AICPA®

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June 8, 2015

Mr. Andrew Keyso, Jr.
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Recommendation that Taxpayers Making Accounting Method Changes for Mischaracterized Section 174 Expenditures Compute a Section 481(a) Adjustment and Receive Audit Protection

Dear Mr. Keyso:

The American Institute of Certified Public Accountants (AICPA) commends the Department of the Treasury ("Treasury") and Internal Revenue Service (IRS) for issuing final regulations under section[1] 174 of the Internal Revenue Code, which modify and clarify the definition of research and experimental expenditures ("R&E expenditures"). The final regulations include a definition of the term "pilot model" which focuses on whether property was produced by (or on behalf of) a taxpayer for the purpose of evaluating and resolving design uncertainty. We believe that this definition will further the objective underlying section 174. However, the AICPA is still concerned that IRS examining agents potentially could misapply the shrinking-back rule (renamed in the final regulations to "Application of section 174 to components of a product") to exclude from section 174 eligibility certain expenditures, such as those related to integration testing activities. Thus, to reduce future controversy in this area, we recommend that the IRS issue additional examples spanning multiple industries related to integration testing.

In this letter, the AICPA respectfully submits comments on procedures for making accounting method changes for R&E expenditures under section 174. Treasury and the IRS removed this project from the Priority Guidance Plan for 2013-2014. For the reasons discussed below, the AICPA recommends that Treasury and IRS add the project to the Priority Guidance Plan for 2015-2016. These comments were developed by the AICPA's Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

The AICPA is the world's largest membership association representing the accounting profession, with more than 400,000 members in 128 countries and a 125-year heritage of serving the public interest. 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

[1] All references herein to "Section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

As discussed further in the document, the AICPA believes that taxpayers seeking to correct prior mischaracterizations of R&E expenditures should treat such corrections as accounting method changes effected with a section 481(a) adjustment. We also believe taxpayers should receive audit protection incident to the filing of a method change request to correct the mischaracterization of R&E expenditures incurred in taxable years prior to the year of change. Therefore, we recommend that the Treasury and IRS add to the Priority Guidance Plan for 2015-2016 the project regarding procedures for changing methods of accounting for R&E expenditures, and adopt the foregoing approach in their Priority Guidance Plan project. We believe this approach will allow taxpayers making accounting method changes for mischaracterized R&E expenditures to clearly reflect taxable income and reduce future controversy in this area.

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We appreciate your consideration of our comments and proposed changes that are necessary to provide clarification to taxpayers. We welcome a further discussion of these issues and our comments, and members of the task force are available to meet with government officials in this regard. If you have any questions, please contact Jane Rohrs, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 370-2290, or jrohrs@deloitte.com; or Melanie Lauridsen, AICPA Technical Manager, at (202) 434-9235, or mlauridsen@aicpa.org.

Respectfully submitted,

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Recommendation that Taxpayers Correcting Mischaracterized Section 174 Expenditures Make Such Changes as An Accounting Method Change with a Section 481(a) Adjustment and Receive Audit Protection

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Recommendation that Taxpayers Correcting Mischaracterized Section 174 Expenditures Make Such Changes as An Accounting Method Change with a Section 481(a) Adjustment and Receive Audit Protection

Scope of Comments

The AICPA welcomes the opportunity to comment on procedures for effecting the correction of prior mischaracterizations of R&E expenditures. These comments are limited in their scope to corrections involving a taxpayer that:

- Has mischaracterized some expenditures as R&E expenditures which, instead, should have been capitalized or inventoried, or (conversely), failed to properly characterize as R&E expenditures certain amounts that were treated as capital expenditures or as inventoriable costs (i.e., a change from an impermissible to a permissible treatment),[2] and is seeking to correct such mischaracterization within the context of its overall current expense or deferred expense method of accounting for R&E expenditures; OR
- Is making a change to comply with the 2014 final "pilot model" regulations under section 174.[3]

Throughout this comment letter, the AICPA refers to "mischaracterized" Section 174 expenditures as Section 174 eligible R&E expenditures that a taxpayer treats in one of three ways:

(1) For a taxpayer whose overall method is to currently expense Section 174 R&E expenditures, costs the taxpayer capitalizes and amortizes or charges to a capital account;
(2) For a taxpayer whose overall method is to currently capitalize and amortize Section 174 R&E expenditures, costs the taxpayer currently expenses or charges to a capital account; OR
(3) For a taxpayer whose overall method is to charge to a capital account Section 174 R&E expenditures, costs the taxpayer currently expenses or capitalizes and amortizes.

The AICPA understands that the regulations under section 174 specifically require that changes from the current expense method to the deferral method, or vice versa (i.e., a change from a permissible to another permissible method of accounting), for R&E expenditures are made under cut-off transition procedures.[4] The AICPA is not proposing changes to such procedures, but is proposing only specific corrections with respect to changes from an impermissible to a permissible treatment for R&E expenditures. The AICPA recommends that Treasury and IRS modify the automatic revenue procedures to add a new Appendix section 7.02 allowing taxpayers to correct mischaracterizations of expenditures as R&E expenditures which, instead, should have been capitalized or inventoried, or (conversely), to treat as R&E expenditures certain amounts that were incorrectly treated as capital expenditures or as inventoriable costs. We recommend that the new Appendix section 7.02 allow taxpayers to treat such corrections as accounting

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[2] Revenue Proc. 2015-14, Appendix § 7.01.
[3] TD 9680, 79 F.R. 42193 (July 21, 2014).
[4] Treasury Reg. §§ 1.174-3(b)(2) and 1.174-4(a)(5) currently require the cut-off method when a taxpayer wishes to change the current expense method to the deferral method, or vice versa (i.e., a change from a permissible to another permissible method of accounting) for R&E expenditures.

method changes effected with a section 481(a) adjustment. We also recommend that the new Appendix section 7.02 provide taxpayers with audit protection incident to the filing of a method change request to correct the mischaracterization of R&E expenditures incurred in taxable years prior to the year of change.

The AICPA also recommends that the new Appendix section 7.02 provide for accounting method changes to comply with the 2014 final pilot model regulations under section 174.[5] We believe the appropriate mechanism for changing the treatment of the mischaracterized section 174 expenditures is generally through an accounting method change request and that, consistent with our comments above, taxpayers should effect the accounting method change with a section 481(a) adjustment and receive audit protection.

Additionally, subsequent to the issuance of Rev. Proc. 2015-14, it is unclear whether Appendix section 7.01 applies to method changes for amounts characterized as R&E expenditures that should have been capitalized or inventoried. Therefore, the AICPA respectfully requests that the Treasury and IRS modify the automatic revenue procedures to clarify that Appendix section 7.01 applies to such changes, and take into account our recommendations with respect to appropriate transition rules.

The AICPA believes the above-described approach and clarification will allow taxpayers making accounting method changes for R&E expenditures to clearly reflect income and reduce future controversy between taxpayers and the IRS.

I. Executive Summary

The current administrative framework provided to a taxpayer that either has mischaracterized an expenditure as a R&E expenditure or has mischaracterized a R&E expenditure as a capital expenditure or an inventoriable expenditure and wishes to correct such mischaracterization is inconsistent and confusing. Prior to the issuance of Rev. Proc. 2015-14,[6] a taxpayer that had mischaracterized R&E expenditures as either a capital expenditure or an inventoriable cost, or vice versa, could effectuate such correction either by:

- Filing an amended tax return for the taxable year in which the mischaracterization occurred (assuming such taxable year is not barred by the statute of limitations); or
- Filing an automatic accounting method change under Appendix section 7.01 of Rev. Proc. 2011-14[7] to correct such mischaracterization prospectively using cut-off transition procedures.

