

## M&A Tax Talk

### Section 174 in M&A transactions

#### Background

The Tax Cuts and Jobs Act of 2017 (TCJA) requires taxpayers to capitalize and amortize specified research or experimental (SRE) expenditures effective for taxable years beginning after December 31, 2021. SRE expenditures are amortized over five years for research performed in the United States and over 15 years for research performed outside of the United States. The TCJA provides that SRE expenditures are research or experimental expenditures that are paid or incurred by the taxpayer during a taxable year in connection with the taxpayer's trade or business and include software development costs. Prior to the change in law, taxpayers could choose to deduct research and development expenditures in the tax year incurred.

The TCJA also includes rules for the treatment of unamortized SRE expenditures when a taxpayer disposes of the property resulting from such expenditures. Specifically, if any property with respect to which SRE expenditures are paid or incurred is disposed of, retired, or abandoned during the amortization period, no deduction is allowed with respect to the unamortized SRE expenditures, and amortization continues with respect to such expenditures over the remainder of the amortization period. The implications of this provision can be significant for sellers in M&A transactions that transfer property (e.g., in-process R&D, know-how, etc.) for which the SRE expenditures have not been fully amortized.

Interim guidance issued in September 2023 includes rules for corporations to determine

the treatment of the unamortized SRE expenditures in various M&A transactions. Taxpayers are generally permitted but not required to apply the provisions of the guidance. Notably, the guidance does not address the treatment of unamortized SRE expenditures with respect to property that is contributed to, distributed from, or transferred from a partnership.

In general, upon disposition of property to which unamortized SRE expenditures relate, the guidance provides that the unamortized SRE expenditures remain with the taxpayer that incurred the expenditures even if the property resulting from the expenditures is transferred. The guidance provides for the carryover of the unamortized SRE expenditures in certain tax-free transactions where the transferor corporation ceases to

exist. Additionally, subject to an anti-abuse rule, the guidance permits a corporation to deduct the unamortized SRE expenditures in its final year, if the corporation ceases to exist in a taxable liquidation.

The following discussion considers the application of the guidance to several common corporate M&A transactions.

### **Treatment of unamortized SRE expenditures in a taxable sale of property**

Under the guidance, a taxpayer that incurred the SRE expenditures with respect to property that is sold is required to continue amortizing the remaining unamortized SRE expenditures notwithstanding its disposition of such property. The guidance provides that a taxpayer is not permitted to take the unamortized SRE expenditures into account in the computation of gain or loss. The result would be the same if the property were sold as part of the sale of a trade or business.

The guidance results in the separation of the unamortized SRE expenditures and the property resulting from such expenditures. This could be beneficial where the property is a capital asset and the sale is to an unrelated third party, resulting in more capital gain and ordinary deduction. Because the deduction is available over time, any benefit may be reduced by the time value of money.

As noted above, a taxpayer may opt not to follow the guidance. The statute provides that a deduction is not permitted upon the transfer or other disposition of property with respect to which the SRE expenditures were incurred. Thus, a position exists for a taxpayer to reduce the gain on the disposition of the property, but not create a loss (i.e., not create a loss deduction).

### **Treatment of unamortized SRE expenditures in a tax-free contribution to capital of a corporation**

The guidance provides that a taxpayer that incurred the SRE expenditures is required to continue amortizing the remaining unamortized SRE expenditures if the property with respect to which the SRE expenditures were incurred is transferred

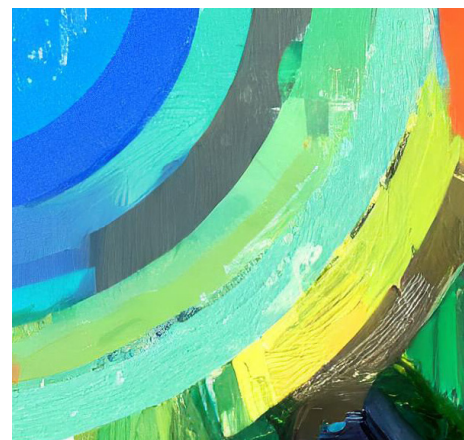
to a corporation in a tax-free contribution. Thus, similar to the sale scenario described above, under the guidance, the property is effectively separated from the unamortized SRE expenditures incurred with respect to such property.

