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November 23, 2023

DELIVERED ELECTRONICALLY

Internal Revenue Service
CC:PA:LPD:PR (Notice 2023-63)
Room 5203
P.O. Box 7604
Ben Franklin Station, Washington, DC 20044

Re: Notice 2023-63 Comments on Amortization of Specified Research or Experimental Expenditures under Section 174

Dear Sir or Madam,

We thank you for the opportunity to provide comments on Notice 2023-63 (the "***Notice***"), which announced the U.S. Department of the Treasury ("***Treasury***") and the Internal Revenue Service's (the "***Service***") intention to issue proposed regulations addressing the capitalization and amortization of specified research or experimental ("***SRE***") expenditures under section 174 of the Code,[1] as amended by Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), commonly referred to as the Tax Cuts and Jobs Act ("***TCJA***").

We commend Treasury and the Service's efforts to provide detailed guidance with regard to section 174. As Treasury and the Service proceed to draft proposed regulations, we ask that the following recommendations be implemented:

- We recommend that the proposed regulations require capitalization of a research provider's research expenditures only where the research provider has financial risk of loss on the research contract, without regard to whether the research provider has rights to use the SRE product. In the alternative, if the two-part test from Section 6 of Notice 2023-63 is retained, we recommend that the proposed regulations provide for capitalization only if the research provider retains substantial rights to exploit any resulting SRE product under the terms of the research contract itself. Capitalization should not be required where the research provider, in addition to providing contract research to the principal, licenses rights in the SRE product from the principal in exchange for separate,

[1] Except as specified otherwise, all section (§) references herein are to the Internal Revenue Code of 1986, as amended (the "***Code***"), and the Treasury Regulations ("***Treas. Reg.***") promulgated thereunder.

arm's length remuneration, or acts as a reseller of the SRE product under a separate, arm's-length agreement;

- We recommend that the proposed regulations provide that a research provider is not considered to bear financial risk of loss merely because it has a right to bonuses if it reaches certain milestones or the underlying contract for research services contains arm's length indemnification provisions, so long as it is fully compensated for its research expenditures without any risk of loss;

- We recommend that the proposed regulations provide that section 174(d) defers recovery of costs on the disposition of the intangibles only if and to the extent the taxpayer would otherwise recognize a loss. We also recommend that the rules in Section 7 of the Notice be modified to treat unamortized basis in a tax-free transaction as basis of the related intangible that is applied to the transferee, with the transferee receiving amortization deductions with respect to that intangible on the same schedule and in the same amounts as the transferor would have received if there had been no transaction;

- We recommend that Treas. Reg. § 1.1016-5(j) be updated to clarify that the same basis adjustment occurs as a result of expenditures that must be "charge[d] to capital account" pursuant to the revised section 174(a)(2)(A). In other words, amounts capitalized under section 174, like other capitalized costs of creating income-producing assets, should be capitalized into the basis of the specific assets to which they relate and should not be siloed in a freestanding R&D expenditure account that is detached from the related assets; and

- We recommend that final regulations interpret "amount allowable as a deduction" in section 280C(c)(1)(B) to refer to the amortization deduction allowable under section 174(a)(2).

I. CONTRACT RESEARCH

Section 6 of the Notice addresses research performed under contract. Under Section 6, the research provider is required to capitalize its research expenditures under section 174 only if, under the terms of the contract the research provider (i) bears "financial risk," or (ii) has a

right to use any resulting SRE product[2] in its trade or business or otherwise exploit any resulting SRE product through sale, lease, or license.

Treasury and the IRS have requested comments on (i) issues arising from the interim guidance set forth in the Notice, (ii) whether the rules for determining whether a party to a research contract has SRE expenditures under section 174 should be similar to the funded research rules under section 41(d)(4)(H), (iii) whether there are other factors that should be considered in determining whether a party to a research contract has SRE expenditures, and (iv) whether special rules are needed for contracts with related foreign research providers and recipients.

The Notice correctly recognizes that the research provider's research expenditures generally should not be capitalized under new section 174, as a typical contract research provider is not engaged in research to develop products for use in its "trade or business" within the meaning of section 174 and Treas. Reg. § 1.174-2(a)(3). We believe, however, that the Notice's standard for capitalization should focus solely on whether the service provider bears "financial risk" under the contract.

