

does not add or modify any economic costs imposed on participants in the FHA multifamily mortgage insurance programs. Rather, the rule eliminates a current regulatory barrier to program eligibility and expand participation in these programs. As discussed earlier in this preamble, section 223(f) of the NHA authorizes FHA mortgage financing for existing multifamily projects, irrespective of whether the project provides rental or cooperative housing. The rule revises the regulations governing eligibility for financing under section 223(f) to enable owners of multifamily cooperative housing projects to refinance their existing mortgage debt with FHA insurance. Accordingly, the undersigned certifies that this rule will not have a significant economic impact on a substantial number of small entities.

Environmental Impact

A Finding of No Significant Impact (FONSI) with respect to the environment was made at the proposed rule stage, in accordance with HUD regulations at 24 CFR part 50, which implements section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)). The FONSI remains applicable to this final rule and is available for public inspection between the hours of 8:00 a.m. and 5:00 p.m. weekdays in the Regulations Division, Office of General Counsel, Room 10276, Department of Housing and Urban Development, 451 7th Street SW., Washington, DC 20410. Due to security measures at the HUD Headquarters building, please schedule an appointment to review the FONSI by calling the Regulations Division at 202-708-3055 (this is not a toll-free number). Individuals with speech or hearing impairments may access this number via TTY by calling the Federal Information Relay Service at (800) 877-8339.

Executive Order 13132, Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from publishing any rule that has federalism implications if the rule either (1) imposes substantial direct compliance costs on state and local governments, and is not required by statute, or (2) the rule preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Unfunded Mandates Reform Act

Title II of the Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) (UMRA) establishes requirements for federal agencies to assess the effects of their regulatory actions on state, local, and tribal governments, and on the private sector. This rule does not impose any federal mandates on any state, local, or tribal governments, or on the private sector, within the meaning of the UMRA.

Paperwork Reduction Act

The information collection requirements for this rule have been approved by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520) and assigned OMB control number 2502-0029. In accordance with the Paperwork Reduction Act, an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information, unless the collection displays a currently valid OMB control number.

Catalogue of Federal Domestic Assistance

The Catalogue of Federal Domestic Assistance Number for the principal FHA mortgage insurance program is 14.155.

List of Subjects in 24 CFR Part 200

Administrative practice and procedure, Claims, Equal employment opportunity, Fair housing, Housing standards, Lead poisoning, Loan programs—housing and community development, Mortgage insurance, Organization and functions (Government agencies), Penalties, Reporting and recordkeeping requirements, Social Security, Unemployment compensation, Wages.

Accordingly, for the reasons stated above, HUD amends 24 CFR part 200 as follows:

PART 200—INTRODUCTION TO FHA PROGRAMS

■ 1. The authority citation for 24 CFR part 200 continues to read as follows:

Authority: 12 U.S.C. 1703, 1709, and 1715b; 42 U.S.C. 3535(d).

■ 2. Revise § 200.24 to read as follows:

§ 200.24 Existing projects.

A mortgage financing the purchase or refinance of an existing rental housing project or refinance of the existing debt of an existing cooperative project under section 207 of the Act, or for refinancing the existing debt of an existing nursing home, intermediate care facility,

assisted living facility, or board and care home, or any combination thereof, under section 232 of the Act, may be insured pursuant to provisions of section 223(f) of the Act and such terms and conditions established by HUD.

Dated: July 15, 2014.

Carol J. Galante,

Assistant Secretary for Housing—Federal Housing Commissioner.

[FR Doc. 2014–17072 Filed 7–18–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9636]

RIN 1545–BE18

Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property; Correction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendments.

SUMMARY: This document contains amendments to correct the final regulations (TD 9636) that provided guidance on the application of sections 162(a) and 263(a) of the Internal Revenue Code (Code) regarding the deduction and capitalization of expenditures related to tangible property. These regulations were published in the **Federal Register** on Thursday, September 19, 2013 (78 FR 57686).

DATES: This correction is effective on July 21, 2014, and is applicable beginning September 19, 2013.

FOR FURTHER INFORMATION CONTACT: Merrill D. Feldstein at (202) 317–5100 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations (TD 9636) that are the subject of this correction provide guidance under sections 162(a) and 263(a) of the Code to amounts paid to acquire, produce, or improve tangible property and affect taxpayers that acquire, produce, or improve tangible property.

