AFTER THE WAIT – IRS'S COMPREHENSIVE GUIDANCE ON SECTION 174 POST TCJA

Edward K. Zollars, CPA
Thomas, Zollars & Lynch, Ltd.
Phoenix, Arizona

Ending a prolonged wait for guidance on the revisions made to IRC §174 by the Tax Cuts and Jobs Act in 2017, which took effect in 2022, the IRS has released Notice 2023-63.[1] This Notice provides guidance related to the newly required amortization of research and experimentation costs.

The History of the Research and Experimental Expense Amortization Provision

Most commentators have viewed the amortization of research expenses provision, added to the law as part of the Tax Cuts and Jobs Act, as a measure that was always expected to be repealed before taking effect. Why, you might ask, would Congress enact a provision that perhaps none of those voting for the bill actually wanted to see implemented? The answer is simple: budget scoring and Senate rules regarding budget reconciliation bills.

Certain members of the House and Senate who generally supported the Tax Cuts and Jobs Act were nevertheless concerned about voting for a bill with too high a cost. This provision served as a revenue-raiser, reducing the overall cost of the bill. When combined with other revenue-raisers—most of which were intended to take effect—it brought the overall projected cost of the law down to a level that at least 51 Senators could accept.

Additionally, under the rules of the U.S. Senate, most bills must receive support from 60 Senators to come before the Senate for a vote. Thus, opponents of a bill that has the support of a majority, but fewer than 60 Senators, can block the bill from becoming law simply by preventing it from coming to a vote.

However, the annual federal budget is an exception; it must be passed. Concerns that the 60-vote rule could create a crisis led to a special set of rules for what is known as the budget reconciliation process. Only a simple majority of the Senate, the same number needed to pass the bill, must consent to allowing the bill to go to a vote. One of the limitations on such a bill is that it must not result in a net increase in the deficit outside of a 10-year budget window. This provision, which would remain in effect permanently, served to offset the cost of provisions in the TCJA that were projected to have costs outside of that 10-year window.

But how could those voting for the bill be certain the provision would not take effect? Legislators supporting the bill were assured that the vast majority of those who would vote against the Tax Cuts and Jobs Act also opposed this change in the law and would not want the provision to become effective. Thus, it was anticipated that at some point within the next five years—before the provision took effect in 2022—it would be repealed, either as

[1] Notice 2023-63, September 8, 2023, https://www.irs.gov/pub/irs-drop/n-23-63.pdf (retrieved September 8, 2023)

part of a later reconciliation package or through a bill that garnered enough support to clear the 60-vote hurdle in the Senate

As 2021 began, it seemed that a repeal was imminent. Although a different party now controlled the Senate, the repeal of the Section 174 provision initially made it into a reconciliation package—the proposed Build Back Better Act (BBBA). However, the BBBA faced opposition not only from minority party Republicans but also from certain Democrats, with one major concern being the cost of the bill.

Eventually, the BBBA evolved into the much less expensive Inflation Reduction Act (IRA). One way the bill's cost was reduced was by removing the repeal of Section 174 from its language. This move, much like with the TCJA, brought the cost of the IRA down to a level where it garnered enough support to be brought to a vote.

While additional attempts were made to pass a provision repealing the TCJA changes to Section 174, no package that could secure 60 votes in the Senate was ever finalized. Increased Congressional concern over budget deficits made it difficult to pass a bill that would be scored as increasing the deficit. Moreover, those who had opposed the TCJA had other provisions they wanted included if they were to allow a bill that increased the deficit to come to a vote in the Senate.

During this period, the IRS seemed to operate under the assumption that Congress would eventually repeal the provision, which was virtually universally opposed on Capitol Hill. This optimistic approach persisted even as 2022 ended without such a repeal being enacted, apparently in the hope that Congress would retroactively repeal the provision in 2023. However, as Congress failed to pass such a provision and even the extended due date for the first returns subject to this change approached, the IRS finally conceded and issued the guidance.

Scope of the Guidance

The Notice outlines this guidance and explains how it will interact with rules related to the credit for increasing research activities under IRC §41:

> The guidance in this notice does not apply for purposes of determining whether an expenditure paid or incurred for taxable years beginning before January 1, 2022, is a research or experimental expenditure under § 174 as in effect for taxable years beginning before January 1, 2022 (former § 174). This notice provides guidance regarding expenditures that are treated as SRE expenditures under § 174 and, therefore, affects expenditures that may be treated as SRE expenditures for purposes of § 41(d)(1)(A) and § 1.41-4(a)(2)(i). However, this notice is not intended to change the rules for determining eligibility for or computation of the research credit under § 41 and the regulations thereunder, including rules for "research with respect to computer software," and the definitions of "qualified research" and "qualified research expenses."[2]

[2] Notice 2023-63, September 8, 2023

The Notice also details the changes made by the TCJA to the treatment of specified research or experimental (SRE) expenditures:

> Section 13206(a) of the TCJA amended former § 174 for amounts paid or incurred in taxable years beginning after December 31, 2021. For such amounts, § 174(a)(1) disallows deductions for SRE expenditures, except as provided in § 174(a)(2). Section 174(a)(2) requires taxpayers to charge SRE expenditures to capital account and allows amortization deductions of such capitalized expenditures ratably over the applicable § 174 amortization period, beginning with the midpoint of the taxable year in which such expenditures are paid or incurred. As used in this notice, the term "applicable § 174 amortization period" refers to a 5-year (60-month) period in the case of SRE expenditures attributable to domestic research or a 15-year (180-month) period in the case of SRE expenditures attributable to foreign research, as defined in section 3.03 of this notice.[3]

The law defines *SRE Expenditures* as follows:

> Section 174(b), as amended by section 13206(a) of the TCJA, defines "SRE expenditures" to mean, with respect to any taxable year beginning after December 31, 2021, research or experimental expenditures that are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business. See *Snow v. Commissioner*, 416 U.S. 500 (1974) ("in connection with" a trade or business is broader than "in carrying on" a trade or business).[4]

The law also amended the treatment of software development costs, subjecting them to the same amortization periods and rules.

> Section 13206(a) of the TCJA added new § 174(c)(3) to require that any amount paid or incurred in connection with the development of any software in taxable years beginning after December 31, 2021, be treated as a research or experimental expenditure (and thus an SRE expenditure to the extent paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business).[5]

The law also included a provision to prevent taxpayers from immediately writing off costs related to property that is being amortized under Section 174:

> Section 13206(a) of the TCJA added new § 174(d) to provide that deductions of SRE expenditures may not be taken on account of the disposition, retirement, or abandonment of property with respect to which such SRE expenditures are paid or incurred. If such property is

[3] Notice 2023-63, September 8, 2023

[4] Notice 2023-63, September 8, 2023

[5] Notice 2023-63, September 8, 2023

> disposed of, retired, or abandoned during the applicable § 174 amortization period, § 174(d) requires that the amortization deductions for such SRE expenditures continue over that period.[6]

The law specifies that this will necessitate a change in the method of accounting for such costs by the taxpayer:

> Section 13206(b) of the TCJA requires taxpayers to apply the provisions of § 174, as amended by section 13206(a) of the TCJA, as a change in method of accounting for purposes of § 481, initiated by the taxpayer and made with the consent of the Secretary of the Treasury or her delegate, and applied on a cutoff basis to SRE expenditures paid or incurred in taxable years beginning after December 31, 2021. Thus, no adjustments under § 481(a) are permitted or required with respect to research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022.[7]

The IRS has previously outlined the method for obtaining this automatic consent to change in accounting method, as described in the Notice:

> On December 12, 2022, the Treasury Department and the IRS issued Rev. Proc. 2023-8, 2023-3 I.R.B. 407, to provide procedures for taxpayers to obtain automatic consent to change methods of accounting to comply with § 174, as amended by the TCJA. On December 29, 2022, the Treasury Department and the IRS issued Rev. Proc. 2023-11, 2023-3 I.R.B. 417, to modify and supersede Rev. Proc. 2023-8. The change in method of accounting provided by Rev. Proc. 2023- 11 was subsequently included in section 7.02 of Rev. Proc. 2023-24, 2023-28 I.R.B. 1207. Section 7.02 of Rev. Proc. 2023-24 implements the requirement imposed by § 13206(b) of the TCJA that a taxpayer must make this change in method of accounting on a cutoff basis if the change was made during the taxpayer's first taxable year beginning after December 31, 2021. However, section 7.02 of Rev. Proc 2023-24 provides that a taxpayer making the change for a taxable year subsequent to the taxpayer's first taxable year beginning after December 31, 2021, is required to make that change with a modified § 481(a) adjustment that takes into account only SRE expenditures paid or incurred in taxable years beginning after December 31, 2021. Section 7.02(7) of Rev. Proc. 2023-24 also provides that a taxpayer that changes its method of accounting for SRE expenditures under the revenue procedure will receive limited audit protection. Specifically, audit protection will not apply for expenditures paid or incurred in taxable years beginning before January 1, 2022. Audit protection also will not apply for expenditures paid or incurred in taxable years beginning after December 31, 2021, if a change in method of accounting is made for the taxable year immediately subsequent to

[6] Notice 2023-63, September 8, 2023

[7] Notice 2023-63, September 8, 2023

> the first taxable year beginning after December 31, 2021. See section 10.02 of this notice for additional procedural guidance the Treasury Department and IRS intend to issue.[8]

Capitalization and Amortization of SRE Expenditures

The Notice announces that the IRS plans to issue proposed regulations in the future. These proposed regulations are expected to be consistent with the preliminary guidance provided in this Notice.

> The Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations consistent with the interim guidance provided in this section 3, which provides taxpayers with clarity regarding the requirement in § 174(a) to capitalize and amortize SRE expenditures and the treatment of short taxable years.[9]

The Notice outlines the general capitalization requirements under the revisions to IRC §174 as follows:

> Taxpayers are required to capitalize SRE expenditures (as defined in section 4.02(2) of this notice) and amortize such expenditures ratably over the applicable § 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.[10]

Foreign research, which is subject to a longer amortization period, is defined as follows:

> The term foreign research means any research conducted outside the United States, the Commonwealth of Puerto Rico, or any U.S. territory or other possession of the United States. See §§ 174(a)(2)(B) and 41(d)(4)(F).[11]

The Notice also details how specific items of SRE are to be categorized as foreign research:

> Taxpayers must look to where the SRE activities (as defined in section 4.02(4) of this notice) are performed to determine whether the corresponding SRE expenditures are attributable to foreign research for purposes of section 3.02 of this notice.[12]

The Notice also defines *midpoint* for purposes of the amortization rules.

> Except as provided in section 3.06 of this notice, for purposes of determining when amortization begins under § 174(a)(2)(B) and

[8] Notice 2023-63, September 8, 2023

[9] Notice 2023-63, September 8, 2023

[10] Notice 2023-63, September 8, 2023

[11] Notice 2023-63, September 8, 2023

[12] Notice 2023-63, September 8, 2023

> section 3.02 of this notice, the term midpoint means the first day of the seventh month of the taxable year in which the SRE expenditures are paid or incurred. See section 7.03 of this notice for interim guidance with respect to SRE expenditures that relate to property disposed of before the midpoint of the taxable year in which such SRE expenditures are paid or incurred.[13]

Special rules for short taxable years are discussed in the Notice, starting with an overview of general rules for such years.

> The amortization deduction for a short taxable year is based on the number of months in the short taxable year. If a short taxable year includes part of a month, the entire month is included in the number of months in the taxable year, but the same month may not be counted more than once. If a taxpayer has two successive short taxable years and the first short taxable year ends in the same month that the second short taxable year begins, the taxpayer should include that month in the first short taxable year and not in the second short taxable year.[14]

The Notice also addresses how the midpoint rule applies to such years:

> The midpoint of a short taxable year is the first day of the midpoint month. In the case of a short taxable year with an even number of months (as determined under section 3.06(1) of this notice), the midpoint month is determined by dividing the number of months in the short taxable year by two and then adding one (for example, for a short taxable year consisting of ten months, the midpoint month is the sixth month of the short taxable year ((10 / 2) + 1 = 6)). In the case of a short taxable year with an odd number of months (as determined under section 3.06(1) of this notice), the midpoint month is the month for which there are an equal number of months before and after such month (for example, for a short taxable year consisting of seven months, the mid-point month is the fourth month of the short taxable year).[15]

The Notice provides the following example of applying the above short year rule:

> **EXAMPLE**
>
> Facts. Taxpayer is a calendar-year taxpayer that incorporated and began operations on October 17, 2022. In 2022, Taxpayer paid or incurred $60,000 in SRE expenditures that were not attributable to foreign research. Taxpayer has no short taxable years after its initial taxable year.
>
> Analysis. Taxpayer has a short taxable year that begins on October 17, 2022, and ends on December 31, 2022, and thus is treated as having a three-month taxable year under section 3.06(1) of this notice. The

[13] Notice 2023-63, September 8, 2023

[14] Notice 2023-63, September 8, 2023

[15] Notice 2023-63, September 8, 2023

midpoint month is November, and thus November 1, 2022, will be treated as the midpoint under section 3.06(2) of this notice. In 2022, Taxpayer amortizes $2,000 of SRE expenditures ($60,000 / 60 months × 2 months). In taxable years 2023 through 2026, each a full 12-month taxable year, Taxpayer amortizes $12,000 ($60,000 / 60 months × 12 months) each year, or $48,000 total. In 2027, Taxpayer amortizes the remaining $10,000 ($60,000 / 60 months × 10 months).[16]

Scope of Section 174

The next section of the Notice discusses the scope of IRC §174, as revised by the Tax Cuts and Jobs Act. The IRS states that this is to provide "taxpayers with clarity in determining whether expenditures are SRE expenditures subject to capitalization and amortization under §174."

Terms Used in Section 174

Terms used in the Notice carry the same meaning as they do in existing Treasury Regulation §1.174-2, unless the Notice specifies otherwise. For example, the term "product" is defined as it is in Treasury Regulation §1.174-2(a)(3). In the existing regulation, that term has the following meaning:

> For purposes of this section, the term product includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.[17]

SRE expenditures are defined in the Notice as follows:

> The term SRE expenditures means, with respect to any taxable year beginning after December 31, 2021, research or experimental expenditures (as defined in section 4.02(3) of this notice), which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.[18]

Research or experimental expenditures are defined as expenditures that:

> (a) satisfy the requirements under § 1.174-2 to be research or experimental expenditures, or
>
> (b) are paid or incurred in connection with the development of any computer software (as provided in section 5 of this notice), regardless of whether such expenditures are research or experimental expenditures under § 1.174-2.[19]

---

[16] Notice 2023-63, September 8, 2023

[17] Treasury Reg. §1.174-2(a)(3), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000005 (retrieved September 9, 2023)

[18] Notice 2023-63, September 8, 2023

[19] Notice 2023-63, September 8, 2023

This section of the Notice cautions that Section 6 of the Notice addresses issues related to whether expenditures paid or incurred pursuant to a contract are considered research or experimental expenditures.

