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Client Alert

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United States: Notice 2023-63 Provides Preview of Eagerly Anticipated Rules on the Treatment of Research & Development Costs

September 2023 Tax News and Developments

In brief

On 8 September 2023, Treasury and the IRS released Notice 2023-63 announcing their intent to issue proposed regulations providing guidance on how to treat research and development costs in light of changes Congress made to the Code in the Tax Cuts and Jobs Act of 2017 (TCJA).[1] While taxpayers were looking forward to the release of proposed regulations under section 174, Treasury and the IRS took the somewhat unusual step of previewing the forthcoming rules in a Notice first. Comments on the Notice are due by 24 November 2023, indicating that it is unlikely that proposed regulations will be released before the end of 2023. This Alert summarizes the guidance in Notice 2023-63 (the "**Notice**").

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Background

The TCJA made a number of changes to Code section 174, effective for taxable years beginning after 31 December 2021. Congress first enacted section 174 in 1954 to ensure that taxpayers could deduct research and experimentation (typically referred to as "R&D") costs on a current year basis, rather than capitalizing and amortizing these amounts.[2] Prior to the TCJA, section 174 allowed taxpayers to choose how to treat R&D costs. Taxpayers could either deduct the costs on a current basis or capitalize the costs and amortize them over 60 months, beginning in the first month the taxpayer realized benefits from the R&D. If taxpayers elected to amortize, in addition to stretching the cost recovery over 60 months, taxpayers were also faced with uncertainty over when the amortization period would begin. The ambiguity arose because, when an R&D project begins, it is often unclear when or if the R&D will bear fruit. Accordingly, taxpayers rarely elected to amortize the costs over 60 months.[3]

The TCJA changed section 174 to provide that, for taxable years beginning after 31 December 2021, taxpayers must capitalize "specified" R&D referred to as "specified research and experimentation expenditures" (SR&E) and amortize the cost. Rather than limiting the scope of section 174, SR&E is broader than the prior definition of R&D in the former

[1] P.L. 115-97.

[2] See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954).

[3] Alternatively, section 59(e) allows a taxpayer to elect to amortize R&D costs that could be deducted under section 174 ratably over a 10 year period. Now that taxpayers cannot deduct their SR&E costs under 174, they also cannot elect to amortize under section 59(e). Section 59(e), in addition to providing significant flexibility, provided taxpayers with far greater certainty because the amortization period began right away. The broad flexibility of section 59(e) and the myriad of benefits that might be associated with such an election are beyond the scope of this alert.

version of section 174. As explained in further detail below, SR&E costs now include costs relating to software development.

Under the TCJA, taxpayers may amortize SR&E costs arising from activities conducted in the United States over 60 months, beginning with the midpoint of the year in which the taxpayers incurred the cost. In the case of SR&E conducted outside of the United States, the amortization period is 15 years, beginning with the midpoint of the year in which the taxpayers incurred the costs. The TCJA also added section 174(c)(3), which provides that taxpayers must treat software development costs as SR&E. In addition, the TCJA added section 174(d), which provides that if a taxpayer sells, exchanges, retires, abandons, or otherwise disposes of property with respect to which SR&E costs have been incurred, it is not entitled to immediate recovery of its basis in the property. Instead, the taxpayer must continue to amortize the SR&E costs over the remainder of the amortization period.

Despite all of these changes to section 174, Congress did not provide any guidance on how to treat the costs of research that one taxpayer performs as a service for another taxpayer (i.e., contract research). Until now, neither Treasury nor the courts had provided any guidance on how to treat such costs. The failure to provide guidance on how to treat contract research left taxpayers uncertain whether the service provider must capitalize its research costs. If so, two different taxpayers could end up essentially capitalizing the same costs. For a variety of reasons, including in particular that having two parties capitalize the same costs makes no sense, we believe that most R&D service providers had not been capitalizing their research costs prior to the release of Notice 2023-63. As explained further below, Notice 2023-63 confirms that service providers do not need to capitalize their research costs.

Capitalization under section 174 and the amortization period

Under section 174(a)(2), a taxpayer must capitalize SR&E costs and amortize the expenditures ratably over a 5-year period, provided the SR&E was conducted in the United States. In the case of SR&E for research performed offshore (i.e., "foreign research"), the amortization period is 15 years. In either case, the amortization period begins with the midpoint of the taxable year in which the taxpayer pays or incurs the expenditures. Section 3 of Notice 2023-63 provides interim guidance on this statutory provision by defining "foreign research" and providing rules to determine the "midpoint" of the taxable year.