In the alternative, if the "right to use" the research is retained as a part of the test, the "right to use" exception should be narrowed and clarified. **In particular, we recommend that the proposed regulations, consistent with the definition of "funded research" under section 41(d)(4)(H), require capitalization of a research provider's research expenditures only where the research provider retains substantial rights to exploit any resulting SRE product under the terms of the research contract itself. Capitalization should not be required where the research provider, in addition to providing contract research to the principal, licenses rights in the SRE product from the principal in exchange for separate, arm's-length remuneration, or acts as a reseller of the SRE product under a separate, arm's-length agreement.**

With respect to the definition of "financial risk," we also recommend that the proposed regulations clarify that a research provider is not considered to bear financial risk of loss merely because it has a right to bonuses if it reaches certain milestones, so long as it is fully compensated for its research expenditures without any risk of loss. Also, we recommend that the proposed regulations clarify that a customary indemnification provision does not cause the service provider to bear financial risk of loss, so long as the indemnification does not relate to the success or failure of the research.

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[2] We use the term "SRE product" as it is defined in Section 6.02(4) of the Notice: "any pilot model, process, formula, invention, technique, patent, computer software, or similar property (or a component thereof) that is subject to protection under applicable domestic or foreign law."

a. The “Right to Use” Prong of the Test in Section 6.04 of the Notice Should be Eliminated

As discussed above, the Notice helpfully provides that contract research service providers do not incur SREs subject to capitalization, unless certain additional requirements are met, namely, that the research provider bears "financial risk” as to the research or has a “right to use” the resulting SRE product. Section 6.04 of the Notice, however, states that a research service provider is required to capitalize R&D expenses under section 174 if either of these conditions is met. We believe this two-part test is too broad in potentially requiring capitalization of the same research expenditures by *both* the research recipient *and* the research provider, a result that was likely unintended by Congress and does not clearly reflect the research provider’s income from rendering services.

In lieu of the two-part test, the proposed regulations should provide a bright line rule that the party who bears financial risk as to the results of a given research expenditure is the only party required to capitalize that research expenditure under section 174. This rule would avoid double capitalization by placing the capitalization on the true party in interest for the research.

Conversely, a research provider that does not bear financial risk is acting in a capacity as a service provider as to the expenses incurred regardless of what rights it retains in the research. In this situation, where the research provider incurs the expenses with a guarantee of receiving a fee at least equal to the expenses, the research provider ‘s costs should be deductible under section 162 and matched to the service fee income. Requiring double capitalization in this scenario would result in the service provider’s taxable income from performing a service for a fee of cost plus a 10-percent markup exceeding its economic income by manifold.

Although many of the issues with the “right to use” part of the test could be addressed through modifications discussed in the following section, relying on financial risk of loss as the sole criterion would provide a clear and administrable rule that achieves appropriate results.

b. Rights in the SRE Product

In the alternative, if the “right to use” prong of Section 6.04 of the Notice is retained, we recommend that the proposed regulations confirm that the research provider is not required to capitalize its research expenditures merely because it obtains rights to the resulting SRE product under a separate arm’s length contract with the recipient of the research. This is consistent with the approach under Treas. Reg. § 1.41-4A(d)(3), which treats the research provider as not having a “substantial right” to research if it has to pay for the use of the resulting product under a separate agreement. It is also consistent with Treas. Reg. § 1.41-

4A(d)(2), which provides that a taxpayer is not treated as performing qualified research if it grants another person the exclusive right to exploit the results of the research, even if it retains formal legal ownership.

We further recommend that the proposed regulations use the term "substantial" rights to define the circumstances where the research provider must capitalize research expenditures due to retained rights under the research contract. The term "substantial rights" would limit capitalization to situations in which the research provider enjoys rights to commercially exploit the SRE product in meaningful ways and generate revenues to which research expenditures would be matched through capitalization. Under a "substantial rights" standard, for example, capitalization would not be required in situations where the research provider's retained rights are merely incidental to the research services or are of *de minimis* commercial value. This is akin to the exclusion of certain "know-how" from the definition of SRE product by Section 6.02(4) of the Notice, and is appropriate.

