

40<sup>th</sup> Annual TEI-SJSU High Tech  
Tax Institute  
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# R&D IN UNCERTAIN TAX TIMES

§174 and §41 Hot Topics

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## AGENDA

- Section 174
- Section 41
- IRS Exams Trends
- Insights from Washington: Outlook for Federal R&D Tax Legislation

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# SECTION 174

Guidance/Hot Topics

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## PROPOSED REGULATIONS

- Critical issues
    - Software – how to distinguish between “upgrade or enhancement” and bug fixes and maintenance (Section 5 of Notice 2023-63)
      - “Computer software” is defined as “any computer program or routine (that is, any sequence of code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine.”
      - “Upgrades and enhancements” are defined as “modifications to existing computer software that result in additional functionality (enabling the software to perform tasks that it was previously incapable of performing), or materially increase speed or efficiency of the software.”
      - However, maintenance activities that do not give rise to upgrades and enhancements are not considered “software development” for purposes of section 174.
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## PROPOSED REGULATIONS

- Critical issues
  - Treatment of unamortized Section 174 costs for pass-through entities in dispositions, distributions, contributions, and terminations
    - Treatment of unamortized Section 174 costs in corporate terminations, and general rules for treatment of unamortized Section 174 costs, covered in Section 7 or Notice 2023-63.
    - Section 174(d) provides that if any property with respect to which SREs are paid or incurred is disposed, retired, or abandoned during the amortization period, no deduction is allowed on account of the disposition, retirement, or abandonment; but the amortization deduction “shall continue with respect to such expenditures.”
    - Notice specifies if the property is subject to Section 174(d) in connection with a Section 381(a) transaction, the acquiring corporation may claim unamortized SRE expenditures unless “a principal purpose of the transaction(s)... is to claim a deduction for the unamortized SRE expenditures.”

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## PROPOSED REGULATIONS

- Critical issues
  - Treatment of costs incurred by parties in a contract research services arrangement (Section 6 of Notice 2023-63; Notice 2023-12)
  - 174(d) Issues

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# ACCOUNTING METHOD CHANGE GUIDANCE FOR SECTION 174

- IRS and Treasury have published five revenue procedures addressing changes in method of accounting for section 174 costs: RP 2023-8, RP 2023-11, RP 2024-9, RP 2024-23, RP 2024-34
  - For changes filed on or after August 29, 2024:
    - Audit protection for taxpayer's 2022 or 2023 tax years only if taxpayer attempted to comply
      - Audit protection for taxpayers that did not attempt to comply if filed in 2024
    - 5-year same item waiver for changes filed in 2022 or 2023
      - Helpful to taxpayers with short tax years
    - Final year of trade or business waiver for changes filed in 2022 or 2023
      - Helpful to taxpayers with short tax years and terminations
    - Successive changes allowed
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## NOTICE 2024-12

- Notice 2024-12 relaxes the reliance rules in Notice 2023-63 by no longer requiring taxpayers to rely on all sections of the Notice
  - Notice 2024-12 provides additional guidance relating to a research service provider:
    - Taxpayer not considered to have “rights” to use or exploit the research if the right is (1) is separately bargained for or (2) was acquired for the limited purpose of performing research activities under a contract with the research recipient
  - Notice 2024-12 obsoletes Section 5 of Revenue Procedure 2000-50 for software development costs incurred in tax years beginning after December 31, 2021
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# SECTION 41

Form 6765 Changes – Procedural Issues – Exam Trends

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## WHY IS THE FORM 6765 CHANGING?

- Aimed to improve the efficiencies of exams and identification of exam issues for research credit.
  - Increase transparency with taxpayer community around clarification of expectations around the information needed to support the research credit issue in general.
  - Provide a consistent and pre-defined format to improve information received for tax administration – conserving resources at IRS and with taxpayers.
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# UPDATED DRAFT FORM 6765

- Initial draft Form 6765 was released in September 2023, including the addition of two entirely new sections, which sought detailed information about business components for both quantitative and qualitative reporting, added new questions seeking various information, and reordered some of the existing fields on the form.
- Updated draft Form 6765 was released in June 2024.
  - Section E of Revised Draft Form remains unchanged from Initial Draft Form 6765
  - Business Component Detail, previously labeled Section F, updated to become Section G
- No instructions have been released although they are anticipated by year-end.

