Capitalizing R&E Expenditures is Odd for Many Reasons

November 6, 2023

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Overview of Guidance to Date

- Section 13206 of Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA) amending section 174 and conforming changes to sections 41(d)(1)(A) and 280C(c)(1)(B) effective for research or experimental expenditures paid or incurred in tax years beginning after 12/31/2021
- Method Change
  - Rev. Proc. 2023-8 – Procedure guidance for taxpayers to obtain automatic consent to change methods of accounting to comply with new section 174
  - Rev. Proc. 2023-11 – Procedure guidance which modifies and supersedes Rev. Proc. 2023-8
  - Revenue Ruling 2023-8 – Revoking Revenue Ruling 58-74, in part, due to new section 174
- Notice 2023-63 - Interim guidance intended to clarify new section 174, as amended by TCJA
- Addresses specified research or experimental (SRE) expenditures – new term
- Forthcoming proposed regulations consistent with the interim guidance provided in sections 3 through 9 of Notice 2023-63 (Expected sometime after November 24, 2023 – the due date of written comments from public)

- Scope of Costs – Section 4, Notice 2023-63
  - How much facilities and overhead should be included?
  - Does intangible amortization get included?
  - Are all severance costs the same?
  - What about indirect or second-level supervision?
- Software Development Costs – Section 5, Notice 2023-63
  - What is software versus integration costs?
  - When does maintenance cost become software?
- Disposition, Retirement or Abandonment – Section 7, Notice 2023-63
  - Do I really have amortization on assets I don't own?
- Capitalization and Amortization – Section 3, Notice 2023-63

- Research Performed under Contract - Section 6 & 8, Notice 2023-63
  - Single capitalization or double capitalization?
  - How much rights is too much?
  - Risk elements and consistency with 41?
  - Exceptions to rights and risk?
  - Are special rules needed for government contracts or long-term contracts under Section 460?
  - Do these rules apply to software development performed under contract?
- Cost sharing – Section 9, Notice 2023-63
  - To net or not to net (not to be confused with Annette)?
  - How do we treat principals with foreign cost plus service providers?
  - Is there alternative treatment as income?

R&D Capitalization in the Cost-Sharing Context

R&D: Cost Sharing

Suppose:

- US Parent (USP) pays its US R&D employees in 2022 $10 billion
- USP has a Cost-Sharing Agreement (CSA) with its Controlled Foreign Corporation (CFC)
  - CFC pays 80% of USP's R&D costs
  - CFC receives non-US intellectual property rights resulting from the R&D

R&D: CSA (cont'd)

- Does $10 billion have to be capitalized?

AND

- Does USP have an immediate income inclusion of $8 billion?

OR

- Do the $10 billion and the $8 billion net?

AND thus:

- Only $2 billion need be capitalized?

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R&D: CSA (Cont'd)

- Some Firms were advising that the amounts did NOT net out – very taxpayer unfavorable.

- Notice 2023-63 clarified: "CST Payments owed to a controlled participant reduce … The amount of the category of IDCs borne directly by that participant that are required to be charged to capital account."

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Potential bad news …

Section 951A GILTI: USP has an immediate income inclusion based on CFC's Global Intangible Low-Taxed Income.

Questions:

- In calculating the GILTI amount from CFC, would the $8 billion have to be capitalized?
  - If YES, then the GILTI inclusion could massively spike upwards.
- If YES, would it be amortizable over five years, or over 15?
  - R&D performed in US, even though paid from outside US.

- Practical implications
  - Adjusting prior imperfections in computation/no 174 computed
  - Audit protection considerations
  - Implications for start-ups/diminimis or difficult to estimate 174
  - Simplified methods or safe harbor approaches – what could they look like?
  - Are there instances where Section 41 QREs could exceed Section 174 SRE expenditures?
  - With elimination of "only reasonable expenditure" language, will reasonable compensation be less of an issue on research credit claims?

Section 280C(c) – Plain Language?

Section 280C(c) Background

- Research Credit Claimants had a choice:
  - EITHER claim a full/gross $100 credit, and lose $100 of deductions
  - OR – 280C(c)(3) election to claim a reduced $79 credit and NO loss of deductions.

Section 280C(c) Background (cont'd)

- Pre-TCJA: Research Credit Claimants that could almost always made a 280C(c) election for a reduced credit
- 2018-2021: Most taxpayers usually still made a 280C(c) election, but not always …

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Section 280C(c) Conforming Changes

- I.R.C. § 280C(c)(1) In General —
  - If—
    - (A) — the amount of the credit determined for the taxable year under section 41(a)(1), exceeds
    - (B) — ***the amount allowable as a deduction*** for such taxable year for qualified research expenses or basic research expenses,
  - the amount chargeable to capital account for the taxable year for such expenses shall be reduced by the amount of such excess.

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Illustration of the New Section 280C(c) (cont'd)

- Assume in 2022:
  - QREs = $1,000
  - (Gross) credit = $100
  - Amortization deduction allowed for such QREs, keeping in mind the mid-year convention = $100.
- Question: Does the credit exceed the deduction?

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Illustration of the New Section 280C(c) (cont'd)

- NO, the credit equals the deduction, thus 280C(c)(1) does nothing.
- And will usually do nothing.
- Thus, the question becomes: Would you prefer a $100 credit, or a $79 credit?

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Implication

- In almost all cases, it will be better not to make the 280C(c) election for a reduced credit.

But Not So Fast!

- **Notice 2023-63 asks:**

  > Should the 'amount allowable as a deduction' reference[] in § 280C(c)(1)(B) … be interpreted to refer to the amortization deduction allowed under § 174(a)(2) or to $0, which is the deduction allowed for the qualified research expenses … under § 174(a)(1)?

- Treasury / IRS contemplate interpreting "the amount allowable as a deduction" as referring to "expense deduction" (i.e., not including an amortization deduction) and thus essentially restoring 280C(c)'s haircut.

Questions

- Is it too good to be true not to have an add-back?
  - But: There was no section 280C(c) add-back the first eight years of the research credit.
- How to reconcile this with Section 280C(**b**) relating to the Orphan Drug Credit?

Treasury & IRS Invite Comments

- Is there internal disagreement in the government over this issue?
- If you have a $100 research credit, you may lose $100 deduction.
  - Or not
  - Depending on how the regulations come out.
- If your research credit is BIG, you should consider submitting comments.

Lastly: Will Congress Fix Section 174?

- i.e., has the last 89 minutes been a waste of your time (other than the CPE)?
- Maybe in December Congress will restore full, immediate deductibility of R&D expenditures for a temporary amount of time?
  - Retroactive?
  - Foreign as well as domestic?
  - And un-do the "conforming change" to section 280C(c)?
- Maybe the holidays won't be so restful?
- Stay tuned!