This rule would be particularly important in the context of intercompany contract research, in which the same subsidiary conducts contract research for its parent company and also performs reseller or other functions for the parent under a separate arm's-length agreement. This situation commonly arises when a taxpayer has a single controlled foreign corporation that houses, directly or through disregarded entities, a research provider and reseller function. If the research division of the subsidiary were housed in a separate corporation from the reseller division, capitalization of the research provider's research expenditures clearly would not be required. There is no policy objective served by having the requirement to capitalize depend on whether both the reseller and research activities are housed in a single foreign corporation or multiple foreign corporations for U.S. tax purposes.

For example, consider a U.S. parent company that hires a foreign subsidiary to act as a research provider to develop an SRE product in exchange for an arm's-length fee. Under the research contract, the research provider has no rights to use or exploit any resulting SRE product for purposes other than providing research under the contract. The research provider creates a widget for the U.S. parent. Under a separate arm's length contract, the U.S. parent designates the same foreign subsidiary (or a disregarded entity of that foreign subsidiary) to market the widget and grants an arm's length license to allow it to distribute the widgets in certain territories. Depending on the terms of the intercompany license or resale agreement, the research provider in this example may be viewed as having a right to sell, lease or license the SRE product.

However, so long as the license or reseller fees are arm's length consideration for the U.S. Parent's IP, the foreign subsidiary research provider does not enjoy any substantial rights in the SRE product that merit capitalization. The research provider does not obtain any rights to the widget that could reasonably be expected to provide benefits beyond the current year. *See*

INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). The research provider also would be treated as performing "funded research" under Treas. Reg. § 1.41-4A(d) because the research provider bears no financial risk of loss and the principal has all exploitation rights to the product (excluding those licensed to the research provider under a separate, arm's-length agreement). As a result, capitalization of the research provider's research expenditures is inappropriate. We recommend that proposed regulations confirm that the research provider's research expenditures would not be capitalized in this scenario.

The result should be the same if, instead of receiving a license, the research provider also enters into a separate arm's length contract with the principal as a limited-risk reseller of widgets. Once again, the research contract does not grant the research provider any rights to the widget that could reasonably be expected to provide benefits beyond the current year. The rights that the research provider enjoys under the reseller agreement are not obtained through the research provider's research expenditures to create the widget. Accordingly, section 174 should not require capitalization. We recommend that proposed regulations confirm that the research provider's research expenditures would also not be capitalized in this scenario.

Nothing in section 174 requires a different result. Section 174(b) defines "SRE expenditures" to include only costs incurred in connection with the taxpayer's *trade or business*. Treas. Reg. § 1.174-2(a)(1) further limits costs subject to section 174 to costs incident to the development or improvement of a product. "Product" is defined in Treas. Reg. § 1.174-2(a)(3) as a product to be used *by the taxpayer* in its trade or business or to be held for sale, lease, or license. Consistent with general principles of capitalization, section 174 only requires capitalization of research expenditures that produce a product expected to provide benefits to the taxpayer beyond the year in which the expenditures are incurred.

c. Financial Risk

The proposed regulations should also clarify the circumstances in which a research provider bears "financial risk." We believe that two fact patterns in particular warrant the IRS and Treasury's attention in clarifying this rule in the proposed regulations. First, assume a research provider is hired to develop an SRE product in exchange for a base fee. If the research provider meets certain milestones measured by results, revenue, or speed, the contract requires the principal to make additional bonus payments to the research provider. The base fee is sufficient to compensate the research provider for its research services. The contract does not grant the research provider any rights to the resulting SRE product for purposes other than providing research under the contract. Assuming that the research provider otherwise receives compensation for its costs, the milestones are payment for successful research and/or exemplary service from the research provider, rather than a transfer of the risk of loss to the research provider. The risk of not achieving the milestone payments is merely risk of forgone profit. The proposed regulations should confirm that the research provider in this situation is

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not required to capitalize its research expenditures merely because it has a right to bonuses if it reaches certain milestones.