## UPDATED DRAFT FORM 6765- SECTION G

**Section G – Business Component Information.** Complete lines 49(a) through 49(f) for each business component you are required to report. See instructions. Attach additional sheets if necessary to capture all business components.

| BC | 49(a)<br>EIN of the controlled group member conducting the research activities on this business component | 49(b)<br>Controlled group member's principal business activity code | 49(c)<br>Business component's name or unique alphanumeric identifier (see instructions) | 49(d)<br>Business component type (select one from available options) |
|----|---|---|---|--|
| 1  |   |   |   |  |
| 2  |   |   |   |  |
| 3  |   |   |   |  |
| 4  |   |   |   |  |
| 5  |   |   |   |  |
| 6  |   |   |   |  |
| 7  |   |   |   |  |
| 8  |   |   |   |  |
| 9  |   |   |   |  |
| 10 |   |   |   |  |
| 11 |   |   |   |  |
| 12 |   |   |   |  |
| 13 |   |   |   |  |
| 14 |   |   |   |  |
| 15 |   |   |   |  |

  

| BC | 49(e)<br>Software (if applicable, select from the available options) | 49(f)<br>Describe the information sought to be discovered. Use the space provided. |
|----|--|--|
| 1  |  |  |
| 2  |  |  |
| 3  |  |  |
| 4  |  |  |
| 5  |  |  |
| 6  |  |  |
| 7  |  |  |
| 8  |  |  |
| 9  |  |  |
| 10 |  |  |
| 11 |  |  |
| 12 |  |  |
| 13 |  |  |
| 14 |  |  |
| 15 |  |  |

Form **6765** (Rev. 12-2024)

UPDATED  
DRAFT  
FORM 6765

**Section E—Other Information.** See instructions.

|           |   |           |  |
|-----------|---|-----------|--|
| <b>37</b> | Enter the number of business components generating the QRE on line 5 or line 20 . . . . .   | <b>37</b> |  |
| <b>38</b> | Enter the amount of officers' wages included on line 42 . . . . .   | <b>38</b> |  |
| <b>39</b> | Did you acquire or dispose of any major portion of a trade or business in the tax year? <input type="checkbox"/> Yes <input type="checkbox"/> No  |           |  |
| <b>40</b> | Did you include any new categories of expenditures as current year QRE? . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No  |           |  |
| <b>41</b> | Did you determine any of the QRE on line 5 or line 20 following the ASC 730 Directive? . . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No   |           |  |
|           | If "Yes," enter the amount from Appendix C Line 19 (you may attach your Appendices A, B, C, and D here)   | <b>41</b> |  |
|           | This ASC 730 Directive only applies to taxpayers with assets equal to or greater than \$10,000,000 who follow U.S. GAAP to prepare their Certified Audited Financial Statements showing the amount of currently expensed Financial Statement R&D. See instructions. |           |  |

**Section F—Qualified Research Expenses Summary.** See instructions.

|           |   |           |  |
|-----------|---|-----------|--|
| <b>A</b>  | Are you required to complete Section G? See instructions to determine if you are required to complete Section G, and how to complete Section F if you are not required to complete Section G . . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No |           |  |
| <b>42</b> | Total wages for qualified services for all business components (do not include any wages used in figuring the work opportunity credit) . . . . .  | <b>42</b> |  |
| <b>43</b> | Total costs of supplies for all business components . . . . .   | <b>43</b> |  |
| <b>44</b> | Total rental or lease cost of computers for all business components . . . . .   | <b>44</b> |  |
| <b>45</b> | Total applicable amount of contract research for all business components (do not include basic research payments). . . . .  | <b>45</b> |  |
| <b>46</b> | Enter the applicable amount of all basic research payments. See instructions . . . . .  | <b>46</b> |  |
| <b>47</b> | Add line 45 and line 46 . . . . .   | <b>47</b> |  |
| <b>48</b> | Add lines 42, 43, 44, and 47, then enter line 48 on either line 5 or line 20, whichever is appropriate . . . . .  | <b>48</b> |  |

Form **6765** (Rev. 12-2024)

