May 10, 2023

The Honorable Lily Batchelder Assistant Secretary for Tax Policy Department of the Treasury 1500 Pennsylvania Avenue, NW Washington, DC 20220	Mr. William Paul Principal Deputy Chief Counsel Internal Revenue Service 1111 Constitution Avenue, NW Washington, DC 20224

RE: Comments on Rev. Proc. 2023-11 – Automatic Change to Required Section 174 Method

Dear Ms. Batchelder and Mr. Paul:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to publish Rev. Proc. 2023-11, which provides guidance for taxpayers changing their method of accounting for specified research or experimental expenditures to comply with section[1] 174. Rev. Proc. 2023-11 generally permits taxpayers to file a statement in lieu of a Form 3115 to obtain automatic consent to change to the required section 174 method (as defined in Section 7.02(1)(b) of the revenue procedure) for specified research or experimental expenditures (as defined in section 174(b)) paid or incurred in taxable years beginning after December 31, 2021.

The AICPA is requesting that Treasury and the IRS issue additional guidance for certain accounting method changes related to specified research or experimental expenditures required to be capitalized under section 174 ("section 174 R&E expenditures"). As explained further below, additional guidance is needed to:

1. Clarify that taxpayers currently capitalizing section 174 R&E expenditures to inventory may remove capitalized section 174 R&E expenditures from inventory when changing to the required section 174 method under Rev. Proc. 2023-11.
2. Allow taxpayers to file a Form 3115 to make an automatic method change to defer intercompany profit under Treas. Reg. § 1.1502-13 when one member of a consolidated group performs research and experimental services for another member of the consolidated group that capitalizes the section 174 R&E expenditures related to those services.

[1] Unless otherwise indicated, all references to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and references to a "Treas. Reg. §" are to the Treasury regulations promulgated under the Code.

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SPECIFIC COMMENTS

1. Section 174 R&E Expenditures Capitalized to Inventory

Overview

In an effort to identify section 174 R&E expenditures to comply with section 174[2] for amounts paid or incurred in taxable years beginning after December 31, 2021, although the majority of taxpayers are generally changing from a current expensing method, many taxpayers have also inadvertently capitalized section 174 R&E expenditures to inventory under the uniform capitalization ("UNICAP") rules provided in section 263A. Taxpayers have capitalized these section 174 R&E expenditures either as section 471 costs (because the section 174 R&E expenditures are capitalized to inventory in a taxpayer's financial statements)[3] or as additional section 263A costs (including capitalizable mixed service costs), even though section 174 R&E expenditures are not required to be capitalized under section 263A.[4]

Rev. Proc. 2023-11 could be interpreted to permit taxpayers to remove section 174 R&E expenditures from inventory as a corollary adjustment, but this interpretation is not free from doubt. As a result, for taxable years beginning after December 31, 2021, a taxpayer that capitalizes section 174 R&E expenditures to inventory under its present method of accounting may be required to capitalize the amortization of section 174 R&E expenditures to inventory after making the method change to capitalize and amortize section 174 R&E expenditures, unless the taxpayer files a separate method change to remove section 174 R&E expenditures from inventory. However, a change to remove capitalized costs from inventory is typically considered a UNICAP method change, and the automatic UNICAP method changes provided in Rev. Proc. 2022-14 do not permit a change to remove capitalized costs from inventory unless the taxpayer is also changing to a UNICAP method specifically described in the regulations under section 263A.[5] Even if a taxpayer could remove section 174 R&E expenditures from inventory by filing an automatic method change to a UNICAP method specifically described in the regulations under section 263A, this may not be desirable. Furthermore, many affected taxpayers have filed a UNICAP method change within the five taxable years ending with their first taxable year beginning after December 31, 2021, in order to comply with the section 263A regulations that were published on November 20, 2018. Therefore, these taxpayers currently would not be eligible to file a UNICAP method change due to the five-year eligibility rule in Section 5.01(1)(f) of Rev. Proc. 2015-13.

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[2] As amended by Section 13206 of Public Law 115-97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA).
[3] See Treas. Reg. § 1.263A-1(d)(2).
[4] See section 263A(c)(2), Treas. Reg. § 1.263A-1(b)(9), and Treas. Reg. § 1.263A-1(e)(3)(iii)(B).
[5] Under Sections 12.01 and 12.02 of Rev. Proc. 2022-14, taxpayers may change to a UNICAP method specifically described in the regulations under section 263A, including any necessary changes in the identification of costs subject to section 263A that will be accounted for using the proposed method.