Subsequent to the issuance of Rev. Proc. 2015-14, it is unclear:

- Whether Appendix section 7.01 applies to method changes for amounts characterized as R&E expenditures which, instead, should have been capitalized or inventoried; and
- How the IRS expects taxpayers to effectuate such mischaracterizations.

[5] TD 9680, 79 F.R. 42193 (July 21, 2014).
[6] 2015–5 I.R.B. 450.
[7] 2011-4 I.R.B. 330, 379.

The AICPA understands that the prior project on the 2013-2014 Priority Guidance Plan was intended to clarify the procedures required to correct mischaracterizations of R&E expenditures, however, subsequently the project was removed from the current Priority Guidance Plan.

Because it is unclear how to effect corrections for mischaracterizations of R&E expenditures, the AICPA recommends that the Treasury and IRS add to the Priority Guidance Plan for 2015-2016 the project regarding procedures for changing methods of accounting for R&E expenditures, and modify the procedures as recommended herein.

The AICPA believes that mischaracterizations of capital or inventoriable expenditures as R&E expenditures, or vice versa, should be corrected by treating the correction as an accounting method change qualifying for the automatic consent procedures under Rev. Proc. 2015-14. Moreover, the transition rule (under which such an accounting method change is implemented) should be a conventional section 481(a) adjustment approach, similar to the approach employed for most other accounting method changes. Computing section 481(a) adjustments for mischaracterized R&E expenditures will place taxpayers on a proper method of accounting for their R&E expenditure, rather than leaving the taxpayer on a hybrid method that only corrects future mischaracterizations of R&E expenditures. Additionally, section 481(a) adjustments prevent the potential omission, or significant deferral of recovery, of some R&E expenditures that may occur if a cut-off transition approach is used. Also, effecting a method change with a section 481(a) adjustment will position taxpayers in no better or worse tax position than if all their R&E expenditures were properly characterized from the outset.

To reduce future controversy in this area, we offer the following recommendation on procedures for effecting accounting method changes for R&E expenditures:

A. Add to the Treasury and IRS Priority Guidance Plan for 2015-2016 the project regarding procedures for changing methods of accounting for R&E expenditures;
B. Modify Rev. Proc. 2015-14 to add a new Appendix section 7.02 to clarify that the automatic procedures apply to corrections of expenditures mischaracterized as R&E expenditures, which, instead, should have been capitalized or inventoried, in addition to corrections for expenditures, capitalized or inventoried that should have been characterized as R&E expenditures. Method changes to correct such mischaracterizations should be implemented with a section 481(a) adjustment and receive audit protection; and
C. Provide in the new Appendix section 7.02 for accounting method changes to comply with the 2014 final pilot model regulations under section 174 (Treas. Reg. § 1.174-2).[8] These changes likewise should enable taxpayers to make the method changes with a section 481(a) adjustment and receive audit protection.

The Treasury and IRS may determine that taxpayers are not entitled to a section 481(a) adjustment incident to an accounting method change to correct mischaracterized R&E expenditures. In that case, the AICPA recommends continuing to permit taxpayers to amend prior income tax returns (for open years) to change the treatment of mischaracterized section 174 expenditures to prevent the omission of recovery of R&E expenditures for taxable years ending prior to the adoption of new procedures.

[8] TD 9680, 79 F.R. 42193 (July 21, 2014).

II. Background on Procedures for Making Accounting Method Changes for R&E Expenditures

A. Research and Development Background

1. Section 174

Under section 174(a), "a taxpayer may treat research or experimental expenditures that are paid or incurred by him during the taxable year in connection with his trade or business as expenses that are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction." Treasury Reg. § 1.174-2(a)(1) defines the term "research or experimental expenditures" as 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. Treasury Reg. § 1.174-2(a)(1) further provides that 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.[9]

Section 174 provides that taxpayers may capitalize, capitalize and depreciate, or currently deduct eligible R&E expenditures.[10]

On July 21, 2014, the Treasury and IRS issued final regulations under section 174, which affect taxpayers that incur R&E expenditures. These regulations address several long-standing issues related to the eligibility of prototype or pilot model costs as R&E expenditures. The regulations provide a definition of a pilot model and address whether the subsequent sale or other business use of a pilot model created to resolve design uncertainties is a factor in determining whether an expenditure falls within the scope of section 174. In addition, the regulations clarify the interaction between the section 174(c) rule requiring capitalization of costs to acquire depreciable property used in connection with research activities and the general definition of R&E expenditures, including costs related to pilot models. The regulations do not provide taxpayers administrative procedures for implementing changes to the provisions in the regulations.

Revenue Proc. 98-60[11] added the administrative procedures by which a taxpayer may obtain automatic consent to change its method of accounting for R&E Expenditures, on Form 3115, *Application for Change in Accounting Method*.

Recently issued, Rev. Proc. 2015-14,[12] Appendix section 7.01, provides automatic procedures for taxpayers changing to a different method or different amortization period for R&E expenditures. Revenue Proc. 2015-14 is effective for Forms 3115 filed on or after January 16, 2015, for a year of change ending on or after May 31, 2014. Under Rev. Proc. 2015-14, Appendix section 7.01, taxpayers may make an accounting method change from treating R&E expenditures:

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9 Treasury Reg. § 1.174-2(a)(1).
10 Section 174(a)(1), (b)(1); Treas. Reg. § 1.174-1.
11 1998-2 C.B. 759, sections 2.11(b), Appendix § 2A.01.
12 2015–5 I.R.B. 450.

- As currently deductible expenses to treating such expenditures as deferred expenses, or vice versa;
- As deferred expenses to a different amortization period;
- As currently deductible expenses or deferred expenses to treating such expenditures as a charge to capital account, or vice versa; or
- Under any provision of the Code other than section 174 to treating such expenditures under section 174.[13]

Accounting method changes made pursuant to Appendix section 7.01 of Rev. Proc. 2015-14 are on a cut-off basis and apply to all R&E expenditures for a particular project or projects on or after the beginning of the year of change.[14] Accordingly, for these accounting method changes a section 481(a) adjustment is neither permitted nor required.[15] Taxpayers do not receive audit protection in connection with these section 174 accounting method changes.[16] Changes in the treatment of computer software costs under Rev. Proc. 2000-50,[17] are not covered by this section but are covered by Appendix section 9 of Rev. Proc. 2015-14.

Under limited transition rules provided by Rev. Proc. 2015-13,[18] taxpayers may file accounting method changes under Rev. Proc. 2011-14 for taxable years ending on or after May 31, 2014, and on or before January 31, 2015, until the due date of the taxpayer's timely filed (including any extension) original federal income tax return for the requested year of change. Under Rev. Proc. 2011-14, Appendix section 7.01, taxpayers may also make accounting method changes to different methods or amortization periods for R&E expenditures under section 174.[19] Revenue Proc. 2011-14, Appendix section 7.01 allows taxpayers to make an accounting method change from treating R&E expenditures:

- As currently deductible expenses to treating such expenditures as deferred expenses, or vice versa;
- As deferred expenses to a different amortization period; or
- As currently deductible expenses or deferred expenses to treating such expenditures as a capital expenditure under section 263(a), or vice versa.