## DRAFT FORM 6765 – NEW LINE DESCRIPTIONS

- Line 49(a). EIN of the controlled group member conducting the research activities on this business component
- Line 49(b). Controlled group member's principal business activity code
- Line 49(c). Business component's name or unique alphanumeric identifier
- Line 49(d). Business component type (select one from available options (product, process, computer software, technique, formula, or invention))
- Line 49(e). Software (if applicable, select one from available options)
- Line 49(f). Describe the information sought to be discovered
- Line 50. Direct research wages for qualified services
- Line 51. Direct supervision wages for qualified services
- Line 52. Direct support wages for qualified services

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## DRAFT FORM 6765 – UPDATED DRAFT CHANGES

- Intended for tax year 2024, other than Section G (business component information), which is optional in 2024.
  - Section G not required for small taxpayers (QREs no more than \$1.5M and no more than \$50M in gross receipts) for a credit claimed on an original return and taxpayers who claim a payroll tax credit under Section 41(h)
- Business component reporting: business components reflecting 80% of total QREs, but no more than 50 business components
  - Intended to be reported at controlled group level
- Instructions will be provided for taxpayers using the ASC 730 Directive, the definition of “officers,” controlled group reporting, and business component descriptive names

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## FORTHCOMING GUIDANCE & TIMING

- Draft Form Instructions are to be released by the end of November 2024
    - Final instructions to be released by the end of January 2025
    - Likely to put out a press release seeking formal comments in the Spring of 2025
  - Final Form 6765 to be released by end of December 2024
  - The IRS will stay agile regarding what future updates, if any, will be necessary based on implementation and feedback received
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## AREAS OF ADDITIONAL CLARITY

- No guidance for taxpayers using statistical sampling to determine QREs
- No guidance for determining whether a taxpayer acquired or disposed of a major portion of a trade or business
- No guidance for determining whether a taxpayer has a “new category” of expenses included in QREs
- No clarity regarding what information is to be reported on a controlled group basis versus a taxpayer basis

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## AMENDED RETURN R&D REFUND CLAIMS (FAA20214101F )

- Administration of the guidance concerning section 41 refund claims continues to frustrate taxpayers and practitioners as it is inconsistent and opaque
- The IRS has extended the transition period (period during which taxpayers will receive a letter requesting compliance within 45 days) to expire on January 10, 2025
- Updated FAQs provide a suggested format that contains information that is not currently requested in FAA20214101F
- Updated FAQs (June 18, 2024) waive the requirement that taxpayers provide (1) the names of the individuals who performed each research activity and (2) the information each individual sought to discover

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## EXAMPLES FROM FAQs – BUSINESS COMPONENT IDENTIFICATION

1. Identify all business components to which the IRC Section 41 research credit claim for refund relates for the claim year.

| Business component number | Business component name | IRC Section 41(D)(2)(B) category |
|---------------------------|-------------------------|----------------------------------|
| 1                         | Alpha Software Suite    | Computer Software                |
| 2                         | Beta Manufacturing Line | Process                          |
| 3                         | Gamma Widget            | Product                          |
| 4                         | Delta Coating           | Formula                          |

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## EXAMPLES FROM FAQs – RESEARCH ACTIVITY IDENTIFICATION

2. Identify all research activities performed by business component.

1. Alpha Software Suite

Taxpayer sought to improve the performance and quality of its inventory and process tracking systems. The research performed included:

- Integrate Radio Frequency Identification (RFID) part tracking with factory process tracking software and accounting software, all currently residing on different software platforms.
- Develop real-time reporting from above software systems so end users can track product through the facility. This requires database development from currently disparate systems.