In addition to correcting a number of typographical and syntactical errors, these correcting amendments clarify the manner of electing to capitalize and depreciate the cost of any rotatable spare part, temporary spare part, or standby emergency spare part under § 1.162–3(d). As published, § 1.162–3(d)(3) of

the final regulations could be misleading regarding the manner of making this election. The election is made by capitalizing the amounts paid to acquire or produce a material or supply and by beginning to depreciate the designated amounts under the rules for accounting for property depreciated under the Modified Accelerated Cost Recovery System (MACRS) under section 168 (MACRS property). The final regulations are corrected to clarify this point.

A similar election to capitalize and depreciate the cost of materials and supplies was provided under § 1.162-3T(d) of the temporary regulations published in the **Federal Register** on Tuesday, December 27, 2011 (TD 9564) (76 FR 81060). While the temporary regulations (TD 9564) were removed from the **Federal Register** on September 19, 2013, in conjunction with publication of the final regulations (TD 9636), the final regulations permit taxpayers to choose to apply § 1.162-3T(d) to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014. The language in § 1.162-3T(d)(3) describing the manner of electing to capitalize and depreciate the cost of materials and supplies is similar to the language in § 1.162-3(d)(3) of the final regulations and could be similarly misleading. However, because the temporary regulations have been withdrawn, the language in § 1.162-3T(d)(3) cannot be corrected. Therefore, for good cause to prevent any confusion for taxpayers who choose to apply § 1.162-3T(d) as contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014, § 1.162-3(j)(3) is clarified to provide that the manner for making the election under § 1.162-3T(d)(3) is the same as the manner for making the election under § 1.162-3(d)(3). In both cases, the election is made by capitalizing the amounts paid to acquire or produce designated materials or supplies and by beginning to depreciate these amounts under the rules for accounting for MACRS property.

Need for Correction

As published, the final regulations contain errors that may prove to be misleading and are in need of clarification.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Correction of Publication

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendments:

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 1.162-3 is amended by:

- 1. Revising the last sentence of paragraph (c)(4)(i).
- 2. Revising the first sentence of paragraphs (c)(4)(ii), (d)(1), and (d)(2).
- 3. Revising paragraph (d)(3).
- 4. Revising the fourth sentence of paragraph (e)(1).
- 5. In paragraph (j)(3) removing the text “section” wherever it appears and adding “§” in its place, and adding two new sentences after the first sentence of the paragraph.

The revisions and addition read as follows:

§ 1.162-3 Materials and supplies.

- * * * * *
- (c) * * *
- (4) * * *
- (i) * * * The factors that must be considered in determining this period are provided under § 1.167(a)-1(b).
- (ii) * * * For taxpayers with an applicable financial statement (as defined in paragraph (c)(4)(iii) of this section), the economic useful life of a unit of property, solely for the purposes of applying the provisions of this paragraph (c), is the useful life initially used by the taxpayer for purposes of determining depreciation in its applicable financial statement, regardless of any salvage value of the property. * * *
- * * * * *
- (d) * * *
- (1) * * * A taxpayer may elect to treat as a capital expenditure and to treat as an asset subject to the allowance for depreciation the cost of any rotatable spare part, temporary spare part, or standby emergency spare part as defined in paragraph (c)(2) or (c)(3) of this section. * * *
- (2) * * * A taxpayer may not elect to capitalize and depreciate under this paragraph (d) any amount paid to acquire or produce a rotatable, temporary, or standby emergency spare part defined in paragraph (c)(2) or (c)(3) of this section if—
- * * * * *
- (3) *Manner of electing.* A taxpayer makes the election under this paragraph (d) by capitalizing the amounts paid to

