May 26, 2022

Ms. Holly Porter
Associate Chief Counsel
Passthroughs & Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Research & Experimental Expenditures under section 174

Dear Ms. Porter:

The American Institute of CPAs (AICPA) recognizes and appreciates the significant volume of guidance that the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) has issued related to Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA or the "Act").[1] Section 13206 of the TCJA amended section 174 and resulted in significant changes to the treatment of research and experimental (R&E) expenditures.

The AICPA is submitting comments on the modifications related to R&E expenditures under section 174. The AICPA has chosen to comment on the specific issues related to section 174 as identified below based upon the IRS priority guidance plan,[2] and we will comment on other areas as necessary going forward. Specifically, the AICPA requests guidance and provides recommendations in the following areas.

1. Identification of categories of section 174(a) expenditures.

- Treasury and IRS should issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.

- Additionally, Treasury and IRS should issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.

2. Issues that have arisen with regard to Rev. Proc. 2000-50.

[1] Public Law 115-97, 131 Stat. 2054.
[2] Item #17 of General Tax Issues on the priority guidance plan lists guidance addressing amortization of research and experimental expenditures under section 174: 2021-2022 Second Quarter Update, released February 22, 2022.

- IRS should modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.

- Additionally, IRS should make a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.

BACKGROUND

Pre-TCJA, section 174 provided taxpayers with the option to immediately expense R&E expenditures under section 174(a) or elect to defer and amortize the expenditures over a period of not less than 60 months under section 174(b), or charge the expenditures to capital account under Reg. § 1.174-1. In addition, taxpayers could elect under section 59(e) to amortize over 10 years expenditures otherwise allowed as a deduction under section 174(a). Prior to the changes, taxpayers that paid or incurred costs for software development could rely on Rev. Proc. 2000-50, which allowed taxpayers to treat software development costs in the same manner as under section 174, including the same options (other than charging to capital account), whether the expenditures met the requirements of section 174 or not.[3]

In addition to mandatory capitalization of R&E expenditures, the TCJA changed the language in section 174 from "research or experimental expenditures" to "specified research or experimental expenditures," and added a special rule under section 174(c)(3) that specifies that for purposes of section 174, any amount paid or incurred in connection with the development of any software is treated as a "specified research or experimental expenditure." As a result, the TCJA effectively eliminates taxpayers' ability to rely on Rev. Proc. 2000-50 to deduct software development expenditures in the year incurred.

SPECIFIC COMMENTS

1. Identification of categories of section 174(a) expenditures

Overview

Many taxpayers that pay or incur section 174 expenditures may not have an established methodology to identify the appropriate amounts of these expenditures that are now subject to mandatory amortization because, prior to the TCJA, the tax accounting treatment of current expensing generally would have been allowable whether the expenses were deductible as ordinary and necessary trade or business expenditures under section 162(a) or R&E expenditures under section 174(a). Taxpayers with research activities conducted in the United States may claim a research credit under section 41 for increasing these activities. The amount of the section

[3] Such costs are also recoverable through deductions for ratable amortization, in accordance with section 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service. Rev. Proc. 2000-50 § 5.01(2).

41 research credit by statute is a function of several variables including the amount of expenditures paid or incurred by the taxpayer that meet the definition of section 174(a) expenses. Although meeting the definition of section 174 is generally considered a threshold requirement for the section 41 research credit, the pool of costs eligible for the credit has been clearly delineated to include only wages, supplies, rental or lease of computers, and contract research expenses.

In contrast to the requirements for the section 41 research credit, the regulations under Reg. § 1.174-2 do not clearly delineate the extent to which various categories of expenses, including direct and indirect costs, fall within the definition of research and experimental expenditures. Rather, the regulations focus on the nature of the activity to which the expenditures relate. The regulations further provide that the qualified activities must involve the elimination of uncertainty in the development or improvement of a product, including products to be used by the taxpayer in its trade or business, or held for sale, lease, or license. With respect to defining the categories of expenses that might fall within the scope of section 174, and thus the amortization requirement provided in the TCJA, the regulations provide a very general standard for identifying section 174 expenditures. Pursuant to the regulations, section 174 applies to all costs that are "incident to" the development or improvement of a product.[4]

