Comments regarding Notice 2023-63 Amortization of Specified Research or Experimental Expenditures under Section 174

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Sycamore Growth Group LLC (Sycamore) appreciates the efforts of the Department of the Treasury and the Internal Revenue Service (IRS) in providing guidance in Notice 2023-63 (Notice) clarifying the capitalization and amortization of specified research or experimental expenditures under Internal Revenue Code Section 174 as amended by the Tax Cuts and Jobs Act (TCJA).[1] Sycamore respectfully submits recommendations on matters that involve the general scope of Section 174 and the treatment of specified research or experimental expenditures.

I. Introduction

With a background in tax law, accounting, and a decade of experience in federal research and development (R&D) credits, Sycamore has conducted extensive research on the historical intent of Section 174, both as originally enacted and as amended in 2017 by the TCJA. Section 174 was initially established by Congress in 1954 to foster innovation and bolster national defense, primarily benefiting startups and research-intensive industries. However, the TCJA brought about changes that should have had a minimal effect on certain taxpayer groups, such as taxpayers conducting R&D as part of carrying on their trade or business. Unexpectedly, the IRS has proposed guidance in Notice 2023-63 that is antithetical to the historical purpose and application of Section 174.

In this comment, we aim to highlight the discrepancies between congressional intent and the proposed guidance found in Notice 2023-63, emphasizing the need for alignment with the law's original purpose and function. We also discuss relevant legal precedence, such as *Snow v. Commissioner*, to illustrate the historical misunderstanding of Section 174 by the IRS and its effect on taxpayers. Ultimately, we advocate for the withdrawal of the guidance for the proposed regulations and the provision of guidance that reflects the legislative intent behind Section 174.

II. Legislative Intent

A. Notice 2023-63 Contradicts the Original Purpose of Section 174

Prior to 1954, there was no definitive guidance on how taxpayers should approach research expenditures. As a result, large businesses with established research and development programs were able to record their research and experimentation (R&E) expenses

[1] Unless otherwise indicated all section references herein are to the Internal Revenue Code (IRC) of 1986, 26 U.S.C., as amended (Code) and to the Treasury Regulations, 26 C.F.R., promulgated thereunder (Treas. Reg.).

on their tax returns, while smaller businesses were denied recording any of their R&E expenses. In the Congressional Record of July 12, 1951, Congressman Camp of Georgia provided an explanation of a Proposed Revenue Revision Act of 1951 submitted by the American Bar Association. Pertaining to a provision closely resembling Section 174, Congressman Camp explained as follows:

> In order to clarify the existing confusion in respect to the tax treatment of such expenditures, and to prevent tax discrimination between large businesses having continuous programs of research and small or beginning enterprises, [Section 154] provides generally that expenditures made in industrial or commercial research and development or improvement of industrial or commercial products, service or processes may, at the election of the taxpayer, be deducted as expenses or capitalized and charged off over a period selected and designated by the taxpayer.[2]

In Congressman Camp's statement, it is important to note that established businesses with a history of conducting R&E have always been afforded the opportunity to deduct or amortize their R&E expenses. There is no discernible indication that Section 174 introduced any substantive modification to this practice, other than providing an option for existing businesses to electively record their R&E under Section 174. Alternatively, these businesses retained the prerogative to continue expensing or capitalizing such expenditures in accordance with other applicable sections of the tax code. Congressman Camp stressed that the primary objective of Section 174 was to mitigate discrimination against startup entities by affording them a means to document their R&E expenses on their tax returns as well.

President Eisenhower revisited the discriminatory issue in his 1954 budget message to Congress:

> At present, companies are often not permitted to deduct currently for research or development expenses. This rule is especially burdensome to small concerns **because large companies with established research laboratories can usually get immediate deductions**. I recommend that all companies be given an option to capitalize or to write-off currently their expenses arising from research and development work. Our tradition of initiative and rapid technical improvements must not be hampered by adverse tax rules.[3]

Notice 2023-63 cites the House and Senate Committee reports on the 1954 code and states that the former Section 174 enacted in 1954 was intended to remove the uncertainty regarding the treatment of capitalizable research or experimental expenditures with no

