January 2014

Proposed Regs. Clarify Research Expenditure Eligibility Under Sec. 174

The IRS in September issued proposed regulations (REG-124148-05) clarifying the application of Sec. 174 to the costs to create "pilot models" or prototypes. The proposed rules state that the reason a taxpayer creates a prototype or other product, and not its subsequent sale or use, determines whether it qualifies under Sec. 174. In addition, the IRS provides a definition of a pilot model and proposes to apply an approach consistent with the Sec. 41 research credit "shrinking back" rule to prototype costs.

Background.

Under Sec. 174(a), taxpayers may treat research or experimental expenditures paid or incurred in a tax year in connection with a trade or business as expenses that are not chargeable to a capital account. They may deduct such expenditures in the year paid or incurred. Regs. Sec. 1.174-2(a)(1) defines "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."

Sec. 174(c) and Regs. Sec. 1.174-2(b)(1) specify that Sec. 174 does not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation that is of a character that is subject to the allowance for depreciation. Regs. Secs. 1.174-2(b)(2) and (4) expand upon this limitation when research or experimental expenditures occur on a project that results, as an end product of the overall effort, in depreciable property to be used in the taxpayer's trade or business. Under this provision, the costs to design the end product may be treated as Sec. 174 costs and deducted in the year incurred, but the cost of the component materials of the asset constructed are not deductible and must be charged to an asset account.

The IRS has argued in the past that Sec. 174(c) precludes Sec. 174 treatment in the case of a subsequent sale of a resulting product to a customer because the sale gives rise to depreciable property in the hands

of the customer. However, in *T.G. Missouri*, 133 T.C. 278 (2009), the Tax Court rejected this argument.

Proposed Regulations.

In particular, adopting the Tax Court's holding in *T.G. Missouri*, the proposed regulations provide that a deduction under Sec. 174(a) is not inconsistent with a taxpayer's subsequent sale or use of a pilot model. In putting forth this rule, the IRS stated that allowing a subsequent event (such as a sale of a resulting product to a customer) to override Sec. 174 eligibility is inconsistent with congressional intent of avoiding uncertainty and encouraging research investment.

Accordingly, the proposed regulations specify that the ultimate success, failure, sale, or other use of research or property resulting from research or experimentation is not relevant for determining Sec. 174 eligibility. The proposed regulations also clarify that the rule requiring capitalization of the costs of depreciable property resulting from a project to design and build property is an application of the general rule and should not be applied to exclude otherwise eligible expenditures.

The proposed regulations also include a number of other helpful clarifications. They specify that the costs of producing a product after uncertainty concerning the development or improvement of the product is eliminated are not eligible expenses under Sec. 174 because the costs are not for research or experimentation, but also state that eligible costs may be incurred after production of a business component commences when uncertainty concerning the development or improvement of a product continues to exist.

The proposed regulations define a pilot model as "any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product." This includes fully functional representations or models of a product and, to the extent the shrinking-back rule applies, a component of a product.

The shrinking-back rule in the proposed regulations, similar to the one in the Sec. 41 regulations (Regs. Sec. 1.41-4(b)(2)), addresses when the requirements for Sec. 174 eligibility are met with respect to only a component part of a product and not the overall product. The IRS states that the shrinking-back rule preserves Sec. 174 eligibility when research expenditures relate to component parts but not the larger project. The proposed regulations' preamble provides as an example research related to an automobile's braking system when the overall design of the automobile and other components is already certain. The proposed regulations also state that the shrinking-back rule is not intended to exclude otherwise eligible expenditures.

The IRS proposes the regulations to apply to tax years ending on or after the final regulations are published. However, the IRS states that taxpayers may rely on the proposed regulations until that time, and it will not challenge return positions consistent with the proposed regulations.

Implications.

The proposed regulations provide a number of helpful clarifications to the application of the Sec. 174 rules. In particular, the rejection of the argument propounded by the IRS in *T.G. Missouri*-that the character of the property resulting from the research could prohibit the application of Sec. 174 to the costs to create the property-will eliminate needless controversy.

Also useful will be the proposed definition of a prototype quoted above. Moreover, the incorporation into this definition of a fully functional representation of a design will help, since the IRS previously questioned whether functional prototypes tested in actual operating environments are necessarily a component of research "in the experimental or laboratory sense." In addition, the example enabling multiple prototypes of a design representation will diminish controversy about the scope of the Sec. 174 rules.

Furthermore, the proposed regulations contain a helpful example of an evolutionary product development effort. While other examples illustrate the creation of "new" products or processes, Prop. Regs. Sec. 1.174-2(a)(11), Example (6), illustrates qualifying costs paid or incurred by a taxpayer seeking "to improve a machine for use in its trade or business."

How the IRS incorporates the research credit shrinking-back concept into the Sec. 174 rules will be important in determining how favorable this rule is for taxpayers in resolving controversies with the IRS. In particular, the statement in the proposed regulations that "[t]he presence of uncertainty concerning the development or improvement of certain components of a product does not necessarily indicate the presence of uncertainty concerning the development or improvement of other components of the product or the product as a whole" (Prop. Regs. Sec. 1.174-2(a)(5)) may create needless controversy if the IRS seeks to isolate the most experimental elements of a product improvement effort without considering the integration issues involved in developing the larger product.

In addition, the proposed rules may place more pressure on determining when uncertainty ends.

On balance, however, the proposed regulations contain several significant taxpayer-favorable clarifications and changes upon which taxpayers may immediately rely.

Source: IRS, AICPA.

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