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Additional guidance for the treatment of section 174 research or experimental expenditures (Notice 2024-12 and Rev. Proc. 2024-9)

Tax Alert

Overview

On December 22, 2023, the Treasury Department (Treasury) and Internal Revenue Service (IRS) issued Rev. Proc. 2024-9, which provides procedural guidance for taxpayers to make accounting method changes to apply the provisions of Notice 2023-63. IRS and Treasury concurrently released Notice 2024-12, which modifies certain provisions of Notice 2023-63.

Issue

The Tax Cuts and Jobs Act of 2017 (TCJA) requires taxpayers to capitalize specified research or experimental (SRE) expenditures paid or incurred in taxable years beginning after December 31, 2021. More specifically, SRE expenditures attributable to US-based research (including software development) must be amortized over a period of 5 years and SRE expenditures attributable to research conducted outside of the US must be amortized over a period of 15 years, beginning with the mid-point of the taxable year in which SRE expenditures are paid or incurred.

Notice 2024-12

Notice 2024-12 clarifies and modifies Notice 2023-63, which was issued on September 8, 2023, and provides interim guidance on the application of section 174 for expenditures paid or incurred in tax years beginning on or after January 1, 2022, as well as announcing the government's intent to issue proposed regulations consistent with such interim guidance. See our previously issued Tax Alert on Notice 2023-63.

Research performed under contract

Notice 2023-63 addressed treatment of expenditures incurred under agreements between a "Research Provider" and "Research Recipient" with respect to an "SRE Product."

Under Notice 2023-63, if the Research Provider does not bear **financial risk** under the terms of the contract *AND* does not have the **right to use any resulting SRE product** in its trade or business or otherwise exploit any resulting SRE Product through sale, lease, or license ("SRE product right"), then research costs paid or incurred pursuant to the contract **are not** SRE expenditures.

Notice 2024-12 modifies the guidance to clarify that if a Research Provider that does not bear financial risk under the terms of the contract with the research recipient obtains an **"excluded SRE product right"** but does not obtain any other SRE product right under the terms of such contract, then the costs paid or incurred by the research provider to perform SRE activities on behalf of the Research Recipient under such contract are not SRE expenditures. An "excluded SRE product right" is an SRE product right that (1) is separately bargained for (that is, an SRE product right that arose from consideration other than the cost paid or incurred by the research provider to perform SRE activities under that contract) or (2) was acquired for the limited purpose of performing SRE activities under that contract or another contract with the Research Recipient.

> ***Observation***
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> There was uncertainty as to whether, if a taxpayer that provided research services and also separately paid an arms-length fee to use the property created through such research would be required to capitalize its costs. Notice 2024-12 makes it clear that the research service provider does not have SRE expenditures under such facts.

Removal of consistency requirement in Notice 2023-63

Notice 2024-12 modifies Notice 2023-63 to permit taxpayers to apply some, but not all provisions of Notice 2023-63. Taxpayers are not required to rely on all the rules described in sections 3 through 9 of Notice 2023-63. Additionally, taxpayers may not rely on the disposition rules described in section 7 of Notice 2023-63, for SRE expenditures paid or incurred with respect to property that is contributed to, distributed from, or transferred from a partnership.

> ***Observation***
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> Taxpayers should consider whether to change to apply all or certain of the provisions in Notice 2023-63 (as modified by Notice 2024-12). In particular, removal of the requirement to apply all of the provisions of Notice 2023-63 provides certain taxpayers that disposed of property resulting from SRE expenditures the option to apply the provisions of the Notice unrelated to dispositions.

Clarification on Rev. Proc. 2000-50

Notice 2024-12 clarifies that taxpayers may continue to rely on Rev. Proc. 2000-50 for software development costs paid or incurred in taxable years beginning on or before December 31, 2021. Rev. Proc. 2000-50 is obsoleted for expenditures paid or incurred in taxable years beginning after December 31, 2021.

> ***Observation***
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> Taxpayers that capitalized and amortized software development costs incurred in tax years prior to tax years beginning on or after January 1,

2022, generally are able to change their method of accounting for such amounts to deduct or, if deducted, to capitalize and amortize—under automatic method change procedures.

Observation

Although the government stated its intent to issue proposed regulations consistent with the guidance in Notice 2023-63, Notice 2024-12 indicates that Treasury and IRS continue to consider written comments submitted under Notice 2023-63. Such comments may result in additional clarifications or modifications to the forthcoming proposed regulations.

Rev. Proc. 2024-9

Rev. Proc. 2024-9 provides procedures for taxpayers to obtain automatic consent of the Commissioner of Internal Revenue (Commissioner) to change methods of accounting in reliance on certain of the interim guidance provided in Notice 2023-63.

Section 7.02 of Rev. Proc. 2023-24: *Change in Method of Accounting for SRE Expenditures*

Rev. Proc. 2024-9 modifies section 7.02 of Rev. Proc. 2023-24 to incorporate procedures for a taxpayer to change its method of accounting for SRE expenditures to rely on interim guidance provided in Notice 2023-63.

For a change in method of accounting to comply with section 174 for the **first taxable year that the TCJA amendments to section 174 are effective**, including changes to rely on the interim guidance in Notice 2023-63:

- A taxpayer files a statement with the taxpayer's original federal return in lieu of a Form 3115.
- The change is made on a cut-off basis.
- The prior five-year change eligibility requirement is waived.

