2000-52 I.R.B. 601.

[10] For this purpose, the term "upgrades and enhancements" generally means modifications to existing computer software that result in additional functionality (enabling the software to perform tasks that it was previously incapable of performing), or materially increase the speed or efficiency of the software.

[11] *See*, *e.g.*, PLR 200236028 (June 4, 2002), and CCA 201549024 (Oct. 23, 2015).

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KPMG Observation

With the exclusion of the aforementioned activities from software development, taxpayers should evaluate the extent to which these types of costs may be currently deductible under section 162. For example, many taxpayers may have assumed that any work on altering or creating code would be a SRE expenditure, even if it relates to routine maintenance and not an upgrade or enhancement.

The costs of purchased software (that is not a section 197 intangible) should continue to be capitalized and amortized over 36 months, beginning with the month the software is placed in service by the taxpayer.[12] Purchased computer software (that is not a section 197 intangible) also generally continues to be eligible for bonus depreciation (at 100 percent if placed in service by December 31, 2022, or 80 percent if placed in service by December 31, 2023).[13]

Section 5 of Rev. Proc. 2000-50 Obsoleted

Prior to the changes made to section 174 by TCJA that became effective in 2022, Rev. Proc. 2000-50 permitted taxpayers to treat software development costs in a manner similar to section 174 expenses (under former section 174), and also provided an alternative method of depreciating software development costs over 36 months from the placed-in-service date.[14] As a result of the changes made by TCJA, section 9.01(1) of Rev. Proc. 2023-24 previously made these methods inapplicable to software development costs paid or incurred in taxable years beginning after December 31, 2021, and the Notice officially obsoletes section 5 of Rev. Proc. 2000-50.

Treatment of Contract Research

Overview

Section 6 of the Notice provides guidance on the treatment of research performed under contract. In a contract research arrangement, the research provider will directly engage in the research activities, and will be compensated by the research recipient, so it is necessary to evaluate whether section 174 applies to both the research provider's direct expenses (including wages, supplies, and facilities) and the research recipient's payment to the research provider. In cases where the contract research arrangement is between related parties, there is a possibility for both parties to be subject to mandatory capitalization and amortization under section 174. For the research provider in such an arrangement, the resulting "double capitalization" also results in a mismatching of the timing of the revenue and the related expenses because the payment from the research recipient (unless contingent) must generally be recognized in the period the costs are incurred/services are provided, not when the amortization is allowed.[15]

Relevance of "activities," "product," and "risk" under former section 174

Under the existing regulations, a taxpayer's costs under former section 174 were classified as RE expenditures if the costs were for "research activities," and were related to the development or improvement of a product. The regulations also provided that in the case of a research recipient under a contract for research, the research recipient's payment would only qualify under section 174 if the research recipient is at financial risk with respect to the success or failure of the research. Neither the regulations nor other guidance addressed whether (1) the "product" had to be a product used by the taxpayer in its trade or business or held for sale or lease (i.e., that the

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[12] Section 167(f)(1). Note that installation costs and costs incurred prior to the placed-in-service date that are not "acquisition related" should generally remain currently deductible under section 162(a).

[13] Section 168(k).

[14] See section 5 of Rev. Proc. 2000-50.

[15] This result would not be the case if the research provider and research recipient are members of a U.S. consolidated group. In this case, Treas. Reg. § 1.1502-13 requires a redetermination of character and timing to achieve a single entity result, so the research provider's corresponding income would be deferred and matched with the research recipient's amortization of expense.

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taxpayer had to have rights to exploit the results of the research), or (2) whether the risk requirement that applied to the research recipient also applied to the research provider.

Guidance under the Notice

The Notice eliminates a significant amount of the uncertainty that taxpayers have faced in evaluating the proper treatment of a contract researcher's (the research provider's) costs under the mandatory capitalization and amortization regime. Specifically, under the Notice, it will be possible in most cases to conclude with a high degree of certainty whether costs for otherwise qualifying research activities of a research provider, a research recipient, or both, are required to be capitalized and amortized, on the basis of a two-factor test set forth in the table below.