Foreign research merely refers to any research conducted outside the United States, Puerto Rico, or any US territory or other US possession. To determine whether SR&E costs are attributable to foreign research, taxpayers must look to where they (or their service provider) physically performed the research and experimentation activities. In other words, you look to where the people performing the research are located, not where the person paying for the research is located.

In an ordinary 12-month year, the "midpoint" of a year refers to the first day of the seventh month of the taxable year in which the taxpayer pays or incurs the SR&E costs. If, for example, a taxpayer is a calendar-year taxpayer, and the taxpayer incurs SR&E costs in January and November 2023, the taxpayer would begin amortizing both costs beginning July 1, 2023.

For taxpayers with short taxable years, the amortization deduction is based on the number of months in the short taxable year. If a short taxable year includes only a portion of a month, the taxpayer must include the entire month in the number of months in the short taxable year, but the taxpayer may not double-count that month. If, for instance, a taxpayer has two successive short taxable years, and the first short taxable year ends in the same month that the second short taxable year begins, the taxpayer should include that month in the first short taxable year and not in the second short taxable year.

The midpoint for short taxable years is the first day of the midpoint month. If the short taxable year has an even number of months, the taxpayer determines the midpoint month by dividing the number of months in the short taxable year by two and then adding one. A taxpayer with a short taxable year of 10 months would begin amortizing SR&E costs beginning the first day of the sixth month of the short taxable year.

If the short taxable year has an odd number of months, the midpoint month is the month for which there are an equal number of months before and after that month. A taxpayer with a short taxable year of 11 months would also begin amortizing SR&E costs beginning the first day of the sixth month, because, in an eleven-month period, there are five months both before and after the sixth month.

Definition of SR&E for section 174 purposes

Section 4 of the Notice addresses the scope of section 174, and specifically whether costs are SR&E costs that are subject to capitalization and amortization under section 174.

Definition of SR&E

SR&E costs that are subject to section 174 are costs that either (i) satisfy the requirements of Treas. Reg. § 1.174-2, or (ii) are paid or incurred in connection with the development of any computer software, without regard to whether such costs satisfy the requirements under Treas. Reg. § 1.174-2. Generally speaking, SR&E costs under Treas. Reg. § 1.174-2 are for research or experimental activities in the experimental or laboratory sense intended to discover information that would eliminate uncertainty concerning the development or improvement or appropriate design of a product or a component or subcomponent of a product.

After setting forth the general definition of SR&E, the Notice provides a non-exhaustive list of the types of costs that are incident to SR&E activities. This list includes:

> **Labor.** For this purpose, labor costs include the cost of full-time, part-time, and contract employees and independent contractors who perform, supervise, or directly support SR&E activities. This cost includes all elements of compensation (including for instance stock based compensation) other than severance costs.
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> **Materials and supplies.** Materials and supplies costs include the costs of materials and supplies, including tools and equipment that are not depreciable under section 168 which are used or consumed to conduct SR&E activities or in the direct support of SR&E activities.
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> **Cost recovery allowances.** Cost recovery allowances include depreciation, amortization, or depletion allowances with respect to property used to perform SR&E activities or in direct support of SR&E activities, even if the property was placed into service in a taxable year that begins on or before 31 December 2021. The Notice confirms that the taxpayers can be required to capitalize certain expenditures twice. First, an initial expenditure can be capitalized under Section 263. Second, the capitalized-amount's depreciation or amortization cost recovery deduction incurred during a year can be capitalized again under Section 174 if the cost recovery amount supports SR&E activities.
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> **Patents.** Patent costs include the costs of obtaining or perfecting a patent, including in particular attorneys' fees.
>
> **Certain operation and management costs.** These costs include rent, utilities, insurance, taxes, repairs and maintenance costs, security costs, and similar overhead costs with respect to facilities, equipment and other assets used to perform SR&E or in direct support of SR&E.
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> **Travel costs.** Travel costs can constitute SR&E costs it they are incurred to perform SR&E or the direct support of SR&E.

The Notice also specifically excludes certain costs from the definition of SR&E that is subject to section 174, even if these costs are incurred as a result of SR&E, including among other things:

> **G&A.** General and administrative costs that only indirectly support or benefit SR&E are not within section 174.
>
> **Interest**. Interest on debt to finance SR&E is not an SR&E cost.
>
> **Certain software testings.** Broadly speaking, these costs include the cost of developing software after it is placed in service or is ready for sale or licensing to others.