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[2] 97 Cong. Rec. A4326 (1951) (remarks of Representative Camp) (Appendix).
[3] H.R. 8300, 83rd Cong., 2d. Sess., 100 Cong. Rec. 3425 (1954).

determinable useful life.[4] This reasoning is grounded in a misinterpretation of the legislative intent behind the original provision. The House and Senate Committee reports explicitly stated that the intent behind Section 174 was twofold: to eliminate the uncertainty *and* to encourage taxpayers to carry on research and experimentation by allowing them the election of either a current deduction of R&D expenditures or a deferred deduction until the invention is first employed for income generation.[5]

The Notice, however, would create a regulatory framework that fundamentally contradicts the original purpose and objectives envisioned by Congress during the law's inception. The Chairmen of the Congressional Tax Committees, whose committee reports were cited in the Notice, reiterated to their respective Houses of Congress that Section 174 was intended to rectify the competitive disadvantage small businesses faced under the current law.[6] These smaller enterprises, often lacking established research programs, were frequently denied the ability to deduct their expenses when striving to innovate and develop new products. In stark contrast, their larger and well-established competitors, equipped with substantial regular research budgets, enjoyed the benefit of expense deductions.[7]

In 1954 Congressman Reed spoke on behalf of the proposed Section 174 and reaffirmed the law's purpose:

> Very often under present law small businesses which are developing new products and do not have established research departments are not allowed to deduct these expenses despite the fact that their large and well-established competitors can obtain the deduction. … This provision will greatly stimulate the search for new products and new inventions upon which the future economic and military strength of our Nation depends. It will be particularly valuable to small and growing businesses.[8]

It is understood that uncertainty regarding the treatment of capitalizable R&D expenses played a role in the enactment of Section 174. However, Stephen Breyer, former associate justice of the U.S. Supreme Court, reasoned that this misconstrues the "intent" portion of legislative intent.[9] In a 1999 law review essay, Edward Heath, then a Juris Doctorate candidate at Notre Dame Law School, wrote:

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[4] Notice 2023-63, 2023-39 I.R.B. 919.
[5] H.R. Rep. No. 1337, 83rd Cong. 2d Sess., 28 (1954); S. Rep. No. 1622, 83rd Cong. 2d Sess. 33 (1954).
[6] 100 Cong. Rec. 3425 (1954) (remarks of Representative Reed); 100 Cong. Rec. 8998 (1954) (remarks of Senator Millikan).
[7] 100 Cong. Rec. 3425 (1954) (remarks of Representative Reed); 100 Cong. Rec. 8998 (1954) (remarks of Senator Millikan).
[8] 100 Cong. Rec. 3425 (1954) (remarks of Representative Reed).
[9] Edward Heath, *How Federal Judges Use Legislative History*, 25 Journal of Legislation 95 (1999) (citing Stephen Breyer, *On the Uses of Legislative History in Interpreting Statutes*, 65 S. Cal. L. Rev. 845, 846 (1992).

> They equate intent with "motive," and say it is nearly impossible for a judge to discover the motives of each member of the Congress — a fairly true observation. Congresswoman A may have voted for a new child tax credit to get reelected, while Congresswoman B may have voted for the credit because she believed it would encourage taxpayers to have more children. These are their motives, and they are as diverse as they are unascertainable by a judge. But intent should not be read as motive. Instead, intent in this context means "purpose," and Breyer contends that it is possible to determine what purpose a legislature had in enacting a particular statute by consulting legislative history.[10]

Similarly, two Congressmen may have had "motives" of clarifying R&D capitalization and encouraging new innovations, respectively. However, Congress's purpose in enacting Section 174 in 1954 was to provide an incentive for small businesses and startups to engage in R&E that would produce tax equality. Therefore, it is puzzling that the IRS would introduce restrictive guidance requiring amortization that will pose a fatal risk to those very taxpayers.

