No. 2024-026
January 18, 2024

KPMG report: Updated accounting method change procedures and clarification of rules addressing capitalization of research and experimentation costs under section 174

The IRS on December 22, 2023, released the following two forms of guidance addressing section 174:

- Notice 2024-12 clarifies and modifies Notice 2023-63 addressing the capitalization and amortization of specified research or experimental (SRE) expenditures under section 174. Of note, the notice specifically clarifies the previously issued guidance relating to contract research providers.
- Revenue Procedure 2024-9 updates the procedures for changing methods of accounting under section 174.

Background

Public Law 115-97 (December 22, 2017), commonly referred to as the "Tax Cuts and Jobs Act" (TCJA), amended section 174 in several ways with the intent of raising revenues to offset tax cuts in other areas. Among the key amendments was the removal of the ability to currently deduct section 174 expenditures, requiring taxpayers to capitalize such costs and recover them through amortization over five years for expenditures incurred in the U.S. and over 15 years for expenditures incurred outside of the U.S.

The IRS on December 12, 2022, released an advance copy of Rev. Proc. 2023-8, providing accounting method change procedures applicable to companies required to capitalize and amortize SRE expenditures. Subsequently, the IRS on December 29, 2022, released Rev. Proc. 2023-11 to amend the procedures set forth in Rev. Proc. 2023-8 for making post-2022 accounting method changes with respect to obtaining audit protection. The IRS on June 15, 2023, released Rev. Proc. 2023-24, providing an updated annual list of automatic accounting method changes, which incorporates the automatic method change procedures issued in Rev. Proc. 2023-11 under section 174.

The IRS on September 8, 2023, issued Notice 2023-63 addressing issues related to section 174 as amended by the TCJA. Given the lack of a legislative deferral or repeal of the requirement to capitalize SRE expenditures, this notice was welcome guidance for taxpayers working to prepare their current year tax returns because it covered several areas that have been unclear in previous guidance. For a more detailed analysis of Notice 2023-63, read a September 2023 report [PDF 432 KB] prepared by KPMG LLP: *What's News in Tax: IRS Releases Initial Guidance on Section 174 SRE Expenditures*

Key points from Notice 2024-12

Notice 2024-12 clarifies and modifies Notice 2023-63, which announced that the Department of Treasury and IRS intend to issue proposed regulations addressing the capitalization and amortization of SRE expenditures under section 174. Specifically, Notice 2024-12 clarifies and modifies three areas of Notice 2023-63 as highlighted below.

- **Research performed under contract: excluded SRE product right.** Notice 2023-63 provides that a research provider's costs paid or incurred in performing SRE activities under a contract with the research recipient are SRE expenditures if the research provider bears financial risk or has an SRE product right (i.e., a right to use any resulting SRE product in a trade or business or otherwise exploit any resulting SRE product through sale, lease, or license). However, research providers that have an SRE product right only upon obtaining approval from an unrelated party (within the meaning of section 267 or 707) are not treated as having an SRE product right.

  While Notice 2023-63 eliminated significant uncertainty that contract research providers faced in evaluating the proper treatment of costs, it did not explicitly address a situation in which a research provider separately acquires rights for consideration thus compensating the research owner for those rights. These arrangements are common for multi-national corporations with complex intercompany research services arrangements. For example, in many cases, in addition to a research services agreement, the parties enter a separate agreement granting the research provider rights to distribute the product developed under the research services agreement and requiring the research provider to pay the research recipient an arms-length royalty for those rights. While not explicitly addressing this situation, KPMG interpreted the notice to exclude expenditures from the definition of SREs in this situation,[1] and Notice 2024-12 confirms that interpretation. Removing the ambiguity, Notice 2024-12 explicitly explains that costs paid or incurred by the research provider to perform SRE activities when the research provider separately bargains for the SRE product right, whether in the same contract or a separate contract, are not SRE expenditures of the research provider (referred to as an "excluded SRE product right") and thus not subject to capitalization under section 174.