While the regulations do not explicitly define which costs are "incident to" the development or improvement of a product, they do provide that costs paid or incurred in the production of a product after the elimination of uncertainty do not qualify as section 174 expenditures. The regulations exclude certain expenditures from section 174 eligibility including ordinary testing for quality control, management studies, and advertising and promotions, amongst others.[5] Additionally, interpretive guidance suggests that allocable indirect costs and overhead may be section 174 eligible.[6]

Up until the TCJA, due to the current expensing option and the explicit constraints on expenses eligible for the section 41 research credit, there has been far less of a need for detailed rules addressing which categories of costs must be allocated to R&E activities and the extent to which such costs are characterized as expenses subject to section 174 treatment. Indirect costs, including overhead and general and administrative costs are of particular concern for many taxpayers, as such costs may be properly allocable to many business activities. In light of the new mandatory amortization regime, there is a need for guidance that provides taxpayers with certainty and uniformity in the accounting for these costs, and that minimizes controversies over the categories of costs associated with R&E activities that are subject to amortization. Without such guidance, some taxpayers will interpret the rules to apply narrowly to direct costs, while others may apply a full-absorption costing method like the rules of section 263A.

[4] Reg. § 1.174-2(a)(1).
[5] Reg. § 1.174-2(a)(6).
[6] Rev. Rul. 73-275, for example, in which the IRS ruled that the expenses connected with a taxpayer's product engineering department including overhead expenses were section 174 eligible.

Recommendation

The AICPA recommends that Treasury and IRS issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.

Additionally, the AICPA recommends that Treasury and IRS issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.

Analysis

In contrast to section 174, the uniform capitalization rules of section 263A provide a requirement to capitalize all direct and indirect costs that directly benefit or are incurred by reason of the production or resale of specified categories of property. In enacting section 263A, Congress provided very detailed rules in the legislative history as to which categories of direct and indirect costs would be subject to capitalization under section 263A. Further, the regulations follow this mandate and provide very detailed rules with a high degree of specificity as to which categories of direct and indirect costs, including overhead and service costs, are required to be allocated to activities and capitalized to property subject to section 263A. The types of activities subject to section 263A are activities for which the capitalization of direct costs, and in some cases certain types of indirect costs, were required to be capitalized under pre-section 263A law. The enactment of section 263A represents a congressional intent to establish more uniform rules for the identification and treatment of indirect costs with respect to tangible property.

Research and experimental expenses were considered a type of indirect cost associated with production of property, but by statute, preserving the current expensing option under section 174(a), this category of costs was explicitly excluded from the capitalization requirement of section 263A.[7]

In 2003, in response to controversies that arose from the Supreme Court's 1992 decision in the *INDOPCO* case,[8] the IRS and Treasury issued final regulations to provide certainty as to the capitalization of costs with respect to intangible assets and benefits, including business acquisitions and restructurings. These regulations provide that taxpayers must capitalize amounts paid to acquire or create certain enumerated categories of intangible assets, and costs that facilitate the acquisition or creation of such intangible assets.[9] In contrast to section 263A, these regulations explicitly provide that employee compensation, overhead, and certain de minimis costs are deemed not to facilitate the acquisition or creation of the enumerated intangibles and therefore are not required to be capitalized. Taxpayers may, however, elect to capitalize employee compensation, overhead, and de minimis costs with respect to such intangibles under the regulations.

[7] Section 263A(c).
[8] INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992).
[9] Reg. § 1.263(a)-4 and Reg. § 1.263(a)-5.