Accounting method changes made pursuant to Appendix section 7.01 of Rev. Proc. 2011-14 are made on a cut-off basis and apply to all R&E expenditures paid or incurred for a particular project or projects on or after the beginning of the year of change.[20] Thus, for these accounting method changes a section 481(a) adjustment is neither permitted nor required.[21] Taxpayers do not receive audit protection in connection with this section 174 accounting method change.[22] In addition,

[13] Revenue. Proc. 2015-14, Appendix § 7.01(2)(a).
[14] Revenue Proc. 2015-14, Appendix § 7.01(4); see also section 174(b)(2), and Treas. Reg. §§ 1.174-3(a), 1.174-3(b)(2), and 1.174-4(a)(5) for more information regarding a cut-off basis.
[15] Id.
[16] Revenue Proc. 2015-14, Appendix § 7.01(6).
[17] 2000-2 C.B. 601, as modified by Rev. Proc. 2007-16, 2007-4 I.R.B. 358.
[18] Section 15 of Rev. Proc. 2015-13, 2015-5 I.R.B. 419.
[19] Revenue Proc. 2011-14, Appendix § 7.01.
[20] Revenue Proc. 2011-14, Appendix § 7.01(4); see also section 174(b)(2), and Treas. Reg. §§ 1.174-3(a), 1.174-3(b)(2), and 1.174-4(a)(5) for more information regarding a cut-off basis.
[21] Id.
[22] Revenue Proc. 2011-14, Appendix § 7.01(6).

changes in the treatment of computer software costs under Rev. Proc. 2000-50,[23] are not covered by this accounting method change but are covered by Appendix section 9 of Rev. Proc. 2011-14.

In Rev. Rul. 58-74[24], a taxpayer used the method of currently deducting R&E expenditures (e.g., costs to obtain a patent), but failed to include certain R&E expenditures (thus, apparently, capitalizing them), The IRS ruled the taxpayer had to file a refund claim or an amended return and claim the additional R&E expenditures for the year or years in which they were omitted. The IRS ruled that the taxpayer should file an amended return to treat the omitted items as deductible R&E expenditures. The IRS also noted that because the taxpayer's method was to expense R&E expenditures, the taxpayer could not apply section 174(b) to such expenditures, or capitalize and later amortize them, or write them off upon abandonment of the project or projects. Hence, the taxpayer would permanently lose the deduction thereof in taxable years closed by the statute of limitations if the taxpayer did not timely file claims or amended returns.

In Rev. Rul. 68-144,[25] the IRS held that where a taxpayer had elected to currently expense all R&E expenditures (with the exception of those on particular projects to which the deferred expense method was elected), it cannot in a later year elect the deferred expense method on new projects unless permission is granted by the IRS.

Revenue Proc. 69-21,[26] and Rev. Rul. 71-248,[27] adopted this requirement – permission to change to a different method must be approved by the Commissioner – for software development costs. Once granted permission, taxpayers must use such method consistently unless permission is granted to change to another method with respect to part or all software development costs.

In Rev. Rul. 90-38,[28] the IRS prohibited a taxpayer from using amended returns to retroactively change from an erroneous to a permissible method of accounting. Revenue Rul. 90-38 involved a taxpayer engaged in real estate development that capitalized interest and other carrying charges but did not make a valid election under section 266, identifying the items it was capitalizing as required under Treas. Reg. § 1.266-1(c)(3). The IRS ruled that since the taxpayer capitalized the costs for two or more consecutive tax years without making a valid election, the taxpayer adopted a method of accounting with respect to the items and could not change that method by filing amended returns for those prior tax years. Instead, the taxpayer had to change its method of accounting by seeking IRS consent under section 446.

Similarly, in TAM 9421003,[29] the IRS ruled that a taxpayer in the oil and gas pipeline business that made an unauthorized method change from currently expensing to capitalizing and amortizing certain software development costs could not subsequently correct the unauthorized method change by amending its returns to deduct currently the costs.

[23] 2000-2 C.B. 601, as modified by Rev. Proc. 2007-16, 2007-4 I.R.B. 358.
[24] 1958-1 C.B. 148.
[25] 1968-1 C.B. 85.
[26] 1969-2 C.B. 303.
[27] 1971-1 C.B. 55.
[28] 1990-1 CB 57.
[29] Feb. 4, 1994.

2. Revenue Proc. 2000-50

In Rev. Proc. 2000-50, the IRS issued guidance related to accounting method changes for software costs. Appendix section 9 of Rev. Proc. 2015-14 covers these changes.[30] Under that section, if a taxpayer treats the costs of computer software in accordance with the applicable method described in Rev. Proc. 2000-50, the IRS will not question the taxpayer's treatment of its costs of computer software. Computer software costs covered under the change include those described in section 2 of Rev. Proc. 2000-50, which states:

> For the purpose of this revenue procedure, "computer software" is any program or routine (that is, any sequence of machine-readable 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. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included. 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 does not include any data or information base described in § 1.197-2 (b) (4) of the Income Tax Regulations (for example, data files, customer lists, or client files) unless the database or item is in the public domain and is incidental to a computer program. Nor does it include any cost of procedures that are external to the computer's operation.

Taxpayers with software development costs may make accounting method changes to treat such costs as currently deductible expenses, like research or experimental expenses under section 174(a), or may treat such costs as capital and recoverable through ratable amortization over either 36 or 60 months.[31]

Accounting method changes for computer software costs under Rev. Proc. 2000-50 are made with a section 481(a) adjustment.[32]

B. Background on Procedural Guidance

1. Section 446

Section 446(e) provides requirements with respect to changes of accounting method. It provides that generally, a taxpayer who changes the method of accounting on the basis of which the taxpayer regularly computes income in keeping the taxpayer's books shall, before computing taxable income under the new method, secure the consent of the Secretary. Section 446(e) was

[30] Note that under section 15 of Rev. Proc. 2015-13, taxpayers may file accounting method changes under Rev. Proc. 2011-14 for taxable years ending on or after May 31, 2014, and on or before January 31, 2015. Until the due date of the taxpayer's timely filed (including any extension) original federal income tax return for the requested year of changes, including changes for software development costs.

[31] Revenue Proc. 2000-50, § 5.

[32] Revenue Proc. 2015-14, Appendix § 9.01; Rev. Proc. 2011-14, Appendix § 9.01.

enacted as part of the Internal Revenue Code of 1954,[33] to codify then-existing regulations that authorized the Commissioner to impose terms and conditions on voluntary changes in method of accounting (i.e., changes initiated by the taxpayer).

Under [Treas. Reg. § 1.446-1(e)(3)(i)](), when securing the IRS's consent for a change in method of accounting, taxpayers must generally file a Form 3115, *Application for Change in Accounting Method*, with the IRS during the tax year in which the taxpayer desires to make the method change. On the application, taxpayers must, to the extent applicable, furnish any amounts that are duplicated or omitted as a result of the proposed change and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. Permission to change a taxpayer's method of accounting is not granted unless the taxpayer agrees to the IRS's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is taken into account.