Just as in the 2022 Supreme Court case of *West Virginia v. Environmental Protection Agency* (EPA),[11] where the EPA faced challenges over regulations inconsistent with congressional intent and policy, the Notice issued by the IRS is similarly at odds with the original intent of Congress. In *West Virginia,* the actions of the EPA were contested for exceeding its regulatory authority and for implementing rules that did not align with the intent of the Clean Air Act. The Supreme Court held that the EPA exceeded its regulatory authority by imposing sweeping regulations without considering the costs and benefits to the regulated entities.[12] The case emphasized that federal agencies, such as the IRS, must consider the economic consequences of their regulations and act within the bounds set by Congress when interpreting and implementing laws. Similarly, the guidance outlined in the Notice not only fails to fulfill the original purpose of the law but also potentially hinders innovation and economic growth, which is contrary to the legislative objectives set forth by Congress. The proposed regulations, based on the guidance, could lead to legal challenges for overstepping the boundaries of its authority and deviating from the original legislative purpose.

If the Notice is finalized as stated, Section 174 will be based on a false premise that strays far from the policy foundation Congress initially intended in 1954 and that the 2017 Congress reaffirmed. The proposed changes to Section 174 will rewrite a provision that was originally enacted to promote innovation, research, and support for startups and small

[10] Edward Heath, *How Federal Judges Use Legislative History*, 25 Journal of Legislation 95 (1999) (citing Stephen Breyer, *On the Uses of Legislative History in Interpreting Statutes*, 65 S. Cal. L. Rev. 845, 846 (1992).
[11] West Virginia v. EPA, 142 S. Ct. 2587 (2022).
[12] West Virginia v. EPA, 142 S. Ct. at 2616.

businesses. Instead of encouraging research endeavors, the guidance for proposed regulations will create disincentives for businesses to engage in critical research and development efforts.

B. The Guidance Creates Conflict with Numerous Tax Code Sections

1. Section 162

The Notice appeals to the House and Senate Committee reports on the 1954 tax code to claim that congressional intent was to address the distinction between ordinary and necessary business expenses and R&D expenses. However, the reports merely acknowledged the ambiguity surrounding the treatment of research and experimental expenditures under the tax code at that time. To sidestep this ambiguity, the legislation allowed taxpayers the option to treat these expenditures as deductible expenses or to capitalize and amortize such expenses, providing flexibility in their accounting practices. This original legislative intent was rooted in the desire to encourage innovation and research without imposing constraints on how taxpayers should classify these expenses. The Notice, which attempts to create a clear separation between ordinary and necessary expenses and R&D expenses, introduces an interpretation that was not present in the initial legislative intent.

Similarly, in *Coltec Industries Inc. v. United States*,[13] the Federal Circuit Court found that the IRS drew an interpretation from the legislative history that was not substantiated by the actual content of the legislative history. In *Coltec*, the government argued that Internal Revenue Code Section 357(c)(3) imposed a limitation, contending that it applied only when a transferor transferred both a liability and the underlying business responsible for generating that liability. In support of its argument, the IRS referred to a statement found in a Senate Committee report that states: “In general, liabilities the payment of which would give rise to a deduction include trade accounts payable and other liabilities (e.g., interest and trades) which relate to the transferred trade or business” (S. Rep. No. 96-498, at 62, 1979). The Federal Circuit Court determined that this statement of legislative history did not suggest that a transfer of a trade or business is a necessary element of the transaction; it merely explained that liabilities that relate to a trade or business are included among the liabilities. In both *Coltec* and the Notice, legislative history is interpreted in a manner that goes beyond the actual content of the reports, attempting to impose rigid distinctions where none were originally intended.[14]

Section 174 and Section 162(2) share the requirement of a “trade or business” for expense deductibility. Nevertheless, while Section 162 demands that a taxpayer is actively “carrying on” a trade or business, Section 174 sets a more lenient standard by necessitating that the expenditure is “in connection with” a trade or business. As a result, Section 174 allows for the immediate deduction of costs that would be categorized as “startup” expenses under

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[13] Coltec Industries Inc. v. U.S., 454 F. 3d 1340 (2006).
[14] Coltec Industries Inc. v. U.S., 454 F. 3d 1340 (2006).

Section 162.[15] The disparities in the phrasing of “in connection with” versus “in carrying on” have substantial implications. Sections 174 and 162 govern distinct phases of the business cycle. When startups accumulate specified research or experimental costs linked to a trade or business, they only have the option to adhere to Section 174. In contrast, Section 162 permits established businesses to immediately deduct the same items as “ordinary and necessary” expenses incurred in “carrying on any trade or business.”