Reg. §1.174-2(a)(1) defines research or experimental expenditure broadly as follows:

> The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense.[20]

The subsection goes on to give costs that automatically would be included as such costs.

> The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.[21]

The regulation goes on to provide information on the nature of such expenditures

> Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product.[22]

The provision clarifies that it is the nature of the activity, rather than the success or failure of the product, that determines whether such expenditures qualify.

> Whether expenditures qualify as research or experimental 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. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174.[23]

Finally, the provision concludes by stating that the commencement of production does not preclude the incurrence of additional §174 costs. As long as uncertainty regarding the

---

[20] Treasury Reg. §1.174-2(a)(1), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000003 (retrieved September 9, 2023)

[21] Treasury Reg. §1.174-2(a)(1), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000003 (retrieved September 9, 2023)

[22] Treasury Reg. §1.174-2(a)(1), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000003 (retrieved September 9, 2023)

[23] Treasury Reg. §1.174-2(a)(1), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000003 (retrieved September 9, 2023)

development or improvement of the product remains, §174 costs will continue to be incurred.

> Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.[24]

Additionally, Treasury Regulation §1.174(a)(6) provides a list of expenditures that are excluded from being considered research or experimental expenditures.

- The ordinary testing or inspection of materials or products for quality control (quality control testing);
- Efficiency surveys;
- Management studies;
- Consumer surveys;
- Advertising or promotions;
- The acquisition of another's patent, model, production or process; or
- Research in connection with literary, historical, or similar projects.[25]

SRE activities means

- Software development activities described in section 5.03 of this notice, or
- Research or experimental activities described in § 1.174-2 (that is, activities in the experimental or laboratory sense intended to discover information that would eliminate uncertainty concerning the development or improvement or appropriate design of a product or a component or subcomponent of a product).[26]

Identification and Allocation of SRE Expenditures

The Notice provides the following summary of what are SRE expenditure requirements:

> As provided in section 4.02(2) and (3) of this notice, SRE expenditures include expenditures that satisfy the requirements under § 1.174-2 or are paid or incurred in connection with the development of any computer software, regardless of whether such software expenditures satisfy the requirements under § 1.174-2.[27]

---

[24] Treasury Reg. §1.174-2(a)(1), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000003 (retrieved September 9, 2023)

[25] Treasury Reg. §1.174-2(a)(6), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000008 (retrieved Setpember 9, 2023)

[26] Notice 2023-63, September 8, 2023

[27] Notice 2023-63, September 8, 2023

A summary of the provisions related to SRE expenditures in Treasury Regulation §1.174-2 is provided next.

> Section 1.174-2(a)(1) and (5) provide that research or experimental expenditures under § 1.174-2 include all costs incident to the development or improvement of a product, a component of a product, or subcomponent of a product, as applicable (that is, research or experimental expenditures under § 1.174-2 include all costs incident to SRE activities described in section 4.02(4)(b) of this notice).[28]

The Notice provides a non-exhaustive list of costs incidental to SRE activities and describes the nature of that list as follows:

> Section 4.03(1) of this notice provides a nonexhaustive list of examples of the types of costs that are incident to SRE activities described in section 4.02(4)(b) of this notice or paid or incurred in connection with software development activities described in sections 4.02(4)(a) and 5.03 of this notice. In other words, section 4.03(1) of this notice provides a non-exhaustive list of examples of the types of costs that are SRE expenditures.[29]

The costs included in that list are provided below:

- **Labor costs**. Labor costs of full-time, part-time, and contract employees and independent contractors who perform, supervise, or directly support SRE activities. Labor costs include all elements of compensation other than severance compensation, such as basic compensation, stock-based compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan.

- **Materials and supplies costs.** Costs of materials and supplies, including tools and equipment that are not depreciable under § 168, which are used or consumed in the performance of SRE activities or in the direct support of SRE activities. For example, a cost described in § 1.162-3, relating to the cost of a material or supply, may be an SRE expenditure.

- **Cost recovery allowances.** Depreciation, amortization, or depletion 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 in a taxable year that begins on or before December 31, 2021. For example, depreciation with respect to a test bed used in the performance of SRE activities, or allocable depreciation with respect to a facility in which SRE activities, or services that directly support SRE activities, are performed.

- **Patent costs.** Costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.

[28] Notice 2023-63, September 8, 2023

[29] Notice 2023-63, September 8, 2023

- **Certain operation and management costs.** Rent, utilities, insurance, taxes, repairs and maintenance costs, security costs, and similar overhead costs with respect to facilities, equipment and other assets used in the performance of SRE activities or in the direct support of SRE activities.

- **Travel costs.** Travel costs for the performance of SRE activities or the direct support of SRE activities.[30]

The Notice also includes a list of costs that are neither required nor permitted to be treated as SRE expenditures:

> Section 4.03(2) of this notice provides a list of costs that are not permitted or required to be treated as SRE expenditures, regardless of whether they may be incident to SRE activities described in section 4.02(4) of this notice.[31]

The costs that are not to be treated as SRE expenditures are listed below:

- Costs paid or incurred by general and administrative service departments (or functions) that only indirectly support or benefit SRE activities (for example, services of payroll personnel in preparing salary checks of research personnel, services of human resources personnel who hire research personnel, or services of accounting personnel who account for research expenses);

- Interest on debt to finance SRE activities;

- Costs paid or incurred for activities described in section 5.05 of this notice (activities not treated as software development);

- 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 listed in § 1.174-2(a)(6)(i)-(vii) (the list from the existing regulation discussed earlier in this article);

- Amounts representing amortization of SRE expenditures; and

- Amounts representing amortization of research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022.[32]

---

[30] Notice 2023-63, September 8, 2023

[31] Notice 2023-63, September 8, 2023

[32] Notice 2023-63, September 8, 2023

Although a cost might appear in the example SRE expenditure list discussed in this section of the Notice, not all such expenditures will necessarily be treated as SRE expenditures that must be capitalized. Instead, a method must be adopted to reasonably allocate such costs between those that qualify as SRE expenditures and those that do not.

> To determine total SRE expenditures for a taxable year, taxpayers must allocate costs, including the types of costs described in section 4.03(1) of this notice, to SRE activities 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 the benefits provided to the SRE activities.[33]

While a taxpayer is permitted to use different methods for different costs, the methods employed must be reasonable and applied consistently.

> The allocation method used for one type of cost may be different than the allocation method used for another type of cost. However, the allocation method used for each type of cost must be applied on a consistent basis. For example, a taxpayer that consistently allocates labor costs described in section 4.03(1)(a) of this notice to SRE activities by multiplying such labor costs by the ratio of the total time the person or people actually spent performing, supervising, or directly supporting SRE activities during the taxable year to the total time the person or people spent performing all services for the taxpayer during the taxable year, meets the requirements in this section 4.03(3). Similarly, a taxpayer that consistently allocates facility cost recovery allowances described in section 4.03(1)(c) of this notice to SRE activities by multiplying such cost recovery allowances by the ratio of the square footage of the area used to conduct or directly support SRE activities to the total square footage of the facility, meets the requirement of this section 4.03(3).[34]

The Notice cautions that even though a method may be deemed reasonable for allocation under this rule, it does not necessarily mean that the same form of allocation would be considered appropriate for other provisions of the IRC.

> An allocation method for a particular type of cost that meets the requirements of this section 4.03(3) may not be appropriate for purposes of allocating that same type of cost under other sections of the Code.[35]

The IRS provides a comprehensive example of applying the allocation rules to numerous expenses in Section 4.03(4) of the Notice. Advisers should consider reviewing this example in detail when looking to apply these rules.

---

[33] Notice 2023-63, September 8, 2023

[34] Notice 2023-63, September 8, 2023

[35] Notice 2023-63, September 8, 2023

Consistency Requirement

The Notice addresses the requirement for consistent treatment of costs as being SRE for all provisions of the IRC. The Notice provides:

> SRE expenditures must be treated consistently for purposes of all provisions under subtitle A of the Code (subtitle A). Thus, expenditures that are defined as SRE expenditures under section 4.02(2) of this notice must be treated as SRE expenditures for all purposes under subtitle A. Such expenditures may not be treated as ordinary and necessary expenses under § 162 or capitalized under § 195, § 263(a), § 263A, or § 471. The amortization deductions arising from such SRE expenditures must also be allocated and apportioned consistent with the rules under §§ 1.861-8 and 1.861-17.[36]

Although not explicitly stated, it should be clear that by imposing this consistency requirement, the IRS is signaling its position that it will not allow a taxpayer to treat an expenditure as an SRE expenditure for purposes of IRC §41 (the credit for increasing research activities) while simultaneously deducting that expense as an ordinary and necessary business expense under IRC §162.

Software Development Expenditures

The IRS plans to issue proposed regulations defining which software development expenditures must be amortized under IRC §174, regardless of whether or not they would otherwise qualify as research and experimental expenditures.

Defined Terms

Section 5 of the Notice provides the following definitions related to software development:

> (1) Computer software. The term computer software generally means 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. The code may be stored on a computing device, affixed to a tangible medium (for example, a disk or DVD), or accessed remotely via a private computer network or the Internet, for example, via cloud computing. Computer software generally includes system software, programming software, application software, embedded software, and all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer software also generally includes computer programs of all classes, for example, operating systems, executive systems, software monitors, compilers and translators, assembly routines, and utility programs as well as application programs.

[36] Notice 2023-63, September 8, 2023

> Computer software includes a computer program, a group of programs, and upgrades and enhancements (as defined in section 5.02(2) of this notice). Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Computer software includes software developed for use by the taxpayer in its trade or business or for sale or licensing to others. Computer software does not include any data or information base described in § 1.197-2(b)(4) unless the database or item is in the public domain and is incidental to a computer program. For example, customer lists or client files are not included in computer software unless such items are in the public domain and incidental to a computer program. Additionally, computer software does not include any procedures that are external to the computer's operation.
>
> (2) Upgrades and enhancements. 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 speed or efficiency of the software.[37]

Activities Treated as Software Development

A non-exclusive list of activities treated as software development for the purposes of IRC §174 is provided in the Notice.

- Planning the development of the computer software (or the upgrades and enhancements to such software), including identification and documentation of the software requirements;
- Designing the computer software (or the upgrades and enhancements to such software);
- 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;

[37] Notice 2023-63, September 8, 2023

- Testing the computer software (or the upgrades and enhancements to such software) and making necessary modifications to address defects identified during testing, but only up until the point in time that:
  - In the case of computer software developed for use by the taxpayer in its trade or business, the computer software is placed in service; and
  - In the case of computer software developed for sale or licensing to others, technological feasibility has been established, product masters(s) have been produced, and the computer software is ready for sale or licensing to others; and
- In the case of computer software developed for sale or licensing to others (or the upgrades and enhancements to such software), production of the product master(s).[38]

Special Rules Related to Purchased Software

The Notice outlines special treatments that apply to purchased software:

> In the case of upgrades and enhancements to purchased computer software, the principles set forth in section 5.03 of this notice apply. However, the purchase and installation of purchased computer software, including the configuration of pre-coded parameters to make such software compatible with the business and reengineering the business to make it compatible with the purchased software, and any planning, designing, modeling, testing, or deployment activities with respect to the purchase and installation of such software, are not activities that constitute software development for purposes of § 174.[39]

Activities Not Treated as Software Development

The Notice provides a list of items not considered software development for the purposes of IRC §174.

- **Computer software developed by a taxpayer for use in its trade or business.** In the case of computer software that is developed for use by the taxpayer in its trade or business (or upgrades and enhancements to such software):
  - Training employees and other stakeholders that will use the computer software;
  - Maintenance activities after the computer software is placed in service that do not give rise to upgrades and enhancements (for example, corrective maintenance to debug, diagnose, and fix programming errors);

[38] Notice 2023-63, September 8, 2023

[39] Notice 2023-63, September 8, 2023

- Data conversion activities, except for activities to develop computer software that facilitate access to existing data or data conversion; and

- Installing the computer software and other activities relating to placing the computer software in service.[40]

- **Computer software developed for sale or licensing to others.** In the case of computer software that is developed for sale or licensing to others (or upgrades and enhancements to such software), activities that occur after such software (or upgrades and enhancements to such software) is ready for sale or licensing to others, such as marketing and promotional activities, maintenance activities that do not give rise to upgrades and enhancements, distribution activities (for example, making the software available via remote access), and customer support activities.[41]

Research Performed Under Contract

Section 6 of the Notice offers guidance on determining when costs paid or incurred for research performed under contract qualify as SRE expenditures.

Definitions

Section 6 provides the following definitions related to research performed under contracts:

- **Research provider.** The term research provider means the party that contracts with a research recipient (as defined in section 6.02(2) of this notice) to:

  - perform research services for the research recipient with respect to an SRE product, or

  - develop an SRE product (as defined in section 6.02(4) of this notice) that the research recipient acquires from the research provider.

- **Research recipient.** The term research recipient means the party that contracts with the research provider to:

  - 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.

- **Financial risk.** The term financial risk means the risk that the research provider may suffer a financial loss related to the failure of the research to produce the desired SRE product.