Further, [Treas. Reg. § 1.446-1(e)(3)(ii)]() provides that, notwithstanding the above provisions, the IRS may prescribe administrative procedures under which taxpayers are permitted to change their method of accounting. The administrative procedures must prescribe those terms and conditions necessary to obtain the IRS's consent to effect the change and to prevent duplicated or omitted amounts. The terms and conditions that the IRS may prescribe may require taxpayers to effect the change in method of accounting on a cut-off basis or by an adjustment under section 481(a) that is taken into account in the taxable year or years prescribed by the IRS.

2. Section 481

Section 481 was also enacted as part of the Internal Revenue Code of 1954,[34] and provides rules for adjustments required by changes in method of accounting. It provides generally that in computing a taxpayer's taxable income for the year of a change in method of accounting, "there shall be taken into account those adjustments, which are determined to be necessary, solely by reason of the change, in order to prevent amounts from being duplicated or omitted."[35]

Under section 481(c), however, a section 481(a) adjustment may be taken into account in such manner and subject to such conditions as prescribed by the IRS.

Treasury Reg. § 1.481-1(a)(1) adds that "in computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change **in order to prevent amounts from being duplicated or omitted.**" (Emphasis added).

As originally enacted, section 481 provided that the portion of the adjustment attributable to pre-1954 Code years was excluded from the required adjustment, regardless of whether the change was voluntary or involuntary. This exclusion enabled taxpayers to change from one permissible method to another permissible method or from an impermissible method to a permissible method without accounting for any duplication or omission of amounts that were attributable to pre-1954 Code years. When it became apparent that this provision was being abused, Congress amended

[33] Pub. L. 591, 68A Stat. 1.
[34] Pub. L. 591, 68A Stat. 1.
[35] Section 481(a).

section 481 in the Technical Amendments Act of 1958,[36] to provide that the section 481(a) adjustment would include amounts attributable to pre-1954 Code years if the change was voluntary, but would exclude such amounts if the IRS required the change.[37]

3. The Cut-off Method

In Rev. Proc. 92-20,[38] the IRS prescribed rules for effecting accounting method changes using a cut-off method. It states the IRS may determine that certain categories of methods of accounting will be changed using a cut-off method.[39] Under the cut-off method, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new method of accounting. Taxpayers will continue to account for any items arising prior to the year of change under their former method of accounting. The revenue procedure states because no items are duplicated or omitted from income when using a cut-off method to effect a change in accounting method, then no net section 481(a) adjustment is necessary.

III. AICPA Specific Comments and Recommendations on Procedures for Effecting Section 174 Method Changes

A. Add to the Treasury and IRS Priority Guidance Plan for 2015-2016 the Project Regarding Procedures for Changing Methods of Accounting for R&E Expenditures

The current administrative framework provided to a taxpayer that either has mischaracterized an expenditure as a R&E expenditure or has mischaracterized a R&E expenditure (as a capital expenditure or an inventoriable expenditure) and wishes to correct such mischaracterization is inconsistent and confusing. Therefore, the AICPA respectfully recommends that the Treasury and IRS add to the Priority Guidance Plan for 2015-2016 the project regarding procedures for changing methods of accounting for R&E expenditures, and modify the procedures as described herein. We believe the recommended approach will provide clarity and simplification for taxpayers.

1. Administrative Framework Prior to Rev. Proc. 2015-14

Prior to the issuance of Rev. Proc. 2015-14,[40] a taxpayer that had mischaracterized R&E expenditures, as either a capital expenditure or an inventoriable cost[41] or vice versa, could effectuate such correction either by:

- Filing an amended tax return for the taxable year in which the mischaracterization occurred (assuming such taxable year is not barred by the statute of limitations), or

[36] Pub. L. 85-866, 72 Stat. 1606.
[37] See also Treas. Reg. § 1.481-1(a)(2).
[38] 1992-12 I.R.B. 10, sec. 2.05(3).
[39] See, e.g., Treas. Reg. § 1.472-8 (f) (2); Rev. Proc. 2011-14, Appendix § 22.
[40] 2015–5 I.R.B. 450.
[41] Note that when referencing inventoriable cost method changes, the AICPA refers to method changes other than those made pursuant Rev. Proc. 2011-14, Appendix § 11.03, which requires all section 174 costs that will be removed from inventory costs must have been identified as section 174 costs at the time that the costs were capitalized to inventory under § 263A and the regulations thereunder.

- Filing an automatic accounting method change under Appendix section 7.01 of Rev. Proc. 2011-14[42] to correct such mischaracterization prospectively using cut-off transition procedures.

This decision was made informally within the National Office of IRS and did not receive widespread publication. Accordingly, the IRS rejected amended returns on examination when some taxpayers sought to use this approach to correct prior mischaracterizations of R&E expenditures.

In rejecting such amended returns, IRS examiners cited the precedents noted above (Rev. Rul. 90-38 and TAM 9421003). As a result, taxpayers are confused about the continued applicability of Rev. Rul. 58-74[43] in light of these controversies.[44]

Another reason many taxpayers have been confused as to what are the proper procedures to correct mischaracterized expenditures is that the IRS National Office has never publicized its policy of permitting the use of amended returns to correct prior mischaracterizations of R&E expenditures.

The present state of affairs appears to leave taxpayers with two alternatives for correcting the mischaracterizations of such expenditures.[45] One alternative is to file an amended return for open taxable years and correct the mischaracterized expenditures arising in those years. Another alternative is for the taxpayer to continue on an improper method of accounting for expenditures incurred in prior taxable years and, under Appendix section 7.01 of Rev. Proc. 2011-14, change to a proper method of accounting for expenditures incurred in the year of change or thereafter (this option is only available through the 2014 tax year due to the limited transition rules provided in Rev. Proc. 2015-13).

If the taxpayer elects the amended return approach, the taxpayer must continue to use its incorrect method of accounting for expenditures incurred in taxable years prior to the earliest open taxable year. Alternatively, if a taxpayer chooses to make an accounting method change under Appendix section 7.01, the taxpayer is required to continue to use its incorrect method of accounting for expenditures incurred prior to the year of change. Thus, neither of these approaches places the taxpayer on a completely proper method of accounting.

Furthermore, if a taxpayer chooses the amended return approach, the taxpayer is subject to challenge by the IRS when claiming depreciation deductions for expenditures incurred and mischaracterized as capital expenditures in closed years. Likewise, as discussed further below, the taxpayer risks potentially losing tax basis permanently in such mischaracterized expenditures when the taxpayer fails to claim depreciation in prior years and the IRS is able to sustain an adjustment under the "allowed or allowable" concept for depreciable property.

[42] 2011-4 I.R.B. 330, 379.
[43] 1958-1 C.B. 148.
[44] To eliminate taxpayer confusion, we respectfully request the Treasury and IRS issue guidance clarifying the applicability of the holding in Rev. Rul. 58-74, and specifically when an accounting method change effected under Rev. Rul. 58-74 via an amended return.
[45] Here, the AICPA refers to taxpayers' ability to amend tax returns in prior years, and file accounting method changes covered by Appendix section 7.01 of Rev. Proc. 2011-14.

2. Administrative Framework Subsequent to Rev. Proc. 2015-14

Subsequent to the issuance of Rev. Proc. 2015-14, there is even more confusion as to the proper administrative procedures for correcting mischaracterizations of R&E expenditures. It appears that taxpayers that mischaracterized R&E expenditures as either a capital expenditure or an inventoriable cost, or vice versa, may still effectuate such correction by filing an amended tax return for the taxable year in which the mischaracterization occurred (assuming such taxable year is not barred by the statute of limitations). The AICPA has the same concerns (discussed above) with the amending option subsequent to the issuance of Rev. Proc. 2015-14.