A second situation relates to customary indemnification provisions present in a contract for research services. For example, assume that a US parent company hires a foreign subsidiary (CFC) to perform contract research services for a cost-plus fee. The research contract is unambiguous that the foreign subsidiary research provider is entitled to receive its fee regardless of the success or failure of the research. However, consistent with arm's length transactions, the intercompany agreement includes a customary indemnification provision, whereby the research provider agrees to indemnify the principal from any losses arising out of the negligence or willful misconduct of the research provider or third parties acting on its behalf. Because this provision does not relate to the success or failure of the research, the proposed regulations should clarify that it does not cause the research provider to become subject to capitalization.

Both of these clarifications are consistent with the existing section 174 regulations and the research credit regulations. Under Treas. Reg. § 1.174-2(b)(3), no deduction is allowed under (pre-2022) section 174(a) if the taxpayer purchases another's product under a performance guarantee—unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account. Under Treas. Reg. § 1.41-2(e)(2), a payment to a research provider that is contingent on the success of the research is considered paid for the product or result rather than the performance of the research, and the payment is not a credit-eligible contract research expense. On the flip side, the research provider may be eligible for the section 41 credit in these circumstances, as its research is not considered to be "funded" under Treas. Reg. § 1.41-4A(d)(1).

Similar principles should circumscribe the concept of "financial risk" in the proposed regulations. The required financial risk should be a risk of non-payment due to the failure to create a viable product or commercial success of the research. Attenuated risks such as the possibility of failing to earn a bonus or being required to indemnify the service recipient from losses unrelated to the results of the research should not require capitalization.

II. Section 174(d)

a. Treatment of Dispositions

Section 7 of the Notice proposes to generally disallow any recovery of SRE expenditures on a sale, exchange or other disposition of property with respect to which SRE expenditures have been paid or incurred, whether the disposition produces gain or loss. Instead of being able to recover SRE expenditures with respect to the asset, the taxpayer that disposes of the intangible property would continue to amortize those expenditures under section 174 despite

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no longer owning the related intangibles. In a tax-free corporate transaction other than a section 381(a) transaction, the unamortized basis would remain with the transferor, rather than being treated as adjusted basis of the intangible, effectively separating the intangible to which the SRE relates from the unamortized SREs.

We respectfully request that Treasury and the IRS reconsider this issue and modify the rules in Section 7 of the Notice to provide that section 174(d) defers recovery of costs only if and to the extent the taxpayer would recognize a loss on the disposition of the intangibles. We also request that the rules be modified to treat unamortized basis in a tax-free transaction as basis of the related intangible that is applied to the transferee, with the transferee receiving amortization deductions with respect to that intangible on the same schedule and in the same amounts as the transferor would have received if there had been no transaction.

The allowance of cost recovery on a taxable disposition follows the statutory text of section 174(d), which only disallows a "deduction." It is clear from the structure of the Code and well-established by longstanding case law that recovery of costs against the proceeds of a sale reduces gross income and does not produce a "deduction" that can be disallowed. The modifications we propose would also harmonize with the manner in which the Service and case law have addressed similar issues under section 59(e) (and predecessor provisions), and also prevent potential distortive results of separating income-producing assets from the costs that were incurred to create them.

b. Taxpayers Should Be Permitted to Use Their Basis to Determine Their Gain or Loss from the Sale, Exchange, or Other Disposition of Property Related to Capitalized SRE Expenditures.

The rules set forth in Section 7 of the Notice interpret Section 174(d), which provides as follows:

> If any property with respect to which specified research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, ***no deduction shall be allowed*** with respect to such expenditures on account of such disposition, retirement, or abandonment and such ***amortization*** deduction shall continue with respect to ***such expenditures***. (Emphasis added)

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Section 174(d), on its face, does not bar basis recovery to reduce or offset gain. It provides that "no ***deduction*** shall be allowed with respect to such expenditures."[3] However, the recovery of basis to reduce gain on a sale of property under section 1001(a) is not a deduction, but part of computing the taxpayer's gross income from a sale.[4] This is in contrast to an abandonment or sale of property at a loss, in which case a taxpayer might claim a deduction under section 165(a). Moreover, as discussed below, case law has long distinguished between the use of basis to calculate gain or loss and the claiming of unrecovered basis as a loss or deduction.