For a change in method of accounting to comply with section 174 for a **taxable year subsequent to the taxable year in which the TCJA amendments to section 174 are effective**, including changes to rely on the interim guidance in Notice 2023-63:

- A taxpayer must file a Form 3115.
- The change generally must be made with a modified section 481(a) adjustment that takes into account only expenditures paid or incurred in taxable years beginning after December 31, 2021. However, if a change results in a modified section 481(a) adjustment that is negative, the taxpayer may choose to implement the change on a cut-off basis.
- Taxpayers are permitted to make a change to comply with section 174 for its second taxable year beginning after December 31, 2021, regardless of whether the taxpayer made, or purported to make, a change for the same item for its first taxable year beginning after December 31, 2021.
- The prior five-year change eligibility requirement is waived for the first or second taxable year beginning after December 31, 2021.
- Taxpayers do not receive audit protection with respect to expenditures paid or incurred in taxable years beginning on or before December 31, 2021. Additionally, if a taxpayer did not make or attempt to make a change to comply with section 174 for its first taxable year beginning after December 31, 2021, audit protection is not granted with respect to expenditures paid or incurred in that first taxable year beginning after December 31, 2021. The consent granted for this change does not create any presumption that the new method of accounting is a permissible method of accounting.
- The automatic consent procedures added by Rev. Proc. 2024-9 do not apply to changes in treatment of expenditures incurred in taxable years beginning

on or before December 31, 2021. The change procedures also do not apply to a change from treating SRE expenditures paid or incurred by a taxpayer that transfers property created by such expenditures in a section 351 exchange as amortizable by the transferee corporation following the exchange to treating such expenditures as amortizable by the transferor. Rev. Proc. 2024-9 notes that such a change is not an accounting method change.

> ***Observation***
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> A taxpayer must have adopted a method of accounting with respect to an item before it can be eligible to change its method of accounting with respect to that item. A taxpayer adopts a method of accounting by treating an item properly in the first return that reflects that item or, if the item is treated erroneously, by treating the item consistently in two or more consecutively filed returns. To the extent a taxpayer has taken a position inconsistent with the Notice in its 2022 taxable year it should consider whether it has adopted a method of accounting with respect to that item and is eligible to change that item through a change in method of accounting.

> ***Observation***
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> Those taxpayers for which a modified section 481(a) adjustment would be negative should consider the impact that section 481(a) adjustment would have on their overall tax liability (e.g., taking into account GILTI, FDII, FTC limitations) and consider whether making the change on a "cut-off" basis may be preferable.

Section 9.01 of Rev. Proc. 2023-24: *Computer software expenditures*

Rev. Proc. 2024-9 clarifies that the methods of accounting available under section 9.01 of Rev. Proc. 2023-24 with respect to the costs of developing computer software (including the option of deducting such costs in the year paid or incurred) under these procedures are limited to costs of developing computer software paid or incurred in any taxable year beginning on or before December 31, 2021.

Section 19 of Rev. Proc. 2023-24: *Special Rules for Long-Term Contracts*

Rev. Proc. 2024-9 adds a new section 19.02 to Rev. Proc. 2024-23, which provides automatic consent for a taxpayer to change its method of accounting so that costs allocable to a long-term contract accounted for using the percentage-of-completion method (PCM) under section 460 include amortization of SRE expenditures consistent with the interim guidance provided in section 8 of Notice 2023-63.

In determining its allocable contract costs (i.e., the numerator of the percentage of completion ratio), a taxpayer must include amortization of SRE expenditures (rather than total SRE expenditures incurred), and treat such amortization as incurred for purposes of determining the percentage of completion as the amortization is deducted. Additionally, in determining the total estimated allocable contract costs (i.e., the denominator of the percentage of completion ratio), a taxpayer may include either: (1) all amortization of SRE expenditures that directly benefit or are incurred by reason of the performance of the long-term contract, or (2) only that portion of such amortization expected to be incurred and deducted during the term of the contract. A taxpayer using the first alternative must report any portion of contract price not previously reported by the taxable year in which the contract is complete in the taxable year following the year the contract is completed.

A change for the taxpayer's first taxable year beginning after December 31, 2021, is made on a cut-off basis and applies to all long-term contracts for which an SRE expenditure[1] is an allocable contract costs (including contracts entered into before the year of change).

If the change is made for a year of change later than the taxpayer's first taxable year beginning after December 31, 2021, such change is made with a modified section 481(a) adjustment that takes into account the section 460 treatment of SRE expenditures paid or incurred in taxable years beginning after December 31, 2021. The change applies to all long-term contracts for which an SRE expenditure is an allocable contract costs (including contracts entered into before the year of change). If the method change results in a negative section 481(a) adjustment, the taxpayer may opt to implement the change on a cut-off basis.

A taxpayer making this change receives audit protection only with respect to expenditures paid or incurred in taxable years beginning after December 31, 2021.

> ***Observation***
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> Taxpayers should assess which of the two optional methods for calculating the denominator with respect to SRE expenditures allocable to section 460 contracts results in the more favorable tax treatment under their particular facts.

State tax considerations

Some states, including California, among others, do not conform to the changes to section 174 made by the TCJA. See this Tax Alert dated June 1, 2023 for general guidance in select states. Taxpayers should consult with a multistate tax specialist on the potential state income tax implications, as each state may have its own rules and procedures, and failure to comply with those state-specific rules and procedures may result in the imposition of penalties.

Footnotes

[1] I.e., a research or experimental expenditure incurred in a taxable year after December 31, 2021 and subject to the mandatory capitalization provisions of TCJA.