

## Definition of Research & Experimentation (R&E) expenditures under section 174 amended

### Final regulations issued

#### Amended definition of research & experimentation (R&E) expenditures under section 174

On July 21, 2014, the Internal Revenue Service (IRS) issued final regulations (TD 9680) (the "Final Regulations") to amend the definition of research and experimental (R&E) expenditures under section 174. The Final Regulations provide guidance on the treatment of amounts incurred in connection with the development of tangible property, particularly costs incurred to design and construct prototypes, and pilot models that ultimately are placed in service by the taxpayer or sold to customers. The Final Regulations are very similar to proposed regulations issued in September of 2013, providing much-needed clarity of the expenditures that fall within the scope of section 174 and that (in some situations) may also qualify for the research credit allowed under section 41.

Notably, the Final Regulations expressly provide (as did the proposed regulations) that "[t]he ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174." Along with this provision, the Final Regulations clarify that "pilot models" eligible for section 174 treatment include any representation or model of a product — even a "fully-functional" unit of property produced by the taxpayer or on its behalf — that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product (meaning that production may have begun but design uncertainty has not yet been eliminated). The Final Regulations clarify that

this concept may include multiple pilot models produced to be used in testing the appropriate design of a product in one or more different environments, without requiring that each pilot model be tested for a purpose that is different from the other pilot models. Eleven examples are contained in the Final Regulations to illustrate the various expenditures that may be deducted under section 174 when incurred to develop a new product for sale or use by the taxpayer (including a "variant product" with different dimensions than an existing commercial product) or to integrate a new or improved component into an existing product for which there otherwise is no design uncertainty as to the product as a whole.

The Final Regulations are generally effective for taxable years ending on or after July 21, 2014. However, Treas. Reg. § 1.174-2(d) specifically provides that taxpayers may apply the provisions of the Final Regulations to taxable years for which the limitations for assessment of tax has not expired. Consequently, the pro-taxpayer clarifications may be used to address issues currently raised by IRS examiners, as well as for taking positions on taxable year 2013 returns, amending prior open-year returns, and possibly modifying carry-forward schedules to reflect increased net operating losses or credit amounts from closed taxable years. Taxpayers wanting to change their tax-accounting method for R&E expenditures from capitalization to expensing treatment should also consider requesting IRS consent for a method change (by filing Form 3115).