[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-124148-05]

RIN 1545-BE64

Research Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document proposes regulations to amend the definition of research and experimental expenditures under section 174 of the Internal Revenue Code (Code). In particular, these proposed regulations provide guidance on the treatment of amounts paid or incurred in connection with the development of tangible property, including pilot models. The regulations will affect taxpayers engaged in research activities. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].**

Requests to speak and outlines of topics to be discussed at the public hearing scheduled for January 8, 2014, at 10 a.m., must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-124148-05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-124148-05), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-124148-05). The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, David McDonnell, (202) 622-3040; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Overview of Provisions

Section 174—Background

Section 174 was enacted as a part of the Internal Revenue Code of 1954 to eliminate uncertainty in the tax accounting treatment of research and experimental expenditures and to encourage taxpayers to carry on research and experimentation. See H.R. Rep. No.1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954). Before the enactment of section 174, courts consistently held that the law required capitalization of product

research and development costs, including production costs of tangible property used in the research process. Under prior law, expenditures related to a taxpayer's research and experimentation generally were capitalized and held in suspense until the taxpayer could determine (1) whether or not the research had failed; and (2) if the research was successful, whether or not the research resulted in property that had a useful life determinable with reasonable accuracy. Research and experimental expenditures resulting in property with a useful life determinable with reasonable accuracy were amortized over the useful life of the property or, if intangible, may have been allocated to tangible assets. For example, if a design developed through research and experimentation ("appropriate design") was used to produce a tangible asset that was used in the taxpayer's trade or business or if the appropriate design was used to produce inventory or other property held for sale to customers, then the research costs were recovered by an adjustment to basis at the time the tangible property was used, sold, placed in service, or otherwise disposed of by the taxpayer. Where, however, projects were not abandoned and a useful life could not be definitely determined, taxpayers had no means of amortizing research expenditures. See H.R. Rep. No.1337, 83d Cong., 2d Sess. 28 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 33 (1954). Congress addressed this issue by enacting section 174, which allows taxpayers to either currently deduct research or experimental expenditures as they are paid or incurred or treat them as deferred expenses amortizable over a period not less than 60 months. See sections 174(a) and (b). Section 174 does not define the phrase "research or experimental expenditures."

In 1957, the IRS published T.D. 6255 (the 1957 Regulations) and adopted §1.174-2(a)(1), which defines the phrase "research or experimental expenditures" as expenditures "which represent research and development costs in the experimental or laboratory sense." In 1994, the IRS published T.D. 8562, which adopted amendments to § 1.174-2(a)(1). The amendments clarified the 1957 Regulations by providing that the determination of whether costs qualify as research or experimental expenditures under section 174 depends upon whether the costs are incident to activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Applying this general rule, costs relating to the production of a product after the uncertainty relating to the development or improvement of the product is eliminated do not qualify under section 174.

Section 174(c)—Depreciable Property

Since its enactment in 1954, section 174(c) has provided, in relevant part, that section 174 shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character that is subject to the allowance under section 167, relating to depreciation, or section 611, relating to depletion, except that allowances under sections 167 and 611 will be considered as expenditures.

Consistent with the statute, the 1957 Regulations provided that expenditures for the acquisition or improvement of property that is subject to an allowance for depreciation or depletion were not deductible under section 174 in

the year of the acquisition or improvement. Section 1.174-2(b)(1). However, in accordance with section 174(c), the 1957 Regulations treated depreciation deductions as section 174 expenditures to the extent that the property to which the allowances related was used in connection with research and experimentation. Section 1.174-2(b)(1).

The 1957 Regulations further provided that expenditures could qualify as research or experimental expenditures even if those expenditures resulted, as an end product of the research and experimentation, in depreciable property to be used in the taxpayer's trade or business. Section 1.174-2(b)(4). However, the 1957 Regulations attempted to make clear that costs resulting in depreciable property were nonetheless required to meet the general requirement for section 174 treatment, namely, that amounts so expended must be for research and experimentation (within the meaning of §1.174-2(a)(1) of the 1957 Regulations). To that end, the 1957 Regulations provided, in relevant part, that amounts expended for research or experimentation do not include the costs of the component materials of depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. Section 1.174-2(b)(4). The 1957 Regulations provide an example where a taxpayer undertakes to develop a new machine for use in the taxpayer's business. The taxpayer expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs that are not attributable to the machine itself. The example concludes that under section

174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine). Section 1.174-2(b)(4). This preamble refers to the rules in §1.174-2(b)(1) and §1.174-2(b)(4) as the "Depreciable Property Rule." The Depreciable Property Rule has remained unchanged from the rule's adoption in the 1957 Regulations.