Basis recovery in a disposition of property occurs as a consequence of the definition of gross income. Pursuant to section 61(a)(3), gross income includes "gains derived from dealings in property." Treas. Reg. § 1.61-6 explains that "[g]enerally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged." Section 1001(a) deletes the "generally" qualifier: "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized." Neither section 61 nor section 1001 describes this basis recovery as a "deduction."

Furthermore, longstanding case law has interpreted disallowances on claiming deductions not to bar recovery of basis to compute gross income from sale of inventory or other property. For example, in *Sullenger v. Commissioner*, 11 T.C. 1076 (1948), *acq.* 1952-2 C.B. 3, a taxpayer who paid more for meat than the government-authorized price sought to recover the full cost on a later sale. The Commissioner argued that the excess over the authorized price should be unrecoverable as a deduction that would be contrary to public policy. The Tax Court rejected that theory, explaining:

> The amounts in question were actually . . . not being claimed by this petitioner as a deduction under section 23 [the predecessor statute to the current section 162]. . . . [T]he Commissioner has always recognized, as

[3] We acknowledge that the Conference Report underlying section 174(d) describes section 174(d) as providing that "any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period." *See* H.R. Conference Report 115-466 (Dec. 15, 2017), at 425. However, the statutory text is clear that section 174(d) only disallows a "deduction"; recovery of cost in the determination of gain is not a deduction. For the reasons discussed in the text, moreover, the Code should not be interpreted in such a way to impose a tax on gross receipts that are not gross income.

[4] *See* § 61(a)(3);§ 1001(a); Treas. Reg. § 1.61-6. The recovery of basis in a disposition of property is not described in any of the Parts or Sections of the Code that set forth deductions, but is instead described in section 61, "Gross Income Defined," and section 1001, "Determination of Amount of and Recognition of Gain or Loss."

> indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory. It is unnecessary to discuss cases involving deductions, since this case does not involve any deduction.[5]

More recently, the Tax Court has held that section 280E's disallowance of deductions associated with sale of controlled substances does not bar recovery of cost of goods sold.[6] Because the use of basis to determine the amount of gain from a disposition does not involve any deduction, it is not prohibited under the plain language of section 174(d) and should not be prohibited under regulations interpreting that paragraph.

The rule proposed in the Notice would result in non-economic taxation. In Example 1 of Section 7.05 of the Notice, Company X has $100,000 of domestic SRE expenditures in 2023 and sells the property in 2025, after claiming $30,000 in amortization deductions with respect to the capitalized SRE expenditures. Assume the sale price is $60,000. Under the rule set forth in the Notice, "Company X does not factor its unamortized SRE expenditures into the computation of gain or loss under § 1001." As a result, the entire $60,000 sale price would be treated as gain, even though Company X actually experiences an economic loss.[7] A rule that proposes to treat an economic loss as a taxable gain does not, per *Sullenger*, "stay within the Constitution." Treasury Regulations should not interpret the Code in a constitutionally defective manner.[8]

In contrast, in the case of a sale, abandonment or other disposition resulting in loss, the plain language of section 174(d) would support a rule denying the taxpayer the section 165 deduction with respect to such loss and providing that amortization of "such expenditures" (*i.e.*, those that were disallowed as a loss) would continue. Furthermore, denying loss deductions is consistent with other areas of the Code such as section 197(f)(1), which denies

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[5] 11 T.C. at 1077. Similar cases distinguishing cost recovery on a sale from a deduction include *Seawright v. Comm'r*, 117 T.C. 294 (2001); *Beatty v. Comm'r*, 106 T.C. 268 (1996); *Max Sobel Wholesale Liquors v. Comm'r*, 69 T.C. 477, *aff'd*, 630 F.2d 670 (9th Cir. 1980); *Atzingen-Whitehouse Dairy, Inc. v. Comm'r*, 36 T.C. 173 (1961); *Pittsburgh Milk Co. v. Comm'r*, 26 T.C. 707 (1956); *Coke v. Comm'r*, 17 T.C. 403 (1951).