[40] Notice 2023-63, September 8, 2023

[41] Notice 2023-63, September 8, 2023

- **SRE product.** The term SRE product means any pilot model, process, formula, invention, technique, patent, computer software, or similar property (or a component thereof) that is subject to protection under applicable domestic or foreign law. For example, mere know-how gained by a research provider through the performance of research services for a research recipient that is not subject to protection under applicable domestic or foreign law does not give rise to an SRE product in the hands of the research provider.[42]

Treatment of Costs Paid or Incurred by a Research Recipient

The Notice provides the following details on the treatment of costs paid or incurred by a research recipient:

> The treatment of costs paid or incurred by the research recipient is governed by the principles set forth in § 1.174-2(a)(10) and (b)(3).[43]

Treasury Reg. §1.174-2(a)(10) provides:

> **(10) Amounts paid to others for research or experimentation.** The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.[44]

While Treasury Reg. §1.174-2(b)(3) reads:

> **(3) Amounts paid to others for research or experimentation resulting in depreciable property.** If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase

[42] Notice 2023-63, September 8, 2023

[43] Notice 2023-63, September 8, 2023

[44] Treasury Reg. §1.174-2(a)(10), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000019 (retrieved September 9, 2023)

> price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under section 174(a). However, see subparagraph (4) of this paragraph.[45]

Treatment of Costs Paid or Incurred by Research Provider

The Notice offers the following guidance related to costs incurred by a research provider:

> If the research provider bears financial risk under the terms of the contract with the research recipient, then costs paid or incurred by the research provider that are incident to the SRE activities (see section 4.03 of this notice) performed by the research provider under the contract are SRE expenditures. However, even if the research provider does not bear financial risk under the terms of the contract with the research recipient, if the research provider has a right to use any resulting SRE product in the trade or business of the research provider or otherwise exploit any resulting SRE product through sale, lease, or license, then costs paid or incurred by the research provider that are incident to the SRE activities performed by the research provider under the contract are SRE expenditures of the research provider for which no deduction is allowed except as provided in § 174(a)(2), regardless of whether the research recipient is required to treat its costs as SRE expenditures under section 6.03 of this notice. For purposes of the preceding sentence, a research provider will not be treated as having a right to use the SRE product in the trade or business of the research provider or otherwise exploit the SRE product through sale, lease, or license if such right is available to the research provider only upon obtaining approval from another party to the research arrangement that is not related to the research provider within the meaning of § 267 or § 707.[46]

[45] Treasury Reg. §1.174-2(b)(3), https://www.taxnotes.com/research/federal/cfr26/1.174-2#cx9b-0000024 (retrieved September 9, 2023)

[46] Notice 2023-63, September 8, 2023

Example Related to Contract Research

The Notice provides the following example to illustrate the principles related to contract research:

> **EXAMPLE**
>
> (1) Facts. Company C engages Company D, a contractor located in the United States, to develop an SRE product for use in Company C's trade or business. The activities undertaken by Company D are undertaken upon Company C's order, and Company D makes no performance guarantees with respect to the SRE product. Company C will pay Company D a fixed sum of $25,000 plus an amount equivalent to Company D's actual expenditures. Company D does not have any right to use or otherwise exploit any resulting SRE product. In 2023, Company D incurs $125,000 of expenditures to successfully develop the product in the United States, and Company C pays to Company D $150,000 pursuant to the terms of the contract.
>
> (2) Analysis. Under section 6.04 of this notice, Company D may not treat the $125,000 of expenditures it incurs to develop the SRE product on behalf of Company C as SRE expenditures under § 174 because (i) Company D does not bear financial risk, and (ii) Company D does not have any right to use or otherwise exploit any resulting SRE product. Under section 6.03 of this notice, the $150,000 paid by Company C is an amount paid to another party for research or experimentation undertaken on Company C's behalf under § 1.174-2(a)(10) and (b)(3) and is thus an SRE expenditure under section 4.02(2) of this notice. The applicable § 174 amortization period is 5 years (60 months) because the research is performed by Company D in the United States. Company C's location is not relevant for determination of the applicable § 174 amortization period.[47]

Disposition, Retirement, or Abandonment of Property

Section 7 offers guidance on the treatment of unamortized SRE expenditures if property, with respect to which such expenditures are paid or incurred, is disposed of, retired, or abandoned during the §174 amortization period.

General Rule

The Notice provides a general rule that applies to such situations, except in cases where a corporation that incurred the expenses ceases to exist.

> Except as provided in section 7.04 of this notice, if any property with respect to which SRE expenditures are paid or incurred is disposed of, retired, or abandoned during the applicable § 174 amortization period, no recovery is allowed with respect to the unamortized SRE expenditures on account of such disposition, retirement, or abandonment, and the taxpayer that disposed of, retired, or abandoned such property continues to amortize such expenditures under § 174 over the remainder of the applicable § 174 amortization period. For purposes of this section 7, the term unamortized SRE expenditures means the amount of any SRE expenditures paid or incurred by the corporation (or its predecessor), less the amount of any

[47] Notice 2023-63, September 8, 2023

> amortization deductions previously allowed to the corporation (or its predecessor) under § 174.[48]

The fact that the property is disposed of prior to the midpoint of the year in which the costs were incurred does not alter the results.

> An amortization deduction is allowed under § 174 for SRE expenditures even if such expenditures relate to property that is disposed of, retired, or abandoned prior to the midpoint of the taxable year in which such expenditures are paid or incurred. Accordingly, such expenditures are subject to the rules in sections 7.02 and 7.04 of this notice.[49]

Transactions in Which the Corporation Ceases to Exist

The Notice outlines two separate treatments if a corporation ceases to exist: one for transactions subject to IRC §381(a), where attributes carry over to the successor corporation, and another for transactions not subject to that provision.

Transactions Subject to IRC §381(a)

The Notice provides for a "step in the shoes" treatment for the successor corporation when the transaction is subject to IRC §381(a), with the successor corporation continuing to amortize the remaining balance of the costs over the remaining term.

> If a corporation ceases to exist for Federal income tax purposes in a transaction or series of transactions described in § 381(a), the acquiring corporation will continue to amortize the distributor or transferor corporation's unamortized SRE expenditures over the remainder of the distributor or transferor corporation's applicable § 174 amortization period beginning with the month of transfer.[50]

Other Transactions Where the Corporation Ceases to Exist

In most other transactions where the corporation ceases to exist, the corporation is granted a deduction for the unamortized balance in its final year.

> Except as provided in section 7.04(2)(b), if a corporation ceases to exist for Federal income tax purposes in a transaction or series of transactions to which § 381(a) does not apply, the corporation is allowed a deduction equal to the unamortized SRE expenditures in its final taxable year.[51]

[48] Notice 2023-63, September 8, 2023

[49] Notice 2023-63, September 8, 2023

[50] Notice 2023-63, September 8, 2023

[51] Notice 2023-63, September 8, 2023

However, in a section entitled "Anti-abuse Exception," the Notice stipulates that the immediate deduction provision will not apply if a principal purpose of the transaction is to claim a deduction for unamortized SRE expenses.

> Section 7.04(2)(a) of this notice does not apply if a principal purpose of the transaction(s) described in section 7.04(2)(a) of this notice is to claim a deduction for the unamortized SRE expenditures.[52]

Generally, the IRS would consider a transaction to have a principal purpose of claiming a deduction for unamortized SRE expenditures if there is no other significant business reason for the transaction and it's clear that the transaction would not have occurred but for the existence of the deduction rule.

Long Term Contracts Under IRC §460

Section 8 of the Notice addresses issues arising from the changes under IRC §174 as they relate to long-term contracts, as defined in IRC §460. Specifically, the guidance pertains to the application of the percentage-of-completion method (PCM) in such circumstances.

Background and Why This Has Become an Issue

The IRS provides a background discussion to elucidate the nature of the problem arising from the change in IRC §174 as it relates to those using PCM accounting for long-term contracts under IRC §460.

> Section 460(a) generally requires use of the PCM to account for taxable income from a long-term contract. Section 1.460-4(b)(2)(i) provides that under the PCM, the portion of the contract price a taxpayer must report in a tax year 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 purposes of the PCM. Under the PCM, a taxpayer generally deducts allocable contract costs as they are incurred. As provided by § 1.460-4(b)(2)(iv), an increase in the percentage of the contract price to be reported is matched by deduction of the incurred costs that cause the increase. Under the current § 460 regulations in § 1.460- 5(b)(2)(vi), allocable contract costs include research or experimental 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 current § 460 regulations were drafted when a taxpayer could deduct currently research or experimental expenses under former § 174. Section 174(a), as amended by the TCJA, requires that SRE expenditures be charged to capital account and deducted over the applicable § 174 amortization period. As a result, the current § 460 regulations provide that incurred research or experimental expenses increase the percentage of the contract price

[52] Notice 2023-63, September 8, 2023

> required to be reported, although § 174(a) prevents a corresponding current deduction of incurred SRE expenditures. The resulting mismatch of contract price and contract costs is inconsistent with the contemplated operation of the PCM.[53]

Revised Treatment of §174 Costs Under PCM

To address the mismatch between the contract price and contract costs triggered under the current §460 regulations following the capitalization of costs under the new IRC §174, the Notice provides the following guidance:

> The Treasury Department and the IRS anticipate issuing proposed regulations that would amend the existing § 460 regulations, including § 1.460-5(b)(2)(vi), to provide that the costs allocable to a long term contract accounted for using the PCM include amortization of SRE expenditures under § 174(a)(2)(B), rather than the capitalized amount of such expenditures, and that such amortization is treated as incurred for purposes of determining the percentage of contract completion as deducted. The amendments would not apply to expenditures previously capitalized under § 59(e)(2)(B) or under former § 174(b), or to independent research and development expenditures, as defined in § 460(c)(5), which are not allocable contract costs. Research or experimental expenditures that are not independent research and development expenditures, however, would remain subject to allocation under § 460(c)(1) regardless of whether they are SRE expenditures.[54]

Cost Sharing Regulations (Reg. §1.482-7)

Another set of regulations impacted by the change in the treatment of §174 expenses pertains to regulations under IRC §482.

Background

As with long-term contracts, the Notice begins by providing the background to the impacted regulation.

> Section 1.482-7(j)(3)(i) addresses cost sharing transaction payments (CST Payments) between controlled participants in a cost sharing arrangement (CSA) that are made to ensure that each controlled participant's share of intangible development costs (IDCs) is in proportion to its share of reasonably anticipated benefits from exploitation of the developed intangibles (RAB share). Section 1.482-7(j)(3)(i) generally provides that CST Payments reduce deductible IDCs borne by the controlled participant to which the CST Payments are owed. Any amount of CST Payment in excess of such deductible

[53] Notice 2023-63, September 8, 2023

[54] Notice 2023-63, September 8, 2023

> IDCs is treated as in consideration for the use of land and tangible property furnished for purposes of the CSA by the controlled participant to which the CST Payment is owed. CST Payments generally are considered the payor's costs of developing intangibles at the location where such development is conducted. See also § 1.482-7(j)(3)(iii), Example 1.[55]

Updated Guidance

The Notice provides the following updated guidance in this area:

> (1) The Treasury Department and the IRS anticipate issuing proposed regulations that would replace the second through fourth sentences of § 1.482-7(j)(3)(i) with rules providing that CST Payments owed to a controlled participant reduce:
>
> > (a) The amount of the category of IDCs borne directly by that participant that are-36- required to be charged to capital account, and
> >
> > (b) The amount of the category of IDCs borne directly by that participant that are not described in section 9.03(1)(a) of this notice and that are deductible.
>
> (2) CST Payments not in excess of the payor's RAB share of the total amount of the IDCs in both categories described in section 9.03(1)(a) and (b) of this notice 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 in both categories described in section 9.03(1)(a) and (b) of this notice will be treated as income.[56]

Applicability Dates

The Notice provides information on the applicability dates of this guidance in Section 10 of the Notice.

> It is anticipated that the forthcoming proposed regulations will provide that rules consistent with the rules described in sections 3 through 9 of this notice would apply for taxable years ending after September 8, 2023. Except as otherwise provided in this section 10.01, prior to the publication date of the forthcoming proposed regulations in the Federal Register, a taxpayer may choose to rely on the rules described in sections 3 through 9 of this notice, including for expenditures paid or incurred in taxable years beginning after

[55] Notice 2023-63, September 8, 2023

[56] Notice 2023-63, September 8, 2023

> December 31, 2021, provided the taxpayer relies on all the rules in sections 3 through 9 of this notice and applies them in a consistent manner. However, taxpayers may not rely on the rules in section 7 of this notice for SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership.[57]

The IRS also plans to release additional guidance, offering taxpayers—a number of whom have already filed their 2022 income tax returns—a method to change their accounting method to align with the guidance in this Notice.

> The Treasury Department and IRS intend to issue guidance in the Internal Revenue Bulletin (see § 601.601(d) of the Procedural Rules) to provide procedures for taxpayers to obtain automatic consent to change methods of accounting to comply with this notice. Until the issuance of such procedural guidance, taxpayers may rely on section 7.02 of Rev. Proc. 2023- 24 to change their methods of accounting under § 174 to comply with this notice. The Treasury Department and IRS anticipate issuing updated procedures that will address situations in which taxpayers have, prior to the issuance of this notice, changed methods of accounting to comply with § 174 as amended by the TCJA but whose treatment of SRE expenditures is not entirely consistent with this notice. Unless specifically authorized by the Commissioner of Internal Revenue or by statute, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting by filing an amended return. See Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Rul. 2023-8, 2023-18 I.R.B. 801.[58]

[57] Notice 2023-63, September 8, 2023

[58] Notice 2023-63, September 8, 2023

Part III – Administrative, Procedural, and Miscellaneous

Guidance on Amortization of Specified Research or Experimental Expenditures under Section 174

Notice 2023-63

SECTION 1. OVERVIEW

This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue proposed regulations (forthcoming proposed regulations) addressing (1) the capitalization and amortization of specified research or experimental (SRE) expenditures under § 174 of the Internal Revenue Code (Code)[1], as amended by Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), (2) the treatment of SRE expenditures under § 460, and (3) the application of § 482 to cost sharing arrangements involving SRE expenditures. The Treasury Department and the IRS intend to propose rules in the forthcoming proposed regulations consistent with the interim guidance provided in sections 3 through 9 of this notice. Section 10 of this notice provides that taxpayers may rely on the interim guidance provided in sections 3 through 9 of this notice prior to the publication date of the forthcoming proposed

[1] Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

regulations in the Federal Register. Section 11 of this notice requests comments, including comments on specific issues and issues not addressed in this notice.

The guidance in this notice does not apply for purposes of determining whether an expenditure paid or incurred for taxable years beginning before January 1, 2022, is a research or experimental expenditure under § 174 as in effect for taxable years beginning before January 1, 2022 (former § 174). This notice provides guidance regarding expenditures that are treated as SRE expenditures under § 174 and, therefore, affects expenditures that may be treated as SRE expenditures for purposes of § 41(d)(1)(A) and § 1.41-4(a)(2)(i). However, this notice is not intended to change the rules for determining eligibility for or computation of the research credit under § 41 and the regulations thereunder, including rules for "research with respect to computer software," and the definitions of "qualified research" and "qualified research expenses."

SECTION 2. BACKGROUND

.01 Prior law treatment of research or experimental expenditures.

(1) In general. Former § 174 was first enacted in 1954 to provide certainty to taxpayers regarding the treatment of otherwise capitalizable research or experimental expenditures with no determinable useful life. See H.R. Rep. No.1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954). Before the enactment of former § 174, courts consistently held that the law required capitalization of product research and development costs, including production costs of tangible property used in the research process. Under such prior law, expenditures related to a taxpayer's research and experimentation generally were capitalized and held in suspense until the taxpayer could determine (1) whether

or not the research had failed; and (2) if the research was successful, whether or not the research resulted in property that had a useful life determinable with reasonable accuracy.

