

IRS Clarifies Guidance on Treatment of Research, Experimentation Expenditures

January 25, 2024

The IRS recently released [Notice 2024-12](#), which provides some clarifications and modifications to prior IRS guidance relating to the tax treatment of specified research and experimentation (SRE) expenditures pursuant to Internal Revenue Code (IRC) Section 174. For background information regarding SRE expenditures and IRC Section 174, please refer to our [May 2023](#) and [September 2023](#) Cooley client alerts.

Applicability date and consistency

Notice 2024-12 reiterates statements in [Notice 2023-63](#) (the subject of the September 2023 Cooley client alert) that it is anticipated that forthcoming proposed regulations consistent with Notice 2023-63 would apply for tax years ending after September 8, 2023, but until proposed regulations are issued, taxpayers may rely on the rules in Notice 2023-63 for expenditures paid or incurred in any tax year beginning after December 31, 2021, provided the taxpayer relies on them in a consistent manner. To facilitate reliance on the rules in Notice 2023-63 in a more administrable manner, however, Notice 2024-12 modifies Notice 2023-63 to remove the requirement that a taxpayer must rely on all the rules in Notice 2023-63 if the taxpayer chooses to rely on any of them. Notice 2024-12 similarly is effective as of September 8, 2023, and can be relied on for expenditures paid or incurred in any tax year beginning after December 31, 2021.

Contract research and experimentation

Notice 2023-63 provided that taxpayers are required to capitalize amounts paid to any third party (a contract researcher) to perform laboratory science, software development or other qualifying research activities on behalf of the taxpayer or its affiliates. A contract researcher that gets paid for research and experimentation work regardless of whether the research succeeds or fails generally is not required to capitalize its research costs. However, a contract researcher will be required to capitalize its research experimentation costs to the extent that one or more of the following applies:

1. The contract researcher bears financial risk in connection with the research.
2. The contract researcher's compensation is contingent on the results of the research.
3. The contract researcher has a right to use or exploit the results of the research, or retains any rights to the intellectual property developed as part of the research (an SRE product right).

Notice 2024-12 clarifies the above rules to provide that if a contract researcher does not bear financial risk under the terms of the contract with the research recipient and the contract researcher obtains an SRE product right that is separately bargained for (i.e., arose from consideration other than the cost paid or incurred by the contract researcher to perform SRE activities under that contract) or was acquired for the limited purpose of performing SRE activities under that contract or another contract with the research recipient, but does not obtain any other SRE product right under the terms of such contract, then the costs paid or incurred by the contract researcher to perform SRE activities on behalf of the research recipient under such contract are not required to be capitalized.

Subsequent developments

Proposed regulations are expected in the second quarter of 2024. Congress is working on delaying the effective date of the change to IRC Section 174, but only for domestic research and experimentation costs.

If you have questions about how these changes may affect your company, we strongly advise you to contact a member of the Cooley tax team, your accountant or other tax adviser.

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