  KPMG observation

  Taxpayers that took a more conservative position in interpreting either Notice 2023-63 or section 174(a) in general—that separately bargained for rights needed to be undertaken by a different entity, or at a minimum, a different contract--should no longer have that concern. Taxpayers in this position now have an opportunity to change their method of accounting in 2023 to expense the unamortized amount of these expenses. See the discussion of the procedures permitting a cumulative section 481(a) adjustment below.

- **Full or partial reliance on any of the rules in Notice 2023-63.** Notice 2023-63 states that the IRS intends to issue proposed regulations consistent with the rules in the notice to apply to tax years ending after September 8, 2023. However, the notice also provides that a taxpayer may choose to rely on the rules in tax years beginning after December 31, 2021, provided the taxpayer relies on and consistently applies all such rules. Notice 2024-12 modifies Notice 2023-63 by removing the requirement that Notice 2023-63 must be fully relied on and applied consistently in an effort to facilitate reliance on the rules in a more administrable manner.

  This modification benefits taxpayers that seek to rely on certain provisions of Notice 2023-63, as modified by Notice 2024-12, but not others, in tax years beginning after December 31, 2021, and before the issuance of final regulations. For example, Section 4.03(1) of Notice 2023-63 gives a nonexclusive list of

[1] See our analysis on page 10 of: IRS Releases Initial Guidance on Section 174 SRE Expenditures [PDF 453 KB]

costs that are SRE expenditures, and excludes amounts paid or incurred for severance from the definition of labor SRE expenditures. While such exclusion is helpful to taxpayers seeking to limit costs subject to capitalization, it negatively impacts the research credit under section 41, which generally provides as a threshold requirement that an expense be a SRE expenditure to be a qualified research expense (QRE). Eligible wages under section 41 are determined based on section 3401(a) which means all tax wages reported on Box 1 of Form W-2 are potentially QREs. Form W-2 Box 1 which includes severance. Given these inconsistencies, and absent the modification in Notice 2024-12 that removes the requirement to fully rely on and apply Notice 2023-63 consistently. If a taxpayer relied on Notice 2023-63 for a certain position, then it would need to exclude severance from Box 1, Schedule W-2 wages in the section 41 research credit. The modification to the applicability of Notice 2023-63 creates opportunities for taxpayers to partially rely on Notice 2023-63 but include severance as SRE expenditures avoiding the need to exclude such costs in the research credit under section 41.

- **Section 5.01 of Rev. Proc. 2000-50 obsoleted for software development costs paid or incurred in tax years beginning after December 31, 2021.** For tax years beginning after December 31, 2021, SRE expenditures subject to capitalization under section 174 include expenditures for software development. Notice 2023-63 provides guidance with respect to determining the types of activities that constitute software development and defines the term "computer software" as consistent with the guidance provided in Rev. Proc. 2000-50.

  Notice 2023-63 obsoleted section 5 of Rev. Proc. 2000-50, which permits taxpayers to treat software development costs in a manner similar to section 174 expenditures under the rules in effect prior to mandatory capitalization. Notice 2024-12 clarifies that section 5 of Rev. Proc. 2000-50 is only obsoleted for expenditures paid or incurred in tax years beginning after December 31, 2021. The clarification allows taxpayers to continue to file method changes to deduct software development expenditures under section 5 of Rev. Proc. 2000-50 that are paid or incurred in tax years beginning on or before December 31, 2021. This is helpful to taxpayers who may have capitalized these costs in the past and that seek to currently change the treatment of these expenses and given that some states do not follow section 174, will provide flexibility for state income tax purposes.

Notice 2024-12 is effective as of September 8, 2023, and may be relied on for expenditures paid or incurred in tax years beginning after December 31, 2021, until forthcoming proposed regulations are published.

