

Code of Federal Regulations -- Title 26: Internal Revenue -- Chapter 1: Internal Revenue Service, Department of the Treasury-- Subchapter A: Income Tax -- Part 1: Income Taxes -- Section 1.174: Research and Experimental Expenditures

1.174-1 Research and experimental expenditures; in general.

Section 174 provides two methods for treating research or experimental expenditures paid or incurred by the taxpayer in connection with his trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred (see § 1.174-3), or they may be deferred and amortized (see § 1.174-4). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. The expenditures to which section 174 applies may relate either to a general research program or to a particular project. See § 1.174-2 for the definition of research and experimental expenditures. The term paid or incurred, as used in section 174 and in §§ 1.174-1 to 1.174-4, inclusive, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25).

1.174-2 Definition of research and experimental expenditures.

(a) In general.

(1) The term research or experimental expenditures, as used in section 174, means 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. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. 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. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

(2) For purposes of this section, the term product includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

(3) The term research or experimental expenditures does not include expenditures for—

- (i) The ordinary testing or inspection of materials or products for quality control (quality control testing);
- (ii) Efficiency surveys;
- (iii) Management studies;
- (iv) Consumer surveys;
- (v) Advertising or promotions;
- (vi) The acquisition of another's patent, model, production or process; or
- (vii) Research in connection with literary, historical, or similar projects.

(4) For purposes of paragraph (a)(3)(i) of this section, testing or inspection to determine whether particular units of materials or products conform to specified parameters is quality control testing.

However, quality control testing does not include testing to determine if the design of the product is appropriate.

(5) See section 263A and the regulations thereunder for cost capitalization rules which apply to expenditures paid or incurred for research in connection with literary, historical, or similar projects involving the production of property, including the production of films, sound recordings, video tapes, books, or similar properties.

(6) Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments. The reasonableness requirement of this paragraph (a)(6) does not apply to the reasonableness of the type or nature of the activities themselves.

(7) This paragraph (a) applies to taxable years beginning after October 3, 1994.

(8) The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

(9) The application of subparagraph (2) of this paragraph may be illustrated by the following examples: Example 1. A engages B to undertake research and experimental work in order to create a particular product. B will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, A pays to B in respect of the project the sum of \$150,000 of which \$25,000 represents an addition to B's laboratory and the balance represents charges for research and experimentation on the project. It is agreed between the parties that A will absorb the entire cost of this addition to B's laboratory which will be retained by B. A may treat the entire \$150,000 as expenditures under section 174.

Example 2. X Corporation, a manufacturer of explosives, contracts with the Y research organization to attempt through research and experimentation the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, Y is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project Y will transfer this tract, including any improvements thereon, to X. Section 174 does not apply to the amount paid to Y representing the costs of the tract of land and improvements.

(b) Certain expenditures with respect to land and other property.

(1) Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 or depletion under section 611, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allowances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to

which the allowances relate is used in connection with research or experimentation. If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) Expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174(a). Such expenditures cannot be amortized under section 174(b) except to the extent provided in paragraph (a)(4) of § 1.174-4.

(3) If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under section 174(a). However, see subparagraph (4) of this paragraph.

(4) The deductions referred to in subparagraphs (2) and (3) of this paragraph for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation. For the purpose of the preceding sentence, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. For example, a taxpayer undertakes to develop a new machine for use in his business. He expends \$30,000 on the project of which \$10,000 represents the actual costs of material, labor, etc., to construct the machine, and \$20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the \$20,000 as expenses not chargeable to capital account, but the \$10,000 must be charged to the asset account (the machine).

(c) Exploration expenditures. The provisions of section 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas or other mineral. See sections 617 and 263.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8562, 59 FR 50160, Oct. 3, 1994]

1.174-3 Treatment as expenses.

(a) In general. Research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174(a). See paragraph (b) of this section. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner under section 174(a)(3) with respect to part or all of the expenditures. See paragraph (b)(3) of this section. Thus, if a change to the deferred expense method under section 174(b) is authorized by the Commissioner with respect to research or experimental expenditures attributable to a particular project or projects, the taxpayer, for the taxable year of the change and for subsequent taxable years, must apply the deferred expense method to all such expenditures paid or incurred during any of those taxable years in connection with the particular project or projects, even though all other research and experimental expenditures are required to be deducted as current expenses under this section. In no event will the taxpayer be permitted to adopt the method described in this section as to part of the expenditures relative to a particular project and adopt for the same taxable year a different method of treating the balance of the expenditures relating to the same project.