Explanation of Provisions and Summary of provisions

This document contains proposed amendments to 26 CFR part 1 under section 174. First, these proposed regulations provide that if expenditures qualify as research or experimental expenditures, it is irrelevant whether a resulting product is ultimately sold or used in the taxpayer's trade or business. Second, these proposed regulations provide that the Depreciable Property Rule contained in §1.174-2(b)(4) is an application of the general definition of research and experimental expenditures contained in §1.174-2(a)(1) to depreciable property. Third, these proposed regulations define the term "pilot model." Fourth, these proposed regulations clarify the general rule that the costs of producing a product after uncertainty concerning the development or improvement of a product is eliminated are not eligible expenses under section 174 because these costs are not for research or experimentation. Finally, these proposed regulations provide a "shrinking-back" provision, similar to the rule provided for in §1.41-4(b)(2), to address situations in which the requirements of §1.174-2(a)(1) are met with respect to only a component part of a larger product and are not met with respect to the overall product itself.

In general

Questions have been raised concerning whether the sale of a product resulting from otherwise qualifying research or experimental expenditures subsequently disqualifies those expenditures from section 174 treatment. Specifically, it has been argued that section 174(c) precludes section 174 treatment in the case of a subsequent sale of a resulting product to a customer, because the sale gives rise to depreciable property in the hands of the customer. See T.G. Missouri Company v. Commissioner, 133 T.C. 278 (2009) (rejecting the Commissioner's argument that research or experimental expenditures were disqualified under section 174 because the product resulting from research was sold to customers and was subject to depreciation in the customers' hands).

The IRS and the Treasury Department believe that an interpretation of the Depreciable Property Rule that creates an override to section 174 eligibility upon the occurrence of a subsequent event (such as a sale of a resulting product or its use in the taxpayer's trade or business) does not further the Congressional purpose of resolving accounting uncertainties and encouraging business investment in research because taxpayers may not be able to know whether an expenditure was section 174 eligible at the time the expense is paid or incurred.

Instead, the IRS and the Treasury Department believe that the Depreciable Property Rule accomplishes two things. First, to the extent that land or depreciable property is used in connection with research or experimentation, the rule limits the amount that a taxpayer can treat as an eligible section 174 expense to depletion or depreciation deductions. Second, the Depreciable

Property Rule in §1.174-2(b)(4) reiterates that the only expenditures related to the production of depreciable property that are deductible section 174 expenditures are amounts expended for research or experimentation. Thus, for example, where a $30,000 total cost expended on a machine includes $20,000 of research-related labor and materials and, after all uncertainties related to the machine are resolved, $10,000 of construction-related labor and materials, the $10,000 of construction-related labor and materials is not a section 174 expenditure because that cost was not a research or experimental cost within the meaning of §1.174-2(a).

Consistent with this interpretation, the IRS and the Treasury Department propose the following revisions to the current regulations and provide additional examples to further administration of the statute.

First, to counter an interpretation that section 174 eligibility can be reversed by a subsequent event, the proposed regulations provide that the ultimate success, failure, sale, or other use of the research or property resulting from research or experimentation is not relevant to a determination of eligibility under section 174.

Second, the proposed regulations amend §1.174-2(b)(4) to provide that the Depreciable Property Rule is an application of the general definition of research or experimental expenditures provided for in §1.174-2(a)(1) and should not be applied to exclude otherwise eligible expenditures.

Third, the proposed regulations define the term “pilot model” as any representation or model of a product that is produced to evaluate and resolve

uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or a component of a product (to the extent the "shrinking-back" provision, described in this preamble, applies).

Fourth, the proposed regulations clarify the general rule that the costs of producing a product after uncertainty concerning the development or improvement of a product is eliminated are not eligible under section 174 because these costs are not for research or experimentation.

Finally, the proposed regulations provide a "shrinking-back" provision, similar to the rule provided in §1.41-4(b)(2), to address situations in which the requirements of §1.174-2(a)(1) are met with respect to only a component part of a larger product and are not met with respect to the overall product itself.

The proposed regulations provide new examples applying the foregoing provisions.