Research Provider				
At Risk	X			
Rights		X		
Both			X	
Neither				X
Treatment	174	174	174	162
Research Recipient				
At Risk	N/A[16]			
Rights		X		
Both			X	
Neither				N/A[17]
Treatment		263	174	

At Risk Requirement

For purposes of applying the outcomes in the table above, the Notice provides additional guidance for determining whether a taxpayer is at risk and/or has rights. Under the Notice, a taxpayer is at risk if it has financial risk, which is defined as the possibility that the taxpayer may suffer a financial loss related to the failure of the research to produce the desired result. As a result, a research provider would be at financial risk to the extent the research provider's compensation for the research is dependent on the success or failure of the research, acceptance by the research recipient, or the research provider provides a performance guarantee for the research. The research recipient would similarly be at financial risk if it commits by contract to pay for the work regardless of the outcome, such as on a time and materials or cost-plus basis.

KPMG Observation

If a research provider performs the research service at cost plus a profit, the provider would not be at risk. If the research provider does not get compensated unless the research produces the intended result, the research provider is at risk under the Notice. Although the Notice does not specifically address a fixed-fee arrangement, KPMG interprets the Notice as treating the research provider as not at risk even if it receives a fixed fee without any performance obligations with respect to the research, except to the extent that the expenses exceed the

[16] It is highly unlikely to find a research recipient who pays for research but does not obtain rights.

[17] It is highly unlikely to find a research recipient who pays for research but does not obtain rights.

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fixed fee, or in total if the payment of any portion of the price is subject to customer acceptance of the product of the research provider's services. This is consistent with a long-standing position on eligibility for the related research credit, whereby it was considered permissible to treat the taxpayer as at risk with respect to the amount of otherwise qualifying expenditures in excess of the fixed fee.

Rights to Research

The Notice provides that a research provider will be considered to have rights to the research if the research provider has a right to use any resulting research product in the trade or business of the research provider or otherwise exploit any resulting product through sale, lease, or license. This definition is narrowed in the case of a research provider that acquires rights to use and exploit the research if that right is available only upon obtaining approval from an unrelated party within the meaning of section 267 or section 707.

The Notice does not disturb a long-standing view that retention of mere know-how from research (the right to use the information gained in further research, but not the ability to sell or use the research specifically) is not considered a right to use or exploit the research.

KPMG Observation

The Notice does not directly address a situation where the research provider is neither at risk nor acquires rights to the research under the research agreement, but separately acquires those rights in exchange for a fee that fully compensates the research owner for those rights (i.e., the payment is on an arm's length, fair market value basis). By not explicitly providing that only rights that the service provider acquires *through the contract research arrangement* are considered when determining whether the research provider has the right to exploits the resulting product, the Notice leaves open some ambiguity as to the treatment of such arrangements. The Notice does not foreclose an interpretation that the right to exploit the resulting product could arise from a separate arrangement and cause the provider's cost to be subject to section 174. However, treating the research provider's costs as subject to section 174 as a result of a separate agreement to use the resulting rights would be a departure from how such arrangements are commonly viewed. Accordingly, although the situation is not addressed in the Notice, we expect that the forthcoming proposed regulations will clarify that it is appropriate to treat the research provider in that situation as not acquiring rights as a result of the research and, therefore, its costs as not being subject to section 174, and we do not anticipate this would change if the Notice is reflected in final regulations.

Disposition, Retirement, or Abandonment of Property

Section 174(d) provides that if any property with respect to which SRE expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment, and such amortization deduction shall continue with respect to such expenditures. The Notice reiterates this rule and provides that, in general, the taxpayer that disposed of such property continues to amortize the SRE expenditures over the remainder of the applicable period. In addition, the Notice provides clarification and exceptions to this general rule for transactions in which a corporation ceases to exist, depending on whether the transaction is described in section 381(a) (which includes tax-free liquidations under section 332, and transfers under section 361 if in connection with a reorganization described in section 368(a)(1)(A), (C), (D), (F) or (G)).

Specifically, the Notice provides that if a corporation ceases to exist in a transaction (or series of transactions) described in section 381(a), the acquiring corporation continues to amortize the SRE expenditures over the remainder of the amortization period, beginning with the month of transfer. If a corporation ceases to exist in a transaction (or series of transactions) to which section 381(a) does not apply, the corporation can deduct the unamortized SRE expenditures in its final taxable year (as long as claiming the deduction for the unamortized SRE expenditures is not a principal purposes of the transaction). In addition, an amortization deduction under

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section 174 is allowed even if expenditures relate to property that is disposed of prior to the midpoint of the taxable year in which they are paid or incurred; accordingly, such expenditures are subject to these disposition rules. The Notice provides several examples of these rules, including their application in the context of a taxable sale of property, a section 351 transfer, and a section 381(a) transaction.