Former § 174 allowed taxpayers to elect to deduct research or experimental expenditures paid or incurred in connection with a trade or business as currently deductible expenses, to capitalize and amortize such expenditures over a period of not less than 60 months, or to charge such expenditures to capital account.

(2) Definition of research or experimental expenditures under former § 174.

The provisions of § 1.174-2 address the scope and definition of research or experimental expenditures under former § 174. Specifically, § 1.174-2(a)(1) provides that the term "research or experimental expenditures" means those expenditures incurred in connection with a taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense, and generally includes all such costs incident to the development or improvement of a product or a component or subcomponent of the product, as well as the costs of obtaining a patent. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Section 1.174-2(a)(3) defines the term "product" to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

Section 1.174-2(a)(10) and (b)(3) generally provide that former § 174 also

applies to expenditures paid or incurred by a taxpayer for research or experimentation carried on by another person or organization (such as a research institute, foundation, engineering company, or similar contractor) on behalf of the taxpayer, provided that such expenditures are made at the taxpayer's order and risk. However, § 1.174-2 does not explicitly address expenditures paid by a contractor for research or experimentation carried on for another person or organization.

Section 1.174-2(a) also provides guidance on expenditures that are not subject to former § 174, including costs paid or incurred in the production of a product after the elimination of uncertainty concerning the development or improvement of the product, and expenditures for: quality control testing, efficiency surveys, management studies, consumer surveys, advertising or promotions, the acquisition of another's product, and research in connection with literary, historical or similar projects. In addition, § 1.174-2(b) and former § 174(c) provide that any expenditure for the acquisition or improvement of land or depreciable property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 or section 611 are not research or experimental expenditures. However, allowances for depreciation and depletion with respect to such property are treated as research or experimental expenditures. Finally, § 1.174-2(c) and former § 174(d) provide that the provisions of former § 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas, or other mineral.

(3) Software development. Prior to the effective date of the TCJA amendments to former § 174, section 5 of Rev. Proc. 2000-50, 2000-2 C.B. 601, permitted

taxpayers to treat costs to develop computer software that were not otherwise treated as research or experimental expenditures under former § 174 as currently deductible expenses or capital expenditures that are amortized over 60 months or 36 months. Accordingly, under section 5 of Rev. Proc. 2000-50, costs to develop computer software that did not otherwise meet the definition of research or experimental expenditures under former § 174 were afforded generally similar treatment to research or experimental expenditures under former § 174. Rev. Proc. 2000-50 does not define software development or otherwise describe software development activities. See also Kellett v. Commissioner, T.C. Memo. 2022-62 (discussing, and questioning the statutory support for, deduction of software development expenditures under Rev. Proc. 2000-50).

.02 Treatment of research or experimental expenditures under the TCJA.

(1) Requirement to capitalize and amortize SRE expenditures. Section 13206(a) of the TCJA amended former § 174 for amounts paid or incurred in taxable years beginning after December 31, 2021. For such amounts, § 174(a)(1) disallows deductions for SRE expenditures, except as provided in § 174(a)(2). Section 174(a)(2) requires taxpayers to charge SRE expenditures to capital account and allows amortization deductions of such capitalized expenditures ratably over the applicable § 174 amortization period, beginning with the midpoint of the taxable year in which such expenditures are paid or incurred. As used in this notice, the term “applicable § 174 amortization period” refers to a 5-year (60-month) period in the case of SRE expenditures attributable to domestic research or a 15-year (180-month) period in the case of SRE expenditures attributable to foreign research, as defined in section 3.03 of

this notice.

(2) Definition of SRE expenditures. Section 174(b), as amended by section 13206(a) of the TCJA, defines "SRE expenditures" to mean, with respect to any taxable year beginning after December 31, 2021, research or experimental expenditures that are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business. See Snow v. Commissioner, 416 U.S. 500 (1974) ("in connection with" a trade or business is broader than "in carrying on" a trade or business).

(3) Software development. Section 13206(a) of the TCJA added new § 174(c)(3) to require that any amount paid or incurred in connection with the development of any software in taxable years beginning after December 31, 2021, be treated as a research or experimental expenditure (and thus an SRE expenditure to the extent paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business).

(4) Amortization deductions for disposed of, retired, or abandoned property. Section 13206(a) of the TCJA added new § 174(d) to provide that deductions of SRE expenditures may not be taken on account of the disposition, retirement, or abandonment of property with respect to which such SRE expenditures are paid or incurred. If such property is disposed of, retired, or abandoned during the applicable § 174 amortization period, § 174(d) requires that the amortization deductions for such SRE expenditures continue over that period.

(5) Other changes to former § 174. Section 13206(a) of the TCJA redesignated former § 174(c) to § 174(c)(1) and former § 174(d) to § 174(c)(2), removed former

§ 174(e), which provided that only reasonable expenditures are considered research or experimental expenditures under former § 174, and also removed former § 174(f), which contained cross-references to basis adjustments under § 1016(a)(14) and to an election for 10-year amortization under § 59(e).

(6) Change in method of accounting.

(a) TCJA requirement. Section 13206(b) of the TCJA requires taxpayers to apply the provisions of § 174, as amended by section 13206(a) of the TCJA, as a change in method of accounting for purposes of § 481, initiated by the taxpayer and made with the consent of the Secretary of the Treasury or her delegate, and applied on a cutoff basis to SRE expenditures paid or incurred in taxable years beginning after December 31, 2021. Thus, no adjustments under § 481(a) are permitted or required with respect to research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022.

(b) Procedural guidance. On December 12, 2022, the Treasury Department and the IRS issued Rev. Proc. 2023-8, 2023-3 I.R.B. 407, to provide procedures for taxpayers to obtain automatic consent to change methods of accounting to comply with § 174, as amended by the TCJA. On December 29, 2022, the Treasury Department and the IRS issued Rev. Proc. 2023-11, 2023-3 I.R.B. 417, to modify and supersede Rev. Proc. 2023-8. The change in method of accounting provided by Rev. Proc. 2023-11 was subsequently included in section 7.02 of Rev. Proc. 2023-24, 2023-28 I.R.B. 1207. Section 7.02 of Rev. Proc. 2023-24 implements the requirement imposed by § 13206(b) of the TCJA that a taxpayer must make this change in method of accounting on a cutoff basis if the change was made during the taxpayer's first taxable year

beginning after December 31, 2021. However, section 7.02 of Rev. Proc 2023-24 provides that a taxpayer making the change for a taxable year subsequent to the taxpayer's first taxable year beginning after December 31, 2021, is required to make that change with a modified § 481(a) adjustment that takes into account only SRE expenditures paid or incurred in taxable years beginning after December 31, 2021. Section 7.02(7) of Rev. Proc. 2023-24 also provides that a taxpayer that changes its method of accounting for SRE expenditures under the revenue procedure will receive limited audit protection. Specifically, audit protection will not apply for expenditures paid or incurred in taxable years beginning before January 1, 2022. Audit protection also will not apply for expenditures paid or incurred in taxable years beginning after December 31, 2021, if a change in method of accounting is made for the taxable year immediately subsequent to the first taxable year beginning after December 31, 2021. See section 10.02 of this notice for additional procedural guidance the Treasury Department and IRS intend to issue.

SECTION 3. CAPITALIZATION AND AMORTIZATION OF SRE EXPENDITURES

.01 Purpose. The Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations consistent with the interim guidance provided in this section 3, which provides taxpayers with clarity regarding the requirement in § 174(a) to capitalize and amortize SRE expenditures and the treatment of short taxable years.

.02 Requirement to capitalize and amortize SRE expenditures. Taxpayers are required to capitalize SRE expenditures (as defined in section 4.02(2) of this notice) and amortize such expenditures ratably over the applicable § 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or

incurred.

.03 Definition of foreign research. The term foreign research means any research conducted outside the United States, the Commonwealth of Puerto Rico, or any U.S. territory or other possession of the United States. See §§ 174(a)(2)(B) and 41(d)(4)(F).

.04 SRE expenditures attributable to foreign research. Taxpayers must look to where the SRE activities (as defined in section 4.02(4) of this notice) are performed to determine whether the corresponding SRE expenditures are attributable to foreign research for purposes of section 3.02 of this notice.

.05 Definition of midpoint. Except as provided in section 3.06 of this notice, for purposes of determining when amortization begins under § 174(a)(2)(B) and section 3.02 of this notice, the term midpoint means the first day of the seventh month of the taxable year in which the SRE expenditures are paid or incurred. See section 7.03 of this notice for interim guidance with respect to SRE expenditures that relate to property disposed of before the midpoint of the taxable year in which such SRE expenditures are paid or incurred.

.06 Short taxable years.

(1) In general. The amortization deduction for a short taxable year is based on the number of months in the short taxable year. If a short taxable year includes part of a month, the entire month is included in the number of months in the taxable year, but the same month may not be counted more than once. If a taxpayer has two successive short taxable years and the first short taxable year ends in the same month that the second short taxable year begins, the taxpayer should include that month in the first short taxable year and not in the second short taxable year.

(2) Midpoint for short taxable years. The midpoint of a short taxable year is the first day of the midpoint month. In the case of a short taxable year with an even number of months (as determined under section 3.06(1) of this notice), the midpoint month is determined by dividing the number of months in the short taxable year by two and then adding one (for example, for a short taxable year consisting of ten months, the midpoint month is the sixth month of the short taxable year ((10 / 2) + 1 = 6)). In the case of a short taxable year with an odd number of months (as determined under section 3.06(1) of this notice), the midpoint month is the month for which there are an equal number of months before and after such month (for example, for a short taxable year consisting of seven months, the mid-point month is the fourth month of the short taxable year).

.07 Example.

(1) Facts. Taxpayer is a calendar-year taxpayer that incorporated and began operations on October 17, 2022. In 2022, Taxpayer paid or incurred $60,000 in SRE expenditures that were not attributable to foreign research. Taxpayer has no short taxable years after its initial taxable year.

(2) Analysis. Taxpayer has a short taxable year that begins on October 17, 2022, and ends on December 31, 2022, and thus is treated as having a three-month taxable year under section 3.06(1) of this notice. The midpoint month is November, and thus November 1, 2022, will be treated as the midpoint under section 3.06(2) of this notice. In 2022, Taxpayer amortizes $2,000 of SRE expenditures ($60,000 / 60 months × 2 months). In taxable years 2023 through 2026, each a full 12-month taxable year, Taxpayer amortizes $12,000 ($60,000 / 60 months × 12 months) each year, or $48,000 total. In 2027, Taxpayer amortizes the remaining $10,000 ($60,000 / 60 months × 10

months).

SECTION 4. SCOPE OF SECTION 174

.01 Purpose. The Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations consistent with the interim guidance provided in this section 4, which provides taxpayers with clarity in determining whether expenditures are SRE expenditures subject to capitalization and amortization under § 174.

.02 Definition of SRE expenditures and other relevant terms. For purposes of this notice:

(1) Terms used in § 1.174-2. Unless otherwise provided, all terms used in this notice have the same meaning as those in § 1.174-2. For example, the term product has the meaning set forth in § 1.174-2(a)(3).

(2) SRE expenditures defined. The term SRE expenditures means, with respect to any taxable year beginning after December 31, 2021, research or experimental expenditures (as defined in section 4.02(3) of this notice), which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.

(3) Research or experimental expenditures defined. The term research or experimental expenditures means expenditures that--

(a) satisfy the requirements under § 1.174-2 to be research or experimental expenditures, or

(b) are paid or incurred in connection with the development of any computer software (as provided in section 5 of this notice), regardless of whether such expenditures are research or experimental expenditures under § 1.174-2.

See section 6 of this notice for rules to determine whether expenditures paid or incurred pursuant to a contract meet the definition of research or experimental expenditures under this section 4.02(3).

(4) SRE activities defined. The term SRE activities means—

(a) software development activities described in section 5.03 of this notice, or

(b) research or experimental activities described in § 1.174-2 (that is, activities in the experimental or laboratory sense intended to discover information that would eliminate uncertainty concerning the development or improvement or appropriate design of a product or a component or subcomponent of a product).

.03 Identification and allocation of SRE expenditures. As provided in section 4.02(2) and (3) of this notice, SRE expenditures include expenditures that satisfy the requirements under § 1.174-2 or are paid or incurred in connection with the development of any computer software, regardless of whether such software expenditures satisfy the requirements under § 1.174-2. Section 1.174-2(a)(1) and (5) provide that research or experimental expenditures under § 1.174-2 include all costs incident to the development or improvement of a product, a component of a product, or subcomponent of a product, as applicable (that is, research or experimental expenditures under § 1.174-2 include all costs incident to SRE activities described in section 4.02(4)(b) of this notice). Section 4.03(1) of this notice provides a non-exhaustive list of examples of the types of costs that are incident to SRE activities described in section 4.02(4)(b) of this notice or paid or incurred in connection with software development activities described in sections 4.02(4)(a) and 5.03 of this notice. In other words, section 4.03(1) of this notice provides a non-exhaustive list of examples

of the types of costs that are SRE expenditures. Section 4.03(2) of this notice provides a list of costs that are not permitted or required to be treated as SRE expenditures, regardless of whether they may be incident to SRE activities described in section 4.02(4) of this notice. Section 4.03(3) of this notice provides interim guidance addressing the allocation of costs, including those described in section 4.03(1) of this notice, to SRE activities.

(1) Examples of costs that are SRE expenditures. The types of costs that are considered incident to SRE activities described in section 4.02(4)(b) of this notice or paid or incurred in connection with software development activities described in sections 4.02(4)(a) and 5.03 of this notice include but are not limited to:

(a) Labor costs. Labor costs of full-time, part-time, and contract employees and independent contractors who perform, supervise, or directly support SRE activities. Labor costs include all elements of compensation other than severance compensation, such as basic compensation, stock-based compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan.

(b) Materials and supplies costs. Costs of materials and supplies, including tools and equipment that are not depreciable under § 168, which are used or consumed in the performance of SRE activities or in the direct support of SRE activities. For example, a cost described in § 1.162-3, relating to the cost of a material or supply, may be an SRE expenditure.

(c) Cost recovery allowances. Depreciation, amortization, or depletion 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 in a taxable year that begins on or before December 31, 2021. For example, depreciation with respect to a test bed used in the performance of SRE activities, or allocable depreciation with respect to a facility in which SRE activities, or services that directly support SRE activities, are performed.

(d) Patent costs. Costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.

(e) Certain operation and management costs. Rent, utilities, insurance, taxes, repairs and maintenance costs, security costs, and similar overhead costs with respect to facilities, equipment and other assets used in the performance of SRE activities or in the direct support of SRE activities.

(f) Travel costs. Travel costs for the performance of SRE activities or the direct support of SRE activities.