Key points from Rev. Proc. 2024-9

Rev. Proc. 2024-9 modifies Section 7.02 of Rev. Proc. 2023-24, which provides automatic procedures for changing methods of accounting for SREs under section 174 paid or incurred in tax years beginning after December 31, 2021. In addition, Rev. Proc. 2024-9 adds Section 19.02 to Rev. Proc. 2023-24 to provide an automatic change for taking SREs into account under the percentage of completion method (PCM) under section 460. These changes are effective for Forms 3115 filed on or after December 22, 2023.

The following highlights the key points from the guidance:

- **General Scope: Option to change a method to rely on the statute or Notice 2023-63.** Section 7.02 of Rev. Proc. 2023-24 provides two options for a taxpayer to change its method of accounting relating to the substantive rules for defining SREs: (1) A change in method of accounting to interpret the statute (i.e., section 174, as amended by the TCJA) without regard to the notice (DCN 265), or (2) a change in method of accounting to rely on Notice 2023-63, as modified by Notice 2024-12 (DCN 270). Given that that the notices may be relied on by taxpayers, in whole or in part, but taxpayers also have the continued opportunity to rely on a reasonable interpretation of the statute without relying on the notices, in most instances a taxpayer following the approach of reasonably interpreting the statute would likely be able to contend that any positions taken that are consistent with the notices are also reasonable interpretations of the statute, but not vice versa. As such, we recommend that any taxpayer making a change under the new procedure designate the change to be under DCN 265, or both DCN 265 and DCN 270, but not DCN 270 by itself.

The modified procedure also makes it explicit that a change to no longer capitalize costs under section 174 that do not meet the definition of an SRE, depending on which option the taxpayer selects—interpretation of the statute or Notice 2023-63, as modified by Notice 2024-12—is included in the scope of the automatic change. In addition, the modified procedure excludes from the automatic change a change from treating SREs paid or incurred by a taxpayer that transfers property with respect to which such SREs were paid or incurred in a section 351 exchange as amortizable by the transferee following such exchange to treating such SREs as amortizable by the transferor following such exchange (since such a change is not a change in method of accounting).

- **Cut-off basis vs. section 481(a) adjustment.** As with the prior guidance, a change in method of accounting for the taxpayer's first tax year beginning after December 31, 2021, is made on a cut-off basis. However, method changes made in a year later than the first year beginning after December 31, 2021 (e.g., 2023) are made with a modified section 481(a) adjustment which takes into account costs paid or incurred in tax years beginning after December 31, 2021. Interestingly, if the change results in a taxpayer favorable ("negative") section 481(a) adjustment, Rev. Proc. 2024-9 provides flexibility allowing the taxpayer to choose between either making the change with an adjustment or on a cut-off basis.

- **Statement attachment or Form 3115.** Consistent with the prior guidance, a change in method of accounting for the taxpayer's first tax year beginning after December 31, 2021 is made by attaching a statement to the taxpayer's tax return for that year. However, changes made for a year later than first year beginning after December 31, 2021 are made by filing Form 3115. The revenue procedure describes certain information that is required to be included in the Form 3115 which is similar to the information that is required for the changes made via return statement.

- **Prior five-year change rule waived for a limited time.** The scope limitation on filing an automatic change if a taxpayer changed its method for the same item in the prior five tax years (found in Section 5.01(1)(f) of Rev. Proc. 2015-13) is waived for a taxpayer's first or second tax year beginning after December 31, 2021 (i.e., it is waived for the 2023 tax year). The revenue procedure clarifies that this is the case even if the taxpayer makes a change for the same item in successive tax years. For example, if the taxpayer changed its method for the first tax year beginning after December 31, 2021 (i.e., 2022), it may file another change for the same item for the second tax year beginning after December 31, 2021 (i.e., 2023) under the automatic procedure.