In addition, taxpayers may file an automatic accounting method change under Appendix section 7.01 of Rev. Proc. 2015-14[46] to correct R&E expenditures that are mischaracterized as either capital or inventoriable costs, prospectively using cut-off transition procedures. However, it is unclear whether Appendix section 7.01 of Rev. Proc. 2015-14 applies to method changes for amounts characterized as R&E expenditures which, instead, should have been capitalized or inventoried.

Specifically, taxpayers and practitioners are confused as to whether the new procedure in Rev. Proc. 2015-14, Appendix section 7.01 (i.e., changes from treating R&E expenditures as currently deductible expenses or deferred expenses to treating such expenditures as "a charge to capital account") applies to method changes for amounts characterized as R&E expenditures which, instead, should have been capitalized or inventoried under sections 263(a) or 263A. Taxpayers and practitioners have interpreted the prior version of that procedure in Rev. Proc. 2011-14, Appendix section 7.01 (i.e., changes from treating R&E expenditures as currently deductible expenses or deferred expenses to treating such expenditures as a capital expenditure under section 263(a)) to apply to method changes for amounts characterized as R&E expenditures which, instead, should have been capitalized or inventoried under sections 263(a) or 263A. The common fact pattern for taxpayers making method changes under that procedure in Proc. 2011-14 that covers changes to capitalize under section 263A certain costs mischaracterized as R&E expenditures. Taxpayers have limited transition guidance under Rev. Proc. 2015-13 to make changes for R&E expenditures under Rev. Proc. 2011-14 through the 2014 tax year.[47] The AICPA is concerned that without clarification to the new procedures, taxpayers may not, after tax year 2014, make automatic accounting method changes to capitalize under section 263A certain costs mischaracterized as R&E expenditures.

The AICPA understands that the prior project on the 2013-2014 Priority Guidance Plan was intended to clarify the procedures required to correct mischaracterizations of R&E expenditures, however, the project was removed from the Priority Guidance Plan.

Because it is unclear how the Treasury and IRS wants taxpayers to effect mischaracterizations of R&E expenditures, the AICPA recommends that the Treasury and IRS add to the Priority Guidance Plan for 2015-2016 the project regarding procedures for changing methods of accounting for R&E expenditures.

Further, we respectfully recommend Treasury and the IRS to modify the automatic change procedures to:

[46] 2011-4 I.R.B. 330, 379.

[47] Section 15 of Rev. Proc. 2015-13, 2015-5 I.R.B. 419.

1) Clearly apply to accounting method changes to capitalize under sections 263(a) and 263A certain costs mischaracterized as R&E expenditures; and
2) Implement R&E accounting method changes correcting mischaracterizations of R&E expenditures with a section 481(a) adjustment and receive audit protection.

B. Modify Rev. Proc. 2015-14 to Add a New Appendix Section 7.02 to Implement Section 174 Accounting Method Changes to Correct Mischaracterizations of R&E Expenditures with a Section 481(a) Adjustment and Receive Audit Protection

For the reasons discussed below, taxpayers correcting a mischaracterization of expenditures as R&E expenditures or correcting the mischaracterization of R&E expenditures as capital or inventoriable expenditures should make such corrections by computing a section 481(a) adjustment and receive audit protection. We believe the recommended approach will provide clarity and simplification for taxpayers. Therefore, the AICPA recommends that Treasury and IRS modify the automatic revenue procedures to add a new Appendix section 7.02 allowing taxpayers to correct mischaracterizations of expenditures as R&E expenditures which, instead, should have been capitalized or inventoried, or (conversely), to treat as R&E expenditures certain amounts that were incorrectly treated as capital expenditures or as inventoriable costs. We recommend that the new Appendix section 7.02 allow taxpayers to treat such corrections as accounting method changes effected with a section 481(a) adjustment. We also recommend that the new Appendix section 7.02 provide taxpayers with audit protection incident to the filing of a method change request to correct the mischaracterization of R&E expenditures incurred in taxable years prior to the year of change.

1. Permanent Omission or Deferral of Depreciation of Capitalized R&E Expenditures

Significantly, certain fact patterns described herein may result in a potentially permanent omission or significant deferral of depreciation related to capitalized R&E expenditures, and place taxpayers in a significantly worse tax position after making such method changes.[48] For example, under section 174 taxpayers may capitalize, capitalize and amortize, or currently deduct eligible R&E expenditures.[49]

A potentially permanent omission of recovery of R&E expenditures may occur if the IRS applies the ruling in Rev. Rul. 58-74 (i.e., a taxpayer must file an amended return to correct the treatment of mischaracterized R&E expenditures) to a taxpayer that initially capitalized but did not amortize R&E expenditures and subsequently, the IRS rules that the costs should have been deducted as R&E expenditures currently or through depreciation in years that are now closed. In this circumstance, a taxpayer is prevented from amending the returns in the closed tax years to deduct the R&E expenditures, and the capitalized R&E expenditures have no remaining basis to recover through additional depreciation deductions in subsequent years. Thus, the taxpayer is prevented from recovering the R&E expenditures in both prior closed years and subsequent years resulting in a permanent omission of cost recovery. While it is possible that section 1311 would apply in such a case (as noted in footnote 58), that outcome is not assured.

[48] The AICPA understands that in very limited circumstances taxpayers may seek to apply the mitigation provisions in §§ 1311-1314 to recover R&E expenditures where inconsistent determinations may cause a potentially permanent omission of recovery of R&E expenditures. We believe these provisions would have limited applicability to correct cumulative income, and the AICPA respectfully recommends that taxpayers should make an accounting method change to correct mischaracterizations described herein with a section 481(a) adjustment.
[49] Section 174(a)(1), (b)(1); Treas. Reg. § 1.174-1.

Additionally, a taxpayer may not recover previously capitalized R&E expenditures in the context of a section 165 loss. Section 165(a) provides a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) limits the losses to those incurred in a trade or business, those incurred in transactions entered into for profit but not connected with a trade or business, and those losses of property due to fire, storm, shipwreck, or other casualty or from theft. If the taxpayer in the above example subsequently abandoned the research effort, it may not get a section 165 loss with respect to the capitalized R&E expenditures, because it is unable to prove a loss was sustained during the subsequent taxable year. The taxpayer would lose the recovery of the R&E expenditures because it could not establish entitlement to the section 165 loss.

Furthermore, the requirement to employ the cut-off method when making R&E accounting method changes under either Appendix section 7.01 of Rev. Proc. 2015-14 or Rev. Proc. 2011-14 may place taxpayers in a significantly worse tax position than if such changes were effected with a section 481(a) adjustment. As noted, if taxpayers correct mischaracterizations of R&E expenditures through use of the procedures in Appendix section 7.01 of Rev. Proc. 2015-14 or Rev. Proc. 2011-14, instead of amending prior returns, they must continue in subsequent years their improper method of accounting for expenditures incurred in prior taxable years and change to a proper method of accounting for expenditures incurred in the year of change or thereafter. Effecting the accounting method change on a cut-off method may significantly defer recovery of any capitalized R&E expenditures since taxpayers that are currently capitalizing, or capitalizing and amortizing, R&E expenditures must continue to capitalize or capitalize and amortize the expenditures incurred prior to the year of change. Taxpayers in this case would either recover the expenditures on disposition of the capitalized asset or through the original recovery period. However, this recovery may be significantly deferred depending on the required recovery period of the asset.