Shrinking-back rule

As with business components under section 41, research or experimental expenditures may relate only to one or more components of a larger product. Taxpayers may refine the design of the product, or even redesign components of the product, after production of the product has begun, particularly in the case of a large tangible asset made up of numerous individual components. In these situations, although a basic design specification of the product may be established, amounts paid to eliminate uncertainty regarding the appropriate design of certain components of the product continue to qualify under section

174. For example, the design of an automobile may be certain except for the appropriateness of design of its braking system. The IRS and the Treasury Department believe that it is inappropriate to deny section 174 eligibility with respect to the development and design of the braking system simply because there is not uncertainty with respect to the automobile's general design. Accordingly, these proposed regulations provide a shrinking-back rule to ensure that section 174 eligibility is preserved in these instances. The IRS and the Treasury Department intend for this rule to be applied and administered in a manner that is consistent with the principles underlying the shrinking-back rule in §1.41-4(b)(2). Thus, for example, the shrinking-back rule applies only if the requirements of section 174 are not met with respect to an overall product (as defined in §1.174-2(a)(1)), and the shrinking-back rule is not itself applied to exclude research or experimental expenditures from section 174 eligibility.

Recordkeeping for section 174

The IRS and the Treasury Department note that the rules generally applicable under section 6001 provide sufficient detail about required documentary substantiation for purposes of section 174. Section 1.6001-1(a) requires the keeping of records sufficient to establish the amount of deductions. The IRS may deny a deduction for failure to provide sufficient records substantiating the claimed deduction.

Proposed effective date

These regulations are proposed to apply to any taxable year ending on or after the date of publication of a Treasury decision adopting these rules as final

regulations in the Federal Register. Notwithstanding the prospective effective date, the IRS will not challenge return positions consistent with these proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date that the final regulations are published in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 8, 2014, beginning at

10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, N.W., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]** and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is David McDonnell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.174-2 is amended as follows:

1. Amending paragraph (a)(1) by adding a heading and adding two sentences at the end.

2. Redesignating paragraph (a)(2) as paragraph (a)(3) and adding a heading to newly designated paragraph (a)(3).

3. Adding paragraph (a)(2).

4. Removing paragraph (a)(7).

5. Redesignating paragraphs (a)(8) and (a)(9) as paragraphs (a)(10) and (a)(11), respectively, and adding headings to newly designated paragraphs (a)(10) and (a)(11).

6. Redesignating paragraphs (a)(3) through (a)(6) as paragraphs (a)(6) through (a)(9), respectively, and adding headings to newly designated paragraphs (a)(6) through (a)(9).

7. Adding paragraphs (a)(4) and (a)(5).

8. Amending newly designated paragraph (a)(7) by removing the language “(a)(3)(i)” and adding “(a)(6)(i)” in its place.

9. Amending newly designated paragraph (a)(9) by removing the language “(a)(6)” and adding “(a)(9)” in its place.

10. Amending newly designated paragraph (a)(11) by removing the language “subparagraph (2) of this paragraph” and adding “this paragraph (a)” in its place.

11. Amending Example 2 in newly designated paragraph (a)(11) by removing the language “X” and adding “S” in its place everywhere “X” appears and by removing the language “Y” and adding “T” in its place everywhere “Y” appears.

12. Amending newly designated paragraph (a)(11) by adding Example 3 through Example 9.

13. Adding headings to paragraphs (b)(1) through (b)(3).

14. Revising paragraph (b)(4).

15. Adding paragraph (b)(5).

16. Adding paragraph (d).

The revisions and additions read as follows:

§1.174-2 Definition of research and experimental expenditures.

(a) In general. (1) Research or experimental expenditures defined. * * * The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under

section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

(2) Production costs. Except as provided in paragraph (a)(5) of this section (shrinking-back rule), costs paid or incurred in the production of a product after the elimination of uncertainty concerning the development or improvement of the product are not eligible under section 174.

(3) Product defined. * * *

(4) Pilot model defined. For purposes of this section, the term pilot model means any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or, to the extent paragraph (a)(5) of this section applies, a component of the product.

(5) Shrinking-back rule. If the requirements of paragraph (a)(1) of this section are not met at the level of a product (as defined in paragraph (a)(3) of this section), then whether expenditures represent research and development costs is determined at the level of the component or subcomponent of the product. The presence of uncertainty concerning the development or improvement of certain components of a product does not necessarily indicate the presence of uncertainty concerning the development or improvement of other components of the product or the product as a whole. The rule in this paragraph (a)(5) is not itself applied as a reason to exclude research or experimental expenditures from

section 174 eligibility. The rule in this paragraph (a)(5) is to be applied and administered in a manner that is consistent with the principles underlying the shrinking-back rule in §1.41-4(b)(2).