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## SECTION 280C ELECTION/REVOCAION

- Statute, as amended by TCJA, requires reduction of the capitalized balance of QREs only if the Section 41 credit exceeds the amount of deductible QREs for the year
  - Only in unusual cases will the reduction be required
  - Only in cases where the excess of the credit is greater than 21% of the current year credit will an election for a reduced credit make sense
  - Election to reduce credit is irrevocable
- Taxpayers that made an inadvertent Section 280C election in 2022 to reduce their credit have not been granted relief to revoke the election

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## EXAM TRENDS

Update on the Current Exam Environment

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## EXAM AND APPEALS TRENDS

Common issues raised by Exam and in Appeals:

- Identification of business components
- Process of experimentation
- Allocation of costs
- Substantiation

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## IDR TRENDS

- IDRs employee information request
  - Identity of employees
  - Identity of employee's supervisor
  - Work address of employee
  - Work address of employee's supervisor
  - Job title of employee
  - Job title of employee's supervisor
  - Description of activities performed by employee on each business component
  - QREs associated with support, supervision, direct research, and how employee QREs are allocated to each business component
  - Information sought to be discovered by employee for each business component
  - Documentation supporting allocation of QREs to business component
  - Documentation supporting the performance of qualifying activities by employee

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## IDR TRENDS

- IDRs business component information requests
    - Identity of business component
    - Identify the type of business component (product, process, formula, technique, invention, computer software)
    - How taxpayer determined that the product was a business component
    - Whether the taxpayer applied the shrink back principle
    - Identify qualified purpose for each business component
    - Identify if business component is for sale, lease, license or used by the taxpayer
    - Identify the core elements of a process of experimentation for each business component and how 80% POE test was satisfied
    - Identify QREs by business component (wages, supplies, computer lease, contract research) and provide substantiation for nexus between QREs and business component
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## INSIGHTS FROM WASHINGTON: OUTLOOK FOR FEDERAL R&D TAX LEGISLATION

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# OUTLOOK FOR TAX LEGISLATION

- Tax Relief for American Families and Workers Act of 2024
  - The Filibuster, Reconciliation, & Tax Policy
  - BEAT & Section 41
  - FDII Swap for ‘Additional R&D Support’?
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## LEADERS OF THE HOUSE OF REPRESENTATIVES

- Minority Leader Hakeem Jeffries (D, New York)
- Speaker of the House Mike Johnson (R, Louisiana)

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## TAX RELIEF FOR AMERICAN FAMILIES AND WORKERS ACT OF 2024

- Retroactively, seamlessly (2022 – 2025) would have:
    - Restores section 174 R&D expensing
    - Restores DA to EBIT section 163(j) business interest limitation
    - Restores 100% bonus depreciation under section 168(k)
  - Also:
    - Enhances Child Tax Credit
    - US-Taiwan Double Tax Relief
    - Disaster Relief
    - Employee Retention Credit enforcement
  - January 2024: Passed the House: 357 – 70
  - August 2024: Republican Senators filibustered
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## H.R. 7024, TAX RELIEF FOR AMERICAN FAMILIES AND WORKERS ACT OF 2024

Section 201 of H.R. 7024 would:

- Temporarily allow current deductibility, or elective capitalization, of domestic research or experimental expenditures under new Section 174A for tax years beginning after December 31, 2021 and before January 1, 2026
  - Maintain 15-year amortization for foreign research or experimental expenditures
  - Permit taxpayers in certain circumstances to make retroactive elections to capitalize domestic research or experimental expenditures
  - Permit taxpayers in certain circumstances to elect to treat the change in law as a change in method of accounting for the second tax year beginning after 31 December 2021
  - Permit certain eligible taxpayers to make or revoke elections under Section 59(e) and Section 280C(c) for their first tax year beginning after 31 December 2021
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## WAYS & MEANS LEADERSHIP

- Jason Smith (R, Missouri)
- Richie Neal (D, Massachusetts)

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### *H.R. 7024, TAX RELIEF FOR AMERICAN FAMILIES AND WORKERS ACT OF 2024 (CONT'D)*

#### Section 280C

- 1981 – 1988: For every \$100 of R&D Credit, lose \$\_\_\_ of R&D Deduction
  - 1989: For every \$100 of R&D Credit, lose \$\_\_\_ of R&D Deduction
  - 1990 – 2021: For every \$100 of R&D Credit, lose \$\_\_\_ of R&D Deduction
    - Or claim a reduced credit
  - 2022 – Present: For every \$100 of R&D Credit, lose \$\_\_\_ of R&D Deduction
    - Usually
    - Under the majority view – IRS to put out guidance
  - Tax Relief for American Families and Workers Act of 2024
    - Would ***permanently*** restore the 280C(c) haircut to the R&D Credit benefit.
    - I.e., for every \$100 of R&D Credit, lose \$\_\_\_ of R&D Deduction
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# JCT ESTIMATE IN *TCJA* FOR AMORTIZING R&E

