[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9680]

RIN 1545-BE64

Research Expenditures

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

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

DATES: Effective date: These regulations are effective **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability date: For date of applicability see §1.174-2(d)

FOR FURTHER INFORMATION CONTACT: David McDonnell at (202) 317-4137 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Summary of Proposed Regulations

On September 6, 2013, a notice of proposed rulemaking (REG-124148-05) and a notice of public hearing were published in the **Federal Register** (78 FR 547896). The IRS and the Treasury Department proposed the following revisions to the current regulations:

First, to counter an interpretation that section 174 eligibility can be reversed by a subsequent event, the proposed regulations provided 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 amended §1.174-2(b)(4) to provide that the Depreciable Property Rule (the rules in §1.174-2(b)(1) and §1.174-2(b)(4)) 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 defined 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 included a fully-functional representation or model of the product or a component of a product (to the extent the shrinking-back rule applies).

Fourth, the proposed regulations clarified 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 provided a shrinking-back rule, 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 also provided new examples applying the foregoing provisions.

Summary of Comments and Explanation of Provisions

Several comments were received in response to the proposed regulations. Following is a discussion of significant comments. Certain other comments presented issues unrelated to the proposed regulations, and they are not adopted or discussed herein.

Uncertainty

Some commentators requested a definition of "uncertainty" because the examples rely on "elimination of uncertainty" as the point when research activities have concluded. Section 1.174-2(a)(1) provides that "[u]ncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product." Because the current regulations already provide a sufficient definition of "uncertainty," and the point at which uncertainty is eliminated (that is, information available to the taxpayer establishes the capability or method for developing or improving the product or the appropriate design of the product) is based on the

taxpayer's facts and circumstances, the final regulations do not provide additional guidance with respect to the definition of "uncertainty."

Some commentators requested a bright-line standard, such as the commencement of commercial production as in section 41(d)(4)(A), to determine when uncertainty is eliminated. Section 1.174-2(a)(1) of the proposed regulations provided that 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. The point at which uncertainty is resolved is based on the taxpayer's facts and circumstances, and therefore a bright-line standard is not appropriate under section 174.

Some commentators requested that the regulations explicitly incorporate the rule of application regarding the discovering information requirement found in section 41(d)(1)(B) and §1.41-4(a)(3)(ii) (that is, there is no requirement that the taxpayer be seeking to obtain information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field, and there is no requirement that the taxpayer succeed in developing a new or improved business component). The IRS and the Treasury Department note that section 174 does not contain any provision defining research or experimentation. In contrast, section 41 provides a statutory definition for "qualified research," which includes a requirement that the research be undertaken for the purpose of discovering information. In addition, neither the section 174 statute nor its legislative history suggest that a taxpayer must seek information that exceeds, expands, or refines the common knowledge of skilled professionals in the particular field in which the

taxpayer is performing research. Section 1.174-2(a)(1) of the current regulations simply provides that "[e]xpenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product." Consequently, this comment is not adopted.

Some commentators questioned how the substantially all requirement in section 41(d)(1)(C) and §1.41-4(a)(6) (that is, 80 percent or more of a taxpayer's research activities, measured on a cost or other consistently applied reasonable basis, constitute elements of a process of experimentation) applies to section 174. Section 174 does not contain a similar "substantially all" requirement. Accordingly, the requirement in section 41(d)(1)(C) and §1.41-4(a)(6) does not apply to section 174.

Supplies

Some commentators requested clarification that indirect or ancillary supplies used in research are eligible under section 174 although ineligible under section 41. Section 1.174-2(a)(1) of the current regulations provides that the term "research or experimental expenditures" "generally includes all such costs incident to the development or improvement of a product." This statement is sufficiently broad to include indirect or ancillary supplies used in research that otherwise satisfies the requirements of section 174. Therefore, revisions to the proposed regulations are not needed to respond to the commentators' concern.

Pilot Model

One commentator expressed concern regarding a proposed example demonstrating the application of the rules in the case of multiple pilot models. The commentator suggested that, under Example 5 of §1.174-2(a)(11) of the proposed regulations, the deductibility of section 174 expenses for multiple pilot models is permitted only if each pilot model is tested for a purpose that is different from any other pilot model. The definition of pilot model contained in §1.174-2(a)(4) of the proposed regulations does not contain a requirement that the pilot model be used to test for a discrete purpose. A pilot model within the definition of §1.174-2(a)(4) of the proposed regulations (including a component to the extent paragraph (a)(5) applies) is eligible for section 174, subject to satisfaction of the other requirements of section 174 and the regulations. The final regulations modify Example 5 to clarify that it is not necessary for each pilot model to be tested for a discrete purpose for the costs of multiple pilot models to qualify as research and experimental expenditures under section 174.