(b) Adoption and change of method —

(1) Adoption without consent. The method described in this section may be adopted for any taxable year beginning after December 31, 1953, and ending after August 16, 1954. The consent of the Commissioner is not required if the taxpayer adopts the method for the first such taxable year in which he pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in his income tax return for such year a deduction for his research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which he incurs such expenditures, he cannot do so in subsequent taxable years unless he obtains the consent of the Commissioner under section 174(a)(2)(B) and subparagraph (2) of this paragraph. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(2) Adoption with consent. A taxpayer may, with the consent of the Commissioner, adopt at any time the method provided in section 174(a). The method adopted in this manner shall be applicable only to expenditures paid or incurred during the taxable year for which the request is made and in subsequent taxable years. A request to adopt this method shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The request shall set forth the name and address of the taxpayer, the first taxable year for which the adoption of the method is requested, and a description of the project or projects with respect to which research or experimental expenditures are to be, or have already been, paid or incurred. The request shall be signed by the taxpayer (or his duly authorized representative) and shall be filed not later than the last day of the first taxable year for which the adoption of the method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(3) Change of method. An application for permission to change to a different method of treating research or experimental expenditures shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the last day of the first taxable year for which the change in method is to apply. See, however, subparagraph (4) of this paragraph, relating to extensions of time. The application shall:

- (i) State the first year to which the requested change is to be applicable;
- (ii) State whether the change is to apply to all research or experimental expenditures paid or incurred by the taxpayer, or only to expenditures attributable to a particular project or projects;
- (iii) Include such information as will identify the project or projects to which the change is applicable;
- (iv) Indicate the number of months (not less than 60) selected for amortization of the expenditures, if any, which are to be treated as deferred expenses under section 174(b);
- (v) State that, upon approval of the application, the taxpayer will make an accounting segregation on his books and records of the research or experimental expenditures to which the change in method is to apply; and
- (vi) State the reasons for the change.

If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting permission to his income tax return for the first taxable year in which the different method is effective.

(4) Special rules. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 174(a) is applicable falls before January 2, 1958, consent is hereby given for the taxpayer to adopt the expense method or to change from the expense method to a different method. In the case of a change from the expense method to a different method, the taxpayer, on or before January 2, 1958, must submit to the district director for the internal revenue district in which the return was filed the information required by subparagraph (3) of this paragraph. For any taxable year for which the expense method or a different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958, if such return is necessary.

1.174-4 Treatment as deferred expenses.

(a) In general.

(1) If a taxpayer has not adopted the method provided in section 174(a) of treating research or experimental expenditures paid or incurred by him in connection with his trade or business as currently deductible expenses, he may, for any taxable year beginning after December 31, 1953, elect to treat such expenditures as deferred expenses under section 174(b), subject to the limitations of subparagraph (2) of this paragraph. If a taxpayer has adopted the method of treating such expenditures as expenses under section 174(a), he may not elect to defer and amortize any such expenditures unless permission to do so is granted under section 174(a)(3). See paragraph (b) of this section.

(2) The election to treat research or experimental expenditures as deferred expenses under section 174(b) applies only to those expenditures which are chargeable to capital account but which are not chargeable to property of a character subject to an allowance for depreciation or depletion under section 167 or 611, respectively. Thus, the election under section 174(b) applies only if the property resulting from the research or experimental expenditures has no determinable useful life. If the property resulting from the expenditures has a determinable useful life, section 174(b) is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life. Amounts treated as deferred expenses are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property. See section 1016(a)(14). See section 174(c) and paragraph (b)(1) of § 1.174-2 for treatment of expenditures for the acquisition or improvement of land or of depreciable or depletable property to be used in connection with the research or experimentation.

(3) Expenditures which are treated as deferred expenses under section 174(b) are allowable as a deduction ratably over a period of not less than 60 consecutive months beginning with the month in which the taxpayer first realizes benefits from the expenditures. The length of the period shall be selected by the taxpayer at the time he makes the election to defer the expenditures. If a taxpayer has two or more separate projects, he may select a different amortization period for each project. In the absence of a showing to the contrary, the taxpayer will be deemed to have begun to realize benefits from the deferred expenditures in the month in which the taxpayer first puts the process, formula, invention, or similar property to which the expenditures relate to an income-producing use. See section 1016(a)(14) for adjustments to basis of property for amounts allowed as deductions under section 174(b) and this section. See section 165 and the regulations thereunder for rules relating to the treatment of losses resulting from abandonment.

(4) If expenditures which the taxpayer has elected to defer and deduct ratably over a period of time in accordance with section 174(b) result in the development of depreciable property, deductions for the unrecovered expenditures, beginning with the time the asset becomes depreciable in character, shall be determined under section 167 (relating to depreciation) and the regulations thereunder. For example, for the taxable year 1954, A, who reports his income on the basis of a calendar year, elects to defer and deduct ratably over a period of 60 months research and experimental expenditures made in connection with a particular project. In 1956, the total of the deferred expenditures amounts to \$60,000. At that time, A has developed a process which he seeks to patent. On July 1, 1956, A first realized benefits from the marketing of products resulting from this process. Therefore, the expenditures deferred are deductible ratably over the 60-month period beginning with July 1, 1956 (when A first realized benefits from the project). In his return for the year 1956, A deducted \$6,000; in 1957, A deducted \$12,000 (\$1,000 per month). On July 1, 1958, a patent protecting his process is obtained by A. In his return for 1958, A is entitled to a deduction of \$6,000, representing the amortizable portion of the deferred expenses attributable to the period prior to July 1, 1958. The balance of the unrecovered expenditures (\$60,000 minus \$24,000, or \$36,000) is to be recovered as a depreciation deduction over the life of the patent commencing with July 1, 1958. Thus, one-half of the annual depreciation deduction based upon the useful life of the patent is also deductible for 1958 (from July 1 to December 31).

