

IRS Issues Interim Guidance on Specified Research or Experimental Expenditures

Alert

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The Internal Revenue Service (IRS) recently announced in [Notice 2023-63](#) (notice) that proposed regulations regarding specified research or experimental (SRE) expenditures would be forthcoming. Until then, taxpayers may rely on the interim guidance provided in the notice, which applies to expenditures paid or incurred on January 1, 2022 or later.

The notice addresses three specific issues related to SRE expenditures:

1. Capitalization and amortization of SRE expenditures under Internal Revenue Code (Code) § 174, as amended by the Tax Cuts and Jobs Act (TCJA).
2. Treatment of SRE expenditures under Code § 460, "percentage of completion method."
3. Application of Code § 482, addressing the allocation of income and deductions among taxpayers, to cost sharing arrangements involving SRE expenditures.

The notice defines SRE expenditures as research or experimental expenditures paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business. "Research or experimental expenditures" are expenditures that either: (1) satisfy Treasury Regulation § 1.174-2; or (2) are paid or incurred in connection with computer software development. Treasury Regulation § 1.174-2(a)(1) defines "research and experimental expenditure" as 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 costs incident to the development or improvement of a product, its component or subcomponent, as well as costs of obtaining a patent. The notice provides guidance in determining whether costs paid or incurred for research performed under a contract are within the definition of SRE expenditures and clarifies whether certain activities constitute software development.

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TCJA amended Code § 174 to require taxpayers to charge SRE expenditures to a capital account and amortize ratably over five years for domestic research and 15 years for foreign research. The notice explains that amortization should begin with the midpoint of the taxable year in which such expenditures are paid or incurred and clarifies how to determine the midpoint for a short taxable year.

If the property is disposed of, retired, or abandoned, no recovery is generally allowed for the unamortized SRE expenditures, and the taxpayer continues to amortize such expenditures for the remainder of the amortization period. However, if a corporation ceases to exist pursuant to Code § 381(a), the acquiring corporation will continue to amortize the distributor or transferor corporation's unamortized SRE expenditures over the remainder of the amortization period beginning with the month of the transfer. If a corporation ceases to exist but § 381(a) does not apply, the corporation is allowed a deduction for the unamortized SRE expenditures in its final taxable year. These rules do not apply to property contributed to, distributed from, or transferred from a partnership.

While the notice primarily focuses on Code § 174, it also provides interim guidance on Code § 460 regarding the application of the "percentage of completion method" to account for income from long-term contracts when allocable contract costs include SRE expenditures. In addition, the notice addresses Code § 482 related to cost sharing transaction payments and provides interim guidance to ensure that participants' respective shares of intangible development costs are proportional to their respective shares of anticipated benefits from exploitation of developed intangibles. As explained above, taxpayers may rely on this interim guidance until the IRS publishes proposed regulations.

For more information on IRS Notice 2023-63, please contact [Charley Jensen](#), [Molly Maurin](#), [Tom Molins](#), [Jay Simpson](#) or the Stinson LLP contact with whom you regularly work.

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