One commentator requested clarification regarding the distinction between a section 174 eligible "pilot model" and a section 174 ineligible "test bed." Furthermore, the commentator construed Example 2 and Example 3 of proposed regulation §1.174-2(b)(5) to state that test beds are depreciable property excluded from section 174. As provided in proposed regulation §1.174-2(a)(4), a 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 proposed examples demonstrate the application of §1.174-2(b)(1), (b)(2), and (b)(4) (that is, when expenditures for

property may be research and experimental expenditures). The facts of the proposed examples do not demonstrate the existence of a pilot model nor do they foreclose the possibility that a test bed may be a pilot model if it meets the definition of a pilot model under proposed regulation §1.174-2(a)(4). For example, if the taxpayer constructed a new test bed as a model test bed and the new test bed was produced to evaluate and resolve uncertainty concerning the test bed during its development or improvement, it could be a pilot model. Because these examples were not intended to illustrate pilot models, the final regulations do not adopt this comment.

Shrinking-Back Rule

Some commentators expressed concern that the shrinking-back rule in §1.174-2(a)(5) of the proposed regulations may exclude from section 174 the cost of testing to eliminate uncertainty regarding the integration of an experimental component with a nonexperimental product. Section 1.174-2(a)(1) of the current regulations provides that the term “research or experimental expenditures” “generally includes all such costs incident to the development or improvement of a product.” This statement is sufficiently broad to encompass the cost of testing (other than testing specifically excluded under current §1.174-1(a)(3) (quality control testing)) performed to eliminate uncertainty with respect to an experimental component and costs to resolve uncertainty regarding integration of an experimental component with a nonexperimental product when the requirements of §1.174-2(a)(1) are not met for the product as a whole.

Therefore, revisions to the proposed regulations are not needed to respond to the commentators' concern.

Some commentators requested that the shrinking-back rule in §1.174-2(a)(5) of the proposed regulations be eliminated. The commentators stated that the shrinking-back rule in §1.41-4(b)(2) is peculiar to section 41 and serves no purpose in section 174. As with business components under section 41, research or experimental expenditures may relate only to one or more components of a larger product. The shrinking-back rule in the proposed regulations was intended to ensure that section 174 eligibility is preserved in instances in which a basic design specification of the product may be established, but there is uncertainty with respect to certain components of the product, even if uncertainty arises after production of the product has begun. Therefore, the substance of the shrinking-back rule is retained in the final regulations. However, in response to commentator concerns, and to avoid any unintended confusion with the shrinking-back rule of §1.41-4(b)(2), the rule in §1.174-2(a)(5) of the proposed regulations has been renamed. Furthermore, the last sentence of §1.174-2(a)(5) of the proposed regulations has been eliminated in response to commentator concerns that references to section 41 may imply that other requirements under section 41, such as the process of elimination requirement, apply to expenditures under section 174.

The final regulations also modify Example 8 of the proposed regulations and include one additional example, Example 9, to demonstrate the application of section 174 to components of a product.

Examples

One commentator expressed concern about Example 7 of §1.174-2(a)(11) of the proposed regulations, which described the development of "a new, experimental aircraft." The commentator believes that the use of the words "new" and "experimental" in proposed Example 7 could be interpreted to establish a new, heightened standard for eligibility for section 174. Section 1.174-2(a)(1) of the current regulations provides the only qualitative criteria for eligibility for section 174 and provides that whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which they relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Terms used in examples do not have substantive meaning that expand or reduce the meaning or application of terms used in the regulations; they are simply describing the facts of the example. Accordingly, the final regulations do not revise Example 7 to remove the descriptive terms "new" or "experimental."

One commentator requested guidance revising §1.174-2(c), regarding exploration expenditures for oil, gas, or minerals. This comment is outside the scope of the proposed regulations which did not propose changes to §1.174-2(c). Therefore, the requested guidance is not adopted in the final regulations.