(2) Costs that are not treated as SRE expenditures. The following costs are not permitted or required to be treated as SRE expenditures, regardless of whether they may be incident to SRE activities described in section 4.02(4)(b) of this notice or paid or incurred in connection with software development activities described in sections 4.02(4)(a) and 5.03 of this notice:

(a) Costs paid or incurred by general and administrative service departments (or functions) that only indirectly support or benefit SRE activities (for example, services of payroll personnel in preparing salary checks of research personnel, services of human resources personnel who hire research personnel, or services of accounting personnel who account for research expenses);

(b) Interest on debt to finance SRE activities;

(c) Costs paid or incurred for activities described in section 5.05 of this notice;

(d) Costs to input content into a website;

(e) 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;

(f) Costs to register an Internet domain name or trademark;

(g) Costs listed in § 1.174-2(a)(6)(i)-(vii);

(h) Amounts representing amortization of SRE expenditures; and

(i) Amounts representing amortization of research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022.

(3) Allocation method. To determine total SRE expenditures for a taxable year, taxpayers must allocate costs, including the types of costs described in section 4.03(1) of this notice, to SRE activities 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 the benefits provided to the SRE activities. The allocation method used for one type of cost may be different than the allocation method used for another type of cost. However, the allocation method used for each type of cost must be applied on a consistent basis. For example, a taxpayer that consistently allocates labor costs described in section 4.03(1)(a) of this notice to SRE activities by multiplying such labor costs by the ratio of the total time the person or people actually spent performing, supervising, or directly supporting SRE activities during the taxable year to the total time the person or people spent performing all services for the taxpayer during the taxable

year, meets the requirements in this section 4.03(3). Similarly, a taxpayer that consistently allocates facility cost recovery allowances described in section 4.03(1)(c) of this notice to SRE activities by multiplying such cost recovery allowances by the ratio of the square footage of the area used to conduct or directly support SRE activities to the total square footage of the facility, meets the requirement of this section 4.03(3). An allocation method for a particular type of cost that meets the requirements of this section 4.03(3) may not be appropriate for purposes of allocating that same type of cost under other sections of the Code.

(4) Example. The following example illustrates the rules set forth in section 4.03 of this notice.

(a) Facts. Company A, a calendar year taxpayer, is engaged in the business of manufacturing chemical products. On January 1, 2023, Company A begins a research project to develop a new product. This research project constitutes an SRE activity. Company A does not undertake any other SRE activities during its 2023 taxable year. Company A is comprised of six departments: (1) the Manufacturing Department, (2) the Research Department, (3) the Engineering Department, (4) the Legal Department, (5) the Personnel Department, and (6) the Accounting Department. The Manufacturing Department does not provide any support services to the Research Department. The Personnel Department provides indirect support services to the Research Department by hiring research personnel and preparing their paychecks but does not directly support any aspect of the research project. The Accounting Department provides indirect support services to the Research Department by paying Research Department invoices and accounting for research costs but does not directly support any aspect of

the research project. The Engineering Department provides direct support services to the Research Department with respect to the research project by collaborating with the Research Department to develop the new product. The Legal Department provides direct support services to the Research Department with respect to the research project by preparing patent applications for the new product. Company A owns the following assets, each of which is used, in whole or in part, to perform research or directly support the research project:

Description	**Department(s)**	**Depreciation for 2023**
10,000 square foot facility	The Manufacturing Department occupies 5,000 square feet of the facility. The other departments each occupy 1,000 square feet.	$200,000
Computers, furniture, and equipment used exclusively for the research project	Research Department	$150,000
Computers, furniture, and equipment used by the Engineering Department	Engineering Department	$100,000
Computers and furniture used by the Legal Department	Legal Department	$20,000

In addition to interest on debt used to finance operations and research and costs specific to the Manufacturing, Personnel, and Accounting Departments, Company A incurs the following costs during its 2023 taxable year:

Description	**Department(s)**	**Total Cost**
Materials and supplies used exclusively for the research project	Research Department	$50,000
Materials and supplies used by the Engineering Department	Engineering Department	$40,000
Materials and supplies used by the Legal Department	Legal Department	$10,000

Labor costs of Research Department employees and their direct supervisor, each of which spends 100% of their time on the research project	Research Department	$600,000
Labor costs of all Engineering Department employees, each of which spends 20% of their time on the research project	Engineering Department	$200,000
Labor costs of all Legal Department employees, each of which spends 10% of their time on the research project	Legal Department	$100,000
Electricity for the facility	The Research Department and the Manufacturing Department consume large amounts of electricity relative to the other departments. The Research Department uses 100,000 kilowatt-hours of electricity. The Manufacturing Department uses 220,000 kilowatt-hours of electricity. The other departments each use 20,000 kilowatt-hours of electricity.	$200,000
Other utilities and overhead costs for the facility	All departments benefit from such costs in proportion to square footage occupied	$100,000
Other miscellaneous overhead costs incurred by the Research Department	Research Department	$50,000
Other miscellaneous overhead costs incurred by the Engineering Department	Engineering Department	$50,000
Other miscellaneous overhead costs incurred by the Legal Department	Legal Department	$50,000

(b) Analysis. Pursuant to section 4.03(1) of this notice, Company A determines that the costs described in the tables in section 4.03(4)(a) are the types of costs that are incident to SRE activities described in section 4.02(4) of this notice. Pursuant to section

4.03(2)(a) of this notice, Company A determines that the costs incurred by the Manufacturing, Personnel, and Accounting Departments are not treated as SRE expenditures because the activities of those departments are not SRE activities and such costs either do not, or only indirectly, support or benefit SRE activities. Similarly, pursuant to section 4.03(2)(b) of this notice, Company A determines that interest on debt used to finance operations and research is not treated as an SRE expenditure. Pursuant to section 4.03(3) of this notice, Company A determines its total SRE expenditures for 2023 by allocating the costs described in the tables in section 4.03(4)(a) of this notice to its SRE activities 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 the benefits provided to the SRE activities as provided in the following table. This allocation method generally relates the costs described in the tables in section 4.03(4)(a) of this notice to SRE activities on the basis of total labor hours spent on such activities; however, for certain costs, Company A determines that a different allocation method more appropriately relates the costs to the benefits that they provide to the SRE activities, such as an allocation method based on the relative square footage of each department. As noted in section 4.03(4)(a), employees in the Research Department spent 100% of their time on SRE activities, employees in the Engineering Department spent 20% of their time on SRE activities, and employees in the Legal Department spent 10% of their time on SRE activities.

Description	**Allocation Method**	**Amount of SRE Expenditure**
Depreciation on facility - $200,000	Research Department: $20,000 ($200,000 × 1,000/10,000 square feet × 100% of time spent by Research Department on research project) + Engineering Department: $4,000 ($200,000 × 1,000/10,000 square feet × 20% of time spent by Engineering Department on research project) + Legal Department: $2,000 ($200,000 × 1,000/10,000 square feet × 10% of time spent by Legal Department on research project)	$26,000
Depreciation on computers, furniture, and equipment used by the Research Department exclusively for the research project - $150,000	$150,000 × 100% use for research project	$150,000
Depreciation on computers, furniture and equipment used by the Engineering Department - $100,000	$100,000 × 20% of time spent by Engineering Department employees on the research project	$20,000
Depreciation on computers and furniture used by the Legal Department - $20,000	$20,000 × 10% of time spent by Legal Department employees on the research project	$2,000
Materials and supplies used exclusively by the Research Department for the research project - $50,000	$50,000 × 100% use for research project	$50,000
Materials and supplies used by the Engineering Department - $40,000	$40,000 × 20% of time spent by Engineering Department employees on the research project	$8,000

Materials and supplies used by the Legal Department - $10,000	$10,000 × 10% of time spent by Legal Department employees on the research project	$1,000
Labor costs of Research Department employees and their direct supervisor - $600,000	$600,000 × 100% of time spent by Research Department employees on the research project	$600,000
Labor costs of Engineering Department employees - $200,000	$200,000 × 20% of time spent by Engineering Department employees on the research project	$40,000
Labor costs of Legal Department employees - $100,000	$100,000 × 10% of time spent by Legal Department employees on the research project	$10,000
Electricity for the facility - $200,000	Research Department $50,000 ($200,000 × 100,000/400,000 kilowatt-hours used for research project) + Engineering Department $2,000 ($200,000 × 20,000/400,000 kilowatt-hours used by Engineering Department × 20% of time spent by Engineering Department employees on the research project) + Legal Department $1,000 ($200,000 × 20,000/400,000 kilowatt-hours used by Legal Department × 10% of time spent by Legal Department employees on research project)	$53,000

Other utilities and overhead costs for the facility - $100,000	Research Department $10,000 ($100,000 × 1,000/10,000 square feet × 100% of time spent by Research Department on research project) + Engineering Department $2,000 ($100,000 × 1,000/10,000 square feet × 20% of time spent by Engineering Department on research project) + Legal Department $1,000 ($100,000 × 1,000/10,000 square feet × 10% of time spent by Legal Department on research project)	$13,000
Other miscellaneous overhead costs incurred by the Research Department - $50,000	$50,000 × 100% of time spent by Research Department employees on the research project	$50,000
Other miscellaneous overhead costs incurred by the Engineering Department - $50,000	$50,000 × 20% of time spent by Engineering Department employees on the research project	$10,000
Other miscellaneous overhead costs incurred by the Legal Department - $50,000	$50,000 × 10% of time spent by Legal Department employees on the research project	$5,000
Total SRE Expenditures		**$1,038,000**

.04 Consistency requirement. SRE expenditures must be treated consistently for purposes of all provisions under subtitle A of the Code (subtitle A). Thus, expenditures that are defined as SRE expenditures under section 4.02(2) of this notice must be treated as SRE expenditures for all purposes under subtitle A. Such expenditures may not be treated as ordinary and necessary expenses under § 162 or capitalized under § 195, § 263(a), § 263A, or § 471. The amortization deductions arising from such SRE

expenditures must also be allocated and apportioned consistent with the rules under §§ 1.861-8 and 1.861-17.

SECTION 5. SOFTWARE DEVELOPMENT

.01 Purpose. The Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations consistent with the interim guidance provided in this section 5, which provides taxpayers with clarity in determining whether certain activities constitute software development for purposes of § 174(c)(3).

.02 Defined terms. For purposes of this notice:

(1) Computer software. The term computer software generally means 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. The code may be stored on a computing device, affixed to a tangible medium (for example, a disk or DVD), or accessed remotely via a private computer network or the Internet, for example, via cloud computing. Computer software generally includes system software, programming software, application software, embedded software, and all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer software also generally includes computer programs of all classes, for example, operating systems, executive systems, software monitors, compilers and translators, assembly routines, and utility programs as well as application programs.

Computer software includes a computer program, a group of programs, and upgrades and enhancements (as defined in section 5.02(2) of this notice). Computer software also includes any incidental and ancillary rights that are necessary to effect the

acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Computer software includes software developed for use by the taxpayer in its trade or business or for sale or licensing to others. Computer software does not include any data or information base described in § 1.197-2(b)(4) unless the database or item is in the public domain and is incidental to a computer program. For example, customer lists or client files are not included in computer software unless such items are in the public domain and incidental to a computer program. Additionally, computer software does not include any procedures that are external to the computer's operation.

(2) Upgrades and enhancements. 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 speed or efficiency of the software.

.03 Activities that are treated as software development. Activities that are treated as software development for purposes of § 174 generally include but are not limited to:

(1) Planning the development of the computer software (or the upgrades and enhancements to such software), including identification and documentation of the software requirements;

(2) Designing the computer software (or the upgrades and enhancements to such software);

(3) Building a model of the computer software (or the upgrades and enhancements to such software);

(4) Writing source code and converting it to machine-readable code;

(5) Testing the computer software (or the upgrades and enhancements to such software) and making necessary modifications to address defects identified during testing, but only up until the point in time that:

(a) In the case of computer software developed for use by the taxpayer in its trade or business, the computer software is placed in service; and

(b) In the case of computer software developed for sale or licensing to others, technological feasibility has been established, product masters(s) have been produced, and the computer software is ready for sale or licensing to others; and

(6) In the case of computer software developed for sale or licensing to others (or the upgrades and enhancements to such software), production of the product master(s).

.04 Software development activities related to purchased computer software. In the case of upgrades and enhancements to purchased computer software, the principles set forth in section 5.03 of this notice apply. However, the purchase and installation of purchased computer software, including the configuration of pre-coded parameters to make such software compatible with the business and reengineering the business to make it compatible with the purchased software, and any planning, designing, modeling, testing, or deployment activities with respect to the purchase and installation of such software, are not activities that constitute software development for purposes of § 174.

.05 Activities that are not treated as software development. The following activities associated with software development projects are not treated as software development for purposes of § 174:

(1) Computer software developed by a taxpayer for use in its trade or business. In the case of computer software that is developed for use by the taxpayer in its trade or

business (or upgrades and enhancements to such software):

(a) Training employees and other stakeholders that will use the computer software;

(b) Maintenance activities after the computer software is placed in service that do not give rise to upgrades and enhancements (for example, corrective maintenance to debug, diagnose, and fix programming errors);

(c) Data conversion activities, except for activities to develop computer software that facilitate access to existing data or data conversion; and

(d) Installing the computer software and other activities relating to placing the computer software in service.

(2) Computer software developed for sale or licensing to others. In the case of computer software that is developed for sale or licensing to others (or upgrades and enhancements to such software), activities that occur after such software (or upgrades and enhancements to such software) is ready for sale or licensing to others, such as marketing and promotional activities, maintenance activities that do not give rise to upgrades and enhancements, distribution activities (for example, making the software available via remote access), and customer support activities.

SECTION 6. RESEARCH PERFORMED UNDER CONTRACT

.01 Purpose. The Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations consistent with the interim guidance provided in this section 6, which provides taxpayers with clarity in determining whether costs paid or incurred for research performed under contract are SRE expenditures under § 174.

.02 Defined terms. For purposes of this section 6:

(1) Research provider. The term research provider means the party that contracts with a research recipient (as defined in section 6.02(2) of this notice) to:

(a) perform research services for the research recipient with respect to an SRE product, or

(b) develop an SRE product (as defined in section 6.02(4) of this notice) that the research recipient acquires from the research provider.

(2) Research recipient. The term research recipient means the party that contracts with the research provider to:

(a) perform research services for the research recipient with respect to an SRE product, or

(b) develop an SRE product that the research recipient acquires from the research provider.

(3) Financial risk. The term financial risk means the risk that the research provider may suffer a financial loss related to the failure of the research to produce the desired SRE product.

(4) SRE product. The term SRE product means any pilot model, process, formula, invention, technique, patent, computer software, or similar property (or a component thereof) that is subject to protection under applicable domestic or foreign law. For example, mere know-how gained by a research provider through the performance of research services for a research recipient that is not subject to protection under applicable domestic or foreign law does not give rise to an SRE product in the hands of the research provider.

