

What's New in Research Tax Incentives?

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Paul Coates

Paul F. Coates is a Senior Revenue Agent in General Business Credit Enterprise Practice Area of Large Business and International (LB&I). In this role, Paul serves as subject matter expert for certain business credit and deduction tax incentives, including the credit for increasing research activities and research or experimental expenditures. The General Business Credit Practice Area provides assistance to identify, develop and present tax issues in direct examinations. The Practice Area also assists to implement compliance and training strategies, corporate tax legislation and regulation and guidance projects throughout LB&I and the IRS. Prior to this role, Paul served as section 174 and section 41 technical advisor in the Issue Practice Group, the predecessor unit of General Business Practice Area.

Paul has more than 38 years of experience as a revenue agent, including team coordinator on aerospace, pharmaceutical, other manufacturer, life insurance and financial industry large cases.

Tony Coughlan



- tony.coughlan@rsmus.com
- RSM Washington National Tax R&D Leader
- Publications in the field of R&D:
 - *An Early 21st Century History of IRS Efforts to Police the Research Credit* (co-author), THE TAX ADVISER (April 2022)
 - *Biden's Proposal to Swap FDII for R&E Expenditure Support*, 103 TAX NOTES INT'L 10 (Sept. 20, 2021)
 - *Research Credit Election Considerations*, 164 TAX NOTES FED'L 193 (Jul. 8, 2019)
 - *Section 174 R&E Deduction Upon Statutory Stock Option Exercise*, 58 TAX LAW. 435 (2005)
 - *R&D Credit Regulations Considered* (co-author), 2003 TAX NOTES TODAY 213-23.
- Senior Tax Counsel, Senate Finance Committee (2009-18):
 - Lead for R&D tax incentives, international tax
 - Significant involvement with drafting of TCJA
- Education:
 - Georgetown University Law Center, LLM (Tax), *with distinction*
 - University of Virginia School of Law, JD, excelled in *corporate tax*
 - Virginia Tech, BS (Math & History), dean's list six terms

Keith Nickels



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Grant Thornton National R&D Credit Practice Leader

Keith has nearly 25 years of public accounting experience with a focus on the R&D tax credit and accounting methods technical areas. He has worked across a large variety of industries, including technology, life sciences, media and entertainment, and aerospace and defense. He specializes in IRS exam controversy and has worked with Fortune 500 and middle-market companies.

Prior to joining Grant Thornton, Keith was a partner in the Specialized Tax Services group and leader of the Life Sciences R&D credit practice at PricewaterhouseCoopers LLP, where he led and managed the pursuit and delivery of tax services related to the

R&D tax credit and Section 174 expenditures. Before that, Keith spent more than 20 years with Ernst & Young LLP's (EY) Tax practice. During that time, he spent eight years in the firm's national Tax department focused on the R&D tax credit and led EY's New York R&D Tax Credit practice.

Between January 2016 and December 2017, Nickels served as the chairperson of the Tax Policy Taskforce at the American Institute of Certified Public Accountants (AICPA).

Matt Normington



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Matt Normington is a leader of Deloitte's West Region national Global Investment & Innovation Incentives (G²) group and has over twenty years of experience dedicated to performing research and development tax credit engagements in the Silicon Valley. Matt has extensive experience leading R&D analyses in the software, manufacturing, pharmaceutical, media & entertainment, retail and aerospace industries. Matt has defended clients in audits performed by the Internal Revenue Service and state tax authorities at all levels.

Matt has a Bachelor of Arts in accounting from Pepperdine University. He is licensed as a Certified Public Accountant (CPA) in the state of California.