Thus, in our examples, the taxpayer may potentially lose permanently entitlement to the recovery of the capitalized R&E expenditures where an accounting method change is applied under Appendix section 7.01 of Rev. Proc. 2015-14 or Rev. Proc. 2011-14, or where an amended return is required. Such fact patterns result in potentially permanently omitting items of deduction and/or significant deferral of cost recovery, thereby placing taxpayers in a worse tax position following the accounting method change.

2. Administrative Policy Behind the Cut-off Method

The AICPA believes that the current approach in Rev. Proc. 2015-14 of requiring a cut-off transition rule for such changes, which has been in effect for several years, is not appropriate for correcting misclassifications of section 174 costs. The cut-off treatment of section 174 expenses in Appendix section 7.01 of Rev. Proc. 2015-14 and Rev. Proc. 2011-14 appears to be based on the fact that the section 174 regulations require the use of a cut-off transition rule when changing from the current expense method to the deferred expense method, and vice-versa. However, that situation is not equivalent to the situation in which R&E expenditures have been mischaracterized as capital expenditures or inventoriable costs.

The changes addressed in the section 174 regulations cover changes in treatment from one proper method to another proper method. In those cases, the IRS has made a policy decision that such changes are made only with prospective effect and do not require the recomputation of the taxpayer's taxable income to reflect the new choice of methods under section 174. As with many other similar types of elections (for example, bonus depreciation, section 59(e), election out of MACRS depreciation), the cutoff method is appropriate.

In contrast, in the case of mischaracterizations of R&E expenditures, the taxpayer's prior method was not a proper choice or election and correcting that improper choice should be implemented similar to any other accounting method change that is implemented with a section 481(a) adjustment. It is clear from the statute and regulations that taxpayers generally are required to make accounting method changes by computing a section 481(a) adjustment.

We understand the Treasury and IRS initially required the use of the cut-off method for a correction of a mischaracterization of R&E expenditures as described herein[50] because a change between the current expense and deferred expense method of accounting for R&E expenditures is effectuated using a cut-off transition rule.[51] In addition, the IRS has been concerned that some taxpayers may lack books and records sufficient to compute a section 481(a) adjustment. As a result, the Treasury and IRS determined that the cut-off method provided an administratively simple mechanism for effecting section 174 accounting method changes.[52]

However, the fact that the transition rule for initially adopting the current expense or deferred expense method of accounting for mischaracterized R&E expenditures is a cut-off method does not dictate that subsequent method changes to correct mischaracterized R&E expenditures warrants the same transition rule. For example, section 263A was implemented for fixed assets with a cut-off transition rule, but subsequent changes to a proper section 263A method for fixed assets requires a section 481(a) adjustment. In addition, in a number of areas in the recently issued repair regulations, the IRS promulgated a transition rule that is described as a "modified section 481(a) adjustment." The AICPA advocates this adjustment, which requires making the original adoption of an elective method with a cut-off transition rule, but any subsequent correction of the elected method would be made with a section 481(a) adjustment back to the effective date of the initial election.[53] In the R&E case, the initial election to expense R&E expenditures is the original adoption under the rules of modified section 481(a) adjustment. Likewise, the IRS is moving to this same type of dichotomy in accounting for long-term contracts, wherein the initial change to section 460 was made by statute as a cut-off transition change, whereas subsequent method changes are made using a section 481(a) adjustment.[54]

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[50] Here, the AICPA refers to taxpayers' ability to file accounting method changes covered by Appendix section 7.01 of Rev. Proc. 2015-14, or its predecessor.

[51] The required use of the cut-off method for certain accounting method changes has been controversial, a fact highlighted in the preamble to the final regulations under section 446 issued in 1995, since in these cases the cut-off method may work to duplicate or omit items of income or deduction and thus may distort taxable income. For example, the preamble to the final section 446 regulations noted that some questioned whether Treasury had the authority to issue regulations that grant the IRS discretion to require taxpayers to use the cut-off method in lieu of effecting accounting method changes with a section 481(a) adjustment. See TD 8608, 60 FR 40077 (Aug. 7, 1995).Treasury and the IRS responded affirmatively stating that its primary justification for using the cut-off basis is "on the basis of simplicity." Id.

[52] TD 8608, 60 FR 40077 (Aug. 7, 1995).

[53] See T.D. 9636, Preamble, 78 FR 57686, 57700 (Sept. 19, 2013).

[54] Proposed Treas. Reg. § 1.460-4(g)(2)(i).

3. Preserving Legislative Intent

Section 481 was enacted in 1954 and was designed to prevent items of income or expense from being omitted or duplicated as a result of a change in method of accounting initiated by either a taxpayer or the Government.[55]

For example, in enacting section 481(a) the Ways and Means Committee stated:

> The changes embodied in your committee's bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles, and to assure that all items of income and deductions are taken into account once, but only once in the computation of taxable income.
>
> *****
>
> Section 481. Adjustments required by changes in method of accounting. If there is a change in the method of accounting employed in computing taxable income from the method employed for the preceding taxable year, adjustments must be made in order that every item of gross income or deduction is taken into account and that none are omitted. At the same time no item is to affect the computation of taxable income more than once. It is only those omissions or doubling ups which are due to the change in method which must be adjusted
>
> *****
>
> Your committee's bill provides that the necessary transitional adjustments will be made in all cases where there is a change in method of accounting, whether the change is voluntary or involuntary.

The Senate Finance Committee noted:

> At present taxpayers who request permission to change their method of accounting (other than to the installment method), or to change the manner in which they compute significant items such as inventories, are required to make certain adjustments in the year of the change. These transitional adjustments are necessary to prevent income and expenses from being reported for tax purposes more than once and to prevent the omission of certain income entirely.[56]

It is clear that Congress sought to provide a mechanism to ensure that taxpayers making accounting method changes would neither omit nor duplicate items of income or deduction, and, thus, taxpayers are neither better nor worse off for income tax purposes after effecting accounting method changes.

The AICPA notes that the Treasury and IRS may require taxpayers to implement certain accounting method changes using a cut-off method.[57] However, we do not believe employing the

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[55] H.R. Rep. No. 1337, 83rd Cong., 2 Sess. 50, A164 (1954), U.S. Code Congressional and Administrative News, p. 4025.; S. Rept. 1622, 83d Cong., 2d Sess. 307-311 (1954); see also Hospital Corp. of Am. v. Comm'r, 107 T.C. 73, 88 (1996); Connors, Inc. v. Comm'r, 71 T.C. 913, 918 (1979).
[56] Id.
[57] Revenue Proc. 92-20, 1992-1 CB 685.

cut-off method when making R&E accounting method changes for mischaracterized expenditures under Appendix section 7.01 of Rev. Proc. 2015-14 or Rev. Proc. 2011-14 is the correct approach since taxpayers risk potentially losing basis permanently in mischaracterized expenditures, and, thus, omitting from income recovery where a section 481(a) adjustment is necessary to correct cumulative income. As noted, taxpayers may also face significant deferral of recovery of R&E expenditures under current administrative procedures for effecting accounting method changes.

