As a general rule, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account; conversely, expenditures made in an effort to establish or to increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions by telephone, the expenditures in connection therewith would not be properly chargeable to capital account. However, if such newspaper, in a special effort to increase its circulation, hires for a limited period 20 additional employees to obtain new subscriptions by means of telephone calls to the general public, the expenditures in connection therewith would be properly chargeable to capital account. If an election is made by a taxpayer to treat any portion of his circulation expenditures as chargeable to capital account and deducted in the year in which they are paid or incurred (see §1.174-3), or they may be deferred and amortized (see §1.174-4). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. The expenditures to which section 174 applies may relate either to a general research program or to a particular project. See §1.174-2 for the definition of research and experimental expenditures. The term paid or incurred, as used in section 174 and in §§1.174-1 to 1.174-4, inclusive, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25).

§ 1.174-2 Definition of research and experimental expenditures.

(a) In general. (1) The term research or experimental expenditures, as used in section 174, means expenditures incurred in connection with the taxpayer’s trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys’ fees expended in making and perfecting a patent application. Expenditures 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. Uncertainty 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. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not...
the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

(2) For purposes of this section, the term product includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

(3) The term research or experimental expenditures does not include expenditures for—

(i) The ordinary testing or inspection of materials or products for quality control (quality control testing);
(ii) Efficiency surveys;
(iii) Management studies;
(iv) Consumer surveys;
(v) Advertising or promotions;
(vi) The acquisition of another’s patent, model, production or process; or
(vii) Research in connection with literary, historical, or similar projects.

(4) For purposes of paragraph (a)(3)(i) of this section, testing or inspection to determine whether particular units of materials or products conform to specified parameters is quality control testing. However, quality control testing does not include testing to determine if the design of the product is appropriate.

(5) See section 263A and the regulations thereunder for cost capitalization rules which apply to expenditures paid or incurred for research in connection with literary, historical, or similar projects involving the production of property, including the production of films, sound recordings, video tapes, books, or similar properties.

(6) Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments. The reasonableness requirement of this paragraph (a)(6) does not apply to the reasonableness of the type or nature of the activities themselves.

(7) This paragraph (a) applies to taxable years beginning after October 3, 1984.

(8) The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer’s behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

(9) The application of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. A engages B to undertake research and experimental work in order to create a particular product. B will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, A pays to B in respect of the project the sum of $150,000 of which $25,000 represents an addition to B’s laboratory and the balance represents charges for research and experimentation on the project. It is agreed between the parties that A will absorb the entire cost of this addition to B’s laboratory which will be retained by B. A may treat the entire $150,000 as expenditures under section 174.

Example 2. X Corporation, a manufacturer of explosives, contracts with the Y research organization to attempt through research and experimentation the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, Y is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project Y will transfer this tract, including any improvements thereon, to X. Section 174 does not apply to the amount paid to Y representing the costs of the tract of land and improvements.
(b) Certain expenditures with respect to land and other property. (1) Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 or depletion under section 611, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allowances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) Expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174(a). Such expenditures cannot be amortized under section 174(b) except to the extent provided in paragraph (a)(4) of §1.174–4.

(3) If expenditures for research or experimentation are incurred in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, a taxpayer undertakes to develop a new machine for use in his business. He expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine).

(c) Exploration expenditures. The provisions of section 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of
§ 1.174–3

Treatment as expenses.

(a) In general. Research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174(a). See paragraph (b) of this section. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner under section 174(a)(3) with respect to part or all of the expenditures. See, however, subparagraph (b) of this paragraph, relating to extensions of time.

(2) Adoption with consent. A taxpayer may, with the consent of the Commissioner, adopt at any time the method provided in section 174(a). The method adopted in this manner shall be applicable only to expenditures paid or incurred during the taxable year for which the request is made and in subsequent taxable years. A request to adopt this method shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The request shall set forth the name and address of the taxpayer, the first taxable year for which the adoption of the method is requested, and a description of the project or projects with respect to which research or experimental expenditures are to be, or have already been, paid or incurred. The request shall be signed by the taxpayer (or his duly authorized representative) and shall be filed not later than the last day of the first taxable year for which the change in method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(b) Adoption and change of method—(1) Adoption without consent. The method described in this section may be adopted by a taxpayer during the taxable year beginning after December 31, 1953, and ending after August 16, 1954. The consent of the Commissioner is not required if the taxpayer adopts the method for the first taxable year in which he pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in his income tax return for such year a deduction for his research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which he incurs such expenditures, he cannot do so in subsequent taxable years unless he obtains the consent of the Commissioner under section 174(a)(2)(B) and subparagraph (2) of this paragraph. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(2) Change of method. An application for permission to change to a different method of treating research or experimental expenditures shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the last day of the first taxable year for which the change in method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.