Section 7.01 of Rev. Proc. 2022-14 previously provided an automatic method change for a taxpayer that is changing from a method of treating research and experimental expenditures under any provision of the Code other than section 174 to the method of treating such expenditures under section 174 and the regulations thereunder. This change is made on a cut-off basis (with no section 481(a) adjustment). However, this automatic method change applies only for taxable years beginning before December 31, 2021, so taxpayers cannot file an automatic method change under Section 7.01 of Rev. Proc. 2022-14 to change from a method of capitalizing section 174 R&E expenditures to inventory to a method of accounting for such expenditures under section 174 for taxable years beginning after December 31, 2021.

Recommendation

The automatic change to the required section 174 method under Rev. Proc. 2023-11 could be interpreted to apply to all taxpayers, regardless of the present method of accounting for section 174 R&E expenditures. However, this interpretation is not certain, so we are requesting Treasury and the IRS to issue guidance clarifying that taxpayers currently capitalizing section 174 R&E expenditures to inventory may remove capitalized section 174 R&E expenditures from inventory when changing to the required section 174 method under Rev. Proc. 2023-11, if desired. We believe that permitting this change to be made under Rev. Proc. 2023-11 instead of treating it as a UNICAP method change is consistent with the historical treatment for changes filed under Section 7.01 of Rev. Proc. 2022-14. Therefore, a method change made under the requested clarifying guidance should be implemented in the same manner as a method change under Section 7.01 of Rev. Proc. 2022-14 (i.e., on a cut-off basis for amounts paid or incurred in the first taxable year beginning after December 31, 2021).

Analysis

If a change to the required section 174 method under Rev. Proc. 2023-11 does not include a change to remove from inventory any section 174 R&E expenditures that have been capitalized to inventory, then most taxpayers that are currently capitalizing section 174 R&E expenditures to inventory would be forced to continue to capitalize these expenditures to inventory for the first tax year beginning after December 31, 2021, because it is too late for most taxpayers to file a non-automatic method change to remove the section 174 R&E expenditures from inventory for that tax year. These taxpayers would have to file a non-automatic method change before the end of their 2023 taxable year to obtain IRS advance consent to change from a method of capitalizing section 174 R&E expenditures to inventory to a method of removing section 174 R&E expenditures from inventory. This result creates an undue administrative burden for taxpayers and the IRS.

This uncertainty and administrative burden could be easily eliminated by simply clarifying that, like the change provided in Section 7.01 of Rev. Proc. 2022-14, the automatic method change under Rev. Proc. 2023-11 applies to a taxpayer that is changing from a method of treating section 174 R&E expenditures under any provision of the Code other than section 174, including a method

that capitalizes these expenditures to inventory, to the required section 174 method. Because this change is made on a cut-off basis, there is no need to revalue beginning inventory and compute a section 481(a) adjustment.

2. Deferred Intercompany Profit under Treas. Reg. § 1.1502-13 for Section 174 R&E Services Provided to Another Member of a Consolidated Group

Overview

Under Treas. Reg. § 1.1502-13(a)(1), the rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions are provided. Treas. Reg. § 1.1502-13(a)(2) provides that, under this section, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The *amount* and *location* of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The *timing,* and the *character, source,* and other *attributes* of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

Treasury Reg. § 1.1502-13(a)(3)(i) notes that the timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member's other methods of accounting. See Treas. Reg. § 1.1502-17 and, with regard to consolidated return years beginning on or after November 7, 2001, Treas. Reg. § 1.446-1(c)(2)(iii). To the extent the timing rules of this section are inconsistent with a member's otherwise applicable methods of accounting, the timing rules of this section control.

Under Treas. Reg. § 1.1502-13(b)(1), an intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or services, and B is the member receiving the property or services. Intercompany transactions include S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized.

Treasury Reg. § 1.1502-13(b)(2)(ii) provides that S's costs or expenses related to an intercompany transaction are included in determining its intercompany items. For example, if S sells inventory to B, S's direct and indirect costs properly includible under section 263A are included in determining its intercompany income. Similarly, related costs or expenses that are not capitalized under S's separate entity method of accounting are included in determining its intercompany items. For example, deductions for employee wages, in addition to other related costs, are included in

determining S's intercompany items from performing services for B, and depreciation deductions are included in determining S's intercompany items from renting property to B.

B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items.[6] For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss; alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

Treasury Reg. § 1.1502-13(c)(1) provides a matching rule under which B's corresponding items and S's intercompany items are taken into account. Treas. Reg. § 1.1502-13(c)(1)(i) states that the separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income and consolidated tax liability as if S and B were divisions of a single corporation and the intercompany transactions were between divisions.