Allocation of SR&E Costs

The Notice provides that taxpayers must allocate costs to SR&E on the basis of a cause-and-effect relationship between the costs and the SR&E. In the alternative, taxpayers may allocate costs to SR&E based on another relationship that reasonably relates the costs to the benefits provided to the SR&E activities. Though taxpayers have the flexibility to use a different allocation method for different types of costs, the methodology used for a type of cost must be applied on a consistent basis. The Notice provides that an allocation method for a particular type of cost may meet the requirements of the Notice, yet may not be appropriate for purposes of allocating that same type of cost under other sections of the Code. The Notice also includes a couple of illustrative examples on how to allocate certain SR&E costs that are not discussed in this Alert, but affected taxpayers should review them.

Consistency Requirement

The Notice also provides that SR&E costs must be treated consistently for purposes of all provisions under subtitle A of the Code. As a result, such expenditures may not be treated as ordinary and necessary costs under section 162, or capitalized under sections 195, 263(a), 263A, or 471. Further, the Notice states that amortization deductions arising from SR&E costs must be allocated and apportioned consistent with the rules under Treas. Reg. § 1.861-8 and -17.

Software

Under section 174(c)(3), a taxpayer must capitalize costs related to "the development of any software" as research or experimental expenditures. Section 5 of the Notice provides an interim definition of "software development." It first defines the terms "computer software" and "upgrades and enhancements" before listing activities treated as software development and activities not treated as software development.

"Computer software" is generally "any computer program or routine 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." The code may be fixed to a tangible medium such as a disk or accessed remotely such as via cloud computing. "Computer software" also includes "upgrades and enhancements," as well as "any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership or, or the right to use the computer software." Further, "computer software" includes software developed for use by the taxpayer either in its trade or business or for sale or licensing to others.

"Computer software" is not any data or information base described in Treas. Reg. § 1.197-2(b)(4) unless the data or information base is in the public domain and incidental to a computer program. This distinction between software and a database is likely to grow in relevance given the increasing importance of big data applications.

"Upgrades and enhancements" generally means modifications to existing computer software resulting in additional functions, increased speed, or improved efficiency of the software.

Generally, activities treated as software development for section 174 purposes include, but are not limited to, the following.

- planning the development of the computer software
- designing the computer software
- building a model of the computer software
- writing source code and converting it to machine-readable code
- testing the computer software (up to the point that a taxpayer places the computer software into service or determines that the computer software is ready for sale or licensing to others)
- producing product master(s), if the taxpayer develops the computer software for sale or licensing to others.

Activities that are not treated as software development vis-à-vis software developed by a taxpayer for use in its trade or business are as follows:

- training employees and other stakeholders that will use the computer software
- maintenance activities after the taxpayer places the computer software into service
- data conversion activities, except for activities to develop computer software that facilitate access to existing data or data conversion
- installing the computer software and other activities relating to placing the computer software into service.

With respect to software developed for sale or licensing to others, post-sale or post-licensing activities are not software development for section 174 purposes. These activities include marketing and promotional activities, maintenance, distribution, and customer support.

In cases in which a taxpayer purchases computer software and then later upgrades or enhances the purchased computer software, the general list of activities considered software development applies. Software development in this context will not include the actual purchase and installation of purchased computer software, including the cost of making the computer software compatible with the business or reengineering the business to make it compatible with the purchased software. Software development will also not include any planning, designing, modeling, testing, or deployment activities with respect to the purchase and installation of purchased computer software.

Contract research

Background

Before Congress amended section 174 in the TCJA, contractors performing contract research services could deduct their operating costs without regard to whether those costs were treated as R&D costs under the prior version of section 174 or not. If a contractor's costs were R&D costs under section 174, the contractor could elect to deduct the costs under section 174(a)(1). If not, the contractor could deduct the costs under section 162 as ordinary and necessary business expenses. In contrast, after Congress amended section 174 to require capitalization and amortization of SR&E costs, contractors performing contract research services could only deduct their operating costs on a current basis if those costs were **not** SR&E costs within the meaning of section 174(b). The statute does not specifically address costs a taxpayer incurs providing research services for the benefit of another person. Until now, Treasury has also been silent on the issue and there is no other guidance directly addressing the issue. The resulting lack of guidance left contractors performing contract research services with material uncertainty with respect to a critical question.