.03 Treatment of costs paid or incurred by research recipient. The treatment of costs

paid or incurred by the research recipient is governed by the principles set forth in § 1.174-2(a)(10) and (b)(3).

.04 Treatment of costs paid or incurred by research provider. If the research provider bears financial risk under the terms of the contract with the research recipient, then costs paid or incurred by the research provider that are incident to the SRE activities (see section 4.03 of this notice) performed by the research provider under the contract are SRE expenditures. However, even if the research provider does not bear financial risk under the terms of the contract with the research recipient, if the research provider has a right to use any resulting SRE product in the trade or business of the research provider or otherwise exploit any resulting SRE product through sale, lease, or license, then costs paid or incurred by the research provider that are incident to the SRE activities performed by the research provider under the contract are SRE expenditures of the research provider for which no deduction is allowed except as provided in § 174(a)(2), regardless of whether the research recipient is required to treat its costs as SRE expenditures under section 6.03 of this notice. For purposes of the preceding sentence, a research provider will not be treated as having a right to use the SRE product in the trade or business of the research provider or otherwise exploit the SRE product through sale, lease, or license if such right is available to the research provider only upon obtaining approval from another party to the research arrangement that is not related to the research provider within the meaning of § 267 or § 707.

.05 Example. The following example illustrates the rules set forth in section 6 of this notice.

(1) Facts. Company C engages Company D, a contractor located in the United

States, to develop an SRE product for use in Company C's trade or business. The activities undertaken by Company D are undertaken upon Company C's order, and Company D makes no performance guarantees with respect to the SRE product. Company C will pay Company D a fixed sum of $25,000 plus an amount equivalent to Company D's actual expenditures. Company D does not have any right to use or otherwise exploit any resulting SRE product. In 2023, Company D incurs $125,000 of expenditures to successfully develop the product in the United States, and Company C pays to Company D $150,000 pursuant to the terms of the contract.

(2) Analysis. Under section 6.04 of this notice, Company D may not treat the $125,000 of expenditures it incurs to develop the SRE product on behalf of Company C as SRE expenditures under § 174 because (i) Company D does not bear financial risk, and (ii) Company D does not have any right to use or otherwise exploit any resulting SRE product. Under section 6.03 of this notice, the $150,000 paid by Company C is an amount paid to another party for research or experimentation undertaken on Company C's behalf under § 1.174-2(a)(10) and (b)(3) and is thus an SRE expenditure under section 4.02(2) of this notice. The applicable § 174 amortization period is 5 years (60 months) because the research is performed by Company D in the United States. Company C's location is not relevant for determination of the applicable § 174 amortization period.

SECTION 7. DISPOSITION, RETIREMENT, OR ABANDONMENT OF PROPERTY

.01 Purpose. The Treasury Department and the IRS intend to propose rules in forthcoming proposed regulations consistent with the interim guidance provided in this section 7, which provides taxpayers with clarity in determining the treatment of

unamortized SRE expenditures if property with respect to which such expenditures are paid or incurred is disposed of, retired, or abandoned in certain transactions during the applicable § 174 amortization period.

.02 In general. Except as provided in section 7.04 of this notice, if any property with respect to which SRE expenditures are paid or incurred is disposed of, retired, or abandoned during the applicable § 174 amortization period, no recovery is allowed with respect to the unamortized SRE expenditures on account of such disposition, retirement, or abandonment, and the taxpayer that disposed of, retired, or abandoned such property continues to amortize such expenditures under § 174 over the remainder of the applicable § 174 amortization period. For purposes of this section 7, the term unamortized SRE expenditures means the amount of any SRE expenditures paid or incurred by the corporation (or its predecessor), less the amount of any amortization deductions previously allowed to the corporation (or its predecessor) under § 174.

.03 Transactions occurring before the midpoint of the taxable year. An amortization deduction is allowed under § 174 for SRE expenditures even if such expenditures relate to property that is disposed of, retired, or abandoned prior to the midpoint of the taxable year in which such expenditures are paid or incurred. Accordingly, such expenditures are subject to the rules in sections 7.02 and 7.04 of this notice.

.04 Transaction in which corporation ceases to exist.

(1) Transaction described in § 381(a). If a corporation ceases to exist for Federal income tax purposes in a transaction or series of transactions described in § 381(a), the acquiring corporation will continue to amortize the distributor or transferor corporation’s unamortized SRE expenditures over the remainder of the distributor or transferor

corporation's applicable § 174 amortization period beginning with the month of transfer.

(2) Transaction not described in § 381(a).

(a) In general. Except as provided in section 7.04(2)(b), if a corporation ceases to exist for Federal income tax purposes in a transaction or series of transactions to which § 381(a) does not apply, the corporation is allowed a deduction equal to the unamortized SRE expenditures in its final taxable year.

(b) Anti-abuse exception. Section 7.04(2)(a) of this notice does not apply if a principal purpose of the transaction(s) described in section 7.04(2)(a) of this notice is to claim a deduction for the unamortized SRE expenditures.

.05 Examples. The following examples illustrate the rules set forth in section 7 of this notice.

(1) Sale of property with respect to which SRE expenditures were incurred.

(a) Facts. Company X, an accrual method, calendar-year taxpayer, incurs $100,000 in SRE expenditures in 2023 for research performed in the United States. On September 30, 2025, Company X sells the property with respect to which such expenditures were incurred to Company Y and recognizes gain under § 1001.

(b) Analysis. In 2023, Company X amortizes $10,000 (10% × $100,000). See section 3.05 of this notice. In 2024, Company X amortizes $20,000 (20% × $100,000). In 2025 through 2028, Company X ratably amortizes the remaining $70,000 ($100,000 – $10,000 – $20,000) notwithstanding Company X's disposition of the assets with respect to which Company X's SRE expenditures were incurred. Company Y does not amortize any portion of the SRE expenditures originally paid or incurred by Company X. Company X does not factor its unamortized SRE expenditures into the computation of

gain or loss under § 1001. See section 7.02 of this notice.

	2023	**2024**	**2025**	**2026**	**2027**	**2028**
Company X amortization %	10%	20%	20%	20%	20%	10%
Company X Dollar amount	$10,000	$20,000	$20,000	$20,000	$20,000	$10,000

(c) Applicable asset acquisition. The results would be the same as in section 7.05(1)(b) of this notice if the sale of property with respect to which the SRE expenditures were incurred were part of an applicable asset acquisition within the meaning of § 1060(c).

(d) Section 351 exchange. The results would be the same as in section 7.05(1)(b) of this notice if X transferred the property with respect to which the SRE expenditures were incurred in an exchange described in § 351.

(2) Section 381 transaction.

(a) Facts. The facts are the same as in section 7.05(1)(a) of this notice, except that, on October 16, 2025, Company X is acquired by Company Z, an accrual method, calendar-year taxpayer, in a transaction described in § 381(a).

(b) Analysis. In 2023, Company X amortizes $10,000 (10% × $100,000). See section 3.05 of this notice. In 2024, Company X amortizes $20,000 (20% × $100,000). In 2025, Company X amortizes $15,000 ((9 months/12 months) × 20% × $100,000), and Company Z amortizes $5,000 ((3 months/12 months) × 20% × $100,000). See sections 3.06(1), 7.02, and 7.04(1) of this notice. In 2026 through 2028, Company Z ratably amortizes the remaining $50,000 ($100,000 – $10,000 – $20,000 – $15,000 – $5,000).

	2023	**2024**	**2025**	**2026**	**2027**	**2028**
Company X amortization %	10%	20%	15%	0%	0%	0%
Company Z amortization %	0%	0%	5%	20%	20%	10%
Company X Dollar amount	$10,000	$20,000	$15,000			
Company Z Dollar amount			$5,000	$20,000	$20,000	$10,000

SECTION 8. LONG-TERM CONTRACTS UNDER § 460

.01 Purpose. The Treasury Department and the IRS are providing this interim guidance to provide taxpayers with information about a proposed revision to the regulations under § 460 in forthcoming proposed regulations regarding how to apply the percentage-of-completion method (PCM) to account for income from long-term contracts when allocable contract costs include SRE expenditures.

.02 Background. Section 460(a) generally requires use of the PCM to account for taxable income from a long-term contract. Section 1.460-4(b)(2)(i) provides that under the PCM, the portion of the contract price a taxpayer must report in a tax year 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 purposes of the PCM. Under the PCM, a taxpayer generally deducts allocable contract costs as they are incurred. As provided by § 1.460-4(b)(2)(iv), an increase in the percentage of the contract price to be reported is matched by deduction of the incurred

costs that cause the increase. Under the current § 460 regulations in § 1.460-5(b)(2)(vi), allocable contract costs include research or experimental 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 current § 460 regulations were drafted when a taxpayer could deduct currently research or experimental expenses under former § 174. Section 174(a), as amended by the TCJA, requires that SRE expenditures be charged to capital account and deducted over the applicable § 174 amortization period. As a result, the current § 460 regulations provide that incurred research or experimental expenses increase the percentage of the contract price required to be reported, although § 174(a) prevents a corresponding current deduction of incurred SRE expenditures. The resulting mismatch of contract price and contract costs is inconsistent with the contemplated operation of the PCM.

.03 Treatment of SRE expenditures under § 460. The Treasury Department and the IRS anticipate issuing proposed regulations that would amend the existing § 460 regulations, including § 1.460-5(b)(2)(vi), to provide that the costs allocable to a long-term contract accounted for using the PCM include amortization of SRE expenditures under § 174(a)(2)(B), rather than the capitalized amount of such expenditures, and that such amortization is treated as incurred for purposes of determining the percentage of contract completion as deducted. The amendments would not apply to expenditures previously capitalized under § 59(e)(2)(B) or under former § 174(b), or to independent research and development expenditures, as defined in § 460(c)(5), which are not allocable contract costs. Research or experimental expenditures that are not

independent research and development expenditures, however, would remain subject to allocation under § 460(c)(1) regardless of whether they are SRE expenditures.

SECTION 9. COST SHARING REGULATIONS AT § 1.482-7

.01 Purpose. The Treasury Department and the IRS are providing this interim guidance to provide taxpayers with information about a proposed revision to § 1.482-7(j)(3)(i) in forthcoming proposed regulations.

.02 Background. Section 1.482-7(j)(3)(i) addresses cost sharing transaction payments (CST Payments) between controlled participants in a cost sharing arrangement (CSA) that are made to ensure that each controlled participant's share of intangible development costs (IDCs) is in proportion to its share of reasonably anticipated benefits from exploitation of the developed intangibles (RAB share). Section 1.482-7(j)(3)(i) generally provides that CST Payments reduce deductible IDCs borne by the controlled participant to which the CST Payments are owed. Any amount of CST Payment in excess of such deductible IDCs is treated as in consideration for the use of land and tangible property furnished for purposes of the CSA by the controlled participant to which the CST Payment is owed. CST Payments generally are considered the payor's costs of developing intangibles at the location where such development is conducted. See also § 1.482-7(j)(3)(iii), Example 1.

.03 Anticipated revisions to § 1.482-7(j)(3)(i).

(1) The Treasury Department and the IRS anticipate issuing proposed regulations that would replace the second through fourth sentences of § 1.482-7(j)(3)(i) with rules providing that CST Payments owed to a controlled participant reduce:

(a) The amount of the category of IDCs borne directly by that participant that are

required to be charged to capital account, and

(b) The amount of the category of IDCs borne directly by that participant that are not described in section 9.03(1)(a) of this notice and that are deductible.

(2) CST Payments not in excess of the payor's RAB share of the total amount of the IDCs in both categories described in section 9.03(1)(a) and (b) of this notice 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 in both categories described in section 9.03(1)(a) and (b) of this notice will be treated as income.

.04 Examples. The examples provided below illustrate the anticipated revisions to § 1.482-7(j)(3)(i).

(1) Example 1.

(a) Facts. 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 charged to capital account and amortized ratably over the 5-year applicable § 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 charged to capital account and amortized ratably over the 15-year

applicable § 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.

(b) Analysis. 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 charged to capital account by $20,000. Accordingly, USP is required to charge $80,000 to capital account, all of which is required to be amortized over 5 years, while FS is required to charge $120,000 to capital account, $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.

(2) Example 2.

(a) Facts. 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 charged to capital account and amortized ratably over the 5-year applicable § 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.

(b) Analysis. 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 charged to capital account 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 charged to capital account make up 50% of the combined amount of IDCs chargeable to capital account and the 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 IDCs chargeable to capital account, $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.

(3) Example 3.

(a) Facts. The facts are the same as in Example 1, except that the $100,000 of IDCs borne by USP consist of (1) $15,000 of IDCs incurred by USP in the United States that are required to be charged to capital account and amortized ratably over the 5-year applicable § 174 amortization period beginning with the midpoint of the taxable year in which such expenditures are paid or incurred, (2) $45,000 of deductible IDCs, and (3) $40,000 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.

(b) Analysis. 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 $15,000 of IDCs that are required to be charged to capital account and the $45,000 of deductible IDCs pro rata to the extent of FS's RAB share of such IDCs. Because the IDCs required to be charged to capital account make up 25% (that is, $15,000 / ($15,000 + $45,000)) of the combined amount of IDCs chargeable to capital account and deductible IDCs directly borne by USP, and because the deductible IDCs make up

75% (that is, $45,000 / ($15,000 + $45,000)) of the combined amount of IDCs chargeable to capital account and deductible IDCs directly borne by USP, 25% of the $20,000 CST Payment, or $5,000, reduces USP's IDCs chargeable to capital account, and 75%, or $15,000, reduces USP's deductible IDCs. Because all $20,000 of the CST Payment is applied against deductible IDCs directly borne by USP and IDCs incurred by USP that are chargeable to capital account, there is no amount of the CST Payment that is treated as income.

SECTION 10. APPLICABILITY DATES

.01 In general. It is anticipated that the forthcoming proposed regulations will provide that rules consistent with the rules described in sections 3 through 9 of this notice would apply for taxable years ending after September 8, 2023. Except as otherwise provided in this section 10.01, prior to the publication date of the forthcoming proposed regulations in the Federal Register, a taxpayer may choose to rely on the rules described in sections 3 through 9 of this notice, including for expenditures paid or incurred in taxable years beginning after December 31, 2021, provided the taxpayer relies on all the rules in sections 3 through 9 of this notice and applies them in a consistent manner. However, taxpayers may not rely on the rules in section 7 of this notice for SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership.