Accordingly, to comport with the legislative intent behind section 481(a), the AICPA believes the appropriate approach to implement accounting method changes for mischaracterized section 174 expenditures is with a section 481(a) adjustment. As a result, this approach would place taxpayers in no better or worse tax position following the accounting method change. Effecting such changes with a section 481(a) would ensure that taxpayers' cumulative income is corrected for the mischaracterization of an expenditure as an R&E expenditure or the mischaracterization of an R&E expenditure as a capital expenditure or an inventoriable expenditure.

4. Consistent Procedures with Implementing Inventory Accounting Method Changes under Rev. Proc. 2011-14[58]

The AICPA believes that taxpayers need consistent administrative procedures for correcting the mischaracterization of R&E expenditures as a capital expenditure or inventoriable cost under Appendix section 11.03 of Rev. Proc. 2011-14.[59] Under that section, all section 174 costs that will be removed from inventory costs must have been identified as section 174 costs at the time that the costs were capitalized to inventory under section 263A and the regulations thereunder. Taxpayers correcting the mischaracterization of R&E expenditures as an inventoriable cost under section 263A pursuant to Appendix section 11.03 must compute a section 481(a) adjustment for inventories, and audit protection is provided for prior years.[60] We believe that consistency and fairness dictates effecting accounting method changes to correct mischaracterized R&E expenditures with a section 481(a) adjustment similar to the requirement to effect accounting method changes to exclude eligible section 174 R&E expenditures from inventory computations with a section 481(a) adjustment and that taxpayers receive audit protection for prior years. We are unaware of a policy reason for the difference in administrative procedures for correcting mischaracterized R&E expenses and changes to exclude eligible section 174 R&E from inventory computations, and we believe taxpayers should compute a section 481(a) adjustment and receive audit protection for both method changes.

5. Consistent Procedures for R&E Expenditures that Are Identical in Nature

The AICPA believes that taxpayers need consistent administrative procedures for effecting section 174 accounting method changes. Consistency would result in taxpayers with research and development expenditures (such as software development expenditures, and R&E expenditures) being similarly situated.

Currently, taxpayers making accounting method changes for software development expenditures under Rev. Proc. 2000-50 must effect such changes with section 481(a) adjustments and receive

[58] Appendix § 11.03 was reserved in Rev. Proc. 2015-14.
[59] As noted above, when we refer to such inventoriable cost method changes, the AICPA refers to method changes other than those made pursuant Appendix § 11.03 of Rev. Proc. 2011-14.
[60] Revenue Proc. 2011-14, § 11.03.

audit protection for the treatment of expenditures in tax years prior to the year of change. The Treasury and IRS believe, and the AICPA agrees, that because software development expenditures are so similar in nature to R&E expenditures, they should receive similar tax treatment.[61] In describing the similarity between software expenditures and R&E expenditures, the Treasury and IRS stated in Rev. Proc. 2000-50:

> The costs of developing computer software (whether or not the particular software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of § 174 as to warrant similar accounting treatment. Accordingly, the Service 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:[62]
>
> (1) 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 § 174 (a); or
>
> (2) 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 § 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 § 167 (f) (1) and the regulations thereunder, over 36 months from the date the software is placed in service.[63]

The Treasury and IRS have viewed software development expenditures as so similar to section 174 expenditures as to warrant similar tax treatment for over 40 years, as Rev. Proc. 69-21,[64] the predecessor to Rev. Proc. 2000-50, afforded similar treatment to software development expenditures.

The AICPA is not aware of a stated policy reason for the different treatment of software development expenditures and other R&E expenditures under section 174 with respect to changes in methods of accounting. Thus, we believe taxpayers making method changes for mischaracterized section 174 expenditures should receive the same treatment as taxpayers making changes for software development expenditures.

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[61] The IRS has acknowledged software development costs are so similar in nature to R&E expenditures that they warrant similar tax treatment. See, e.g., Rev. Proc. 2000-50.

[62] Revenue Proc. 2000-50.

[63] Revenue Rul. 71-248, 1971-1 C.B. 55.

[64] 1969-2 C.B. 303.

6. Encouraging Taxpayer Compliance

As noted in the AICPA's comment letter regarding the previously proposed regulations under section 174,[65] there has been significant controversy between taxpayers and the IRS regarding the uncertainty as to the tax treatment of R&E expenditures and eligibility under section 174. With the issuance of final regulations under section 174, taxpayers have more certainty as to the tax treatment of R&E expenditures. For example, prior to the issuance of the final section 174 regulations, taxpayers may not have deducted all eligible R&E expenditures, such as the cost of prototypes that become depreciable property when subsequently transferred to another person.[66] Taxpayers now seek to become compliant with section 174 and its regulations with respect to R&E expenditures.

Additionally, the new IRS reporting rules for Schedule UTP, *Uncertain Tax Positions*, and Schedule M-3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*, have incentivized taxpayers to become compliant with section 174 and its regulations with respect to R&E expenditures. We believe requiring taxpayers to effect accounting method changes for section 174 expenditures with a section 481(a) adjustment will incentivize taxpayers to become compliant with section 174 and its regulations, and also maintain detailed, accurate records allowing for the computation of an accurate adjustment and will foster compliance with the new IRS reporting rules.

Therefore, permitting taxpayers to effect accounting method changes for section 174 expenditures with section 481(a) adjustments would encourage compliance with section 174 and the IRS' new reporting requirements.

7. Promoting Economic Growth

The AICPA believes requiring taxpayers to effect accounting method changes for mischaracterized section 174 expenditures with a section 481(a) adjustment will provide certainty as to the treatment of mischaracterized R&E expenditures and will incentivize U.S. taxpayers to engage in research, thereby promoting U.S. economic growth. Requiring taxpayers to recover section 174 expenditures through section 481(a) adjustments, where in the circumstances described above recovery may be precluded in full or delayed, will generate current year recoveries, which will lead to increased domestic investment in R&D, which was the purpose of the enactment of section 174.[67]

Congress enacted section 174 to provide an economic incentive, particularly for small and growing businesses to engage in the search for new products.[68] For example, in the legislative history of section 174, Congress' two purposes for enacting the section were described as:

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[65] See AICPA Comments on Proposed Regulations to Amend the Definition of Research and Experimental Expenditures under section 174 of the Internal Revenue Code (Reg. 124148-05) (Dec. 11, 2013).
[66] This position is consistent with the IRS's position in the case of *T.G. Missouri Company v. Commissioner*, 133 T.C. 278 (2009).
[67] H.R. Rep. No. 1337 at 28 (1954). See also Rev. Rul. 85-186, 1985-2 C.B. 84.
[68] Id.

(1) To encourage research and experimental activities; and
(2) To eliminate the uncertainty as to the tax treatment of R&E expenditures.[69]

The AICPA believes with additional administrative flexibility to effect accounting method changes with section 481(a) adjustments, taxpayers would increase their investments in research in technologies and innovation, which will positively impact U.S. businesses and the economy.

8. Providing Audit Protection

To the extent taxpayers may make accounting method changes for mischaracterized R&E expenditures with a section 481(a) adjustment, the AICPA believes and recommends that taxpayers should receive audit protection for prior years. This suggestion is in the IRS's interest because taxpayers changing from a method where R&E expenditures have been improperly capitalized or included in inventory would have an economic incentive to voluntarily fix their prior erroneous method.