Effective/Applicability Date

These regulations apply to taxable years ending on or after the date of their publication as final regulations in the **Federal Register**. Taxpayers may

apply the final regulations to taxable years for which the limitations for assessment of tax has not expired.

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, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

Drafting Information

The principal author of these 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.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

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:

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

2. By removing paragraph (a)(7).

3. By redesignating paragraphs (a)(8) and (9) as paragraphs (a)(10) and (11), respectively, and adding headings to them.

4. By redesignating paragraphs (a)(3) through (6) as paragraphs (a)(6) through (9), respectively, and adding headings to them.

5. By redesignating paragraph (a)(2) as paragraph (a)(3) and adding a heading to newly designated paragraph (a)(3).

6. By adding new paragraphs (a)(2), (4) and (5).

7. In newly redesignated paragraph (a)(7), by removing the language "(a)(3)(i)" and adding "(a)(6)(i)" in its place.

8. In newly redesignated paragraph (a)(9), by removing the language "(a)(6)" and adding "(a)(9)" in its place.

9. By revising newly redesignated paragraph (a)(11) introductory text.

10. In Example 1 in newly redesignated paragraph (a)(11) by adding a heading.

11. In Example 2 in newly redesignated paragraph (a)(11) by adding a heading, removing the language "X" and adding "S" in its place everywhere "X"

appears, and removing the language “Y” and adding “T” in its place everywhere “Y” appears.

12. In newly redesignated paragraph (a)(11) by adding Example 3 through Example 10.

13. In paragraphs (b)(1) through (3) by adding headings.

14. By revising paragraph (b)(4).

15. By adding paragraph (b)(5).

16. By 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 (the rule concerning the application of section 174 to components of a product), 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) Application of section 174 to components of a product. 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.

(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. The following examples illustrate the application of this paragraph (a).

Example 1. Amounts paid to others for research or experimentation allowed as a deduction. * * *

Example 2. Amounts paid to others not allowable as a deduction. * * *

Example 3. Pilot model. 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. Product component redesign. 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. Multiple pilot models. V is a manufacturer that designs a new product. V incurs $5,000 to produce a number of 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). In some cases, V uses more than one model to test in a particular environment. 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. Development of a new component; pilot model. 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. Disposition of a pilot model. 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. Development of new component; pilot model. 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 the performance of an existing aircraft engine design that Y already manufactures and sells. To test the appropriate design of the new compressor blade and evaluate the impact of fatigue on the compressor blade design, Y produces and installs the compressor blade on an aircraft engine held by Y in its inventory. 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 (regarding the application of section 174 to components of a product). 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. Variant product. T is a fuselage manufacturer for commercial and military aircraft. T is modifying one of its existing fuselage products, Class 20XX-1, to enable it to carry a larger passenger and cargo load. T modifies the Class 20XX-1 design by extending its length by 40 feet. T incurs $1,000,000 to develop and evaluate different designs to resolve uncertainty with respect to the appropriate design of the new fuselage class, Class 20XX-2. The $1,000,000 of costs represents research and development costs in the experimental or laboratory sense. Although Class 20XX-2, is a variant of Class 20XX-1, Class 20XX-2 is a new product because the information available to T as a result of T's development of Class 20XX-1 does not resolve uncertainty with respect to T's development of Class 20XX-2. Therefore, the $1,000,000 of costs that T incurred to develop and evaluate the Class 20XX-2 qualifies as research or experimental expenditures under section 174. Paragraph (a)(5) of this section does not apply, as the requirements of paragraph (a)(1) of this section are met with respect to the entire product.

Example 10. New process development. 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 following examples illustrate the application of paragraph (b) of this section.

Example 1. Amounts paid to others for research or experimentation resulting in depreciable property. 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. Expenditures with respect to other property. 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. Expenditure resulting in depreciable property. 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/applicability date. The eighth and ninth sentences of §1.174-2(a)(1); §1.174-2(a)(2); §1.174-2(a)(4); §1.174-2(a)(5); §1.174-2(a)(11) Example 3 through Example 10; §1.174-2(b)(4); and §1.174-2(b)(5) apply to taxable years ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. Taxpayers may apply the provisions enumerated in the preceding sentence to taxable years for which the limitations for assessment of tax has not expired.

John Dalrymple

Deputy Commissioner for Services and Enforcement.

Approved: June 27, 2014

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2014-16956 Filed 07/18/2014 at 8:45 am;

Publication Date: 07/21/2014]