The 1974 Supreme Court case *Snow v. Commissioner* discussed this issue further.[16] Despite the comprehensive legislative background of Section 174, the IRS took a restrictive view. In *Snow*, the petitioner formed a partnership to develop an incinerator and subsequently incurred expenses in connection with the incinerator’s development.[17] Although the partnership did not profit from the incinerators, the partnership deducted the expenditures under Section 174(a)(1).[18] The IRS disallowed the deduction by interpreting the “in connection with a trade or business” language to mean a taxpayer must be actively engaged in a trade or business to be eligible for the R&D deduction. The IRS (Stuart Smith, Commissioner) further unsuccessfully argued that Section 174 was enacted to clear up confusion on the treatment of R&E expenditures.

The Supreme Court ruled unanimously in favor of Snow, holding that the partnership incurred the expenses “in connection with” its trade or business. In its analysis, the Supreme Court acknowledged that the words “trade or business” can be found in roughly 60 different sections of the tax code.[19] Because Congress wrote “in connection with” into Section 174(a)(1), the phrase includes research and development activities regardless of whether the taxpayer has started selling the developed products. Requiring taxpayers to be actively engaged in product sales to claim the deduction would unfairly deny small businesses the ability to claim the deduction. The Supreme Court’s less stringent interpretation of Section 174 affirmed both the legislative intent to equalize treatment for research and development expenses between taxpayers and the fact that Section 174 has always functioned in unison with the rest of the code.

Moreover, the oral arguments from *Snow* reveal that the Commissioner, Stuart Smith, took the case to court failing to recognize Congress’ original purpose for writing Section 174, which, among other things, cost the Commissioner the case. When asked if he knew what had motivated the enactment of Section 174, Stuart Smith stated, “I am not sure I know the answer to that question.”[20] Despite the Supreme Court’s unanimous ruling against the Commissioner,

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[15] House Ways and Means Committee on General Revenue Revision, 83rd Cong., 1st Sess. (1953).
[16] 416 U.S. 500 (1974).
[17] 416 U.S. 500 (1974).
[18] IRC Section 174(a)(1) allows a taxpayer to deduct “experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account.”
[19] 416 U.S. at 503 (1974).
[20] Transcript of Oral Argument, 416 U.S. 500 (1974) (No. 73-641).

now, nearly 50 years later, the Notice repeats the Commissioner's mistake by failing to accurately characterize Congress' original intent.

2. Section 41 and the R&D Tax Credit

Existing treasury regulations have long recognized that certain R&E expenses are governed by other code sections.[21] The Notice asserts that Section 174 overrules Sections 162, 195, 263(a), 263A, and 471.[22] If the proposed regulations found in the guidance are finalized, it will create further inconsistency with the legislative purpose of Section 174 and, at the same time, undermine the intended function of the R&D tax credit governed by Section 41.

Section 41 was enacted in 1981 to "encourage economic growth through reductions in individual income tax rates, the expensing of depreciable property, incentives for small businesses, and incentives for savings, and for other purposes."[23] More specifically, the credit aimed to "reverse the decline in research spending by industry" and motivate companies "to bear the significant costs … which must be incurred to initiate or expand research programs in a trade or business."[24] The Senate conference agreement stated, "The 'carrying on' test for purposes of the new credit is the same as for purposes of Section 162."[25] This shows that Congress intended Sections 162 and 41 to work together.

i. The "May" Clause

The Notice, however, rewrites Section 41 by nullifying the effect of the "may" clause; this creates an unnecessary conflict between various code sections. Section 41(d)(1) states, "The term 'qualified research' means research with respect to which expenditures *may* be treated as expenses under Section 174."[26] The "may" clause, as explicitly phrased, speaks to the elective nature of Section 174 and establishes a permissive interpretation.[27] With respect to principles of, among others, statutory interpretation, legislative drafting, and administrative law, it is commonly understood that the term *may* is used intentionally to confer a choice or leave a decision to be made by the affected parties. It unequivocally signifies that taxpayers have the discretion to choose whether to treat their research expenditures as expenses under Section 174.