acquire or produce a rotatable, temporary, or standby emergency spare part in the taxable year the amounts are paid and by beginning to depreciate the costs when the asset is placed in service by the taxpayer for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. Section 1.263(a)-2 provides for the treatment of amounts paid to acquire or produce real or personal tangible property. A taxpayer must make the election under this paragraph (d) in its timely filed original Federal tax return (including extensions) for the taxable year the asset is placed in service by the taxpayer for purposes of determining depreciation. Sections 301.9100-1 through 301.9100-3 of this chapter provide the rules governing extensions of the time to make regulatory elections. In the case of an S corporation or a partnership, the election is made by the S corporation or partnership, and not by the shareholders or partners. A taxpayer may make an election for each rotatable, temporary, or standby emergency spare part that qualifies for the election under this paragraph (d). This election does not apply to an asset or a portion thereof placed in service and disposed of in the same taxable year. A taxpayer may revoke an election made under this paragraph (d) or made under § 1.162-3T(d), as contained in 26 CFR part 1, revised as of April 1, 2013, only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the interests of the Government. See generally § 301.9100-3 of this chapter. The manner of electing and revoking the election to capitalize under this paragraph (d) or under § 1.162-3T(d), as contained in 26 CFR part 1, revised as of April 1, 2013, may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter). An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal tax return.

(e) * * *

(1) * * * If a taxpayer uses the optional method for rotatable parts for pools of rotatable and temporary spare parts for which the taxpayer does not use the optional method for its books and records, then the taxpayer must use the optional method for all its pools in

the same trade or business, whether rotatable or temporary. * * *

* * * * *

(j) * * *

(3) * * * In applying § 1.162–3T(d)(3), as contained in 26 CFR part 1, revised as of April 1, 2013, a taxpayer makes the election under § 1.162–3T(d) by capitalizing the amounts paid to acquire or produce a material or supply in the taxable year the amounts are paid and by beginning to depreciate the costs when the asset is placed in service by the taxpayer for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. The election under § 1.162–3T(d), as contained in 26 CFR part 1, revised as of April 1, 2013, does not apply to an asset or a portion thereof placed in service and disposed of in the same taxable year. * * *

■ **Par. 3.** Section 1.162–4 is amended by revising the last sentence of paragraph (a) to read as follows:

§ 1.162–4 Repairs.

(a) * * * Optionally, § 1.263(a)–3(n) provides an election to capitalize amounts paid for repair and maintenance consistent with the taxpayer's books and records.

* * * * *

■ **Par. 4.** Section 1.263(a)–0 is amended by revising the entry in the outline of the regulations for § 1.263(a)–2(f)(3)(ii) to read as follows:

§ 1.263(a)–0 Outline of regulations under section 263(a).

* * * * *

§ 1.263(a)–2 Amounts paid to acquire or produce tangible property.

* * * * *

(f) * * *

(3) * * *

(ii) Treatment of inherently facilitative amounts allocable to property not acquired.

* * * * *

■ **Par. 5.** Section 1.263(a)–1 is amended by:

- 1. Revising the second sentence of paragraph (f)(1).
- 2. Revising paragraphs (f)(1)(i)(B)(2), (f)(1)(ii)(B)(2), (f)(3)(iv), and (f)(3)(vii).
- 3. Revising the third sentence of paragraph (f)(5).
- 4. Revising the heading of paragraph (f)(7) *Example 6*.

The revisions read as follows:

§ 1.263(a)–1 Capital expenditures; in general.

* * * * *

(f) * * *

(1) * * * However, section 263A and the regulations under section 263A require taxpayers to capitalize the direct and allocable indirect costs of property produced by the taxpayer (for example, property improved by the taxpayer) and property acquired for resale.

(i) * * *

(B) * * *

(2) Amounts paid for property with an economic useful life (as defined in § 1.162–3(c)(4)) of 12 months or less;

* * * * *

(ii) * * *

(B) * * *

(2) Amounts paid for property with an economic useful life (as defined in § 1.162–3(c)(4)) of 12 months or less;

* * * * *

(3) * * *

(iv) *Treatment of de minimis amounts.* An amount paid for property to which a taxpayer properly applies the de minimis safe harbor contained in this paragraph (f) is not treated as a capital expenditure under § 1.263(a)–2(d)(1) or § 1.263(a)–3(d) or as a material and supply under § 1.162–3, and may be deducted under § 1.162–1 in the taxable year the amount is paid provided the amount otherwise constitutes an ordinary and necessary expense incurred in carrying on a trade or business.