(IN BILLIONS) (JAN. 2024 EST.)

| Provision                  | 2024         | 2025         | 2026        | 2027        | 2028        | 2029        | 2030       | 2031       | 2032 | 2033 | 2024-2033   |
|----------------------------|--------------|--------------|-------------|-------------|-------------|-------------|------------|------------|------|------|-------------|
| Deduction for domestic R&E | <b>-82.7</b> | <b>-19.8</b> | <b>15.1</b> | <b>30.3</b> | <b>23.9</b> | <b>15.8</b> | <b>7.4</b> | <b>1.5</b> | --   | --   | <b>-8.5</b> |

JCT

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## BUT WHAT IS THE SECTION 280C(C) RESTORATION SCORE?

- Not officially stated
- BUT JCT has stated that the tax expenditure amount for the section 41 research credit for the five-year period (2022-2024) is: \$104 Billion.
  - So, about \$21 Billion per year
- If \$21 Billion is currently deductible (because section 280C(c) generally does not apply), but suddenly becomes no longer deductible (because section 280C(c) is restored) ...
  - That is, if we assume a 21% tax rate, then \$21 Billion of deductions is worth ... more than \$4 billion?
  - So, restoring section 280C(c) would mean \$4 Billion of additional tax paid every year?
  - So, for ten years, more than \$40 B?

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## QUESTION PRESENTED

*Is a four-year temporary restoration of section 174 R&D expensing worth a permanent restoration of the section 280C(c) haircut to the section 41 research credit benefit?*

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## QUESTION PRESENTED

*Is a four-year temporary restoration of section 174 R&D expensing worth a permanent restoration of the section 280C(c) haircut to the section 41 research credit benefit?*

Assume:

- Four-year domestic-only 174 expensing restoration: -\$8.5 B
- Permanent Section 280C(c) haircut restoration: \$40+ B?

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## QUESTION PRESENTED

*Is a four-year temporary restoration of section 174 R&D expensing worth a permanent restoration of the section 280C(c) haircut to the section 41 research credit benefit?*

Assume:

- Four-year domestic-only 174 expensing restoration: -\$8.5 B
- Permanent Section 280C(c) haircut restoration: \$40+ B

That is, is paying \$40B to get a \$8.5B benefit worth it?

Caveat: Your results may vary.

- If section 41 claim is small, but section 174 amount is large, then perhaps the trade-off *is* worth it
  - Depending on interest rates / cost of capital
  - Other effects: FDII benefit; cost-sharing
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REPUBLICAN SENATORS FILIBUSTERED

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*H.R. 7024, TAX RELIEF FOR AMERICAN FAMILIES AND WORKERS ACT OF 2024  
(CONT'D)*

- What's Next?
- TBD
- Lame Duck?
- Retroactive?

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## **PERMANENT RESTORATION OF SECTION 174 (1954-2021)?**

### *COULD IT HAPPEN?*

- Ten-Year Scoring Window
- Foreign R&D
- Cost of Permanent Restoration v. cost of four-year domestic restoration?
- Fear of future Congress repealing permanent restoration?

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## **FILIBUSTER & RECONCILIATION**

- Filibuster: Allows for unlimited debate in US Senate
- Cloture: 60-vote super-majority to end debate
- Reconciliation: Exception to filibuster for budget bills in US Senate
  - Only 51 votes needed
  - A net tax cut in Year 11 or beyond is “extraneous”
  - That’s why most tax cuts are temporary

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## IF THE FILIBUSTER WERE GONE ...

- Would reconciliation no longer be important?
  - Would we see much less sunseting of tax legislation after ten years?
  - Would ten-year scores become obsolete?
  - Would section 174 expensing be permanently restored?
  - Would tax law become more stable or less stable?
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## OTHER SPECIFIC R&D ITEMS FOR NEAR FUTURE

- 2026: R&D Credit status for BEAT taxpayers
- Swap FDII for “Additional R&D Support”?
  - *See Coughlan, Biden’s Proposal to Swap FDII for R&E Expenditure Support*, 103 TAX NOTES INT’L 10 (Sept. 20, 2021)