.02 Additional procedural guidance. The Treasury Department and IRS intend to issue guidance in the Internal Revenue Bulletin (see § 601.601(d) of the Procedural Rules) to provide procedures for taxpayers to obtain automatic consent to change methods of accounting to comply with this notice. Until the issuance of

such procedural guidance, taxpayers may rely on section 7.02 of Rev. Proc. 2023-24 to change their methods of accounting under § 174 to comply with this notice. The Treasury Department and IRS anticipate issuing updated procedures that will address situations in which taxpayers have, prior to the issuance of this notice, changed methods of accounting to comply with § 174 as amended by the TCJA but whose treatment of SRE expenditures is not entirely consistent with this notice. Unless specifically authorized by the Commissioner of Internal Revenue or by statute, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting by filing an amended return. See Rev. Rul. 90-38, 1990-1 C.B. 57; Rev. Rul. 2023-8, 2023-18 I.R.B. 801.

SECTION 11. REQUEST FOR COMMENTS

.01 Comments regarding guidance provided in this notice. The Treasury Department and the IRS request comments on issues arising from the interim guidance set forth in this notice. In addition to general comments regarding the provisions of this notice, the Treasury Department and the IRS request comments to address the following issues:

(1) Scope of § 174 (section 4 of this notice).

(a) Whether additional guidance is needed regarding identifying expenditures allocable to SRE activities and allocating such expenditures to SRE activities.

(b) Whether simplified methods or safe harbors should be provided for identifying expenditures allocable to SRE activities and allocating such expenditures to SRE activities. If so, what methods or safe harbors should be provided? Are special methods needed for government research contracts?

(2) Software development (sections 4 and 5 of this notice).

(a) The definition of computer software is based on section 2 of Rev. Proc. 2000-50 and § 1.197-2(c)(4)(iv). Is there a more appropriate definition under the Financial Accounting Standards Board Accounting Standards Codifications (ASCs) or an appropriate industry standard that should be used instead? If so, what ASC or industry standard definition should be used? Additionally, to what extent should ASC guidance or an appropriate industry standard be used to determine activities that are software development activities, and costs that are software development costs, for purposes of § 174?

(b) What examples of costs that are, or are not, software development costs would be helpful to include in the forthcoming proposed regulations?

(c) Are special rules and examples needed to determine what activities related to developing a website would be software development?

(3) Research performed under contract (section 6 of this notice).

(a) Should the rules for determining whether a party to a research contract has SRE expenditures under § 174 be similar to the funded research rules under § 41(d)(4)(H)?

(b) Are special rules needed for service or manufacturing production contracts with the government, including § 460 long-term contracts?

(c) Are there other factors that should be considered in determining whether a party to a research contract has SRE expenditures?

(d) Are special rules or safe harbors needed to determine if research performed under a contract is foreign research (for example, where a research recipient pays the research provider for research that is performed by the research provider both inside

and outside the U.S.)?

(e) Are special rules needed for contracts with related foreign research providers and recipients?

(4) Disposition, retirement, or abandonment of property (section 7 of this notice). What, if any, changes to the rules in section 7 of this notice are appropriate to address potential abuses?

(5) Long-term contracts under § 460 (section 8 of this notice). In the case of SRE expenditures allocable to long-term contracts accounted for under the PCM set forth in § 460, do estimated total allocable contract costs include all SRE expenditures that directly benefit or are incurred by reason of the performance of the long-term contract or, alternatively, only that portion of the SRE expenditures expected to be amortized during the term of the contract? Under the first alternative, a taxpayer would be required to report any remaining portion of the contract price not previously reported by the tax year following the tax year in which the contract is completed, notwithstanding that some portion of the SRE expenditures remain unamortized. See § 460(b)(1).

.02 Comments regarding rules not included in this notice. The Treasury Department and the IRS continue to study issues that are not addressed in this notice, including but not limited to whether the general requirements governing record retention under § 1.6001-1 are adequate for purposes of substantiating expenditures under § 174, whether the definition of “pilot model” under § 1.174-2(a)(4) should be amended, and whether and how § 59(e) applies to § 174 expenditures. In addition to requests for comments on these issues, the Treasury Department and the IRS request comments on the following specific issues not addressed by this notice:

(1) Under what circumstances should unamortized SRE expenditures continue to be amortized or accelerated with respect to property that is contributed to, distributed from, or transferred from a partnership?

(2) Under what circumstances should unamortized SRE expenditures 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 that otherwise terminates under § 708 and the regulations thereunder? Is there potential for abuse as a result of allowing a deduction for unamortized SRE expenditures in the final year of a partnership that liquidates or otherwise terminates? If so, what rules are appropriate to address such abuse?

(3) Should special rules apply to start-up companies or small taxpayers? If so, how should § 174 be applied in such cases?

(4) Sections 280C(c)(1)(B) and 56(b)(2)(A) each refer to an "amount allowable as a deduction" for qualified research expenses or basic research expenses (in the case of § 280C(c)(1)(B)), and § 174(a) (in the case of § 56(b)(2)(A)). On the one hand, § 174(a)(1) (as amended by the TCJA) does not allow a deduction for qualified research expenses or basic research expenses because such expenses are required to be charged to capital account. On the other hand, § 174(a)(2) allows an amortization deduction with respect to the capitalized amount of such expenses. Should the "amount allowable as a deduction" references in §§ 280C(c)(1)(B) and 56(b)(2)(A) be interpreted to refer to the amortization deduction allowed under § 174(a)(2) or to $0, which is the deduction allowed for the qualified research expenses or basis research expenses under § 174(a)(1)? The Treasury Department and IRS request comments on this

interpretation and how to resolve any potential issues that might arise by applying the same interpretation to both §§ 280C(c)(1)(B) and 56(b)(2)(A).

.03 Procedures for submitting comments.

(1) Deadline. Written comments should be submitted by November 24, 2023. Consideration will be given, however, to any written comment submitted after November 24, 2023, if such consideration will not delay the issuance of the forthcoming proposed regulations.

(2) Form and manner. The subject line for the comments should include a reference to Notice 2023-63. All commenters are strongly encouraged to submit comments electronically. However, comments may be submitted in one of two ways:

(a) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2023-0040 in the search field on the regulations.gov homepage to find this notice and submit comments); or

(b) By mail to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2023-63), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044.

(3) Publication of comments. The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket on www.regulations.gov.

SECTION 12. EFFECT ON OTHER DOCUMENTS

As a result of the TCJA amendments to § 174 and the rules in sections 3 through 5 of this notice, section 5 of Rev. Proc. 2000-50 is obsolete.

SECTION 13. DRAFTING AND CONTACT INFORMATION

The principal author of this notice is Bruce Chang of the Office of the Associate

Chief Counsel (Income Tax and Accounting). Other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, please contact Mr. Chang at (202) 317-4870 (not a toll-free number). For further information regarding corporate matters in section 7 of this notice, please contact Austin Diamond-Jones of the Office of Associate Chief Counsel (Corporate) at (202) 317-5085 (not a toll-free number). For further information regarding section 9 of this notice, please contact Annette Ofori of the Office of Associate Chief Counsel (International) at (202) 317-4910 (not a toll-free number).

After the Wait – IRS's Comprehensive Guidance on Section 174 Post TCJA

Edward K. Zollars, CPA (Arizona)
Monthly Tax Update
THOMAS, ZOLLARS & LYNCH, LTD.

1

1

THOMAS, ZOLLARS & LYNCH, LTD.

The Revenue Raiser (That Was Supposed to Be Repealed Before it Took Effect)

- In 2017 the at-risk Republican majority in both chambers sought to pass the Tax Cuts and Jobs Cut after the frustration of failing to repeal the Affordable Care Act
- However, to get the bill through the Senate, some Senators had a cap on the maximum scored spending for the bill

2

2

THOMAS, ZOLLARS & LYNCH, LTD.

The Revenue Raiser (That Was Supposed to Be Repealed Before it Took Effect)

- Such a problem confronted the Democrats in 2010 with the Affordable Care Act and they found a neat trick
  - To reduce the scored cost of the bill, they adopted a Cadillac tax on certain health plans that would take effect a number of years later
  - All members knew this provision would be very unpopular, but they also figured that meant it would get repealed before it took effect

3

3

THOMAS, ZOLLARS & LYNCH, LTD.

The Revenue Raiser (That Was Supposed to Be Repealed Before it Took Effect)

- Such a problem confronted the Democrats in 2010 with the Affordable Care Act and they found a neat trick
  - This trick worked - the Cadillac tax never took effect
  - When it was repealed, no one brought in a replacement revenue raiser
  - Congress likes reusing old tricks, so…

4

4

THOMAS, ZOLLARS & LYNCH, LTD.

The Revenue Raiser (That Was Supposed to Be Repealed Before it Took Effect)

- The §174 law change everyone hated - but it was included in the TCJA
  - Section 174 had always allowed full expensing of research expenditures
  - Would now be changed, beginning in 2022 (five years later) to require the expenses to be amortized over five years (15 for foreign research)
  - Raised a good bit of money (I know, it's just a timing issue, but we are looking at a 10 year scoring window)

5

5

THOMAS, ZOLLARS & LYNCH, LTD.

The Revenue Raiser (That Was Supposed to Be Repealed Before it Took Effect)

- Was on path to be repealed because, as expected, everyone hated it
  - Was included in the Build Back Better Act
  - However that bill stalled and cost was again a key objection
  - Was not part of the much slimmed down Inflation Reduction Act

6

6

THOMAS, ZOLLARS & LYNCH, LTD.

The Revenue Raiser (That Was Supposed to Be Repealed Before it Took Effect)

- The failure of later attempts
  - No agreement could be reached at the end of 2022 to bundle the provision
  - Attempts to remove it retroactively throughout 2023 all failed to gain traction
    - Congress has been distracted by other issues
    - Still no clear agreement on what it would need to be packaged with
  - Eventually, even the extended due dates arrived and the new §174 ended up on tax returns.

7

7

IRC §174(a)

(a) **In general.** In the case of a taxpayer's specified research or experimental expenditures for any taxable year —

(1) except as provided in paragraph (2), no deduction shall be allowed for such expenditures, and

(2) the taxpayer shall —

(A) charge such expenditures to capital account, and

(B) be allowed an amortization deduction of such expenditures ratably over the 5-year period (15-year period in the case of any specified research or experimental expenditures which are attributable to foreign research (within the meaning of section 41(d)(4)(F))) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.

8

8

IRC §174(b) - What Exactly Do We Amortize?

(b) **Specified research or experimental expenditures.** For purposes of this section, the term "specified research or experimental expenditures" means, with respect to any taxable year, research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.

Photo by Louis Reed on Unsplash

9

9

IRC §174(c)(3) The Software Issue

(c) **Special rules.**
…
(3) Software development. For purposes of this section, any amount paid or incurred in connection with the development of any software shall be treated as a research or experimental expenditure.

Photo by Louis Reed on Unsplash

10

10

IRC §174(d) Disposition

(d) **Treatment upon disposition, retirement, or abandonment.** If any property with respect to which specified research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, **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

Photo by Markus Spiske on Unsplash

11

11

THOMAS, ZOLLARS & LYNCH, LTD.

Historical Definitions

- Reg. §1.174-2 Definition of Research and Experimental Expenditures
  - Has contained more information on what are such expenditures (though not the software development costs added in by TCJA)
  - Most of the interest in this area has been driven by IRC §41 Credit for Increasing Research Activities
    - At §41(d)(1)(A), there are four criteria established for qualified research under IRC 41, all of which must be met
    - Section 174 is specifically referenced as one of the requirements

12

12

IRC §41(d)(1)

(d) **Qualified research defined.** For purposes of this section --

(1) In general. The term "qualified research" means research --

(A) with respect to which expenditures may be treated as specified research or experimental expenditures under section 174,

(B) which is undertaken for the purpose of discovering information--

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

Such term does not include any activity described in paragraph (4).

13

13

THOMAS, ZOLLARS & LYNCH, LTD.

Section 41's Interest in the Area

- Note that every expenditure that is §41 "qualified research" must be a §174 expense (and thus amortized) but…
- Not every §174 expenditure will be qualified research under IRC §41
- Thus, by the structure of the statute, Section 174 specified research expenditures
  - Must include every item that could qualify under §41 as qualified research but
  - Likely includes many other expenditures as well

14

14

Reg. §1.174-2(a)(1) - Definition of Research and Experimental Expenditures

(1) **Research or experimental expenditures defined.** The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent **research and development costs in the experimental or laboratory sense.** The term generally includes **all such costs incident to the development or improvement of a product**. The term includes the **costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.** Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities **intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.** Uncertainty exists if the information available to the taxpayer **does not establish the capability or method for developing or improving the product or the appropriate design of the product.** Whether expenditures qualify as research or experimental 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. **The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174.** Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

15

15

Reg. §1.174-2(a)(2) - Production Costs Generally Excluded

(2) Production costs. Except as provided in paragraph (a)(5) of this section (the rule concerning the application of section 174 to **components of a product**), **costs paid or incurred in the production of a product after the elimination of uncertainty** concerning the development or improvement of the product are not eligible under section 174.

16

16

Reg. §1.174-2(a)(3) - Product

(3) Product defined. For purposes of this section, t**he term product includes any pilot model, process, formula, invention, technique, patent, or similar property**, and **includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.**

17

17

Reg. §1.174-2(a)(4) - Pilot Model

(4) Pilot model defined. For purposes of this section, the term pilot model means **any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product.** The term includes a fully-functional representation or model of the product or, to the extent paragraph (a)(5) of this section applies, a component of the product.

18

18

Reg. §1.174-2(a)(5) - Components

(5) Application of section 174 to components of a product. If the requirements of paragraph (a)(1) of this section are not met at the level of a product (as defined in paragraph (a)(3) of this section), then whether expenditures represent research and development costs is **determined at the level of the component or subcomponent of the product.** The presence of uncertainty concerning the development or improvement of certain components of a product does not necessarily indicate the presence of uncertainty concerning the development or improvement of other components of the product or the product as a whole. The rule in this paragraph (a)(5) is not itself applied as a reason to exclude research or experimental expenditures from section 174 eligibility.

19

19

Reg. §1.174-2(a)(6) - Exclusions

(6) Research or experimental expenditures -- exclusions. The term research or experimental expenditures does not include expenditures for--

(i) The ordinary testing or inspection of materials or products for quality control (quality control testing);

(ii) Efficiency surveys;

(iii) Management studies;

(iv) Consumer surveys;

(v) Advertising or promotions;

(vi) The acquisition of another's patent, model, production or process; or

(vii) Research in connection with literary, historical, or similar projects.