The statute does not specifically require that the taxpayer that incurred the unamortized SRE expenditures continue to amortize such amounts. As a result, a taxpayer that does not rely on the transfer provisions of the guidance may consider whether the general authorities applicable to tax-free contributions to corporations permit a carryover of unamortized SRE expenditures, with the transferee corporation continuing to amortize the unamortized SRE expenditures post-contribution.

### **Treatment of unamortized SRE expenditures in certain tax-free transactions**

Under the guidance, if a corporation ceases to exist in certain tax-free transactions, such as a tax-free reorganization or liquidation, the acquiring corporation will continue to amortize the transferor corporation's unamortized SRE expenditures over the remainder of the transferor's applicable amortization period beginning with the month of transfer. Because the government has previously determined that mandatory capitalization and amortization is a method of accounting, the accounting method carryover provisions for such transactions applies.

The combination of this provision and the guidance for tax-free contributions could allow for the property resulting from the unamortized SRE expenditures to remain offshore (e.g., the property is currently held by a controlled foreign corporation [CFC]), with the unamortized SRE expenditures deducted by a US entity, where, for example, the property is contributed from one CFC to another subsidiary CFC in a tax-free contribution, followed by a tax-free liquidation of the contributing CFC into its US shareholder. This would have the effect of leaving the property offshore and moving the deduction into the United States.