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[21] See Treas. Reg. §1.174-1; Treas. Reg. §1.174-2(b)(1); Treas. Reg. §1.471-11(c)(ii).
[22] Notice 2023-63, 2023-39 I.R.B. 919.
[23] Sen. Rep. No. 97-215, at 1 (1981).
[24] H.R. Rep. No. 97-201 (1981).
[25] Sen. Rep. No. 97-215, at 223 (1981).
[26] IRC Section 41(d)(1).
[27] Drafting Legislation, House Office of the Legislative Counsel, www.legcounsel.house.gov/holc-guide-legislative-drafting ("the term 'may' means that it is permitted but not required").

When the TCJA was passed in 2017, Congress consciously chose to retain the word *may* when defining qualified research under Section 41. This language preservation is evidence of legislative intent and serves as a clear reaffirmation of Congress' commitment to maintaining the option for taxpayers. When Congress reenacts a statute without making changes to a provision that has previously received a clear and authoritative administrative or judicial interpretation, the Court often considers this as Congress ratifying that interpretation.[28] Furthermore, congressional inaction is construed as approving an interpretation.[29] Inaction is seen as approval if Congress has awareness that an interpretation has generated widespread attention and controversy.[30] Given that the R&D tax credit has been the subject of extensive litigation, it is evident that Congress was well aware of the existing interpretations. If Congress had intended to make the use of Section 174 mandatory, it could have taken the action to change *may* to *shall* when amending the provision in 2017.[31] Taking such action would have been a fundamental shift in language that would unequivocally *require* the use of Section 174. By choosing not to amend the "may" clause, Congress signaled its intent to uphold the option for taxpayers to treat research expenditures as expenses under Section 174.

III. Repercussions

The historical intent of Section 174 underscores its objective of fostering research and innovation. Research and innovation are frequently spearheaded by government contractors that play a pivotal role in bolstering national defense. These contractors are at the forefront of creating cutting-edge technologies and solutions safeguarding our nation. The effect of the Notice, as currently drafted, will inadvertently jeopardize our national security.

To this end, Sycamore is aware of multiple Department of Defense contractors that will be forced to back out of their government contracts if Notice 2023-63 is finalized. This will set back our national defense efforts, leaving us behind the world scene in innovation and making us vulnerable to attack. Not only this, but the Notice would single-handedly move our country away from laissez-faire economics to an economic system that favors businesses serving the government. While it may be advisable for Congress to pass legislation aimed at supporting government research contractors, the IRS would overstep its authority by introducing a safe harbor clause that favors government contractors. If the IRS were to include such a clause in its

[28] Pierce v. Underwood, 487 U.S. 552, 567 (1988) (reenactment of a "statute that had in fact been given a consistent judicial interpretation . . . generally includes the settled judicial interpretation").
[29] Bob Jones Univ. v. United States, 461 U.S. 574 (1938).
[30] Bob Jones Univ. v. United States, 461 U.S. 574 (1938).
[31] RSL Funding LLC v. Alford, 239 Cal. App. 4th 741 ("Settled principles of statutory construction direct that courts ordinarily construe the word 'may' as permissive and the word 'shall' as mandatory").

regulations, the constitutionality[32] of its actions would be challenged in the courts, as evidenced by *West Virginia v. EPA*, whereby the EPA was found to have exceeded its regulatory authority.

Implementing the proposed regulations based on the proffered guidance will significantly disincentivize innovation and research investment. By altering the tax treatment of R&E expenses in a manner contrary to the long-standing principles of Section 174 and Section 41, the IRS risks discouraging businesses from pursuing research and development initiatives. The unintended consequences of the Notice may be that companies, rather than increasing their research activities, could become hesitant due to the uncertainty and potential financial repercussions created by the inconsistent application of the law. Further, these same companies may be left with no choice but to abandon the tax credit altogether because of its nonrefundable nature and the negative effect of amortization in order to avoid bankruptcy.

As an example of how the guidance would work, consider a small-business research contractor building a custom machine for a commercial manufacturer. The company performs R&D on behalf of a commercial manufacturer, taking on financial risk in addition to retaining rights for their work.