[6] *See, e.g.*, *Patients Mut. Assistance Collective Corp. v. Comm'r*, 151 T.C. 176 (2018), *aff'd*, 995 F.3d 671 (9th Cir. 2021).

[7] Company X would be able to use $20,000 of amortization deductions to offset the $60,000 gain. But even if the $30,000 in amortization deductions taken in previous years were available as net operating loss carryovers, Company X would still have a phantom gain on the disposition even though the amount realized on the sale was less than Company X's remaining basis in the transferred property.

[8] *See, e.g.*, *Crowell v. Benson*, 285 U.S. 22 (1932); *Estate of Ceppi v. Comm'r*, 78 T.C. 320, 323 (1982), *modified and aff'd*, 698 F.2d 17 (1st Cir. 1983).

recognition of a loss on the disposition or worthlessness of a section 197 intangible until the related goodwill is disposed of.[9]

We therefore recommend a rule that (1) denies a loss *deduction* arising from dispositions, retirements, and abandonments of property related to SRE expenditures but that (2) allows recovery of basis in determining the amount of gain or loss from a disposition of such property.

c. In a Tax-Free Transfer of an Intangible, the Transferee Should Inherit the Transferor's Unamortized SREs in the Same Manner as Other Basis in Property.

As stated above, the Notice proposes a rule under which an acquirer in a transaction described in section 381(a) would step into the shoes of the transferor with respect to remaining amortization of SRE expenditures capitalized under section 174. In other cases, however, such as a section 351 transaction, the Notice would cause the SREs to remain at the transferor level and effectively sever this basis from the related intangibles.[10] **We recommend that the proposed regulations modify this rule from the Notice and treat unamortized SREs as basis in any nonrecognition transaction in which the property related to SRE expenditures is transferred. Consistent with the Notice's proposed rule for section 381(a) transactions, the transferee in any nonrecognition transaction in which the property related to SRE expenditures is transferred should receive amortization deductions with respect to that property on the same schedule and in the same amounts as the transferor would have received if there had been no transaction.**

Section 174(a)(2)(A) provides that R&D expenses that are deferred under the new regime are "charged to the capital account." As discussed further below, we believe charging these expenses to the capital account should entail an adjustment to basis of the related intangibles under section 1016(a)(1), consistent with treatment of similar amounts under former law section 174(b) and section 59(e). It would therefore follow that when intangibles are transferred in a tax-free transaction, their basis should reflect the capitalized SREs.

Providing that capitalized SREs are treated as basis of the related intangible in a section 351 or other non-recognition transaction, rather than as a separate capital account, is the result reached by the Court of Claims in *Philadelphia & Reading Corp. v. United States*, 602 F.2d 338 (Ct. Cl. 1979). There, the Court of Claims addressed how deferred mining development expenses capitalized under section 616(b) were treated in a case where the taxpayer incurring the expenses transferred a mine to a subsidiary in a transaction governed by

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9 *See also* §§ 267, 465, and 704(d).

10 *See* Notice 2023-63, § 7.05(2) (Example).

section 351. Section 616(b), like section 59(e) and post-TCJA section 174, did not explicitly address the issue. The Court of Claims took a policy-based and logical approach, concluding that a section 351 transfer involved continued ownership of the same investment in modified form and should be treated as continued ownership of the mine as to which the deferred expenses were incurred. The Court also stressed that it would be illogical to treat the deferred expenses as charged to a separate capital account, severed from the basis of the underlying mine, and rejected that position in holding that the capitalized expenses traveled with the mine to the transferee. In private rulings, the Service has followed the holding of *Philadelphia and Reading Corp.* in tax-free transfers of intangibles that had R&D expenses capitalized under section 59(e).[11]

The same logic and rationale apply equally here. **We recommend that the proposed regulations revisit the approach of tax-free transfers and treat unamortized SREs as basis that travels with the related intangibles in a tax-free transaction.**

d. Regulations Should Confirm That the Capitalization of SREs Under Section 174 Results in an Adjustment to the Taxpayer's Basis in the Relevant Intangible.

