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In this article, Levy and Christenson examine the history of section 174 and highlight key changes to and distinctions between it and the new section 174A introduced by the One Big Beautiful Bill Act, and they explore the implications for how amortized expenses should be viewed in the broader context of the code.

The One Big Beautiful Bill Act (P.L. 119-21) introduced welcome relief for taxpayers incurring domestic research and experimentation expenditures, which since 2022 they have been required to capitalize and amortize over a period of five years under section 174. Under new section 174A, taxpayers may immediately deduct domestic R&E expenditures, while the treatment of foreign R&E expenditures under section 174 remains largely unchanged. This article explores the twists and turns section 174 has taken, some of which remain relevant to taxpayers still amortizing historical expenses. It also highlights key changes to and distinctions between section 174 and new section 174A and explores what those changes may tell us about how amortized expenses should be viewed in the broader context of the code.

Overview

Congress first enacted section 174 as part of the Internal Revenue Code of 1954, and from then until 2022, taxpayers were permitted to immediately deduct R&E expenses or to make certain elections to amortize those expenses. Since 2022, when changes introduced by the Tax Cuts and Jobs Act took effect, taxpayers incurring R&E expenses have been required to capitalize those expenses under section 174 and amortize them over a period of five years for domestic research, or 15 years for foreign research. In the OBBBA, Congress introduced new section 174A, which restores an immediate deduction for domestic R&E expenses. Taxpayers may also elect to capitalize the expenses and amortize them over a period of their choosing, which must be at least five years. For foreign R&E expenses, section 174 continues to apply, though the OBBBA made some clarifications to the statute. New section 174A, and the changes to section 174, apply to tax years beginning after December 31, 2024. The rapid changes in the statute within the course of just a few years and the sometimes subtle changes to the language used to describe the treatment of R&E expenditures may leave taxpayers confused about their options and the broader implications of their elections.

Section 174 Before the TCJA

Until 1954, the code had no specific provision addressing the treatment of R&E expenditures. Instead, their treatment was governed by general capitalization principles. Under section 23(a)(1) of the IRC of 1939 (as under current section 162), a taxpayer was allowed to deduct "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Under section 24(a)(2) of the 1939 code (as under current section 263), however, no deduction was allowed for amounts paid "for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Those expenses were instead capitalized and then deducted under the depreciation and depletion provisions of the code. In sum, taxpayers first had to determine whether an expenditure should be treated as a current expense or a capital expenditure; then they separately had to determine whether the cost could be recovered through either a tax deduction or basis recovery, and if so, when. In the case of R&E expenditures, both questions were problematic.

Section 174 was enacted as part of the IRC of 1954. The legislative history refers to significant confusion at the time concerning the tax accounting of R&E expenditures. The House report explained:

> No specific treatment is authorized by present law for research and experimental expenditures. To the extent that they are ordinary and necessary they are deductible; to the extent that they are capital in nature they are to be capitalized and amortized over useful life. Losses are permitted where amounts have been capitalized in connection with abandoned projets, and recovery through amortization is provided where the useful life of these capital items is deteminable, as in the case of a patent. However, where projects are not abandoned and where a useful life cannot be definitely determined, taxpayers have had no means of amortizing research expenditures.[1]

The record shows that Congress wanted to encourage innovation and development activities and acknowledged that the tax accounting for R&E expenditures needed to be distinct from the accounting for expenditures on ordinary and necessary business activities.

As enacted in 1954, and before it was amended by the TCJA, section 174(a) allowed taxpayers an immediate deduction for R&E expenses incurred in connection with a trade or business. Under section 174(b), taxpayers could instead elect to treat certain R&E expenses as deferred expenses to be amortized ratably over a period chosen by the taxpayer of not less than five years. The election was available only for expenses that were chargeable to capital account but not chargeable to property subject to the depreciation allowance in section 167 (for example, property acquired for use in the research activity) or the depletion allowance in section 611. The section 174(b) election, once made, had to be applied consistently for all R&E expenses relating to a particular project. Because the election was not available for expenses chargeable to property that was subject to depreciation or depletion, it did not apply to property that had a determinable useful life. If the expenses did relate to property with a determinable useful life, then, according to the pre-TCJA regulations, section 174(b) did not apply, and the expenses instead had to be amortized or depreciated over the determinable useful life. A taxpayer could not use section 174(b) to elect a different amortization period.