KPMG Observation

These rules provide needed clarification as to how the section 174(d) disposition rule will apply in certain situations, including those where the taxpayer that incurred the SRE expenditures ceases to exist and thus cannot continue to amortize the costs. However, the provisions and examples only apply to corporate transactions, and the Notice specifies that taxpayers may not rely on these rules for SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership. Therefore, until further guidance is issued, partnerships and other taxpayers that engage in one of these partnership transactions will have to continue to rely on existing authorities in determining a reasonable approach for the treatment of their unamortized SRE expenditures. Under existing authority, the accounting methods do not generally carry over in a transfer to or from a partnership, or a partnership termination. In the case of a partnership termination, it is likely that the unamortized costs can be recovered by the transferor (absent a tax-avoidance scenario).

Treatment of Long-Term Contracts

Section 8 of the Notice provides interim guidance to taxpayers using the percentage of completion method ("PCM") to recognize income from long-term manufacturing and construction contracts under section 460 and that incur SRE expenditures allocable to those contracts. Taxpayers required to use PCM determine the portion of the contract price to include in income by applying a ratio of allocable contract costs incurred to total estimated allocable contract costs. On the expense side, taxpayers generally deduct allocable contract costs as paid or incurred under section 461. RE expenditures (other than so-called independent research and development expenses)[18] are allocable contract costs under the PCM. A taxpayer incurring RE expenditures under former section 174 would generally include costs incurred in the numerator of the PCM ratio (thereby increasing the portion of the contract price included in income) but would have a deduction for the expenditures to match the income inclusion. However, under section 174 as amended by TCJA, while the amount of SRE expenditures incurred for the year would be included in the numerator of the PCM ratio, taxpayers would only be entitled to amortization deductions for the expenses, resulting in a mismatch of income and expenses. Treasury and the IRS recognize that this mismatch is inconsistent with the intended operation of the PCM and explain in the Notice their intent to issue proposed regulations under section 460 that would treat as allocable contract costs the amortization of SRE expenditures incurred for year, rather than the capitalized amount of SRE expenditures incurred for the year. Note that the proposal is limited to the amortization of SRE expenditures under section 174 as amended by TCJA and does not apply to the amortization of amounts previously capitalized and amortized under section 59(e) or former section 174(b).

KPMG Observation

Prior to the Notice, only informal non-precedential guidance had addressed the interplay of section 174 costs and PCM (under former section 174). Specifically, FAA 20205301F (Sept. 28, 2020) reached the conclusion that the full amount of incurred section 174 costs, and not only the current amortization, must be included in the numerator of the PCM ratio in the case of an elective section 59(e) election for otherwise deductible costs under former section 174. Although the Notice does not apply to section 59(e) elections, the position in the Notice is likely a reasonable interpretation of existing law, notwithstanding FAA20205301F, given the long-standing consistent treatment of depreciation on tangible property under section 460.

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[18] *See* Treas. Reg. § 1.460-1(b)(9).

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Treatment of Qualified Cost Sharing Arrangements

The Notice also addresses the treatment of certain payments made in respect of SRE expenditures by taxpayers that have entered into a qualified cost sharing arrangement ("QCSA"), described in Treas. Reg. § 1.482-7.

Background

A QCSA is an arrangement governed by transfer pricing regulations in which two or more participants agree to share the costs and risks of developing intangible property ("IP") that satisfies the administrative requirements outlined in the relevant Treasury regulations. The participants share costs and risks in proportion to their reasonably anticipated benefits ("RAB") from the QCSA. All controlled participants in a QCSA must engage in "cost sharing transactions" ("CSTs"), which are generally payments ("CST Payments") between the controlled participants so that in each taxable year each controlled participant's share of costs is in proportion to its RAB share.

The costs that are shared under a QCSA are referred to as "intangible development costs," or "IDCs." "IDCs" generally mean all costs that relate to the development of IP under the QCSA. Notably, IDCs exclude acquisition costs for land or depreciable property, even if they relate to the development of the IP. IDCs do include, however, the arm's length rental charge for the use of such land or depreciable tangible property. While the definition of IDCs is not synonymous with the definition of SRE expenditures, the IDCs of many companies are also SRE expenditures, such that there is significant overlap between a participant's IDCs and costs that would qualify as SRE expenditures.

The Treasury regulations under section 482 provide special rules regarding the character of CST Payments. The relevant Treasury regulations specify that CST Payment received by a payee "will be applied pro rata against the deductions for the taxable year that the payee is allowed in connection with the IDCs." As such, to the extent that a participant's deductions are offset by CST Payments, the offset should be treated as a reimbursement, or a reduction of such costs incurred by the payee, rather than as income to the recipient. Absent this rule, taxpayers would need to determine whether the reimbursement doctrine applies to the CST Payment, which could be a difficult determination.