Amended section 174 takes away the option of current expensing under section 174(a). Many, if not most, taxpayers have relied on and consistently used the current expensing method for decades where they have had little need to apply a full-absorption regime.[10] In amending section 174 to eliminate the current expensing option, and mandate amortization for all section 174(a) expenses, including all software development activities, Congress gave no indication that a switch to mandatory amortization should be subjected to a full-absorption regime such as the uniform capitalization regime under section 263A. To the contrary, as evidenced by the need to add a Code section to mandate a full-absorption type regime, it can be inferred that such a regime should be the subject of congressional action rather than administrative mandate. Further, the new mandatory amortization regime mirrors the prior elective amortization option under section 59(e) whereby, to our knowledge and experience relying upon the available guidance, taxpayers availing themselves of that election have never applied a full-absorption regime to allocate additional overhead and general and administrative costs to the pool of costs subject to the election. Similarly, under the former alternative election to either defer and amortize the costs under section 174(b) or charge the expenses to capital account, and which applied to all costs allocable to specific projects, the IRS has never sought to require taxpayers to apply a full-absorption methodology to the project costs subject to these elections. These elections have been in place for almost 70 years without any indication in our practical experience of such a requirement.[11]

The legislative history leading up to the enactment of the uniform capitalization rules indicates a perception that congressional action was necessary to mandate full-absorption costing with respect to the various categories of properties subjected to those rules.[12] As evidenced by the statutory language, regulations, and legislative history, imposing such a regime requires detailed and specific rules defining the categories of costs subject to capitalization, the categories of costs not subject to capitalization and methods of allocating costs to the appropriate property or cost objective. Congress gave no indication that in mandating that section 174 expenses be amortized rather than currently expensed, taxpayers would also be subject to a full-absorption costing regime like the one contained in section 263A. Further, given that section 263A treats section 174 expenses themselves as an indirect cost that are not required to be capitalized to property subject to section 263A, it would seem incongruous to then treat section 174 costs themselves as a direct cost that is burdened with indirect costs such as overhead and general and administrative costs. For these reasons, congressional action setting forth a specific requirement and detailed rules is necessary to require that taxpayers apply a full-absorption costing regime for purposes of defining the types and categories of costs that are classified as R&E costs under section 174(a).

In the absence of such an explicit requirement referencing more detailed rules, guidance should clarify that taxpayers are required to allocate direct costs, including wages, contractor costs, other

[10] See Reg. § 1.471-11.

[11] We note that an example in Reg. § 1.174-4(c) indicates that utilities and depreciation are part of the section 174 expenses for a taxpayer's facility. However, this illustration is not contained within the general definitional rule in Reg. § 1.174-2, and does not purport to establish a detailed regulatory regime similar to the uniform capitalization rules of section 263A.

[12] Staff of the Joint Committee on Taxation, JCS-10-87, General Explanation of the Tax Reform Act of 1986 (H.R.3838, 99th Congress; Public Law 99-514), 508-509 (1987).

direct labor costs, and materials and supplies, to the particular costs objective and are not required to allocate indirect costs such as overhead and general and administrative costs to such activity for purposes of identifying the amount of costs required to be amortized under section 174. At the same time, it would also provide a clear reflection of income to permit taxpayers on an elective basis to allocate overhead expenses for this purpose. This election could be patterned after the election Treasury and IRS adopted in 2003 under the intangibles regulations.[13]

2. Issues that have arisen with regard to Rev. Proc. 2000-50

Overview

Rev. Proc. 2000-50 provided guidance under prior law for the treatment of costs paid or incurred to develop, purchase, lease, or license computer software, and provides automatic consent for accounting method changes from one optional method to another. However, section 4 of Rev. Proc. 2000-50 explicitly states that this revenue procedure does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as a research and experimentation expenditure under section 174.

Section 5 of Rev. Proc. 2000-50 provides that the costs of developing computer software (whether or not the particular computer software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant similar accounting treatment. Accordingly, the IRS will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where:

- All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full *in accordance with rules similar to those applicable under section 174(a)*; or

- All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, *in accordance with rules similar to those provided by section 174(b)* and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in section 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.

Section 9.01 of Rev. Proc. 2022-14 provides the latest automatic method change procedures for a taxpayer that wants to change its method of accounting for the costs of computer software to a method described in Rev. Proc. 2000-50, including a taxpayer that wants to change its treatment of the costs of developing computer software to one of the methods described above (but only for software development costs incurred in taxable years for which the mandatory amortization rules under section 174 are not in effect). However, section 9.01(2) of Rev. Proc. 2022-14

[13] See Reg. § 1.263(a)-4(e)(4)(iv).

similarly states that this change does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as R&E expenditures under section 174.

