

Treasury Decision 8562

Internal Revenue Service

1994-2 C.B. 30

Section 174. —Research and Experimental Expenditures

26 CFR 1.174-2: Definition of research and experimental expenditures.

T.D. 8562

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

Research or Experimental Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains amendments to the Income Tax Regulations clarifying the definition of *research or experimental expenditures* and providing guidance regarding the reasonableness requirement of section 174(e), added to the Internal Revenue Code by the Revenue Reconciliation Act of 1989. These amendments affect taxpayers conducting research or experimentation in connection with a trade or business.

EFFECTIVE DATE: October 3, 1994.

SUPPLEMENTARY INFORMATION:

Background

Section 174 of the Internal Revenue Code (Code) provides two alternative methods that taxpayers may use to account for research or experimental expenditures. A taxpayer may either deduct the expenditures in the year in which they are paid or incurred, or treat the expenditures as deferred expenses, amortizable over a period of at least 60 months. In 1957, the IRS adopted § 1.174-2(a)(1), which defines the term *research or experimental expenditures* as expenditures which represent research and development costs in the experimental or laboratory sense (22 FR 7901 (October 4, 1957)).

In 1993, the IRS proposed amendments to § 1.174-2(a)(1) to clarify the definition of *research or experimental expenditures* (58 FR 15819 [PS-2-89, 1993-1 C.B. 904] (March 24,

1993)). The amendments also provide guidance regarding section 174(e), which was added to the Code by the Revenue Reconciliation Act of 1989. Section 174(e) provides that the accounting rules of section 174 apply to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances.

The IRS received comments on the proposed amendments both in writing and at a public hearing on June 18, 1993. This Treasury decision adopts the proposed amendments with several revisions in response to public comments.

Explanation of Provisions

A. Clarification of Uncertainty Test

As noted above, the 1957 regulations define *research or experimental expenditures* as expenditures which represent research and development costs in the experimental or laboratory sense. The proposed amendments provide 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. Under the proposed amendments, the requisite uncertainty exists if the information reasonably available to the taxpayer does not establish the capability or method for developing or improving the product.

Several commentators expressed concern that the uncertainty test provided in the proposed amendments could be construed to limit unduly the definition of *research or experimental expenditures*. In particular, the commentators argued that the test could exclude expenditures incurred to determine the appropriate design of a product if the taxpayer knows at the outset that the procedure will be successful. In such a case, the taxpayer is not uncertain as to either its capability to develop the product or the method by which it will develop the product.

The Treasury Department and the IRS agree that a taxpayer's knowledge that a product development project will be successful does not preclude the process of determining the appropriate design of the product from qualifying as research. The Treasury Department and the IRS also agree that the language of the uncertainty test provided in the proposed amendments could be construed to reach a result contrary to that intended. The final amendments thus clarify the uncertainty test. Under the final amendments, the requisite uncertainty exists if the information available to the taxpayer does not establish either (i) the capability or method for developing or improving the product, or (ii) the appropriate design of the product.

The uncertainty test, as clarified in the final amendments, reflects the dual purposes of section 174. Congress enacted section 174 not only to encourage research, but also to avoid the difficult tax accounting questions that would arise regarding research expenditures in the absence of special tax accounting rules. See H. Rep. 1337, 83d Cong., 2d Sess. (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4053. These difficult tax accounting questions would not be limited to cases in which the success of a product development project is in doubt. If a given line of inquiry proves to be unfruitful, questions could arise regarding whether the costs involved could be deducted, or whether the knowledge gained from the inquiry might contribute sufficiently to the

ultimate design of the product that the costs must be capitalized. In short, the tax accounting questions that section 174 was meant to resolve can arise whenever the taxpayer is uncertain as to the capability or method for developing or improving the product, or the appropriate design of the product.

The proposed amendments apply the uncertainty test with reference to “the information reasonably available to the taxpayer.” The Treasury Department and the IRS agree with the commentators that the meaning of the phrase *reasonably available* is unclear. Further, the phrase could be read to impose an unintended restriction on the definition of research or experimental expenditures. Information could be considered to be *reasonably available* to a taxpayer if the taxpayer can obtain the information through procedures that, while not particularly involved, are nonetheless in the nature of research activities. To avoid the ambiguities resulting from the term *reasonably*, the final amendments provide for the application of the uncertainty test with reference to the information actually available to the taxpayer. The removal of the term *reasonably* is not intended to expand the information considered to be available to the taxpayer.

B. Validation Testing.

The 1957 regulations exclude from the definition of research the ordinary testing or inspection of materials or products for quality control. Several commentators on the proposed amendments asked for clarification that research includes validation testing to ensure that a product design meets its intended objectives. In response to these comments, the final amendments clarify that the existing exclusion for quality control testing does not apply to testing to determine if the design of a product is appropriate.

C. Effective Date

The final amendments retain the effective date of the proposed amendments, and thus apply to taxable years beginning after October 3, 1994. Some commentators requested that the proposed amendments apply to all open taxable years. Because the amendments merely clarify the existing definition of *research or experimental expenditures*, retroactive application of the amendments is unnecessary. Return positions consistent with the amendments will be consistent with the existing regulations and will be recognized as such by the IRS.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on their impact on small business.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.174-2 is amended as follows:

1. Paragraph (a)(1) is revised.
2. Paragraphs (a)(2) and (3) are redesignated as paragraphs (a)(8) and (9), respectively.
3. New paragraphs (a)(2) through (7) are added.
4. Paragraph (c) is amended by removing the reference “sections 615” and adding “sections 617” in its place.
5. The additions and revisions read as follows:

§ 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.

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Margaret Milner Richardson,

Commissioner of Internal Revenue.

Approved September 9, 1994.

Leslie Samuels,

Assistant Secretary of the Treasury.

(Filed by the Office of the Federal register on September 30, 1994, 8:45 a.m., and published in the issue of the Federal Register for October 3, 1994, 59 F.R. 50159)