Contractors performing contract research typically provide research services on a "cost plus" basis (i.e., their service fees consist of an amount equal to their incurred costs, plus a fixed profit margin or other agreed upon profit component). Service fees are generally paid as services are provided, with the bulk of those fees reflecting cost reimbursements. Thus, treating service costs of contractors performing contract research services as SR&E costs would result in a significant mismatch between the timing of the contractors' taxable income and related deductions. Consider for instance the case of a taxpayer whose entire business consists of performing contract research services for others on a cost plus basis. Taxpayers in this business may receive cost plus 5% to 10% of their costs, and possibly more. Even if they do earn more than cost plus 10%, if they are not entitled to deduct the costs they incur in the process of providing the service, the US tax on the gross service income will very likely exceed the profit margin the taxpayer realizes providing the service. In other words, if section 174 applies it would ordinarily convert a profitable cost plus service into a business generating net operating losses. In the intercompany context, US multinationals with foreign subsidiaries providing contract research services would similarly experience a large upfront increase in subpart F or tested income with the related cost recovery lagging substantially behind (over fifteen years) and potentially being lost altogether.

Section 174(b) defines SR&E costs as "***research or experimental expenditures*** which are paid or incurred by the taxpayer during [a] taxable year ***in connection with the taxpayer's trade or business***." Although a contractor's service costs relate to research and experimental activities, and its service costs are incurred in connection with the contractor's trade or business, the contractor's service costs are not in the nature of research or experimentation in connection with its own service business. In fact, contractors may not retain any rights to IP resulting from their contract research services and accordingly have no assets to which their costs might be capitalized. Thus, the plain language of the Code provides strong support for the argument that the service costs contract research service providers incur while performing research funded by another party are outside the scope of section 174, and thus should be deductible under section 162. Further, as described above, requiring contractors performing contract research services to capitalize their service costs would result in a significant timing mismatch between recognition of income and related costs. Moreover, it simply does not make sense to have two taxpayers capitalize the same cost. For these (and several other) reasons, many contractors performing contract research services have taken the post-TCJA position that their service costs are not SR&E costs within the meaning of section 174.

Contract research exclusion rule

The Notice generally validates many contractors' view that they are not required to capitalize and amortize their service costs under new section 174. Before diving into the details of Treasury's proposed treatment of costs paid or incurred by contractors performing contract research services, the Notice defines a few key terms:

- A "research provider" means the party that contracts with a "research recipient" to (a) perform research services for the research recipient with respect to an "SR&E product," or (b) develop an SR&E product that the research recipient acquires from the research provider.
- A "research recipient" means the party that contracts with the research provider to (a) perform research services for the research recipient with respect to an SR&E product, or (b) develop an SR&E product that the research recipient acquires from the research provider.
- "Financial risk" means the risk that the research provider may suffer a financial loss related to the failure of the research to produce the desired SR&E product.
- The term "SR&E product" means any pilot model, process, formula, invention, technique, patent, computer software, or similar property (or a component thereof) that is protected under domestic or foreign law. Mere know-how, for example, that a research provider obtains by performing research services for a research recipient does not give rise to an SR&E product in the hands of the research provider because domestic and foreign law do not protect know-how.

Under the Notice, costs paid or incurred by a research provider may be treated as SR&E expenditures only if (i) the research provider bears financial risk under the terms of the contract with a research recipient, or (ii) the research provider has a right (not dependent on approval from another (unrelated) party to the research arrangement) to use any resulting SR&E product in its trade or business or to otherwise exploit any resulting SR&E product through sale, lease, or license.

If either of the above conditions is met, then costs paid or incurred by a research provider that are incident to SR&E activities performed under the contract are treated as SR&E costs of the research provider which must be capitalized and amortized under section 174, without regard to whether the research recipient is required to treat its costs as SR&E costs.

Although the Notice generally excludes service providers from the scope of section 174, the Notice (not surprisingly) confirms that costs a taxpayers pays to a service provider are within the scope of section 174 and subject to the principles set forth in Treas. Reg. § 1.174-2(a)(10) and (b)(3).

Observations

Treasury has interpreted section 174 as applying to contractors performing contract research services in a manner that generally makes sense and eliminates many of the unintentional problems and uncertainties created by amended section 174. Treasury could improve its proposed rules by refining the two prongs that trigger application of section 174 to research providers, as discussed below.