Importantly, this provision refers to "deductions" for the taxable year, not "costs" or "IDCs." The Treasury regulations further provides that "[p]ayments received in excess of such deductions will be treated as in consideration for use of the land and tangible property furnished for purposes of the [QCSA] by the payee." In that regard, a literal read of the current Treasury regulations appears to provide that participants first determine their deductions for IDCs without regard to any CST payments, and then CST payments are applied against deductions. If CSTs exceed deductions after taking into account, for example, the application of section 174 to any IDCs, the excess is treated as gross income.

Proposed changes to Treas. Reg. § 1.482-7

The Notice proposes the removal of language in the existing regulation that requires participants to determine the deductions associated with their directly incurred IDCs before considering CST Payments. The Notice proposes a new rule that the CST Payments owed to another controlled participant would generally reduce the amount of IDCs borne directly by that participant that are required to be charged to capital account, including SRE Expenditures, as well as other IDCs that are deductible. In most circumstances, this will result in CST Payments being treated as a reimbursement of a portion of the CST payee's SRE expenditures rather than an income inclusion.

CST Payments, however, that do not exceed the payor's RAB share of the total amount of the IDCs described above (i.e., IDCs that are chargeable to capital account or deductible) would reduce the amount of each such category of IDCs in the same proportion that the total amount of the IDCs in each category bears to the total amount of IDCs in both categories. CST Payments in excess of the payor's RAB Share of the total amount of IDCs that are chargeable to capital account or deductible would be treated as income to the recipient of the CST

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Payment. This situation is most likely to occur when a significant portion of the CST payee's IDCs consist of non-deductible items such as an arm's length charge for making land or depreciable tangible property available, or stock-based compensation in circumstances where the taxpayer elects to use the method for measuring and timing the inclusion of such compensation based on its financial statement treatment of such costs.

The Notice provides examples in support of how proposed future rules on the character of CST Payments would apply. In the first example, a U.S. parent agrees to bear 40% of the IDCs incurred during the term of a QCSA entered into with its wholly owned foreign subsidiary (with the latter bearing the remaining 60%) towards the development of a miniature widget, the Small R. Each controlled participant incurs $100,000 of IDCs on an annual basis to perform research in the U.S. and Country X, respectively. Under section 174, these IDCs are charged to the capital account and amortized ratably over 5-year and 15-year periods starting with the midpoint of the taxable year in which they are paid or incurred. In this scenario, because the U.S. parent's share is only $80,000 (because it only agreed to bear 40% of the total $200,000 in IDCs), the foreign subsidiary must make a $20,000 CST Payment to U.S. parent, which reduces U.S. parent's IDCs to $80,000. U.S. parent is required to charge $80,000 to the capital account, all of which is required to be amortized over a 5-year period. The foreign subsidiary, on the other hand, would be required to charge $120,000 to the capital account, of which $100,000 would be amortized over 15 years because it is associated with foreign research. The $20,000 CST Payment from the foreign subsidiary to the U.S. parent would be amortized over a 5-year period because it is associated with research conducted in the United States even though the payor is resident in Country X.

The analysis would, however, be different if, in the above example, the $100,000 of the IDCs borne by the U.S. parent consisted of $5,000 of Section 174 IDCs for research conducted in the United States, $5,000 of deductible IDCs, and $90,000 of arm's length rental charge for the use of the U.S. parent's facility in the United States In this case, the foreign subsidiary's RAB share amount of IDCs that are either required to be charged to capital account or deductible is only $6,000 (60% of ($5,000 + $5,000)), which is less than the total amount of the CST Payment. Accordingly, only $6,000 will be treated as reducing the IDCs that are required to be charged to capital account or deductible (applied pro rata, so $3,000 would reduce each category) and the remaining $14,000 would be treated as income.

KPMG Observation

The Notice would provide significant relief to QCSA participants that incur IDCs attributable to SRE expenditures by introducing a new ordering rule under which the controlled participant receiving CST Payments would first reduce directly incurred IDCs that are deductible, either currently or in the future, by the amount of the CST Payments received before determining the amount of section 174 deductions for the year. It would thus permit the recipient of a CST Payment to offset or "net" the CST Payment against its SRE expenditures in part or in whole, even if those SRE expenditures are not fully amortizable in the current taxable year.

