**Internal Revenue Service**

Department of the Treasury

Number: **INFO 2001-0228**
Release Date: 9/28/2001
Index Number: 168.00-00

Washington, DC 20224

Person to Contact:
[redacted]
Telephone Number:
[redacted]
Refer Reply To:
CC:PSI:6 - COR - 114949-01
Date:

August 22, 2001

Re: Application for Consent to Amortize Deferred Expenses
[redacted]

Dear [redacted]:

This letter is in response to your letter dated February 21, 2001, to the Commissioner of Internal Revenue, relating to an election for the 2001 tax year to defer expenditures associated with obtaining your United States and foreign patents for a heat recovery system and to amortize those deferred expenditures under section 174 of the Internal Revenue Code. Based on your description of the transaction and assuming that all the expenditures which were incurred in prior years were eligible for treatment under section 174, section 174 is not available for the recovery of the expenditures because the expenses were incurred in prior years and you did not make an election to amortize under section 174. However, as explained below, if the expenditures result in a depreciable or inventoriable item, the expenditures may be recovered, respectively, through depreciation or as cost of goods sold.

Section 174 of the Code and the regulations thereunder provide two methods for treating research and experimental expenditures (R&E) paid or incurred by a taxpayer in connection with the taxpayer's trade or business.

Section 174(a) of the Code provides that a taxpayer may elect to treat R&E as expenses not chargeable to capital account. Expenditures to which the election applies are allowed as a deduction. The statute provides that this method may be adopted, without the consent of the Secretary, for the taxpayer's first tax year in which R&E are paid or incurred. If the taxpayer adopts this method, the method will apply to all R&E paid or incurred by the taxpayer for the tax year and must be adhered to for all subsequent years unless, with permission of the Secretary, a change is authorized with respect to all or part of such R&E. The statute also provides that a taxpayer may adopt

this method at any time with the consent of the Secretary.

Section 174(b) of the Code provides that a taxpayer may elect, under regulations, to amortize (treat as deferred expenses) R&E over a period of not less that 60 months. If the taxpayer elects to defer R&E, the method and the period selected must be adhered to for the tax year of the election and all subsequent years unless, with the approval of the Secretary, a change is authorized with respect to part or all of such R&E. The election under § 174(b) will not apply to any expenditure paid or incurred in a tax year before the year for which the election is made.

Section 1.174-1 of the Income Tax Regulations provides that R&E that are neither treated as expenses or deferred and amortized must be charged to capital account and clarifies that R&E to which § 174 of the Code applies may relate to a general research program or to a particular project.

Section 1.174-3 of the regulations provides rules for making the election to expense R&E under § 174(a) of the Code and for requesting permission to change to or from that method.

Section 1.174-4 of the regulations provides rules for making the election to defer R&E under § 174(b) of the Code and for requesting permission to change to or from that method.

Revenue Ruling 58-74, 1958-1 C.B. 148, applies these rules to a situation in which the taxpayer, who has made a valid election to deduct R&E under § 174 (a) in a prior year, fails to include, as a deduction on the return for the tax year, an amount that was incurred for research and experimentation. The taxpayer discovers the omission in a subsequent year. The ruling restates the rule that appears in the statute, namely that the election to expense must be adhered to for all years subsequent to the valid election unless permission is granted to change. The ruling reasons that since the taxpayer did not have permission to change, the taxpayer has no permissible alternative means of recovering the R&E beyond deduction in the year paid or incurred. Accordingly, the ruling concludes that in order to recover the expenditure the taxpayer must file an amended return if the year of the omission remains open. If the year of the omission is closed, the deduction is lost.

Thus, in the case of a taxpayer who has not made an election under section 174 of the Code (that is, there is neither an election to expense or to defer and amortize such costs), the taxpayer is deemed to have capitalized the costs. Further, although a taxpayer may elect to treat future R&E expenditures under the rules of section 174, such change in method will not be applicable to costs incurred in prior years. The costs incurred in prior years, in the absence of a section 174 election, must be recovered through depreciation to the extent the costs relate to a depreciable item. However, if the R&E project results in an item that is properly treated as an inventoriable item, the

costs are recovered as costs of goods sold. If the R&E expenditures do not result in either a depreciable or inventoriable item (i.e., the project is a failure), the taxpayer would recover the costs through a deduction under section 165.

A discussion describing the procedure for recovering the expenditures through depreciation when the expenditures relate to depreciable items follows.

Under section 167 of the Code a patent, which has been placed in service, is subject to depreciation. See 1.167(a)-3 of the regulations. The expenditures described in your letter appear to reflect those patent costs subject to depreciation under section 167. See 1.167(a)-6. If the expenditures are patent costs subject to depreciation, your consistent treatment of not claiming depreciation deductions allowable for those expenditures identified with obtaining your United States and foreign patents reflects a method of accounting.

A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required. To obtain the Commissioner's consent to make a change in method of accounting, section 1.446-1(e)(3)(i) of the regulations requires the taxpayer to file Form 3115, Application for Change in Accounting Method, with the Commissioner during the taxable year in which the taxpayer desires to make the change of accounting method. See section 5.01 of Rev. Proc. 97-27, 1997-1 C.B. at 684. However, if the taxpayer and property are within the scope of Rev. 99-49, 1999-2 C.B. 725, including its APPENDIX, see section 6.02 of this revenue procedure for the requirements for filing the Form 3115.

In computing a taxpayer's taxable income for any taxable year in which the taxpayer's method of accounting differs from the method of accounting used in computing taxable income for the preceding taxable year, section 481(a) of the Code provides that there shall be taken into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. On its filed Form 3115, a taxpayer represents the amount of the entire net positive or negative adjustment required under section 481(a) for the year of change. Currently, the section 481(a) adjustment period for positive and negative section 481(a) adjustments is 4 taxable years. Thus, in a Form 3115 involving a net negative section 481(a) adjustment, if a taxpayer is granted permission by the Commissioner to change its method of accounting, the taxpayer must take the net negative section 481(a) adjustment into account ratably over 4 taxable years in computing taxable income, beginning with the year of change.

In view of the foregoing discussion, we believe that you may be able to depreciate those expenditures identified with the patents you own that have been placed in service and have not expired prior to 2001 (presumably, the year of change) by filing a Form 3115 to obtain the Commissioner's consent to make a change in method of accounting. Given the complex factual and legal issues present in your situation, we advise you to consider seeking the assistance of a tax professional for this matter.

This letter has called your attention to certain general principles of tax law. It is intended for informational purposes only and does not constitute a ruling. See section 2.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 9. We hope this letter will be helpful to you; however, if you should have any additional questions or comments, please contact our office at (202) 622-3110.

Sincerely yours,

Kathleen Reed

KATHLEEN REED
Acting Chief, Branch 6
Office of Associate Chief Counsel
(Passthroughs and Special Industries)