Financial Risk

First, the Notice provides that a research provider's costs must be treated as SR&E expenditures if the research provider bears financial risk under the terms of the contract with a research recipient (the "financial risk prong").

Notably, the Notice does not specify a threshold degree of financial risk required to trigger application of section 174 to a research provider. As currently drafted, it appears that a research provider's assumption of any degree of financial risk related to research failure could potentially be interpreted to cause its service costs to be treated as SR&E expenditures. Yet, we doubt Treasury intended for the rule to have such broad application.

For example, assume an SR&E contract requires the research provider to indemnify the research recipient for financial losses related to research failure to the extent such failure is caused by gross negligence or willful misconduct of the service provider. Should the service provider's limited indemnity obligation be treated as "financial risk" for purposes of determining whether the service provider's service costs are SR&E costs? We think not.

More broadly, it is unclear why research providers should be penalized for accepting financial risk under contract research arrangements. The mere assumption of financial risk may justify a higher profit margin, but does not necessarily mean that the research provider will retain any rights in SR&E products to which its service costs can be capitalized. We suspect that Treasury included this requirement because research service providers are typically compensated on a cost plus basis so that they do not bear financial risk. Moreover, these rules are consistent with the rules for funding in the R&D credit context. In that context, the party funding the research is generally the party entitled to the R&D tax credit.[4] Yet, unrelated parties may want to construct arrangements where the service provider has no rights to the IP, but has some upside for success and some downside for failure. We see no policy justification for issuing regulations that provide taxpayers with an incentive to avoid all such arrangements.

In any event, Treasury should consider adopting a more flexible approach, under which the "financial risk prong" only triggers the application of section 174 to a research provider if the research provider bears a substantial amount of financial risk under the contract. Alternatively, Treasury should except certain forms of standard / de minimis contractual risk from the definition of "financial risk" so that typical contract research arrangements do not inadvertently trigger the application of section 174 to a research provider.

Right to Use

Second, the Notice provides that a research provider's costs may be treated as SR&E expenditures if the research provider has an unfettered right to use any resulting SR&E product in its trade or business or to otherwise exploit any resulting SR&E product through sale, lease, or license (the "right to use prong").

As noted above, the "right to use prong" is helpfully limited to cases in which domestic and foreign law protects the results of the research. The Notice provides that research results such as know-how, which domestic and foreign law do not protect are not within the definition of an "SR&E product." Thus, common arrangements permitting a research provider to further exploit know-how obtained in the research process should not trigger application of section 174 to the research provider.

Treasury should similarly clarify that other common rights of use are excepted. For example, under typical SR&E arrangements, research providers are granted a non-exclusive, royalty-free license to use the research recipient's IP in performing contract services. Such licenses are often necessary to enable the contractual arrangement and should be explicitly excluded from the definition of "SR&E products" so that they do not trigger application of section 174 to the research provider.

Treasury should also consider softening application of the "right to use prong" in other cases where the service provider does not obtain material rights. Consider, for example, the case of a related party that provides research services and also provides distribution services to its affiliates. This situation arises in many industries, including for instance, the pharmaceutical industry. In this situation, the research provider has a right to use SR&E products in another service role (i.e., as a limited risk distributor) but does not ultimately receive any of the return that the research results generate. Instead, such a service provider merely receives a routine return and the owner of the research results obtains the premium that the research generates. The license to use the research merely to distribute the product is not a substantial right and should not drag the service provider into the scope of section 174.

Similar issues also arise in the case of contract manufacturers that also develop or refine products for their customers. In many cases, these research providers manufacture the products that they develop for their customers. This type of arrangement arises for both related and unrelated parties. In this situation, the contract manufacturer cannot, as a legal matter, manufacture the product without violating its customer's IP right unless it has license to use the IP to manufacture the product for the customer. These licenses are typically very restrictive and only allow the service provider to manufacture the product under the terms of the contract with the service recipient. The service provider cannot use the IP to manufacture the product for anyone else. Moreover, the service provider typically receives a cost plus return or a formulary return that is expected to yield a cost plus return.

These types of very limited rights to the results of the research that merely allow a service provider to perform additional services for the service recipient should not be within the scope of the rule requiring a party to capitalize SR&E costs.