- **Limited audit protection is provided.** The new procedure narrows the scope of the denial of audit protection. Instead of denying it altogether for 2022 tax years, the revenue procedure only precludes a taxpayer from obtaining audit protection for 2022 if they did not make an accounting method change to capitalize SREs in 2022. Specifically, a taxpayer will not receive audit protection for a change made for the second year beginning after December 31, 2021 if it did not change, or attempt to change, its method for the first year beginning after December 31, 2021. As an example, if a taxpayer changed its method for 2022 and files a subsequent change for 2023, the change for 2023 will have audit protection (assuming it is otherwise available—e.g., the taxpayer is not under IRS examination). However, if the taxpayer waited to change its method until 2023, it would not have audit protection.

- **Non-applicability of two-year rule requiring the filing of two tax returns before filing a change in method of accounting.** IRS guidance provides that a taxpayer will not be treated as having adopted an improper accounting method until they file at least two consecutive tax returns using the method of accounting.[2] Although there is a view that the two-year rule also applies when a taxpayer incorrectly makes a method change for an item, Rev. Proc. 2024-9 indicates that a taxpayer may use the revenue procedure "for its second tax 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 tax year beginning after December 31, 2021."

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[2] See Rev. Rul. 90-38.

- **Taxpayers who filed returns in early 2023.** The revenue procedure provides a transition rule for taxpayers who filed a federal income tax return on or before January 17, 2023, for a tax year beginning after December 31, 2021. Those taxpayers are deemed to have complied with Section 7.02 of Rev. Proc. 2023-24 to change their method for SREs paid or incurred in the first tax year beginning after December 31, 2021 if the taxpayer (1) reported the amount of SREs paid or incurred for such tax year on Part VI of Form 4562, *Depreciation and Amortization,* filed with the Federal income tax return, and (2) properly capitalized and amortized the SREs in accordance with Section 174 for that year.

- **Automatic method change under Section 460.** A new Section 19.02 is added to Rev. Proc. 2023-24 to provide a method change to rely on Section 8 of Notice 2023-63, which addresses taking SREs into account under the PCM (DCN 271). The method change applies to treat the costs allocable to a long-term contract accounted for using the PCM to include only amortization deductions of such SREs, rather than the total amount incurred and capitalized under section 174. In addition, the amortization deduction for the SREs is treated as incurred for purposes of determining the percentage of contract completion in the tax year the amortization is deducted. This has the effect of not requiring the taxpayer to allocate the entire capitalized amount of allocable SRE expenditures to the contract, while only being permitted to deduct the amortization of such costs. This change would permit the taxpayer to only allocate the amortization amount of allocable SRE expenditures (i.e., only include the current year amortization amount in the numerator of the PCM formula) and to deduct the amortization as a cost incurred for the year in determining the percentage of the contract completed for the year. Lastly, the procedure provides that "estimated total allocable contract costs" in the denominator of the PCM formula will include either (1) all amortization of SREs that directly benefit or are incurred by reason of the performance of the long-term contract (i.e., the entire capitalized amount of allocable SREs), or (2) only that portion of such amortization expected to be incurred and deducted during the term of the contract (i.e., only the portion of allocable SREs to be amortized during the contract term). A taxpayer using the first alternative must report any portion of the contract price not previously reported by the tax year following the tax year in which the contract is completed, notwithstanding that some portion of the SREs remain unamortized.

  This change is made on a cut-off basis for the taxpayer's first tax year beginning after December 31, 2021, but applies to contracts entered into before the year of change for which an SRE expenditure is an allocable contract cost (so that the method change results in an adjustment to revenue and costs for existing contracts, not just new contracts). A change made for a year later the first tax year beginning after December 31, 2021 is made with a modified Section 481(a) adjustment, taking into account costs paid or incurred in tax years beginning after December 31, 2021 (again, including contracts entered into before the year of change). If the change results in a negative Section 481(a) adjustment, the taxpayer may choose to implement the change with an adjustment or on a cut-off basis. The five-year prior change scope limitation does not apply to a change made for the taxpayer's first or second tax year beginning after December 31, 2021.

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