New Section 174 R&E Capitalization

Section 174: 70-Year History

- Pre-1954: Confusion ...
 - Controversy whether research costs are deducted as period expenses or capital expenditures subject to depreciation or amortization.
 - Gillam Manufacturing Company, Hazeltine, Red Yeast and other court cases
- 1954-2021: Section 174 Research and Experimental Expenditures
 - Former Section 174 and regulations provides three permissible methods for the treatment of R&E (expensed under section 174(a), deferred under section 174(b) or charged to capital account or capitalized under Treas. Reg. 1.174-1) in computing taxable income.
 - What are and are not R&E expenditures defined in Section 174(c) and (d) and Treas. Reg. 174-2 “Definition of research and experimental expenditures”.
 - Regulations under former section 174 (Treas. Reg. 1.174-1; -3 and -4) provide the specific rules for adopting a permissible method or changing from one method to another method.
- 2022 and subsequent years: Section 174 Amortization of Research and Experimental Expenditures as amended by Section 13206 of P.L. 115-97 (TCJA)
 - No discretionary treatment for the treatment of specified research or experimental expenditure (“SRE”)
 - Section 174(b) defines SRE as research or experimental expenditures paid or incurred in tax years beginning after 12/31/2021.
 - Specified R&E (“SRE”) are charged to single capital account and amortized either 5 years (domestic) or 15 years (foreign) with mid-point convention.
 - New Section 174(c)(1) and (2) retained old exclusion rules for land and other property and exploration expenditures.
 - Section 174(c)(3) provides that amount paid or incurred in connection with the development of any software are SRE.
 - Section 174(d) provides no deduction is allowed on disposition, retirement or abandonment of any property with respect to SRE. Taxpayer must continue to amortize SRE.
 - Former section 174(e) (reasonable expense) and (f) (Cross-references to section 1016 and section 59(e).
 - Conforming changes to section 280C and section 41(d)(1)(A).

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R&E and SRE

- Other than the new inclusion rule for amounts paid or incurred to develop software, the definition of what are or are not R&E has not changed under new section 174.
 - Published guidance and regulations over 70 years sets forth the definition of R&E, including T.D. 6500, T.D. 8562; T.D. 9680, revenue rulings, court cases and other guidance.
 - Since T.D. 6500, “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.”
 - Section 174 expenses are different and from section 162 expenses, including different trade or business tests.
 - Certain costs which are not treated as R&E in conformity with taxpayer’s method may still be credit eligible expenses under section 41(d)(1)(A).
 - Norwest
 - Software development costs under Revenue Procedure 2000-50
 - Treas. Reg. 1.41-6(i) Intra-group transactions generally provides U.S. related service
- 8 may claim qualified research expenses for credit.

Software Development Costs under Revenue Procedure 2000-50

- Rev. Proc. 2000-50 provides guidelines on the treatment of computer software costs (presumably its applicability will be modified for tax years beginning after December 31, 2021).
- Computer software is defined as “any program or routine (that is, any sequence of machine-readable 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”
- Rev. Proc. 2000-50 states that software development costs so closely resemble §174 expenditures that the IRS will not disturb a taxpayer’s treatment of software development cost where the taxpayer:
 - Section 5.01(1) of Rev. Proc. 2000-50 provides that the costs properly attributable to the development of computer software by the taxpayer are allowed to be treated as current expenses and deducted in full.
 - Section 6.01(2) of Rev. Proc. 2000-50 provides that with respect to the costs of acquired computer software, the Service will not disturb the taxpayer's treatment of costs that are separately stated if the costs are consistently treated as capital expenditures for an intangible asset the cost of which is to be recovered by amortization deductions ratably over a period of 36 months beginning with the month the software is placed in service, in accordance with the rules under 167(f)(1). See 1.167(a)- 14(b)(1).

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Examples of Software Development Costs

- PLR 200236028 and CCA 201549024 address a taxpayer’s purchase of ERP software from a third party and the extent to which such costs are treated as “software development” for purposes of Rev. Proc. 2000-50.
- Costs treated as software development costs
 - Costs incurred for writing of machine-readable code
- Costs not treated as software development costs
 - Separately stated computer hardware costs
 - Costs of purchased software or similar costs under Section 6 of Rev. Proc. 2000-50
 - Employee training and related costs (e.g., maintenance, troubleshooting, running reports during training), which are deductible as section 162 expenses
 - Costs related to software installation/modification costs, e.g., incurred for option selection and implementation of embedded templates
 - Undefined miscellaneous costs under a taxpayer’s consulting contract
- Technical consulting costs relating to the modeling and design of additional software were allocable partially to software development costs and partially to installation/modification costs

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Possible Approaches to Estimate SRE

Consider whether adjustments to "Book R&D" or QREs may be necessary for the following costs:	Adjustment Needed For:
Increase for costs incident to the development of a product, including costs of obtaining a patent, such as attorneys' fees expended in making or perfecting patent application.	Both Book R&D and QREs
Increase for costs "incident to research" that have not already been coded as "R&D" for financial statement (e.g. overhead such as shared services or purchasing department activities, taxable stock-based and bonus compensation to R&D employees, customer-funded research other than cost reimbursement contract)	
Increase for cost of developing software for internal use or intended for sale (ASC 350-40, -50 and 985) that is not classified as "R&D" for financial statement purposes.	
Increase (generally) for material M adjustments (e.g., bonus depreciation related to research property, section 197 intangibles (e.g., amortized "know-how" used in research))	
Increase for costs included as QREs but not coded as "R&D" for financial statement purposes (e.g., acquisition and improvement costs of pilot model)	Book R&D
Decrease for costs not incident to product development that are nonetheless classified as R&D for financial statement purposes (see following slide)	
Increase to "Gross up" contract research (only 65% of contract research included for research credit purposes)	
Increase for Foreign research	