(5) The election shall be applicable to all research and experimental expenditures paid or incurred by the taxpayer or, if so limited by the taxpayer's election, to all such expenditures with respect to the particular project, subject to the limitations of subparagraph (2) of this paragraph. The election shall apply for the taxable year for which the election is made and for all subsequent taxable years, unless a change to a different treatment is authorized by the Commissioner under section 174(b)(2). See paragraph (b)(2) of this section. Likewise, the taxpayer shall adhere to the amortization period selected at the time of the election unless a different period of amortization with respect to a part or all of the expenditures is similarly authorized. However, no change in method will be permitted with respect to expenditures paid or incurred before the taxable year to which the change is to apply. In no event will the taxpayer be permitted to treat part of the expenditures with respect to a particular project as deferred expenses under section 174(b) and to adopt a different method of treating the balance of the expenditures relating to the same project for the same taxable year. The election under this section shall not apply to any expenditures paid or incurred before the taxable year for which the taxpayer makes the election.

(b) Election and change of method —

(1) Election. The election under section 174(b) shall be made not later than the time (including extensions) prescribed by law for filing the return for the taxable year for which the method is to be

adopted. The election shall be made by attaching a statement to the taxpayer's return for the first taxable year to which the election is applicable. The statement shall be signed by the taxpayer (or his duly authorized representative), and shall:

- (i) Set forth the name and address of the taxpayer;
- (ii) Designate the first taxable year to which the election is to apply;
- (iii) State whether the election is intended to apply to all expenditures within the permissible scope of the election, or only to a particular project or projects, and, if the latter, include such information as will identify the project or projects as to which the election is to apply;
- (iv) Set forth the amount of all research or experimental expenditures paid or incurred during the taxable year for which the election is made;
- (v) Indicate the number of months (not less than 60) selected for amortization of the deferred expenses for each project; and
- (vi) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(2) Change to a different method or period. Application for permission to change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the end of the first taxable year in which the different method or different amortization period is to be used (unless subparagraph (3) of this paragraph, relating to extensions of time, is applicable). The application shall set forth the following information with regard to the research or experimental expenditures which are being treated under section 174(b) as deferred expenses:

- (i) Total amount of research or experimental expenditures attributable to each project;
- (ii) Amortization period applicable to each project; and
- (iii) Unamortized expenditures attributable to each project at the beginning of the taxable year in which the application is filed.

In addition, the application shall set forth the length of the new period or periods proposed, or the new method of treatment proposed, the reasons for the proposed change, and such information as will identify the project or projects to which the expenditures affected by the change relate. If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting the permission to his income tax return for the first taxable year in which the different method or period is to be effective.

(3) Special rules. If the last day prescribed by law for filing a return for any taxable year for which the deferred method provided in section 174(b) has been adopted falls before January 2, 1958, consent is hereby given for the taxpayer to change from such method and adopt a different method of treating research or experimental expenditures, provided that on or before January 2, 1958, he submits to the district director for the district in which the return was filed the information required by subparagraph (2) of this paragraph, relating to a change to a different method or period. For any taxable year for which the different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958.

(c) Example. The application of this section is illustrated by the following example:

Example. N Corporation is engaged in the business of manufacturing chemical products. On January 1, 1955, work is begun on a special research project. N Corporation elects, pursuant to section 174(b), to defer the expenditures relating to the special project and to amortize the expenditures over a period of 72 months beginning with the month in which benefits from the expenditures are first realized. On January 1, 1955, N Corporation also purchased for \$57,600 a building having a remaining useful life of 12 years as of the date of purchase and no salvage value at the end of the period. Fifty percent of the building's facilities are to be used in connection with the special research project. During 1955, N Corporation pays or incurs the following expenditures relating to the special research project:

Salaries	\$15,000	
Heat, light and power	\$700	
Drawings	\$2,000	
Models	\$6,500	
Laboratory materials	\$8,000	
Attorneys' fees	\$1,400	
Depreciation on building attributable to project (50 percent of \$4,800 allowable depreciation)		\$2,400
Total research and development expenditures	\$36,000	

The above expenditures result in a process which is marketable but not patentable and which has no determinable useful life. N Corporation first realizes benefits from the process in January 1956. N Corporation is entitled to deduct the amount of \$6,000 ($\$36,000 \times 12 \text{ months} \div 72 \text{ months}$) as deferred expenses under section 174(b) in computing taxable income for 1956.

Source: http://www.ecfr.gov/cgi-bin/text-idx?SID=5b703c67daacea899101c0ce1b50ea24&c=ecfr&tpl=/ecfrbrowse/Title26/26cfrv3_02.tpl - December 27, 2012