(6) Research or experimental expenditures--exclusions. * * *

(7) Quality control testing. * * *

(8) Expenditures for literary, historical, or similar research—cross reference. * * *

(9) Research or experimental expenditures limited to reasonable amounts. * * *

(10) Amounts paid to others for research or experimentation. * * *

(11) Examples. * * *

Example 3. U is engaged in the manufacture and sale of custom machines. U contracts to design and produce a machine to meet a customer's specifications. Because U has never designed a machine with these specifications, U is uncertain regarding the appropriate design of the machine, and particularly whether features desired by the customer can be designed and integrated into a functional machine. U incurs a total of $31,000 on the project. Of the $31,000, U incurs $10,000 of costs on materials and labor to produce a model that is used to evaluate and resolve the uncertainty concerning the appropriate design. U also incurs $1,000 of costs using the model to test whether certain features can be integrated into the design of the machine. This $11,000 of costs represents research and development costs in the experimental or laboratory sense. After uncertainty is eliminated, U incurs $20,000 to produce the machine for sale to the customer based on the appropriate design. The model produced and used to evaluate and resolve uncertainty is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, the $10,000 incurred to produce the model and the $1,000 incurred on design testing activities qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the $20,000 that U incurred to produce the machine for sale to the customer based on the appropriate design. See paragraph (a)(2) of this section (relating to production costs).

Example 4. Assume the same facts as Example 3, except that during a quality control test of the machine, a component of the machine fails to function due to the component's inappropriate design. U incurs an additional $8,000

(including design retesting) to reconfigure the component's design. The $8,000 of costs represents research and development costs in the experimental or laboratory sense. After the elimination of uncertainty regarding the appropriate design of the component, U incurs an additional $2,000 on its production. The reconfigured component produced and used to evaluate and resolve uncertainty with respect to the component is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, in addition to the $11,000 of research and experimental expenditures previously incurred, the $8,000 incurred on design activities to establish the appropriate design of the component qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the additional $2,000 that U incurred for the production after the elimination of uncertainty of the re-designed component based on the appropriate design or to the $20,000 previously incurred to produce the machine. See paragraph (a)(2) of this section (relating to production costs).

Example 5. V is a manufacturer that designs a new product. V incurs $5,000 to produce several models of the product that are to be used in testing the appropriate design before the product is mass-produced for sale. The $5,000 of costs represents research and development costs in the experimental or laboratory sense. Multiple models are necessary to test the design in a variety of different environments (exposure to extreme heat, exposure to extreme cold, submersion, and vibration). Upon completion of several years of testing, V enters into a contract to sell one of the models to a customer, and uses another model in its trade or business. The remaining models were rendered inoperable as a result of the testing process. Because V produced the models to resolve uncertainty regarding the appropriate design of the product, the models are pilot models under paragraph (a)(4) of this section. Therefore, the $5,000 that V incurred in producing the models qualifies as research or experimental expenditures under section 174. See also paragraph (a)(1) of this section (ultimate use is not relevant).

Example 6. W wants to improve a machine for use in its trade or business and incurs $20,000 to develop a new component for the machine. The $20,000 is incurred for engineering labor and materials to produce a model of the new component that is used to eliminate uncertainty regarding the development of the new component for the machine. The $20,000 of costs represents research and experimental costs in the experimental or laboratory sense. After W completes its research and experimentation on the new component, W incurs $10,000 for materials and labor to produce the component and incorporate it into the machine. The model produced and used to evaluate and resolve uncertainty with respect to the new component is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, the $20,000 incurred to produce the model and eliminate uncertainty regarding the development of the new component qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the $10,000 of production costs of the component because those costs were not incurred for research or

experimentation. See paragraph (a)(2) of this section (relating to production costs).

Example 7. X is a manufacturer of aircraft. X is researching and developing a new, experimental aircraft that can take off and land vertically. To evaluate and resolve uncertainty during the development or improvement of the product and test the appropriate design of the experimental aircraft, X produces a working aircraft at a cost of $5,000,000. The $5,000,000 of costs represents research and development costs in the experimental or laboratory sense. In a later year, X sells the aircraft. Because X produced the aircraft to resolve uncertainty regarding the appropriate design of the product during the development of the experimental aircraft, the aircraft is a pilot model under paragraph (a)(4) of this section. Therefore, the $5,000,000 of costs that X incurred in producing the aircraft qualifies as research or experimental expenditures under section 174. Further, it would not matter if X sold the pilot model or incorporated it in its own business as a demonstration model. See paragraph (a)(1) of this section (ultimate use is not relevant).