* * * * *

(vii) *Combined expensing accounting procedures.* For purposes of paragraphs (f)(1)(i) and (f)(1)(ii) of this section, if the taxpayer has, at the beginning of the taxable year, accounting procedures treating as an expense for non-tax purposes amounts paid for property costing less than a specified dollar amount and amounts paid for property with an economic useful life (as defined in § 1.162–3(c)(4)) of 12 months or less, then a taxpayer electing to apply the de minimis safe harbor under this paragraph (f) must apply the provisions of this paragraph (f) to amounts qualifying under either accounting procedure.

* * * * *

(5) * * * Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. * * *

* * * * *

(7) * * *

Example 6. De minimis safe harbor; non-invoice additional costs. * * *

* * * * *

■ **Par. 6.** Section 1.263(a)–2 is amended by:

- 1. Revising the second sentence of paragraph (d)(1).

- 2. Revising the second sentence of paragraph (f)(2)(iv)(A) and the fifth sentence of paragraph (f)(2)(iv)(B).
- 3. Revising the heading of paragraph (f)(3)(ii).

- 4. Removing the text “section” in the last sentence of paragraph (h)(2).

The revisions read as follows:

§ 1.263(a)–2 Amounts paid to acquire or produce tangible property.

* * * * *

(d) * * *

(1) * * * Section 1.263(a)–3(f) provides the rules for determining whether amounts are for leasehold improvements. * * *

* * * * *

(f) * * *

(2) * * *

(iv) * * *

(A) * * * However, section 263A provides rules for employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(B) * * * Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections.

* * * * *

(3) * * *

(ii) *Treatment of inherently facilitative amounts allocable to property not acquired.* * * *

* * * * *

■ **Par. 7.** Section 1.263(a)–3 is amended by:

- 1. Revising the second and third sentences of paragraph (d) and adding a new fourth sentence.
- 2. Revising the second sentence of paragraph (e)(2)(i).
- 3. Revising first and third sentences of paragraph (f)(2)(i).
- 4. Revising the first, second, and last sentences of paragraph (f)(3)(i).
- 5. Removing the eighth sentence of paragraph (g)(2)(ii) *Example 3*.
- 6. Revising paragraph (h)(4).
- 7. Revising the last sentence of paragraph (h)(5)(ii).
- 8. Revising the second sentence of paragraph (h)(6).
- 9. Revising the first sentence and removing the second sentence of paragraph (i)(6) *Example 3(ii)*.
- 10. Revising the next to the last sentence of paragraph (j)(3) *Example 11* and removing the last sentence of this paragraph.
- 11. Revising paragraphs (k)(1)(v) and (k)(1)(vi).
- 12. Revising the first sentence of paragraph (k)(2).
- 13. Revising the last sentence of paragraph (k)(7) *Example 7*.

■ 14. Removing the sixth sentence of paragraph (k)(7) *Example 30*.

■ 15. Revising the second sentence of paragraph (n)(2).

The revisions and addition read as follows:

§ 1.263(a)–3 Amounts paid to improve tangible property.

* * * * *

(d) * * * However, paragraph (f) of this section applies to the treatment of amounts paid to improve leased property. Section 263A provides the requirement to capitalize the direct and allocable indirect costs of property produced by the taxpayer and property acquired for resale. Section 1016 provides for the addition of capitalized amounts to the basis of the property, and section 168 governs the treatment of additions or improvements for depreciation purposes. * * *

* * * * *

(e) * * *

(2) * * *

(i) * * * Paragraph (e)(2)(iii) of this section provides the unit of property for condominiums, paragraph (e)(2)(iv) of this section provides the unit of property for cooperatives, and paragraph (e)(2)(v) of this section provides the unit of property for leased buildings.

* * * * *

(f) * * *

(2) * * *

(i) * * * A taxpayer lessee must capitalize the related amounts, as determined under paragraph (g)(3) of this section, that it pays to improve, as defined under paragraph (d) of this section, a leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or when the improvement constitutes a substitute for rent. * * * A taxpayer lessee must also capitalize the related amounts that a lessor pays to improve, as defined under paragraph (d) of this section, a leased property if the lessee is the owner of the improvement, except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. * * *