Before its amendment pursuant to the Tax Cuts and Jobs Act, section 174 explicitly provided that capitalized research and experimentation expenditures resulted in an adjustment to the basis of the related property pursuant to section 1016(a)(1).[12] Treas. Reg. § 1.1016-5(j) echoes this statutory provision, which dated from 1954: "Research and experimental expenditures treated as deferred expenses under section 174(b) are chargeable to capital account and shall be an adjustment to the basis of the property to which they relate." **We recommend that Treas. Reg. § 1.1016-5(j) be updated to clarify that the same basis adjustment occurs as a result of expenditures that must be "charge[d] to capital account" pursuant to the revised section 174(a)(2)(A). In other words, amounts capitalized under section 174, like other capitalized costs of creating income-producing assets, should be capitalized into the basis of the specific assets to which they relate and not be siloed in a generic R&D expenditure account that stands detached from the related assets.**

Updating the regulation to clarify that section 174 capitalization results in section 1016 basis adjustments would be consistent with the statutory language. Section 1016(a)(1)

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[11] PLR 200812015 (transfer of Business A and Business B intangibles in a tax-free spinoff under section 355) and PLR 201033014 (same).

[12] *See* § 174(b) (1954-2021) ("Such deferred expenses are expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustments to basis of property).").

provides that basis in property "shall in all cases" be properly adjusted to reflect costs "chargeable to capital account."

This recommendation is consistent with the regulations that were adopted under section 59(e), which allows taxpayers to elect to amortize "qualified expenditures" over 10 years and not treat those expenditures as tax preferences for purposes of the alternative minimum tax. Section 59(e)(2)(B), which was not revised under the TCJA, provides that research and experimentation expenditures otherwise deductible under section 174(a) are qualified expenditures if a taxpayer elects to amortize them. Even though section 59(e), unlike section 174(a)(2)(A), contains no reference to charging the amortized expenditures to capital account, a 2001 private letter ruling[13] and later the 2004 regulations[14] explained that the amortized expenditures increase the taxpayer's basis in the related asset. Given the similarity of mandatory amortization of section 174 expenses to elective amortization under old section 59(e), Treas. Reg. § 1.1016-5(j) should be updated to achieve the same result under the current version of Section 174.

III. Section 280C

Treasury and the IRS have requested comments on how to interpret the reference in section 280C(c)(1)(B) to an "amount allowable as a deduction." Specifically, the Notice asks whether the "amount allowable as a deduction" should be interpreted to refer to (1) zero, the disallowed deduction for qualified research expenses or basic research expenses under section 174(a)(1) (the "***Zero Approach***"), or (2) the amortization deduction with respect to the capitalized amount of these expenses allowed under section 174(a)(2) (the "***Amortization Approach***").[15] **We recommend that Treasury and the IRS adopt the Amortization Approach to the reference in section 280C(c)(1)(B).**

The text of section 280C unambiguously supports the application of the Amortization Approach. Section 280C(c)(1)(B) refers to "the amount allowable as a deduction for the taxable year *for qualified research expenses*."[16] To be "qualified research expenses" under section 41, expenses must first be research or experimental expenditures under section 174. And under section 174, an amortization deduction is, unequivocally, an amount allowable as a deduction for research or experimental expenditures incurred during the taxable year (referred to in section 174 as "specified research or experimental expenditures"). In this regard,

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[13] PLR 200117006 (Jan. 17, 2001).

[14] T.D. 9168, 69 Fed. Reg. 76,614 (2004). *See* Treas. Reg. § 1.59-1(b)(2) (providing that expenditures are "properly chargeable to capital account" under Section 1016).

[15] IRS Notice 2023-63, section 11.02(4).

[16] "Basic research expenses" are also included, which we do not address for simplicity.

section 174(a)(2) states that a taxpayer "*shall be allowed an amortization deduction*" of its specified research or experimental expenditures ratably over a five-year period. This is plainly the deduction to which section 280C(c)(1)(B) refers.

