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KPMG report: Analysis and observations on Rev. Procs. 2023-8 and 2023-11, guidance for accounting method changes under section 174

The IRS on December 12, 2022, released an advance copy of [Rev. Proc. 2023-8](#) [PDF 133 KB] that provides accounting method change procedures applicable to companies required to capitalize and amortize specified research and experimental (R&E) expenses under section 174. Under Pub. L. No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (TCJA), R&E costs incurred in tax years beginning after December 31, 2021, must be capitalized and amortized over five years if the research is performed in the United States and over 15 years if performed outside of the United States, including a half-year convention for the year incurred.

Rev. Proc. 2023-8 provides that a taxpayer's change in treatment is a change in method of accounting subject to the procedures, terms, and conditions for obtaining the Commissioner's consent. The revenue procedure amends the automatic consent procedures in [Rev. Proc. 2022-14](#) [PDF 1.7 MB] (457 pages) to provide automatic consent for this change in accounting method and provides a streamlined procedure if the accounting method change is made for the first effective year, and then reverts to the ordinary automatic change procedures for changes made after the first year.

The IRS on December 29, 2022, released an advance copy [Rev. Proc. 2023-11](#) [PDF 121 KB], to amend the procedures set forth in Rev. Proc. 2023-8 for making post-2022 accounting method changes. As revised, taxpayers making a change for the tax year following the first effective year will not receive audit protection for costs subject to mandatory amortization in the first effective year.

The key points of each procedure are summarized below.

Change made for a taxpayer's first tax year beginning after December 31, 2021

- The change is implemented on a cut-off basis.
- The requirement to file Form 3115, *Application for Change in Accounting Method* (including the Ogden, UT copy), is waived for the first effective year. However, a statement must be included with the return for the first tax year beginning after December 31, 2021, that includes the following information for each applicant:
 - The name and employer identification number or social security number, as applicable, of the applicant that has paid or incurred specified R&E expenditures after December 31, 2021
 - The beginning and ending dates of the first tax year in which the change to the required section 174 method takes effect for the applicant (year of change)
 - The designated automatic accounting method change number for this change (DCN 265)
 - A description of the type of expenditures included as specified research or experimental expenditures
 - The amount of specified research or experimental expenditures paid or incurred by the applicant during the year of change, and
 - A declaration that the applicant is changing the method of accounting for specified research or experimental expenditures to capitalize such expenditures to a specified research or experimental capital account, and amortize such amount over either a five-year period for domestic research or 15-year period for foreign research (as applicable) beginning with the mid-point of the tax year in which such expenditures are paid or incurred in accordance with the method permitted under section 174 for the year of change. Also, the declaration must state that the applicant is making the change on a cut-off basis.

The five-year prior change eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 does not apply to changes to the required section 174 method for the taxpayer's first tax year beginning after December 31, 2021.

Year of change later than the first tax year beginning after December 31, 2021

- **Modified section 481(a) adjustment** – The change is made with a modified section 481(a) adjustment that includes only specified R&E costs paid or incurred in tax years beginning after December 31, 2021.
- **Form 3115** – Normal procedures applicable to automatic changes are required, including the filing of Form 3115. The attachment to Form 3115 must include the following:
 - A description of the type of expenditures included as specified research or experimental expenditures
 - The tax year(s) in which the specified research or experimental expenditures subject to the change were paid or incurred by the applicant, and
 - A declaration that the applicant is changing its method of accounting for specified research or experimental expenditures to capitalize such expenditures to a specified research or experimental capital account, and amortize such amount over either a five-year period for domestic research or 15-year period for foreign research (as applicable) beginning with the mid-point of the tax year in which such expenditures are paid or incurred in accordance with the method permitted under section 174 for the year of change. The declaration must state that the applicant is making the change with a modified section 481(a) adjustment that takes into account only specified research or experimental expenditures paid or incurred in tax years beginning after December 31, 2021.

Audit protection

Rev. Proc. 2023-8 provides that no audit protection is provided for expenditures paid or incurred in tax years beginning on or before December 31, 2021. See section 8.02(2) of Rev. Proc. 2015-13. This is generally consistent with the automatic procedures in effect prior to the TCJA changes, which did not provide audit protection for R&E changes. In addition, Rev. Proc. 2023-11 amended Rev. Proc. 2023-8 to deny audit protection for expenditures incurred in the first effective year if a voluntary change is made for the second effective year (e.g., a calendar 2023 change does not receive audit protection).

However, any change made for a tax year after the year immediately subsequent to the first effective year (for calendar 2024 or later tax years) is subject to the ordinarily applicable terms and conditions regarding audit protection. This means that a calendar year taxpayer will have to comply with the mandatory amortization rules for 2022, its first effective year, as it would not be able to file a Form 3115 in 2023 and receive audit protection. Instead, the taxpayer would face IRS exam exposure for interest and penalties in 2022 for as long as that tax year remained open under the statute of limitations.

As with any change, automatic or non-automatic, the IRS on examination reserves the right to examine a taxpayer's section 481(a) adjustment and the taxpayer's application of the proposed method. Accordingly, section 2.03(7) of Rev. Proc. 2023-8 states that the IRS may change the characterization or classification of expenditures as specified research or experimental expenditures as defined in section 174(b) in order to apply section 174 as well as the change to the proper amount of expenditures paid or incurred in each tax year beginning after December 31, 2021. In those situations, the IRS has the ability to increase the section 481 adjustment for any additional section 174 costs identified on exam and require the taxpayer to include those costs in income in the year of change rather than the four-year spread. If a taxpayer were to make a voluntary change for the tax year immediately following the effective year (calendar 2022), the IRS could move the year of change back to 2022 on exam and impose interest and penalties.

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