[4] Note, for purposes of the R&D tax credit, payments from one affiliate to another are disregarded and the party performing the research is the party entitled to the credit. Treas. Reg. § 1.41-6(i)(2):

Disposition, retirement and abandonment

If a taxpayer sells, exchanges, retires, abandons or otherwise disposes of any property with respect to which the taxpayer has paid or incurred any SR&E during the amortization period set forth in section 174, the taxpayer is not entitled to immediately recover the unamortized amount. Instead, the taxpayer must continue to amortize the cost over the remainder of the section 174 amortization period. This rule continues to apply to the acquiring corporation if the taxpayer ceases to exist pursuant to a transaction subject to section 381 such as a tax-free reorganization under section 368 or a tax free liquidation under section 332. On the other hand, if the taxpayer ceases to exist in a transaction that is not subject to section 381, such as a taxable liquidation under section 331, the taxpayer may deduct the remainder of the unamortized SR&E cost in its final taxable year.

Long term contracts under section 460

The Notice also announces updates to the section 460 regulations that clarify how SR&E amortization deductions are taken into account when determining long-term contract revenue. These updates confirm that the "matching principles" inherent within section 460 require that the long-term contract costs deducted during a year must "match" the costs that are used to determine long-term contract revenue for that year. These updates confirm that taxpayers will only recognize revenue under section 460 long-term contracts attributable to R&E costs as the taxpayer deducts the amortization for those R&E costs.

Under the percentage-of-completion method of accounting (PCM) in section 460, a taxpayer is generally required to recognize revenue under a long-term contract based on when the taxpayer "incurs" costs on that contract. The current section 460 regulations, which pre-date the TCJA (and thus do not account for the change to section 174 that went into effect in 2022), provide that taxpayers must allocate "research and experimental ***expenses***" (R&E Expenses) to long-term contracts and that taxpayers must recognize long-term contract revenue as these R&E Expenses are incurred.

When Treasury promulgated the section 460 regulations, former section 174 specifically mentioned R&E Expenses, and taxpayers were allowed an immediate deduction for their R&E Expenses. Therefore, to the extent a taxpayer incurred an R&E cost during a year (assuming no elections were made), the taxpayer was allowed a deduction for their R&E Expenses during the year and the taxpayer also included their R&E Expenses in its calculations for determining long-term contract revenue.

After the amendments to section 174, taxpayers no longer have R&E Expenses. Instead, taxpayers only have SR&E "expenditures" that give rise to amortization deductions over time (5 or 15 years, depending on the place the activity was performed). Thus, after the section 174 amendments, a potential mismatch could have arisen if taxpayers could only deduct R&E amortization deductions during the taxable year, but the entire R&D Expense for the year was taken into account when determining long-term contract revenue. The Notice confirms that an interpretation that provides a mismatch between the amount of contract costs deducted and the amount of contract costs used to determine long-term contract revenue is inappropriate and incorrect.

The Notice announces that Treasury and the IRS intend to update the section 460 regulations to provide that the R&E Expenses that are used to determine long-term contract revenue under the PCM is the amortization of SR&E expenditures under section 174(a)(2)(B), and that such amortization is treated as incurred for purposes of determining the percentage of contract completion as deducted. Effectively, this change clarifies that the "matching" principle inherent within section 460 applies and that the amount a taxpayer may currently deduct for its amortization of SR&E costs is the relevant cost that should be used for purposes of calculating the taxpayer's section 460 revenue.

The Notice also states that any final regulations will not apply to costs that are not allocable contract costs, such as expenses previously capitalized under section 59(e) or former section 174(b). The Notice likely included this language so it would not undermine the government's position in cases in which taxpayers made section 59(e) elections for pre-2022 tax years.[5]

[5] See, e.g., LAFA 20205301f.

In the Request for Comments, the Notice asks whether total allocable contract costs should include "**all** SR&E expenditures that directly benefit or are incurred in connection with the long-term contract" or "**only that portion** of the SR&E expenditures expected to be amortized during the term of the contract?" (Emphasis added.)

The proposed revisions to the section 460 regulations are a welcome clarification. Taxpayers that use the PCM have already had to consider the impact of section 174 amortization, and the proposed updates in the forthcoming proposed regulations reflect a reasonable interpretation of the statute and sound tax policy. The request for comments is important and should not be overlooked by taxpayers. While welcome, the proposed changes to the section 460 regulations do not completely address the changes needed to fully account for section 174 amortization. The request for comments focuses in on the missing piece−namely, what is the appropriate scope of total allocable contract costs in the numerator of the PCM calculation? In our view, it would be appropriate to include all SR&E expenditures that directly benefit or are incurred in connection with long-term contracts in the numerator.