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What are not R&E Expenditures

- The section 174 regulations specifically exclude certain costs from the definition of R&E expenditures
 - Ordinary testing or inspection of materials for quality control
 - Efficiency surveys
 - Management studies
 - Consumer surveys
 - Advertising or promotions
 - Acquisition of another's patent, model, production or process
 - Research in connection with literary, historical, or similar projects
 - Land & other property; exploration expenditures
- Other types of costs arguably outside of the definitional scope of section 174:
 - General and administrative expenses incident to the taxpayer's activities as a whole rather than incident to the development of products in particular (finance, accounting, and human resources)
 - Activity that is related solely to business operations or maintenance (e.g. routine support of production line, routine customer support)

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R&E and SRE Paid Or Incurred Under Contractual Arrangements

- Do R&E expenditures paid or incurred by a service provider under contract on behalf of and at the economic risk of a customer fall within the definitional scope of section 174?
- Economic risk is borne by a customer where payment is not contingent on the success of research (e.g. “time and materials” or “cost plus” contracts).
- Some commentators suggest that additional guidance is needed to address whether costs paid or incurred under contractual arrangements are SRE.
- The section 174 regulations address the issue of research performed under contract only from the perspective of the customer or service recipient (i.e. the *payor*):
 - Expenditures paid or incurred for research carried on in taxpayer’s behalf by another person or organization (i.e., payor’s behalf) are R&E expenditures ***only if*** the research is undertaken upon the taxpayer’s order and at the taxpayer’s risk (Treas. Reg. § 1.174-2(b)(3)).
 - Does this provision *imply* that a taxpayer acting as a research service provider must also be “at risk” to treat costs as R&E expenditures? The answer is not clear.

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Section 41 Funded Research

- Does the exclusion of “funded research” from research credit eligibility imply that section 174 does not already contain such an exclusion? The answer is not clear.
- Section 41(d)(1) defines qualified research (in part) as expenditures that may be treated as specified research or experimental expenditures under section 174.
- Section 41(d)(4)(H) also excludes “Funded Research” from the definition of qualified research.
- The predecessor statute to section 41 (former section 44F(d)) defined qualified research as having (in relevant part):
 - “*the same meaning as the term research or experimental has under section 174, **except** that such term shall not include... (3) qualified research **to the extent funded** by any grant, contract, or otherwise by another person (or any governmental entity).”* (emphasis added)
- Absent guidance from the IRS this will continue to be an area of uncertainty for taxpayers.

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Possible IRS Guidance – New Section 174

- Guidance to Conform to Statutory Method for Treatment of SRE
 - Is Form 3115 needed?
 - Correction of an Error
 - Impermissible Method
- Possible changes to form and instructions
 - Form 4562, Part VI
 - M-3, Part III, R&D Line Item
- Section 59(e)(2)(B): Can taxpayer make annual dollar election for SRE amortizable amount or amortization deduction?
- Section 41(d)(1)(A): What does “may” mean in the R&E capitalization era?



JCT Estimate in TCJA for Amortizing R&E (in billions)

Provision	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2018-2027
Amortization of R&E	--	--	--	--	24.2	32.9	26.0	18.9	11.4	6.3	119.7

Current state v. future state

Post-2021

- Significant changes to the treatment of R&E expenditures in 2022 as a result of Tax Cuts and Jobs Act (TCJA)
 - *Required* capitalization and amortization
 - Domestic – 5 years (SL, Mid point)
 - Foreign – 15 years (SL, Mid-Point)
- Software development costs are defined as section 174 expenditures.
- The deductions are not accelerated even if the property is sold or abandoned.

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Taxpayers Need to Comply

- Maybe Congress will repeal or defer new section 174(a) ...
 - HR 1304 (Estes-Larson)
 - American Innovation and Jobs Act
 - Made in America: Effect of the U.S. Tax Code on Domestic Manufacturing (Senate Finance Committee hearing, March 16, 2021)
- But maybe Congress won't ...
 - Child Tax Credit
 - What will tomorrow's election mean?
- Compliance matters
 - Estimated Tax Implications
 - Provision Implication
- Is Congress hearing your voice?

