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method changes for mischaracterized R&E expenditures with a section 481(a) adjustment they should receive audit protection for prior years.

Jun. 10, 2015

The [American Institute of CPAs](#) (AICPA) recommended in a June 8 [letter](#) to the Internal Revenue Service (IRS) that taxpayers making an accounting method change for mischaracterized research and experimental expenditures (R&E expenditures) under Internal Revenue Code section 174 should compute a section 481(a) adjustment.

The AICPA explained that the current administrative framework provided to a taxpayer – who either has mischaracterized an expenditure as an R&E expenditure or has mischaracterized an R&E expenditure as a capital expenditure or an inventorable expenditure and wishes to correct such mischaracterization – is inconsistent and confusing. Prior to the issuance of Rev. Proc. 2015-14 a taxpayer who had mischaracterized R&E expenditures as either a capital expenditure or an inventorable cost, or vice versa, could effectuate such correction either by:

- Filing an amended tax return for the taxable year in which the mischaracterization occurred (assuming such taxable year is not barred by the statute of limitations); or
- Filing an automatic accounting method change under Appendix section 7.01 of Rev. Proc. 2011-14 to correct such mischaracterization prospectively using cut-off transition procedures.

Subsequent to the issuance of Rev. Proc. 2015-14, it is unclear:

- Whether Appendix section 7.01 applies to method changes for amounts characterized as R&E expenditures which, instead, should have been capitalized or

inventoried; and

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addition to corrections for expenditures, capitalized or inventoried that should have been characterized as R&E expenditures. Method changes to correct such mischaracterizations should be implemented with a section 481(a) adjustment and receive audit protection; and

3. Provide in the new Appendix section 7.02 for accounting method changes to comply with the 2014 final pilot model regulations under section 174 ([Treas. Reg. § 1.174-2](#)). These changes likewise should enable taxpayers to make the method changes with a section 481(a) adjustment and receive audit protection.

Furthermore, the AICPA recommended that to the extent taxpayers may make accounting method changes for mischaracterized R&E expenditures with a section 481(a) adjustment they should receive audit protection for prior years. This suggestion, the AICPA wrote, is in the IRS's interest because taxpayers changing from a method where R&E expenditures have been improperly capitalized or included in inventory would have an economic incentive to voluntarily fix their prior erroneous method.

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