* * * * *

(3) * * *

(i) * * * A taxpayer lessor must capitalize the related amounts, as determined under paragraph (g)(3) of this section, that it pays directly, or indirectly through a construction allowance to the lessee, to improve, as defined in paragraph (d) of this section, a leased property when the lessor is the owner of the improvement or to the

extent that section 110 applies to the construction allowance. A lessor must also capitalize the related amounts that the lessee pays to improve a leased property, as defined in paragraph (e) of this section, when the lessee's improvement constitutes a substitute for rent. * * * See paragraph (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

* * * * *

(h) * * *

(4) *Eligible building property.* For purposes of this section, the term *eligible building property* refers to each unit of property defined in paragraph (e)(2)(i) (building), paragraph (e)(2)(iii)(A) (condominium), paragraph (e)(2)(iv)(A) (cooperative), or paragraph (e)(2)(v)(A) (leased building or portion of building) of this section, as applicable, that has an unadjusted basis of \$1,000,000 or less.

(5) * * *

(ii) * * * Section 1.263(a)–4(f)(5)(ii) provides the factors that are significant in determining whether there exists a reasonable expectancy of renewal for purposes of this paragraph.

(6) * * * Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. * * *

* * * * *

(i) * * *

(6) * * *

Example 3. * * *

(ii) The additional aircraft engines are rotatable spare parts under § 1.162–3(c)(2) because they were acquired separately from the aircraft, are removable from the aircraft, and are repaired and reinstalled on other aircraft or stored for later installation. * * *

* * * * *

(j) * * *

(3) * * *

Example 11. * * * Under paragraph (g)(4) of this section, City C's new requirement that K's building meet certain safety standards to continue to operate is not relevant in determining whether the amount paid improved the building.

* * * * *

(k) * * *

(1) * * *

(v) Results in the rebuilding of the unit of property to a like-new condition as determined under paragraph (k)(5) of this section after the end of its class life as defined in paragraph (i)(4) of this section; or

(vi) Is for the replacement of a part or combination of parts that comprise a major component or a substantial

structural part of a unit of property as determined under paragraph (k)(6) of this section.

(2) * * * An amount is paid to improve a building if it is paid to restore, as defined under paragraph (k)(1) of this section, a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or portion of building) of this section. * * *

* * * * *

(7) * * *

Example 7. * * * However, paragraphs (k)(1)(vi) and (k)(6) of this section are applicable for determining whether any amounts must be capitalized because they are paid for the replacement of a major component or a substantial structural part of the unit of property.

* * * * *

(n) * * *

(2) * * * Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. * * *

■ **Par. 8.** Section 1.263A–1 is amended by revising paragraph (l) to read as follows:

§ 1.263A–1 Uniform capitalization of costs.

* * * * *

(l) *Effective/applicability date*—(1) *In general.* Except as provided in (l)(2), (l)(3), and (l)(4) of this section, the effective dates for this section are provided in paragraph (a)(2) of this section.

(2) *Mixed service costs; self-constructed tangible personal property produced on a routine and repetitive basis.* Paragraphs (h)(2)(i)(D), (k), and (l)(2) of this section apply for taxable years ending on or after August 2, 2005.

(3) *Costs allocable to property sold; indirect costs; licensing and franchise costs.* Paragraphs (c)(5), (e)(3)(i), and (e)(3)(ii)(U) of this section apply for taxable years ending on or after January 13, 2014.

(4) *Materials and supplies*—(i) *In general.* The last sentence of paragraphs (e)(2)(i)(A) and (e)(3)(ii)(E) of this section, and paragraph (l)(4) of this section apply to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2014.

(ii) *Early application of this section.* A taxpayer may choose to apply the last sentence of paragraphs (e)(2)(i)(A) and (e)(3)(ii)(E) of this section, and paragraph (l)(4) of this section to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.263A–1T(b)(14), the introductory phrase of § 1.263A–1T(c)(4), the last sentence of § 1.263A–1T(e)(2)(i)(A), the last sentence of § 1.263A–1T(e)(3)(ii)(E), § 1.263A–1T(l), and § 1.263A–1T(m)(2), as these provisions are contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

Martin V. Franks,

Branch Chief, Publications and Regulations Branch, Legal Processing Division, Associate Chief Counsel (Procedure and Administration).

[FR Doc. 2014–17080 Filed 7–18–14; 8:45 am]

BILLING CODE 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 July 21, 2014.

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.