

IRS Publishes Guidance on Tax Rules for Software Development, Research Expenses

September 25, 2023

The Tax Cuts and Jobs Act of 2017 (TCJA) introduced significant changes to the tax treatment of specified research and experimentation (SRE) expenditures. Historically, companies were able to immediately deduct all costs associated with research and experimentation activities under Internal Revenue Code (IRC), Section 174, including costs related to laboratory research, computer software development, and contract research performed by third-party or affiliated research entities. As explained in an April 2023 Cooley client alert, the TCJA introduced new rules for tax years beginning after December 31, 2021, requiring taxpayers to capitalize SRE expenditures and amortize them over five years for research performed in the United States or 15 years for research performed outside the United States. Although members of Congress on both sides of the aisle have publicly supported a repeal of the SRE expenditure capitalization rules introduced by the TCJA, congressional action has not yet been taken.

The IRS recently published Notice 2023-63 to provide guidance on how these relatively new capitalization rules under IRC Section 174 should be applied by taxpayers – and to preview proposed regulations that soon will follow. The notice is effective for tax years ending after September 8, 2023, but taxpayers can apply them to, and rely on the guidance in the notice for, any tax year beginning after December 31, 2021, provided that it is applied consistently.

Computer software development costs

As noted above, the new mandatory capitalization rules apply to certain software development costs. The notice indicates that taxpayers are required to capitalize certain costs related to the development of new software programs, as well as certain enhancements to existing software where the enhancements result in additional functionality or increased efficiency. The notice states that costs from activities such as planning software development, documenting software requirements, designing and building a model of computer software, and writing code are subject to the new capitalization rules. However, taxpayers are not required to capitalize any costs incurred after the computer software is ready for sale or license to others, such as costs related to marketing, distribution, or customer support.

The notice also excludes certain costs for software developed by a taxpayer for use in their own business, including costs related to employee training, maintenance and data entry. In light of the different tax deductibility rules applicable to amounts expended in advance of a sale or license versus amounts expended after sale or license, taxpayers should carefully document their research and experimentation expenses to properly allocate the costs to periods before and after software is ready for sale or license.

Contract research

Taxpayers are required to capitalize amounts paid to others to perform laboratory science, software development or other qualifying research activities. This includes amounts paid to third-party contract researchers and entities performing research and development activities for the benefit of their affiliates.

A contract researcher being paid for research and experimentation work will often be able to deduct the costs incurred in connection with research and experimentation activities. However, the notice indicates that a contract researcher will be required to capitalize its research costs if it bears financial risk in connection with the research or has a right to use or exploit the results of the research. A contract researcher that gets paid whether the research succeeds or fails will not be required to capitalize its research costs. Alternatively, if a contract researcher's compensation is contingent on the results of the research or it retains any rights to the intellectual property developed as part of the research, costs incurred in connection with the contractor's research will be required to be capitalized. If a contract researcher wants to avoid the current IRC Section 174 capitalization

rules, it will be important to limit the researcher's right to use or exploit any results of the research arrangement.

The notice does not address cost-sharing arrangements in which a group of affiliated entities or joint venture partners collectively work on a research project by sharing development costs in proportion to their expected benefit. However, the notice does indicate that further guidance will be forthcoming on this topic.

Disposition, retirement or abandonment of property

Typically, taxpayers can deduct any remaining basis in depreciable property at the time that property is sold, exchanged, retired or abandoned. However, the TCJA added special rules that apply to the disposition, retirement, or abandonment of property that results from research and experimentation activities. Instead of being able to immediately deduct any remaining costs when the property is sold, taxpayers will be required to continue to amortize SRE expenditures over the original five- or 15-year period.

These rules may have significant ramifications for companies in the life sciences or technology sector that commonly sell intellectual property. For example, current tax law requires taxpayers to recognize income from the sale of developed IP without offset against unamortized SRE expenditures incurred in developing the IP. Instead, these SRE expenditures must continue to be amortized in future years pursuant to the original SRE expenditure amortization schedule, even though the taxpayer has sold the applicable IP.

The notice includes special rules that apply to certain transactions in which a corporation ceases to exist for federal income tax purposes. If a corporation ceases to exist for federal income tax purposes pursuant to a tax-deferred liquidation, a contribution to a controlled corporation or other reorganization, the successor company generally steps into the shoes of the company that performed the research. If a corporation ceases to exist for federal income tax purposes not pursuant to a transaction described in the preceding sentence, the corporation is generally allowed to deduct the remaining unamortized SRE expenditures. These special rules do not apply to partnerships.

If you have questions about how these changes may impact your company, we strongly suggest contacting a member of the Cooley tax team, your accountant or other tax adviser.

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