Recommendation

AICPA is requesting guidance that would allow taxpayers to file a Form 3115 to make an automatic method change to defer intercompany profit under Treas. Reg. § 1.1502-13 when one member of a consolidated group performs R&E services for another member of the consolidated group that capitalizes the section 174 R&E expenditures related to those services. The method change would apply when the buying member (B) has capitalized intercompany section 174 R&E expenditures for amounts paid to the service provider (S), and S, under its present method of accounting, has not properly deferred the intercompany profit under Treas. Reg. § 1.1502-13 related to the intercompany R&E services provided by S to B when B has capitalized the intercompany R&E expenditures (e.g., under section 174(b) or section 59(e)). Pursuant to Treas. Reg. §1.1502-17(b)(2), this method change will be implemented on a cut-off basis.

Analysis

Treas. Reg. § 1.1502-13(c)(7)(G) has the following example:

> *Example 7. Performance of services*. (1) Facts. S is a driller of water wells. B operates a ranch in a remote location, and B's taxable income from the ranch is not subject to section 447. B's ranch requires water to maintain its cattle. During Year 1, S drills an artesian well on B's ranch in exchange for $100 from B, and S incurs $80 of expenses (e.g., for

[6] Treas. Reg. § 1.1502-15(b)(3)(i)

> employees and equipment). B capitalizes its $100 cost for the well under section 263, and takes into account $10 of cost recovery deductions in each of Years 2 through 11. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. If S and B were divisions of a single corporation, the costs incurred in drilling the well would be capitalized.
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> (2) Definitions. Under paragraph (b)(1) of this section, the service transaction is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraph (b)(2)(ii) of this section, S's $100 of income and $80 of related expenses are both included in determining its intercompany income of $20.
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> (3) Timing and attributes. S's $20 of intercompany income is taken into account under the matching rule to reflect the $20 difference between B's corresponding items taken into account (based on its $100 cost basis in the well) and the recomputed corresponding items (based on the $80 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's $80 of expenses). In Year 1, S takes into account $80 of its income and the $80 of expenses. In each of Years 2 through 11, S takes $2 of its $20 intercompany income into account to reflect the annual $2 difference between B's $10 of cost recovery deductions taken into account and the $8 of recomputed cost recovery deductions. S's $100 income and $80 expenses, and B's cost recovery deductions, are ordinary items (because S's and B's items would be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section). If S's offsetting $80 of income and expense would not be taken into account in the same year under its separate entity method of accounting, they nevertheless must be taken into account under this section in a manner that clearly reflects consolidated taxable income. See paragraph (a)(3)(i) of this section.

Treasury Reg. § 1.1502-17(a) provides that, in general, the method of accounting to be used by each member of the group shall be determined in accordance with the provisions of section 446 as if such member filed a separate return.

If a member changes its method of accounting for intercompany transactions for a consolidated return year, the change in method generally will be affected on a cut-off basis.[7]

Under the rules provided above, if one member of a consolidated group (S) performs R&E services for another member of the consolidated group (B), and B capitalizes and amortizes the amounts it paid to S under the required section 174 method, then S must defer the intercompany profit related to the R&E services it provided to B. S recognizes the deferred intercompany profit as B takes into account the amortization of the capitalized section 174 R&E expenditures related to the intercompany R&E services.

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[7] Treas. Reg. § 1.1502-17(b)(2)

If, under its method of accounting, B has not capitalized intercompany section 174 R&E expenditures for amounts paid to S prior to December 31, 2021 (e.g., under section 174(b) or section 59(e)), then S can adopt a proper method of accounting for intercompany profit under Treas. Reg. § 1.1502-13 related to the intercompany section 174 R&E expenditures that B pays or incurs after December 31, 2021, and accounts for under the required section 174 method. However, if B capitalized intercompany section 174 R&E expenditures for amounts paid to S prior to December 31, 2021, then S must change to a proper method of accounting for intercompany profit under Treas. Reg. § 1.1502-13 related to the intercompany section 174 R&E expenditures that B pays or incurs after December 31, 2021, and accounts for under the required section 174 method.

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The AICPA is the world's largest member association representation the accounting profession, with more than 421,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Jim Martin, Chair, AICPA Section 174 Method Change Task Force at (540) 455-8416 or james.e.martin@pwc.com; Reema Patel, Senior Manager - AICPA Tax Policy & Advocacy, at (202) 434-9217, or Reema.Patel@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,

Jan Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Daniel I. Werfel, Commissioner, Internal Revenue Service
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Colin Campbell, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
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