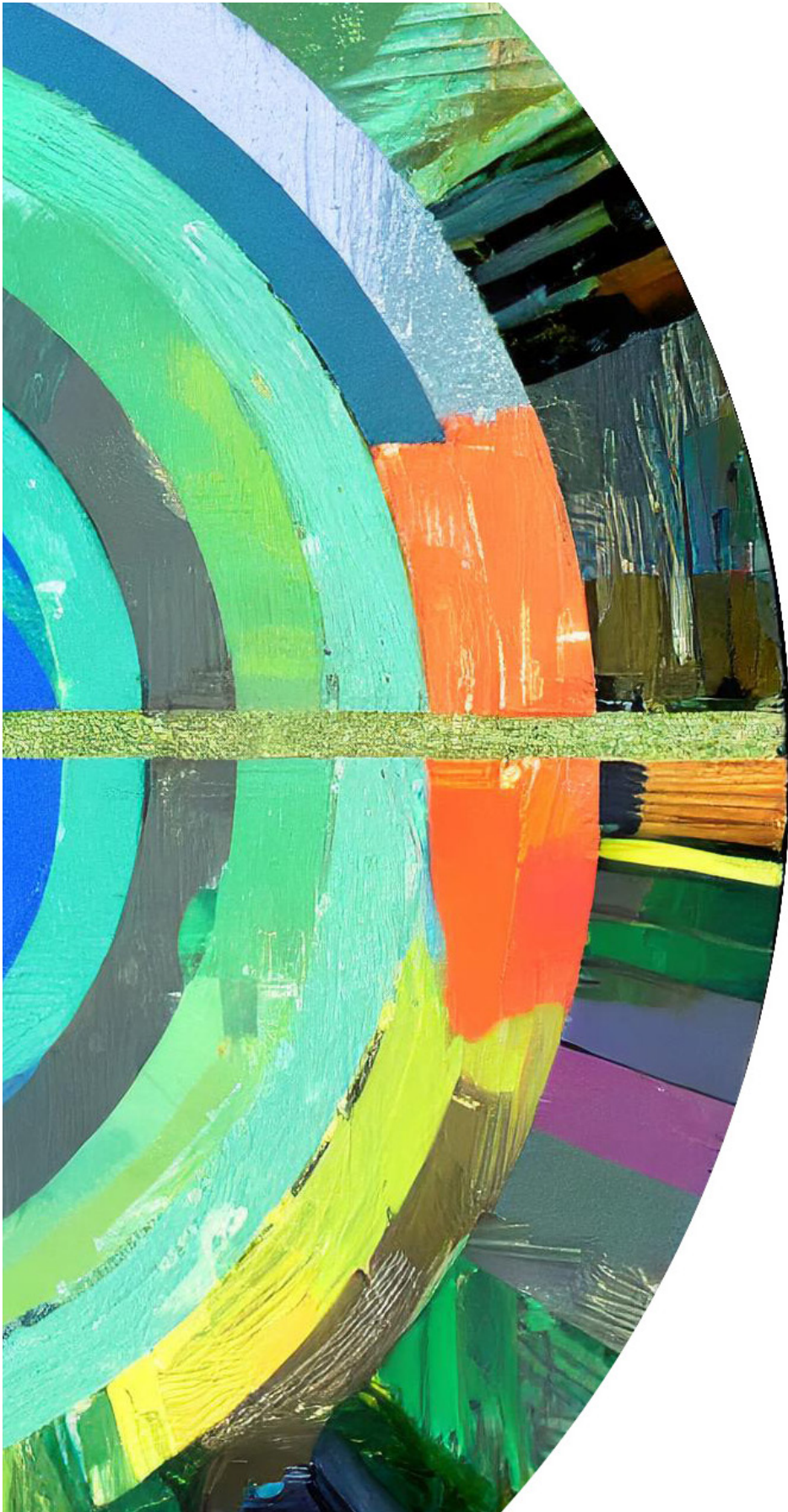


## Private equity insights

Private equity sponsors should carefully consider the implications of section 174 when evaluating both acquisitions and dispositions as significant timing differences may arise between the deduction of certain SRE expenditures for financial reporting purposes and tax purposes.

It is important to consult with your tax adviser as these timing differences could affect cash flow modeling. In addition, consideration should be given to whether there may be any value attributable to certain unamortized SRE deductions that are expected to be transferred. For example, unamortized SRE deductions transferred with an acquired business may give rise to a tax deduction benefit during the projected holding period. Similarly, there may be value associated with unamortized SRE deductions that are delivered to a potential buyer in connection with an exit of a portfolio company.





### **Treatment of unamortized SRE expenditures in a taxable liquidation**

The statute does not address whether unamortized SRE expenditures are deductible in the final year of a corporation's trade or business. Under the guidance, if a corporation ceases to exist in a taxable liquidation transaction, the corporation is allowed to deduct the unamortized SRE expenditures in its final taxable year, but only if acceleration of the unamortized SRE expenditures is not a principal purpose of the liquidation.

### **Treatment of unamortized SRE expenditures in a stock sale**

Although not addressed explicitly in the guidance, in a transaction in which a buyer acquires all of the stock of a corporation that incurred SRE expenditures, the corporation continues amortizing the remaining unamortized SRE expenditures. If an election is made to treat the stock sale as an asset sale for tax purposes, the result would be the same as the discussion above for the sale of property with respect to which the unamortized SRE expenditures were incurred, and the corresponding tax-free liquidation rules, as applicable.

### **Conclusion**

It is important for sellers to understand the treatment of unamortized SRE expenditures in various transactions. Sellers should be aware of the potential for higher gain (possibly capital gain) on the sale of property resulting from unamortized SRE expenditures. Additionally, in certain tax-free transfers the separation of the unamortized SRE expenditures from the property resulting from the SRE expenditures may have unintended consequences. Understanding the potential tax consequences and available options to transferors for transfers of property resulting from unamortized SRE expenditures, can help both transferors and transferees prepare for purchase and sales negotiations and can help mitigate unexpected post-transfer tax impacts.

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