Section 59(e), enacted in 1986, provided a third option: Under this provision, taxpayers could elect to deduct R&E expenses ratably over a 10-year period. They could make the election for all or any portion of a qualified expenditure by referring to a particular dollar amount and could change their approach from year to year by choosing whether to amortize the expenses for that particular year under section 59(e).

If taxpayers chose not to take an immediate deduction, but instead to amortize an R&E expense under either section 174(b) or section 59(e), the expense resulted in a proper adjustment to basis under section 1016.[2]

Section 174 thus resolved the uncertainty under pre-1954 law about whether R&E expenditures were to be treated as current or capital expenditures and, if the latter, whether and when a taxpayer could recover the expenses via a deduction. For capitalized amounts, section 174(b) created a regime similar to section 263 (the successor to former section 24 in the 1954 code) in that certain expenses resulting in benefits lasting more than one year were capitalized and, if applicable, amortized.

Interestingly, though, Congress used different language in sections 174(b) and 59(e) than it did in section 263. Section 174(b) refers to "deferred expenses," and section 59(e) similarly allows a taxpayer to deduct expenses ratably over a period of years. This language raises important questions

[1] H.R. Rep. No. 83-1337, at 28 (1954).

[2] *See* section 1016(a)(14) and (20), as in effect immediately before the TCJA.

about whether Congress viewed the deferred expense approach as somehow different from the general approach to capitalization exemplified by section 263 — for example, whether Congress merely intended section 174(b) (and perhaps even section 59(e)) to defer expenses rather than capitalize them.

While Congress did not clarify the nature of this deferred expense account under pre-TCJA section 174(b) (or the analogous account under section 59(e)), it is significant that section 1016 refers to adjustments to the basis "of the property." For this reason, it seems appropriate to analogize the deferred expenses account to costs incurred to create or improve property, which are capitalized under section 263. Although section 263 does not apply to R&E expenditures (which are excluded from its scope), the approach taken in section 263 is instructive for understanding how section 174 applies. The regulations under section 263, which were finalized in 2003, acknowledge that certain types of expenses (such as payments concerning financial interests, prepaid expenses, contractual rights, licenses or memberships, and similar rights) do not give rise to a traditional intangible asset. Reg. section 1.263(a)-4 clarifies that these types of expenses should be treated as creating an intangible asset that can then be amortized. Similarly, while section 174 expenditures (or section 59(e) amounts) will not always attach to a specific item of property, section 1016(a)(1) makes clear that the capitalized expenses result in proper adjustment to the basis of the property, which can then generally be recovered under the depreciation and amortization provisions of the code. Indeed, pre-TCJA section 174 cross-referenced section 1016(a)(14) for "adjustments to basis of property for amounts allowed as deductions as deferred expenses under [pre-TCJA section 174(b)(1)]"[3] and explained that expenses deferred under section 174(b) should be considered "expenditures properly chargeable to capital account for purposes of section 1016(a)(1) (relating to adjustments to basis of property)."[4] These references suggest that, like certain expenses described in reg. section 1.263(a)-4, amortized R&E expenditures under section 174(b) may be viewed as creating an intangible asset (or, at a minimum, an account that is treated similarly to an intangible asset).

TCJA Amendments to Section 174

The TCJA made significant changes to section 174 that upended the treatment of R&E expenses. The legislative history for the TCJA recognizes that generally, business expenses that give rise to an asset having a useful life of more than one year must be capitalized and depreciated. Consistent with this general treatment, the TCJA amended section 174 to require taxpayers to capitalize R&E expenses (rather than permit taxpayers to elect to capitalize them) and amortize them over a period of either five years (for domestic research) or 15 years (for foreign research). Recognizing the significant potential effect of this change on taxpayers, who for decades had relied on the ability to expense R&E in making decisions on whether and when to invest in R&E activity, Congress deferred the effective date to 2022. Many taxpayers and practitioners expected Congress to take action well before that date to restore immediate deductions for R&E expenses, but Congress ultimately failed to act, and the TCJA amendments to section 174 were in effect for tax years beginning January 1, 2022, through December 31, 2024.