Coordinating cost sharing and the new version of section 174

The Notice anticipates questions about the interaction between section 174 and the rules for cost sharing arrangements (CSAs) pursuant to Treas. Reg. § 1.482-7. In a cost sharing arrangement, each party pays its share of the costs for developing intangibles based on its relative anticipated benefits. Treas. Reg. § 1.482-7(j)(3)(i) generally provides that any amounts a party pays for its share of the intangibles in a cost sharing arrangement must be treated as the payor's cost of developing intangibles at the location where the development is conducted. The regulations go on to provide that any such cost sharing payments that a party receives reduce the recipient's deductible intangible development costs ("IDCs"). Each cost sharing payment a participant receives must be treated as coming pro rata from payments made by all payors and will be applied pro rata against the deductions in the taxable year that the payee is allowed in connection with the IDCs. Any cost sharing payments received in excess of those deductions must be treated as in consideration for the use of the land and tangible property furnished for purposes of the CSA by the payee.[6]

The Notice indicates that Treasury and the IRS anticipate issuing proposed regulations that would update and replace the rules in Treas. Reg. § 1.482-7(j)(3)(i) by providing that cost sharing payments owed to a controlled participant reduce (i) the amount of the category of IDCs that the participant directly bears that are required to be charged to capital account, and (ii) the amount of the IDCs that the participant directly bears that are not required to be charged to capital account and that are deductible. Any cost sharing payments that are not in excess of the payor's share of reasonably anticipated benefits from exploiting the developed intangibles ("RAB share") of the total amount of the IDCs that are required to be charged to capital account and that are not required to be charged to capital account, but that are deductible, reduce the amount of each category of IDCs in the same proportion that the total amount of IDCs in each category bears to the total amount of IDCs in both categories. If there is any leftover amount of cost sharing payments in excess of the payor's RAB share, that leftover amount is treated as income.

After the TCJA's changes to section 174, there was uncertainty about how these provisions in the cost-sharing regulations interacted with section 174 because the current rules in Treas. Reg. § 1.482-7(j)(3)(i) assumed that the costs of SR&E activities are currently deductible under section 174, whereas the current version of section 174, as discussed above, requires taxpayers to capitalize and amortize these costs. This tension created the potential for payments received from other controlled participants to exceed allowable deductions in a taxable year, which could have potential implications on the income inclusions of the controlled participants. The regulations that Treasury and the IRS intend to issue are intended to resolve this ambiguity.

Conclusion and effective dates

Notice 2023-63 indicates that the regulations the Notice previews will apply to taxable years ending after 8 September 2023. This effective date essentially makes the regulations retroactively effective as of the beginning of the first taxable year beginning before 8 September 2023. More importantly for many taxpayers, including in particular those engaged in contract research services, taxpayers may rely on the Notice and treat it as effective as of the same effective date as

[6] Treas. Reg. § 1.482-7(j)(3); see also Treas. Reg. §1.482-7(j)(3)(iii), Ex. 1.

the changes that Congress made to section 174 in the TCJA. Specifically, taxpayers may rely on the Notice for costs paid or incurred in taxable years beginning after 31 December 2021, provided the taxpayer follows all of the rules in the Notice and applies them consistently.

We welcome Treasury's guidance on a variety of issues Congress left open when it changed section 174 in connection with the TCJA. The guidance in many cases confirms that taxpayers can take the positions that they have already been taking. To the extent that taxpayers were concerned about what the guidance might say, taxpayers should generally be relieved. In a number of cases, however, the guidance is a little too restrictive. As discussed above, taxpayers can reasonably ask why the rules change for contract research when the service provider bears some small amount of risk. To the extent that risk remains relevant, the question will be how much risk will trigger the rule. Similarly, the guidance does not adequately account for the types of very limited rights to the results of the research that merely allow the service provider to perform additional services for the service recipient (e.g., routine distribution and contract manufacturing services). Taxpayers now have an early preview of the upcoming regulations and those taxpayers that may be adversely impacted by the restrictive rules in the Notice should speak out and explain their concerns to Treasury. We expect Treasury to be open to reasonable comments.

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