Further, the Joint Committee on Taxation explained that the Amortization Approach is intended in section 280C(c)(1)(B). It specifically noted that where "a taxpayer's research credit under section 41 for a taxable year beginning after 2021 exceeds the amount allowed as *an amortization deduction* under the provision for such taxable year, the amount chargeable to capital account under the provision for such taxable year must be reduced by that excess amount."[17]

A contrary reading of section 280C in favor of the Zero Approach would distort the statutory language to such an extent as to make it unrecognizable. Treasury and the Service would have to read out of the Code both section 174(a)(2) and the words "except as provided in paragraph (2)" in section 174(a)(1), and pretend as if section 174(a) simply disallowed a deduction for research and experimental expenditures. That would be an impermissible interpretation of the statute.

Additionally, when Congress amended section 174 in the TCJA, it made conforming amendments to section 280C(c). Before the TCJA, section 280C(c)(1) generally reduced a taxpayer's section 174 deductions by the qualified research expenses ("***QREs***") or basic research expenses used to determine the research credit under section 41. A similar rule existed under section 280C(c)(2) when a taxpayer capitalized rather than deducted expenses under section 174. Section 280C(c)(2) was titled "Similar rule where taxpayer capitalizes rather than deducts expenses" and required the amount by which the taxpayer's section 41(a)(1) credit exceeds "the amount allowable as a deduction" for QREs or basic research expenses (determined without regard to subsection (c)(1)) to reduce the taxpayer's capitalized expenses. Both of these rules were to prevent double counting as section 174 current year deductions or amortization deductions and further as section 41 credits.[18]

As amended by the TCJA, section 280C(c)(1) was removed and subsection (c)(2) remained identical to the pre-TCJA subsection (c)(2) except (i) the reference to old subsection (c)(1) was deleted, (ii) old subsection (c)(2)'s title was removed as it was no longer needed after subsection (c)(1) was deleted, and (iii) old subsection (c)(2) was renumbered as subsection (c)(1).

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[17] Joint Committee on Taxation, *General Explanation of Public Law 115-97,* Rep. No. JCS 1-18, at 145 n.686 (Dec. 20, 2018) (emphasis added).

[18] Further, under section 280C(c)(3), taxpayers could alternatively elect to claim a reduced research credit under section 41 instead of reducing its section 174 deductions.

Thus, before the TCJA, subsection (c)(2) addressed situations when the section 41(a)(1) credit exceeded the amortization deduction under section 174. Now, after amendment by the TCJA, this subsection should still, now labeled as subsection (c)(1), continue to address situations involving amortization deductions.[19] There is no evidence in the legislative history or the text itself to suggest that Congress intended a different interpretation. Congress amended section 280C(c) as part of the TCJA and did not make any changes to the substantive language of prior subsection (c)(2). Congress could have made changes to how the subsection operates, but it did not.[20] Accordingly, the Amortization Approach should be adopted consistent with the clear intent of Congress.[21]

Accordingly, we recommend that final regulations adopt the Amortization Approach (and not the Zero Approach) for section 280C(c)(1)(B) and interpret "amount allowable as a deduction" to refer to the amortization deduction allowable under section 174(a)(2).

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[19] *See also* Joint Committee on Taxation, *General Explanation of Public Law 115-97,* Rep. No. JCS 1-18, at 145 n.686 (Dec. 20, 2018).

[20] As the U.S. Supreme Court has repeatedly recognized, it is the duty of courts to interpret statutes holistically – that is, to "fit, if possible, all parts into an harmonious whole . . . ." *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 133 (2000) (quoting *FTC v. Mandel Bros., Inc.*, 359 U.S. 385, 389, (1959)).

[21] Treasury and the IRS have also asked as to how "amount allowable as a deduction" should be interpreted in the context of section 56(b)(2), which provides limitations on deductions in the context of the alternative minimum tax ("***AMT***") on individuals (and which was not amended in the TCJA). Section 56(b)(2) provides that the "amount allowable as a deduction" under section 174 must be amortized for individual AMT purposes. Although the words "amount allowable as a deduction" are the same in sections 280C(c)(1)(B) and 56(b)(2), the context and the practical result of the two provisions may be sufficiently different as to warrant a different result under section 56(b)(2). We make no recommendation as to the proper interpretation of "amount allowable as a deduction" in section 56(b)(2).

IV. Conclusion

We thank you for your time and consideration.

Sincerely,

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