Section 59(e) remained unchanged, but many taxpayers viewed the changes to section 174 as significantly reducing section 59(e)'s relevance. It was unclear whether (or to what extent) taxpayers technically could even still make a new election during this period because section 59(e) limits the election to amounts that would otherwise have been deductible.

Notably, the TCJA also added section 174(d) to the code (TCJA section 174(d)).[5] TCJA section 174(d) provides that if a taxpayer disposes of any property for which R&E expenses have been incurred, the taxpayer cannot take any deduction for the remaining unrecovered expenses at that time. Instead, the taxpayer must continue to

[3] Section 174(f), as in effect immediately before the TCJA.

[4] Section 174(b)(1), as in effect immediately before the TCJA.

[5] TCJA section 174(d) refers to section 174(d) as in effect from 2022 to 2024. Other references to section 174(d) in this article refer to section 174(d) as in effect after the OBBBA.

amortize the expenses. Ordinarily, a taxpayer would be entitled to subtract its basis when calculating the gain from disposing of an asset, and TCJA section 174(d) arguably was a departure from this principle.

The TCJA also removed the cross-reference in former section 174(f) to section 1016(a)(14). Interestingly, section 1016(a)(14) did not change and continued to refer to former section 174(b)(1). The reasons for removing the cross-reference in section 174(f) are unclear. In removing the cross-reference to section 1016(a)(14) from the TCJA version of section 174, Congress may simply have been recognizing that the treatment of basis under TCJA section 174(d) was unique. That said, TCJA section 174(d) does not necessarily mean that TCJA section 174 does not create basis at all. The question of whether an expense is capitalized into basis is distinct from the question of when that basis may be recovered. Even without a specific reference to section 1016(a)(14), the more general rule of section 1016(a)(1) requires adjustments to basis for amounts treated as chargeable to capital account. TCJA section 174(d) could be read as changing only how and when that basis is recovered, not whether basis is created at all. Another way to interpret section 174(d) is that it treats section 174 as creating a separate amortizable asset, distinct from any property that resulted from the research activity. In this view, even if a taxpayer sells the underlying property, it generally retains the section 174 amortizable asset.

In Notice 2023-63, 2023-39 IRB 919, the IRS recognized that TCJA section 174(d) could be problematic in situations in which a taxpayer transfers its assets and then ceases to exist. If the taxpayer no longer exists, it might never be able to recover its remaining unamortized R&E expenses. Notice 2023-63 provides relief for taxable transactions in which a corporation ceases to exist (such as taxable liquidations or mergers), and allows the corporation to deduct the remaining unamortized section 174 expenses in its final year. This relief does not extend to transactions governed by section 381, however, because in that case a successor will generally exist that can potentially claim the remaining deductions.

R&E Expenses After the OBBBA

New section 174A allows taxpayers to deduct domestic R&E expenses or, at the taxpayer's election, capitalize and amortize them. The scope of R&E expenditures under section 174A is the same as under section 174.

The election to capitalize domestic R&E under section 174A(c) may be made for any tax year, and it must be filed by the deadline for filing the annual return, including extensions. Once a taxpayer has made the election, it will apply for that year and all subsequent years unless the IRS grants approval for a change in method. The statute provides for the secretary to promulgate regulations or other guidance on how the election is made. Treasury and the IRS have not yet issued guidance under section 174A, and it remains to be seen what issues that guidance may cover. Regulations under pre-TCJA section 174(b), for instance, allowed different elections for separate projects; Treasury may decide to adopt a similar approach to section 174A.

The legislation includes transition rules for taxpayers that incurred domestic R&E expenses that were capitalized under TCJA section 174. For domestic R&E expenses incurred (and capitalized) in tax years beginning after December 31, 2021, and before January 1, 2025, a taxpayer may elect to deduct any remaining unamortized amount either in the first tax year beginning after December 31, 2024, or ratably over that year and the subsequent tax year. A separate transition rule applies for small businesses that meet the gross receipts test of section 448(c) for the first tax year beginning after December 31, 2024 (that is, taxpayers with gross receipts of less than $31 million). These taxpayers may elect to apply section 174A retroactively for years beginning after December 31, 2021.

Section 174 remains largely unchanged after the OBBBA, except that it is limited to foreign R&E expenses. Importantly, section 1016(a)(14) now refers to the capitalization provisions in section 174 (rather than now-obsolete section 174(b)(1)) and section 174A. As a result, section 1016(a)(14) now requires that proper adjustments be made to the basis of property "for amounts allowed as deductions under section 174 or 174A(c) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years."