Example 8. Y is a manufacturer of aircraft engines. Y is researching and developing a new type of compressor blade, a component of an aircraft engine, to improve its existing aircraft engine design's performance. To test the appropriate design of the new compressor blade and evaluate the impact of fatigue on the design, Y produces and installs the compressor blade on an aircraft engine produced by Y. The costs of producing and installing the compressor blade component that Y incurred represent research and development costs in the experimental or laboratory sense. Because Y produced the compressor blade component to resolve uncertainty regarding the appropriate design of the component, the component is a pilot model under paragraph (a)(4) of this section. Therefore, the costs that Y incurred to produce and install the component qualify as research or experimental expenditures under section 174. See paragraph (a)(5) of this section (shrinking-back rule). However, section 174 does not apply to Y's costs of producing the aircraft engine on which the component was installed. See paragraph (a)(2) of this section (relating to production costs).

Example 9. Z is a wine producer. Z is researching and developing a new wine production process that involves the use of a different method of crushing the wine grapes. In order to test the effectiveness of the new method of crushing wine grapes, Z incurs $2,000 in labor and materials to conduct the test on this part of the new manufacturing process. The $2,000 of costs represents research and development costs in the experimental or laboratory sense. Therefore, the $2,000 incurred qualifies as research or experimental expenditures under section 174 because it is a cost incident to the development or improvement of a component of a process.

(b) * * * (1) Land and other property. * * *

(2) Expenditure resulting in depreciable property. * * *

(3) Amounts paid to others for research or experimentation resulting in depreciable property. * * *

(4) Deductions limited to amounts expended for research or experimentation. The deductions referred to in paragraphs (b)(2) and (3) of this section for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation within the meaning of section 174 and paragraph (a) of this section.

(5) Examples. The application of paragraph (b) of this section may be illustrated by the following examples:

Example 1. X is a tool manufacturer. X has developed a new tool design, and orders a specially-built machine from Y to produce X's new tool. The machine is built upon X's order and at X's risk, and Y does not provide a guarantee of economic utility. There is uncertainty regarding the appropriate design of the machine. Under X's contract with Y, X pays $15,000 for Y's engineering and design labor, $5,000 for materials and supplies used to develop the appropriate design of the machine, and $10,000 for Y's machine production materials and labor. The $15,000 of engineering and design labor costs and the $5,000 of materials and supplies costs represent research and development costs in the experimental or laboratory sense. Therefore, the $15,000 X pays Y for Y's engineering and design labor and the $5,000 for materials and supplies used to develop the appropriate design of the machine are for research or experimentation under section 174. However, section 174 does not apply to the $10,000 of production costs of the machine because those costs were not incurred for research or experimentation. See paragraph (a)(2) of this section (relating to production costs) and paragraph (b)(4) of this section (limiting deduction to amounts expended for research or experimentation).

Example 2. Z is an aircraft manufacturer. Z incurs $5,000,000 to construct a new test bed that will be used in the development and improvement of Z's aircraft. No portion of Z's $5,000,000 of costs to construct the new test bed represent research and development costs in the experimental or laboratory sense to develop or improve the test bed. Because no portion of the costs to construct the new test bed were incurred for research or experimentation, the

$5,000,000 will be considered an amount paid or incurred in the production of depreciable property to be used in the taxpayer's trade or business that are not allowable under section 174. However, the allowances for depreciation of the test bed are considered research and experimental expenditures of other products, for purposes of section 174, to the extent the test bed is used in connection with research or experimentation of other products. See paragraph (b)(1) of this section (depreciation allowances may be considered research or experimental expenditures).

Example 3. Assume the same facts as Example 2, except that $50,000 of the costs of the test bed relates to costs to resolve uncertainties regarding the new test bed design. The $50,000 of costs represents research and development costs in the experimental or laboratory sense. Because $50,000 of Z's costs to construct the new test bed was incurred for research and experimentation, the costs qualify as research or experimental expenditures under section 174. Paragraph (b)(2) of this section applies to $50,000 of Z's costs for the test bed because they are expenditures for research or experimentation that result in depreciable property to be used in the taxpayer's trade or business. Z's remaining $4,950,000 of costs is not allowable under section 174 because these costs were not incurred for research or experimentation.

* * * * *

(d) Effective date. These amendments to paragraphs (a) and (b) of this section apply to taxable years ending on or after the date the final regulations are published in the Federal Register. Notwithstanding the prospective effective date, the IRS will not challenge return positions consistent with these proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date that the final regulations are published in the Federal Register.

Beth Tucker,

Deputy Commissioner for Operations Support.

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