20

20

Reg. §1.174-2(a)(9) - Limited to Reasonable Amounts

(9) Research or experimental expenditures limited to reasonable amounts. Section 174 applies to a research or experimental expenditure **only to the extent that the amount of the expenditure is reasonable under the circumstances.** In general, the amount of an expenditure for research or experimental activities is reasonable **if the amount would ordinarily be paid for like activities by like enterprises under like circumstances.** Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as d**isguised dividends, gifts, loans, or similar payments.** The reasonableness requirement of this paragraph (a)(96) does not apply to the reasonableness of the type or nature of the activities themselves.

21

21

Reg. §1.174-2(a)(10) - Amounts Paid to Others

(10) Amounts paid to others for research or experimentation. The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). **However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174 relates,** to the extent that they represent **expenditures for the acquisition or improvement of land or depreciable property**, used in connection with the research or experimentation, **to which the taxpayer acquires rights of ownership.**

22

22

THOMAS, ZOLLARS & LYNCH, LTD.

Why Those Rules Matter

- There was no indication that Congress meant to change the long-standing definitions of research and experimental expenditures in IRC §174 - simply used identical language
- Unfortunately, many had spent years attempting to expand that definition to maximize §41 research credits
  - So we are researching with an opposite view - we want to show why our expenditures are like ones the IRS prevailed on in a §41 case
  - But remember we need to be consistent with prior positions the taxpayer has taken, otherwise the taxpayer may be whipsawed

23

23

THOMAS, ZOLLARS & LYNCH, LTD.

IRS Finally Issues Guidance

- The IRS had not issued any guidance related to new §174 following the passage of TCJA until September of 2023 except for a basic accounting method change provision
- Appears the IRS was betting this would never become law, so guidance would be a waste of time
- On September 8 (one week before the extended returns for the first affected passthroughs were due) the IRS broke their silence with Notice 2023-63

24

24

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63

- IRC §174 was changed in the Tax Cuts & Jobs Act in 2017 to require amortization of
  - Research & experimental expenditures
  - Software development costs (new)
- Amortization over
  - 5 years for domestic expenditures
  - 15 years for foreign expenditures
- Effective for **tax years beginning** after December 31, 2021

25

25

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope of Guidance

- Does not apply to years beginning before January 1, 2022
- But is expected to apply for §41 credit for increasing research activities to the extent it defines research & experimental expenditures
  - The IRS is making it clear that they aren't going to take kindly to taxpayers who attempt to change positions after claiming §41 credits on certain expenditures in the past
  - Similarly, any expenditure being claimed for a §41 credit should be shown as being amortized under §174

26

26

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63

- Outlines what is expected to be contained in proposed regulations to be released
- In the interim, taxpayers may rely upon the guidance in the Notice (that is, the IRS will not challenge a position consistent with the Notice)
- Not sure if we will ever see these regulations issued
  - IRS may still be hoping this gets repealed, if not retroactively then at least going forward
  - There is precedent with the lack of such regulations promised in Notice 2020-75 for the passthrough entity tax

27

27

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63

- Interprets key provisions of TCJA, with two of major focus with special guidance
  - Section 13206(a) of the TCJA - amortization and cannot be taken into account due to dispositions and adds software development
  - Section 13206(b) of the TCJA - change of accounting method with cut-off treatment (Rev. Proc. 2023-11 contains procedure to obtain required consent)

28

28

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Capitalization Provisions

- SRE - stands for “Specified Research Activities” in the Notice
- Must amortize SREs ratably over the correct amortization period
  - Beginning with the midpoint of the taxable year in which expenditures are paid or incurred
  - Regardless of when the expenses are actually incurred or paid during the year (Notice Section 3.02)

29

29

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Capitalization Provisions

- Foreign research - any research conducted outside the United States, the Commonwealth of Puerto Rico, or any U.S. territory or other possession of the United States (Section 3.03)
- Must look to where SRE activities are performed to determine whether the corresponding SRS expenditures are attributable to foreign research (Section 3.04)

30

30

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Capitalization Provisions

- Midpoint definition
  - Generally first day of seventh month of tax year (so July 1 for 12-month calendar years is the date the property is placed in service.
    - This creates a mid-year convention for the year the asset is placed in service
    - A standard straight line deduction over the next 4 (or 14) years
    - Another ½ year in the 6th or 16th year
  - For short years, midpoint is different for months with even or odd number of months
    - Even number of months - Divide number of months by two and add one
    - Odd number of months - Month with an equal number of months before and after the month

31

31

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Capitalization Provisions

Facts. Taxpayer is a **calendar-year taxpayer** that **incorporated and began operations on October 17, 2022**. In 2022, Taxpayer paid or incurred $60,000 in SRE expenditures that were not attributable to foreign research. Taxpayer has no short taxable years after its initial taxable year.

Analysis. Taxpayer has a short taxable year that begins on October 17, 2022, and ends on December 31, 2022, and thus is treated as having a **three-month taxable year** under section 3.06(1) of this notice. The midpoint month is November, and thus **November 1, 2022, will be treated as the midpoint** under section 3.06(2) of this notice. In 2022, Taxpayer amortizes $2,000 of SRE expenditures (**$60,000 ÷ 60 months × 2 months)**. In taxable years 2023 through 2026, each a full 12-month taxable year, Taxpayer amortizes $12,000 **($60,000 ÷ 60 months × 12 months)** each year, or $48,000 total. In 2027, Taxpayer amortizes the remaining $10,000 **($60,000 ÷ 60 months × 10 months)**.

32

32

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- Terms have the same meaning as is found in Reg. §1.174-2 and **product** has the meaning found in Reg. §1.174-2(a)
- **SRE expenditures** - research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.

33

33

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Research and experimental expenditures** - expenditures that
  - Satisfy the requirements under §1.174-2 to be research or experimental expenditures, or
  - Are paid or incurred in connection with the development of any computer software regardless of whether such expenditures are research or experimental expenditures under §1.174-2.

34

34

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **SRE activities** -
  - Software development activities or
  - Research or experimental activities described in §1.174-2 (that is, activities in the experimental or laboratory sense intended to discover information that would eliminate uncertainty concerning the development or improvement or appropriate design of a product or a component or subcomponent of a product)

35

35

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Identification and allocation of SRE activities** -
  - Non-exhaustive list of includable costs (subject to allocation)
    - **Labor costs** - includes all elements of compensation
    - **Materials and supply costs** - Costs of materials and supplies, including tools and equipment that are not depreciable under §168, which are used or consumed in the performance of SRE activities or in the direct support of SRE activities.
    - **Cost recovery allowances** - Depreciation, amortization, or depletion 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 in a taxable year that begins on or before December 31, 2021.

36

36

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Identification and allocation of SRE activities** -
  - Non-exhaustive list of includable costs (subject to allocation)
    - **Patent costs** - Costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application.
    - **Certain operation and management costs** - Rent, utilities, insurance, taxes, repairs and maintenance costs, security costs, and similar overhead costs with respect to facilities, equipment and other assets used in the performance of SRE activities or in the direct support of SRE activities.

37

37

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Identification and allocation of SRE activities** -
  - Non-exhaustive list of includable costs (subject to allocation)
    - **Travel costs** - Travel costs for the performance of SRE activities or the direct support of SRE activities.

38

38

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Identification and allocation of SRE activities** -
  - Costs not treated as SRE activities
    - Costs paid or incurred by general and administrative service departments (or functions) that only indirectly support or benefit SRE activities (for example, services of payroll personnel in preparing salary checks of research personnel, services of human resources personnel who hire research personnel, or services of accounting personnel who account for research expenses);
    - Interest on debt to finance SRE activities;
    - Costs excluded from software development costs found later in the notice
    - Costs to input content into a website;

39

39

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Identification and allocation of SRE activities** -
  - Costs not treated as SRE activities
    - 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 listed in §1.174-2(a)(6)(i)-(vii) (the original 174 definition regulation discussed earlier in this session)
    - Amounts representing amortization of SRE expenditures; and
    - Amounts representing amortization of research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022.

40

40

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Scope (Section 4)

- **Allocation method**
  - Must allocate costs (including those mentioned specifically as SRE expenditures) to SRE activities 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 the benefits provided to the SRE activities.
  - Can have different methods for different activities, but must apply methods consistently from year to year
  - Do not assume allocation used for §174 will be treated as appropriate under other provisions of the Code
  - Example at 4.03(4) has a number of specific expenses and allocations

41

41

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- **Computer software** - 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.
- **Upgrades and enhancements** - 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 speed or efficiency of the software.

42

42

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- Activities that are treated as software development:
  - Planning the development of the computer software (or the upgrades and enhancements to such software), including identification and documentation of the software requirements;
  - Designing the computer software (or the upgrades and enhancements to such software);
  - 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;

43

43

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- Activities that are treated as software development:
  - Testing the computer software/upgrades and enhancements and making necessary modifications to address defects identified during testing, but only up until the point in time that:
    - In the case of computer software developed for use by the taxpayer in its trade or business, the computer software is placed in service; and
    - In the case of computer software developed for sale or licensing to others, technological feasibility has been established, product masters(s) have been produced, and the computer software is ready for sale or licensing to others;

44

44

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- Activities that are treated as software development:
  - In the case of computer software developed for sale or licensing to others (or the upgrades and enhancements to such software), production of the product master(s).

45

45

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- Software development activities related to purchased computer software.
  - Principles set forth on the immediately preceding slides apply in this case as well but
  - The purchase and installation of purchased computer software, including the configuration of pre-coded parameters to make such software compatible with the business and reengineering the business to make it compatible with the purchased software, and any planning, designing, modeling, testing, or deployment activities with respect to the purchase and installation of such software, are not activities that constitute software development for purposes of §174.

46

46

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- Activities that are not treated as software development - Computer software developed by a taxpayer for use in its trade or business.
  - Training employees and other stakeholders that will use the computer software;
  - Maintenance activities after the computer software is placed in service that do not give rise to upgrades and enhancements;
  - Data conversion activities, except for activities to develop computer software that facilitate access to existing data or data conversion; and
  - Installing the computer software and other activities relating to placing the computer software in service.

47

47

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Software Development (Section 5)

- Activities that are not treated as software development - Computer software developed for sale or licensing to others
  - Activities that occur after such software (or upgrades and enhancements to such software) is ready for sale or licensing to others
  - Such activities include marketing and promotional activities, maintenance activities that do not give rise to upgrades and enhancements, distribution activities (for example, making the software available via remote access), and customer support activities.

48

48

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

- **Research provider** - the party that contracts with a research recipient to
  - 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.
- **Research recipient** - the party that contracts with the research provider to
  - 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.
- Key issue is who has to capitalize costs under §174?

49

49

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

- **Financial risk** - the risk that the research provider may suffer a financial loss related to the failure of the research to produce the desired SRE product.
- **SRE product** - any pilot model, process, formula, invention, technique, patent, computer software, or similar property (or a component thereof) that is subject to protection under applicable domestic or foreign law.

50

50

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

- **Treatment by the research recipient** - governed by the principles set forth in §1.174-2(a)(10) and (b)(3) (prior guidance mainly referenced in §41 issues previously)

51

51

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

- **Treatment of costs paid or incurred by research provider** -
  - If the research provider bears financial risk under the terms of the contract with the research recipient, then costs paid or incurred by the research provider that are incident to the SRE activities

52

52

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

- **Treatment of costs paid or incurred by research provider** -
  - Even if the research provider does not bear financial risk under the terms of the contract with the research recipient, if
    - The research provider has a right to use any resulting SRE product in the trade or business of the research provider or
    - Otherwise exploit any resulting SRE product through sale, lease, or license, then costs paid or incurred by the research provider that are incident to the SRE activities performed by the research provider under the contract are SRE expenditures of the research provider

53

53

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

Facts. Company C engages **Company D, a contractor** located in the United States, to develop an SRE product for use in Company C's trade or business. The activities undertaken by Company D are undertaken upon Company C's order, and **Company D makes no performance guarantees with respect to the SRE product.** Company C will pay Company D a fixed sum of $25,000 plus an amount equivalent to Company D's actual expenditures. **Company D does not have any right to use or otherwise exploit any resulting SRE product.** In 2023, Company D incurs $125,000 of expenditures to successfully develop the product in the United States, and Company C pays to Company D $150,000 pursuant to the terms of the contract.

54

54

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Research Performed Under Contract (Section 6)

Analysis. Under section 6.04 of this notice, **Company D may not treat** the $125,000 of expenditures it incurs to develop the SRE product on behalf of Company C **as SRE expenditures** under §174 because (i) Company D does not bear financial risk, and (ii) Company D **does not have any right to use or otherwise exploit any resulting SRE product.** Under section 6.03 of this notice, the $150,000 paid by **Company C** is an amount paid to another party for research or experimentation undertaken on Company C's behalf under §1.174-2(a)(10) and (b)(3) and **is thus an SRE expenditure** under section 4.02(2) of this notice. The applicable §174 amortization period is 5 years (60 months) because the research is performed by Company D in the United States. Company C's location is not relevant for determination of the applicable §174 amortization period.

55

55

THOMAS, ZOLLARS & LYNCH, LTD.

Notice 2023-63 - Disposition, Retirement or Abandonment of Property (Section 7)

- Disposition, retirement or abandonment of property
  - Generally cannot write off balance by claiming related property is worthless or otherwise disposed of
  - Special rule if corporation ceases to exist
    - If transaction covered by §381(a) (tax free corporate reorganizer), then successor continues to amortize the costs (just as under the general rule) but
    - If the transaction is not covered by §381(a) (normally the corporation is being liquidated or otherwise ceases to exist in a taxable transaction)
      - Generally the taxpayer can write off the balance but
      - Cannot write off, though, if violate anti-abuse rule (transaction motivated solely to accelerate the write-off)

56

56

THOMAS, ZOLLARS & LYNCH, LTD.

Additional Special Rules

- **Long-term contracts** - Percentage of Completion Method will include only amortization of costs under §174(a) in the costs of the contract (not the entire amount as under prior la)
- **Cost sharing arrangements under Reg. §1.482-7** - the IRS will revise regulations to require §174 costs to be allocated in accordance with expected benefits

57

57

THOMAS, ZOLLARS & LYNCH, LTD.

Applicability Dates and Change of Methods

- Regulations expect to apply to years ending after September 8, 2023
- Generally taxpayers can rely on the rules provided in the Notice except for rules in section 7 (disposition) of the notice for SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership

58

58

THOMAS, ZOLLARS & LYNCH, LTD.

Applicability Dates and Change of Methods

- Change of accounting method automatic permission
  - IRS expects to issue revised guidance but
  - Can continue to use existing Rev. Proc. until updated guidance is issued

59

59

After the Wait – IRS's Comprehensive Guidance on Section 174 Post TCJA

Edward K. Zollars, CPA (Arizona)
Monthly Tax Update

THOMAS, ZOLLARS & LYNCH, LTD.

edzollars@thomaszollarslynch.com

60

60