Congress also made an additional change to section 174(d): Amended section 174(d) now provides that when a taxpayer disposes of an asset for which it has incurred foreign R&E expenses that were capitalized, the taxpayer may not recover any basis in that asset that was attributable to the R&E expenses. Section 174(d) says the taxpayer may not reduce its amount realized by the amount of the capitalized R&E expenditures (that is, the taxpayer may not subtract the capitalized R&E expenditures from the amount realized in determining the gain or loss on the transaction). Instead, the taxpayer must continue to amortize that amount. Moreover, section 174(d) no longer applies to domestic R&E expenses, and there is no parallel provision in new section 174A. This appears to mean that immediate basis recovery is possible for domestic R&E expenses that a taxpayer capitalized, either under old section 174 or electively under section 174A or 59(e). For foreign R&E expenses, section 174(d) generally does not allow immediate basis recovery upon a disposition of the property. It remains to be seen whether Treasury will finalize the guidance in Notice 2023-63 allowing relief for taxable liquidations, mergers, and similar transactions. (For that matter, it is not entirely clear that Notice 2023-63 is still valid guidance for 2025 and beyond and, if it is, how that guidance could be applied to section 174A.) The change to section 174(d), together with the now-clear link between sections 174 and 174A(c), on the one hand, and the basis provisions of section 1016, on the other, demonstrates that Congress viewed sections 174 and 174A(c) as true capitalization provisions that give rise to amortizable basis.

Key Implications for Taxpayers

Section 174A provides welcome flexibility for taxpayers concerning the treatment of domestic R&E expenditures. Taxpayers should, however, carefully consider the overall effect of this new provision. The increased deductions from immediate expensing may adversely affect taxpayers' positions on the corporate alternative minimum tax, the base erosion and antiabuse tax, section 250, and the foreign tax credit provisions. Moreover, because of the rapid pace of the changes to section 174 in recent years, taxpayers may find themselves concurrently applying multiple regimes. They may begin deducting domestic R&E expenditures in 2025 while they are still amortizing prior-year expenses under TCJA section 174 and even pre-TCJA sections 59(e) and 174(b), or they might choose to amortize current expenditures under new section 174A(c) while continuing to amortize prior-year amounts under those separate provisions. Careful modeling will be needed to evaluate each taxpayer's position. Section 59(e) may once again become a useful tool for companies to help manage these issues by allowing companies to spread the costs over 10 years. This election, along with the new elections provided in section 174 itself, gives taxpayers some flexibility to customize the timing of their deductions to fit their particular circumstances.

The updates to sections 174 and 1016 also provide more clarity on the conceptual underpinnings of section 174 (as well as the elective capitalization provision in section 174A). These updates clarify that the R&E capitalization regime is broadly similar to general capitalization principles under the code.

The OBBBA made conforming changes to other provisions in the code, such as sections 41 and 280C. Section 41 generally provides a credit for certain expenses incurred for qualified research. Under pre-OBBBA section 41(d)(1), one requirement for qualified research was that expenditures for it "may be treated as specified research or experimental expenditures under section 174." The OBBBA updates section 41(d)(1) to require that expenses be "treated as domestic research or experimental expenditures under section 174A." Further, section 280C(c) was amended to generally provide that section 41 credits may reduce the amount of deductions available for R&E expenses. Pre-OBBBA section 280C(c) said the amount of R&E expenses charged to capital account and capitalized under section 174 had to be reduced by the amount of the credit allowed under section 41, but only to the extent that the section 41 credit amount for that year exceeded the amount allowable as a deduction for qualified research expenses. In Notice 2023-63, Treasury requested guidance on how to interpret the amount allowable as a deduction and whether it refers to the amortization deduction allowed under section 174. Amended section 280C(c) now reduces the amount of capitalized expenses under section 174A by the amount of the section 41 credit.

Other mentions of section 174 have similarly been updated to refer to section 174A when applicable, including references in the corporate alternative minimum tax provisions, the allocation provisions of section 864, the startup expenditure provisions of section 195, section 263, and other capitalization provisions. Taxpayers will want to consider the effect, if any, of these changes on their tax position. ■