However, this Notice provides relief only to participants in a QCSA that would meet all the relevant administrative requirements in Treas. Reg. § 1.482-7. This relief does not extend to participants in a nonqualified CSA. Accordingly, the treatment of cost sharing payments made under a nonqualified CSA will depend on whether they are properly characterized as gross income or as reimbursements. Nonqualified CSA participants may, in fact, be further affected by Section 6.04 of this Notice, which requires that even such SREs that are incurred by contract R&D service providers that do not bear the financial risk of the research are amortized under section 174, so long as the contract R&D service provider has the right to use any resulting product in its trade or business or otherwise exploit any resulting product through sale, lease, or license.

While the forthcoming regulations implementing the Notice are expected to apply prospectively to taxable years ending after September 8, 2023, any election by a taxpayer to retrospectively apply the relief under section 9 of the Notice to a QCSA to a taxable year beginning after December 31, 2021, would entail the application of the other rules in the Notice, including section 6 of the Notice, to any contract R&D service provider or to a non-QCSA controlled participant.

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Procedures

The Notice announces that Treasury and the IRS intend to issue procedural guidance for taxpayers to obtain automatic consent to change methods of accounting to comply with the Notice. Until the issuance of such guidance, taxpayers are directed to continue to rely on the automatic change procedures outlined in section 7.02 of Rev. Proc. 2023-24[19] to change their method of accounting under section 174 to comply with the Notice. The procedures under section 7.02 of Rev. Proc. 2023-24 permit taxpayers to change their method of accounting for SRE expenditures to the required section 174 method by filing a statement in lieu of Form 3115 for which the year of change is the first taxable year beginning after December 31, 2021, and implement the change on a cut-off basis.

The Notice indicates that forthcoming procedural guidance will address situations in which taxpayers have already filed accounting method changes to comply with section 174 but who have treated SRE expenditures inconsistently with the guidance provided in the Notice. Although taxpayers are generally prohibited under Rev. Proc. 2015-13[20] from changing their method of accounting under the automatic change procedures if they have changed their method for the same item within five taxable years, this eligibility rule is waived in section 7.02 of Rev. Proc. 2023-24 for the taxpayer's first taxable year beginning after December 31, 2021. Presumably, any future guidance will extend the time period for which this eligibility rule is waived. Taxpayers are not permitted to make a retroactive change in method of accounting by filing an amended return unless specifically authorized in future guidance or by statute.

Requests for Comments

The Notice requests comments on various issues that were covered therein and additional topics that are outside the scope of the Notice. Comments requested include, for example:

- Whether safe harbor methods or simplified methods should be provided for identifying expenditures allocable to SRE activities and allocating such expenditures to SRE activities;
- Whether the definition of computer software included in section 5 of the Notice should be based on the definition in Rev. Proc. 2000-50 and Treas. Reg. § 1.197-2(c)(4)(iv), or a more appropriate definition under the FASB Accounting Standards Codifications or appropriate industry standard;
- Whether special rules are needed to determine whether a taxpayer incurs SRE expenditures in regards to service or manufacturing production contracts with the government;
- What safe harbors should be considered for determining whether contract research is foreign research;
- In the case of PCM contracts, whether total allocable contract costs should include all SRE expenditures that directly benefit or are incurred by reason of the long-term contract or only that portion of the SRE expenditure that is expected to be amortized during the term of the contract. In the former alternative, the government has indicated taxpayers would be required to recognize any remaining portion of the contract price not previously reported by the taxable year following the year in which the contract is completed;
- Whether the definition of "pilot model" under Treas. Reg. § 1.174-2(a)(4) should be amended;
- Whether and how section 59(e) applies to SRE expenditures;
- Circumstances where unamortized SRE expenditures should continue to be amortized or accelerated with respect to property contributed to, distributed from, or transferred from a partnership;

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[19] 2023-28 I.R.B. 1207.

[20] 2015-5 I.R.B. 419.

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- Circumstances where unamortized SRE expenditures should continue to be amortized or accelerated with respect to property of a partnership that is a party to a merger, consolidation, division, or liquidation, or otherwise terminates under section 708;
- Whether special rules or safe harbors should be considered for small taxpayers or start-up companies; and
- Whether the phrase "amount allowable as a deduction" in sections 280C(c)(1)(B) and 56(b)(2)(A) should be interpreted to mean (i) $0 or (ii) the amount of amortization allowed with respect to such expenditures. If future guidance indicates that it should be interpreted to be $0, the credit will always exceed the allowable amount and taxpayers would be advised to elect the reduced credit in order to minimize tax liability.

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