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Minimize R&E Subject to Capitalization?

- Would the expenditure otherwise be deductible under Section 162?
 - Rights & Risk analysis
 - Section 482-7 and other related and unrelated contractual arrangements
- If you successfully argue that a given expenditure is NOT a R&E expenditure under section 174, are you sure it is deductible under section 162?
- Would this harm the Section 41 Research Credit claim?
- Will this harm 1.861-17 R&E apportionment and FTC planning? FDII implications?

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IRS
ON
SPECIFICITY
REQUIREMENT

Overview of Key Changes

- IRS issued October 15, 2021 Chief Counsel Memorandum 20214101F, January 3, 2022 memorandum, and February 9, 2022 FAQ update
- Five items that taxpayers are now required to provide when applying for research credit refund claims:
 - All the business components that form the factual basis for the section 41 research credit claim for the claim year;
 - all research activities performed by business components;
 - all individuals who performed each research activity by business component;
 - all the information each individual sought to discover by business component; and
 - the total qualified employee wage expenses, supply expenses, and contract research expenses.
- One year transition period with a 45-day window to perfect claims, effective for claims filed beginning January 10, 2022

Issues and Concerns

- Does this impact only refund claims? Or all claims?
- Is this consistent with Rev. Proc. 2011-42 Statistical Sampling?
- Can taxpayers challenge a refund claim that the IRS finds deficient?
- Many have criticized the IRS for its informal implementation of the changes.
 - ABA, AICPA, and National Association of Manufacturers have each sent letters requesting clarification or delay of implementation.

IRS FAQ Clarifications

- Taxpayers using Statistical Sampling must provide the first four items of information for all units in the sample
- BBA Passthrough refund claims: must file the five items of information with an administrative adjustment request rather than an amended return
- Non-BBA Passthrough refund claims: may file the five items of information with an amended return, but partners/shareholders must include the five items of information
- Determinations are eligible for challenge before IRS appeals during the one-year transition period. Taxpayers will have 45 days to revise claims to provide the necessary five items. Appeals resolution is not available for refund claims rejected on the basis that they are deficient or otherwise not processible
- IRS will review each credit claim to ensure validity, and attempt to make determinations within 6 months of receipt

R&D and Specificity – A Brief Look Back & Update

Feb 8 – 3 Additional FAQs

- BBA partnerships: BBA partnerships do not file an amended return, but rather file an Administrative Adjustment Request (AAR), with the five items of information. The BBA partners, however, do not need to provide the five items of information with their amended tax return with the attached Form 8986.
- Non-BBA pass-throughs: TEFRA partnerships, S corporations and other non-BBA pass-throughs, however, “may” include the five items of information with their amended return. The partners or S corporation shareholders, however, “are required to include the five items of information with their amended tax return claiming the Research Credit.”
- Appeals: According to the FAQ update, “the Appeals resolution process is not available for refund claims that are rejected on the basis that they are deficient.” In this case the IRS will issue a no consideration letter. No consideration letters will not be appealable to the IRS Independent Office of Appeals. The taxpayers will also not be able to bring a refund suit in the appropriate district court or federal court of claims.

...

Speaking of Specificity ...

- Where do Form 6765 amendments stand?



SECTION 280C(c)

Silver Lining to R&E Capitalization?

280C(c) Background

Research Credit Claimants have 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.

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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)(1) '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 280C(c)

Assume in 2022:

- o QREs = \$1,000
- o (Gross) credit = \$100

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Illustration of the new 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 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.**

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Making the 280C(c) Election

- Made on a timely-filed (with extensions) original return.
- 2022 change
- So ... taxpayers have until 10/15/2023
- So ... nothing to think about for the next year?

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Provision Implication

- When is Q1 provision made for Calendar 2022?
- How to account for 280C(c) for Q1 provision?

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New 280C(c) Caveats

- IRS may fight this: “Scrivener’s error!”
- Would Congress add this to their list of technical corrections?
- Too Hypothetical?
 - Betting money is that Congress restores full, immediate deductibility of R&E expensing, and restores “old” 280C(c) at the same time.



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Recent Legislation



Inflation Reduction Act of 2022

- **Sec. 13902** – Increase In Research Credit Against Payroll Tax for Small Businesses
 - Beginning after 12/31/2022, increases the limit in any election from \$250k to \$500k
 - Modifies rules and limitations for allowance of the credit, carryovers, and deductions