There has been longstanding uncertainty regarding whether taxpayers were deemed to have historically treated the costs of computer software as R&E expenditures under section 174 that would have precluded such taxpayers from changing their methods of accounting for the costs of computer software under the automatic change procedures of Rev. Proc. 2000-50 and Rev. Proc. 2022-14. In addition, while automatic change procedures are available for a change in the treatment of section 174 costs, a change in accounting method under section 174, must be implemented on a cutoff basis rather than with a section 481(a) adjustment like a change in accounting method under Rev. Proc 2000-50.

Recommendation

The AICPA recommends that the IRS modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.

Additionally, the AICPA recommends that the IRS makes a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.

Analysis

Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Similarly, for tax years prior to 2022, section 174(a) allows for immediate expensing of R&E expenditures that are paid or incurred by a taxpayer during the taxable year in connection with its trade or business, although taxpayers may elect under section 174(b) to capitalize and amortize such costs ratably over a period of not less than 60 months. Regulation § 1.174-2(a)(1) defines R&E expenditures under section 174 as expenditures incurred in connection with the taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense.

The IRS published Rev. Proc. 2000-50 to update, modify, and restate the guidelines for the treatment of the costs of computer software.[14] Rev. Proc. 2000-50 provides separate rules for the costs of developing computer software, costs of acquired computer software, and leased or licensed computer software. As mentioned above, the guidance provides three allowable methods of accounting for software development costs (two of which are based on rules *similar*

[14] Rev. Proc. 69-21 provided similar rules prior to the issuance of Rev. Proc. 2000-50.

to those provided by section 174). These options were provided to eliminate controversy and reduce disputes with taxpayers.[15]

The current guidance under Rev. Proc. 2000-50 does not apply to "costs that a taxpayer has treated as R&E expenditures under section 174." However, this specific wording has generated much uncertainty regarding whether certain taxpayers can apply the guidance under Rev. Proc. 2000-50, as illustrated by the following examples:

- Example 1: Taxpayer has historically treated various types of computer software costs (i.e., amounts paid or incurred to develop, purchase, lease, and/or license computer software) as immediate expenses. The taxpayer has now determined a method change is required under Rev. Proc. 2000-50 for the treatment of certain costs (e.g., the purchased software should be capitalized and amortized ratably over a period of 36 months in accordance with section 6.01(2) of Rev. Proc. 2000-50 and section 167(f)(1)).

- Example 2: Taxpayer previously changed its method of accounting for the costs of developing computer software under section 5.01(1) of Rev. Proc. 2000-50 to treat as current expenses *in accordance with rules similar to those applicable under section 174(a)*. The taxpayer has now decided to change its method of accounting for the costs of developing computer software to another method provided under section 5 of Rev. Proc. 2000-50 (e.g., capitalize and amortize ratably over a period of 36 months).

Example 1 Analysis:

In example 1, the taxpayer historically treated the computer software costs as immediate expenses. However, has the taxpayer immediately expensed such costs as ordinary and necessary business expenses under section 162 or as R&E costs under section 174? If some of the costs actually meet the requirements of section 174 (e.g., resolving uncertainty) and others do not, would the statement only apply to the former or would it also apply if the taxpayer erroneously treated the expenses as section 174 costs? Based on this statement, could Rev. Proc. 2000-50 also be interpreted to apply only to software development expenses that do not in fact meet the requirements of section 174 (by virtue of the statement that the costs at issue "closely resemble" section 174 expenses, which creates an implication that the procedure might not apply to all software expenses but only the subset of software development expenses that do not in fact meet the requirements of section 174).

It may be impossible to distinguish whether an expense was deducted as an ordinary and necessary business expense under section 162 or as R&E costs under section 174 based on how the costs were reflected on the taxpayer's federal income tax returns, and it would seem to defeat the purpose of Rev. Proc. 2000-50 to scope out of the method change any of the above situations.