However, taxpayers that previously deducted expenses to which section 174 does not apply are unlikely to come forward and volunteer a correction of such method through the filing of an accounting method change request if they do not receive audit protection. In that type of situation, an examining agent could easily take the disclosures on the Form 3115 and propose audit adjustments for prior open years. Then the taxpayer would have no defense against such adjustments. Under those circumstances, we do not believe taxpayers would volunteer to file an accounting method change request.

In order for the IRS to facilitate its voluntary disclosure policy for accounting method changes (i.e., "carrot and stick" approach), there must be an incentive for taxpayers to act. Providing audit protection for accounting method changes where taxpayers employ a section 481(a) adjustment would create such an incentive and eliminate the disincentive that a lack of audit protection creates. We believe that the absence of audit protection discourages taxpayers that have mischaracterized R&E expenditures to correct such mischaracterizations.

In summary, the AICPA recommends that Treasury and IRS modify the automatic revenue procedures to add a new Appendix section 7.02 allowing taxpayers to correct mischaracterizations of expenditures as R&E expenditures which, instead, should have been capitalized or inventoried, or (conversely), to treat as R&E expenditures certain amounts that were incorrectly treated as capital expenditures or as inventoriable costs. We recommend that the new Appendix section 7.02 allow taxpayers to treat such corrections as accounting method changes effected with a section 481(a) adjustment. We also recommend that the new Appendix section 7.02 provide taxpayers with audit protection incident to the filing of a method change request to correct the mischaracterization of R&E expenditures incurred in taxable years prior to the year of change.

[69] H.R. Rep. No. 1337 at 28 (1954). See also Rev. Rul. 85-186. The House Ways and Means Committee Report No. 1337 described the purpose of enacting section was "[t]o eliminate uncertainty and to encourage taxpayers to carry on research and experimentation the committee bill provides that these expenditures . . . may, at the option of the taxpayer, be treated as deductible expenses."

C. Provide in the New Appendix Section 7.02 for Accounting Method Changes to Comply with Treas. Reg. § 1.174-2,[70] which Likewise Should Require Taxpayers to Make Method Changes with a Section 481(a) Adjustment and Receive Audit Protection

The AICPA seeks procedural guidance from the Treasury and IRS indicating how taxpayers should implement the final section 174 regulations. As noted above, on July 21, 2014, the Treasury and IRS issued final regulations under section 174, which affect taxpayers that incur R&E expenditures. These regulations address several long-standing issues related to the eligibility of prototype or pilot model expenditures as R&E expenditures. The regulations provide a definition of a pilot model and address whether the subsequent sale or other business use of a pilot model created to resolve design uncertainties is a factor in section 174 eligibility. In addition, the regulations clarify the interaction between the section 174(c) rule requiring capitalization of costs to acquire depreciable property used in connection with research activities and the general definition of R&E expenditures, including costs related to pilot models.

However, the regulations do not provide taxpayers administrative procedures for implementing changes to the provisions in the regulations. That is, the final regulations do not address whether taxpayers should make accounting method changes to conform to the final regulations either through amendment or an accounting method change, and if through an accounting method change request, with a section 481(a) adjustment or using cut-off method.

The AICPA believes the appropriate mechanism for changing the treatment of mischaracterized section 174 expenditures is generally through an accounting method change request and that, consistent with our comments above, taxpayers should effect the accounting method change with a section 481(a) adjustment.

The AICPA believes requiring taxpayers to effect accounting method changes for section 174 expenditures with a section 481(a) adjustment will prevent the potential full omission or delayed recovery of mischaracterized R&E expenditures, and, thus, comport with the purpose behind the enactment of section 481(a).

Therefore, the AICPA recommends that the new Appendix section 7.02 provide for accounting method changes to comply with the 2014 final pilot model regulations under section 174.[71] We believe the appropriate mechanism for changing the treatment of the mischaracterized section 174 expenditures is generally through an accounting method change request and that, consistent with our comments above, taxpayers should effect the accounting method change with a section 481(a) adjustment and receive audit protection.

To the extent the Treasury and IRS determine taxpayers should continue to make accounting method changes for mischaracterized section 174 expenditures using a cut-off method, the AICPA also recommends that taxpayers should have flexibility to amend in open tax years prior income tax returns to change the treatment of mischaracterized section 174 expenditures to prevent the omission of recovery of R&E expenditures, for taxable years ending prior to the adoption of new procedures.

[70] TD 9680, 79 F.R. 42193 (July 21, 2014).
[71] TD 9680, 79 F.R. 42193 (July 21, 2014).

IV. Conclusion

Because it is unclear how to effect mischaracterizations of R&E expenditures under administrative procedures, the AICPA recommends that the Treasury and IRS add to the Priority Guidance Plan for 2015-2016 the project regarding procedures for changing methods of accounting for R&E expenditures. Further, we respectfully recommend the Treasury and IRS modify the automatic change procedures to 1) clearly apply to accounting method changes to capitalize under sections 263(a) and 263A certain costs mischaracterized as R&E expenditures, and 2) provide that taxpayers compute a section 481(a) adjustment for section 174 accounting method changes and receive audit protection. Taxpayers correcting through administrative procedures the mischaracterization of an R&E expenditure as a capital expenditure or an inventoriable cost risk permanently losing tax basis or significantly deferring the recovery of basis, and, thus, are placed in significantly worse tax position following the accounting method change. The purpose and intent behind Congress' enactment of section 481(a) was to ensure that taxpayers neither duplicate nor omit items from their cumulative income when effecting accounting method changes. However, the current administrative requirement to employ a cut-off method when making section 174 accounting method changes is inconsistent with the purpose and intent behind Congress' enactment of section 481(a). Moreover, these alternatives for correcting such mischaracterizations of R&E expenditures represent an incomplete correction of what is admittedly an incorrect method of accounting.

An administrative framework that requires taxpayers to compute section 481(a) adjustments for section 174 accounting method changes would provide a clear and consistent policy that is aligned with how other method changes are handled where adjustments are needed to prevent the duplication or omission of items from cumulative income. The AICPA believes that taxpayers should receive audit protection for accounting method changes where taxpayers may make the changes with a section 481(a) adjustment.

Requiring taxpayers to effect section 174 accounting method changes with section 481(a) adjustments will make consistent current administrative procedures for R&E expenditures, incentivize taxpayer compliance with section 174 and IRS's new reporting rules, and encourage investment into domestic R&E, thereby spurring U.S. economic development. The AICPA respectfully requests the Treasury and IRS issue guidance providing administrative procedures for taxpayers making accounting method changes to comply with the final regulations under section 174, and the AICPA recommends the guidance require taxpayers to make section 174 accounting method changes with a section 481(a) adjustment and afford audit protection for such changes.

Finally, to the extent the Treasury and IRS determine that taxpayers should continue to make accounting method changes for mischaracterized section 174 expenditures using a cut-off method, the AICPA requests that taxpayers should have flexibility to amend prior income tax returns (for open years) to change the treatment of R&E expenditures. Such option will prevent taxpayers' omission of the recovery of R&E expenditures for taxable years ending prior to the adoption of new procedures.

The AICPA believes the above-described approach will allow taxpayers making accounting method changes for R&E expenditures to clearly reflect income and will reduce future controversy between taxpayers and the IRS.