Per the legislative intent and purpose of Section 174, the small-business research contractor could choose not to elect for Section 174 treatment and instead record their R&E expenditures as cost of goods sold under Section 471 or as ordinary and necessary business expenses under Section 162. If the research contractor has $1 million in business expenses and $100,000 of taxable net income, the research contractor, in accordance with Sections 174 and 41, can record R&E expenses under Section 471. As a result, the research contractor's taxable income remains $100,000, which generates $12,615 [utilizing applicable tax brackets] in federal taxes. Furthermore, the company can also claim R&D tax credits under Section 41, resulting in the company being incentivized with lower tax liabilities.

By contrast, Notice 2023-63 would remove the elective nature of Section 174 and *require* that the small-business research contractor amortize its expenses. Accordingly, the company could use only 10% of its $1 million of business expenses on that year's tax return. This would generate $1 million of taxable income, resulting in a payment of $300,086 [utilizing applicable tax brackets] in federal tax. This is an amount more than 10 times what the research contractor would pay under Section 174 as it currently stands. This is a devastating financial blow to small businesses performing R&D, such as engineering firms, federal research contractors, automation companies, architectural firms, and more.

[32] The power to make, interpret, and amend tax laws fundamentally belongs to the legislative branch of government — Congress. The IRS, as an administrative agency, lacks the authority to unilaterally alter the tax code in ways that substantially affect taxpayer's rights and obligations. Introducing a safe harbor clause that would counterbalance the effects of a regulation would be tantamount to legislative action, usurping the role of Congress. U.S. Constitution, Article I.

IV. Recommendations

The guidance on proposed regulations has unintended consequences that disproportionately affect certain taxpayers. While it is understandable that the IRS seeks to increase revenue and curb potential abuses of the R&D tax credit, the IRS must seek a solution that is fair across various sectors of the economy. The U.S. Tax Court has explicitly explained the need for such a balance:

> We should not disregard the existence of an asset for which Congress intended tax advantages merely because the parties attempted to maximize the advantage of those benefits for one of the parties to a transaction. [The Commissioner] should recognize that in instances where there are not shams and depreciable assets exist, some person or entity is entitled to the intended tax advantages.[33]

The IRS should draw a clear distinction between business research and investment research, aligning the treatment of each with the original congressional intent as articulated in the tax code. When properly applied, both types of research expenses are eligible for Section 41 research credits. Business research expenses *may* be recorded under Section 174, whereas investment research (because it is not in the course of carrying on the trade or business) *must* be recorded under Section 174. A good faith test should be introduced to ensure clarity and accuracy, incorporating precise language that definitively determines when an activity is no longer part of "carrying on" a trade or business but is connected to a future business. The IRS could, as an example, make the declaration that R&E "in connection with" is a stage of business before "carrying on a business," which is consistent with the original congressional intent.

The IRS must uphold the well-established principle that R&E expenses can remain eligible for research credits while simultaneously permitting their recording under other sections of the tax code. To align with congressional intent, taxpayers must retain the flexibility to choose the most suitable classification for their expenses, such as recording project costs under Section 471, cost of goods sold, or Section 162, ordinary and necessary business expenses. Implementing clear definitions and guidelines is essential to ensure that different taxpayers can confidently classify their expenditures and avoid potential misinterpretations or misapplications of the law. Failure to incorporate such guidance risks undermining the purpose of Section 174 and will lead to confusion and inequity in its application.

V. Conclusion

The Notice pertaining to Section 174 represents a significant departure from the legislative intent behind the provision. Section 174 was originally enacted with the aim of fostering innovation and equalizing the tax treatment of R&D expenses for all taxpayers.

[33] Leahy v. Commissioner, 87 T.C. 56, 72 (1986).

However, the Notice's reinterpretation and proposed guidance have disrupted this historical purpose and application of the provision. These modifications not only undermine the spirit of tax equality and innovation but also create inconsistency with the intended function of the R&D tax credit governed by Section 41. The approach of the IRS disregards the permissive nature of the "may" clause in Section 41(d)(1), which Congress consciously preserved when passing the TCJA in 2017. This preservation signifies Congress' intent to maintain the option for taxpayers to treat research expenditures as expenses under Section 174.

In light of these discrepancies and the adverse effect on research activities, the IRS must withdraw the guidance on proposed regulations and instead create a distinction between business research and investment research that is consistent with congressional intent. This realignment will not only preserve the intended benefits for startups and research-intensive industries but also uphold the principles of fairness and tax equality that have been integral to this provision since its inception.