[15] Section 13206 of the Tax Cuts and Jobs Act (Pub. L. No. 115-97, 131 Stat. 2054) amended section 174 to include any amount paid or incurred in connection with the development of any software as a research or experimental expenditure effective for amounts paid or incurred in taxable years beginning after December 31, 2021, which will render the guidance in Rev. Proc. 2000-50 obsolete with respect to software development costs.

Furthermore, the guidance under Rev. Proc. 2000-50 was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine whether such costs are deductible as R&E expenditures under section 174. The results of such study would be highly subjective anyways given the lack of current guidance under section 174 with respect to computer software costs. In fact, the government previously issued proposed regulations under section 174 in 1983 (47 FR 2790) and 1989 (54 FR 21224) attempting to clarify the treatment of software development costs under section 174 only to withdraw those amendments to the regulations in 1993 (58 FR 15819) and instead lean on the administrative guidance contained in Rev. Proc. 69-21. See below excerpt from the preamble to the 1993 proposed regulations under section 174:

> In Revenue Procedure 69-21, 1969-2 C.B. 303, the IRS announced that, as a matter of administrative practice, it would allow taxpayers to treat software development costs in a manner similar to the manner research or experimental expenditures are treated under section 174. The 1983 proposed regulation, however, would have provided additional conditions on the qualification of software development costs as research or experimental expenditures beyond those applicable to other products.
>
> In the preamble to the 1989 proposed regulation, the IRS announced that it is studying the continuing validity of Rev. Proc. 69-21. The IRS has no present intention of changing its administrative position contained in Rev. Proc. 69-21, but it continues to study its viability. Taxpayers may continue to rely on Rev. Proc. 69-21. The amendments proposed in this document do not provide additional conditions applicable to computer software development costs. The IRS again invites comments on the proper tax accounting treatment of software development costs that do not qualify as research or experimental expenditures.

The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 1 from applying Rev. Proc. 2000-50 based on its present method of accounting. In fact, allowing this taxpayer to apply the guidance in Rev. Proc. 2000-50 would result in greater compliance with the Code. Therefore, the IRS should modify the scope limitations under section 4 of Rev. Proc. 2000-50 and section 9.01(2) of Rev. Proc. 2022-14 to clarify the limitation on costs that a taxpayer has treated as an R&E expenditure under section 174 only applies to costs that have been subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.

Example 2 Analysis:

In example 2, the taxpayer's present method of accounting for software development costs is in accordance with section 5.01(1) of Rev. Proc. 2000-50, which is based on "rules similar to those applicable under section 174(a)." This language has led many taxpayers and practitioners to question whether the taxpayer's present method would render them ineligible to make a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50.

As mentioned above, the guidance under section 5 of Rev. Proc. 2000-50 was provided to eliminate controversy and reduce disputes with taxpayers due to the uncertainty of the extent to which software development costs actually meet the definition of R&E expenditures under section 174. In fact, section 5.01 of Rev. Proc. 2000-50 indicates that the costs of developing computer software "in many respects so closely resemble the kind of R&E expenditures that fall within the purview of section 174 as to warrant similar accounting treatment." Thus, the IRS seems to indicate that certain software development costs are not necessarily R&E costs under section 174 but should be afforded similar treatment. However, this guidance was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine which of their software development costs meet the classification criteria of section 174 requirements, and which do not.

The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 2 from making a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50 merely because it presently treats such costs as current expenses.

* * * * *

The AICPA is the world's largest member association representing the accounting profession, with more than 431,000 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 David Strong, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (616) 752-4251, or david.strong@crowe.com; Elizabeth Young, Senior Manager — AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@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 Lily Batchelder, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
Mr. William Paul, Principal Deputy Chief Counsel and Deputy Chief Counsel, Office of Chief Counsel, Internal Revenue Service
Mr. Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Mr. Scott Vance, Associate Chief Counsel, Income Tax & Accounting, Internal Revenue Service
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Julie Hanlon-Bolton, Income Tax & Accounting, Internal Revenue Service
Ms. Karla Meola, Income Tax & Accounting, Internal Revenue Service
Ms. Jennifer A. Records, Senior Technician Reviewer, Passthroughs & Special Industries, Internal Revenue Service