Section 174 – Recently Issued Guidance & State Tax Implications

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Course Objectives

- Understand recently issued substantive guidance through IRS Notices
- Discuss the impact to taxpayers & practical advice for compliance
- Address recent legislative development on Capitol Hill
- Understand the interplay between Section 174 & Section 41 (R&E tax credit)
- Discuss state conformity to Section 174
- Evaluate constitutional arguments related to Section 174 for state purposes

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Agenda

- Background
  - Qualified & Excluded Section 174 Activities
  - Interplay between Section 174 & Section 41 (research credit)
- Notice 2023-63 & 2024-12 Guidance on Amortization of Sec. 174 Expenditures
  - Eligible/Excluded activities & expenses
  - Software development
  - Research performed under contract
  - Dispositions
- State Conformity to Section 174
- State Constitutional Arguments Related to Section 174
- Research Credit Update
  - IRS audit environment
  - Recent & upcoming administrative requirements
  - Case law update

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Section 174 Background

174 Background

- Governs the U.S. federal income tax treatment of research & experimental expenditures
  - TCJA 2017 reversed 6+ decades of how R&D expenses are treated for tax
- IRC Sec. 174(b) renamed Research or Experimental Expenditures ("R&E") to Specified Research or Experimental Expenditures ("SRE")
- Mandatory capitalization
  - 5-year domestic SREs
  - 15-year for foreign SREs
- Additional guidance
  - Method change – Rev. Proc. 2023-08; 2023-11; 2024-09
  - Notice 2023-63 – Administrative guidance (Sep. 8, 2023)
  - Notice 2024-12 – Administrative guidance (Dec. 22, 2023)

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Section 174 Activity Requirements

- Includes all expenses paid or incurred in connection with taxpayer’s trade or business
- Activities undertaken represent R&D in the experimental or laboratory sense:
  - Intended to eliminate uncertainty – Capability, methodology, or appropriateness of design
- “*Incident* to the development or improvement of a product”
- “Product”
  - Includes any tangible product, process, formula, invention, pilot model, software, technique, patent, or similar property used in the taxpayer’s business or held for sale, lease, or license.
- Eligible expenses include:
  - Direct Costs, *e.g.*, wages, supplies, & contract research
  - Indirect Costs, *e.g.*, overhead, utilities, rent, depreciation
  - Any & all software development costs (regardless of internal- or external-use) are now governed by new amortization rules

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Activities Not Considered Research & Development – Examples

- Acquisition of another's patent, model, production, or process
- Acquisition or improvement of depreciable property
- Post-production activities including routine quality control
- Consumer surveys, management studies, & efficiency studies
- Advertising or promotions
- General & administrative activities related to taxpayer's business, *e.g.*, Accounting, Finance, HR, Legal

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Section 174 vs. Section 41 Activities & Expenditures

IRC Section 41 vs. Section 174 – Qualifying Expenses

Legend: Yes / No

	Type of Expense	Qualified Under Sec. 41	Qualified Under Sec. 174
1	Labor Costs	Yes (Taxable Wages)	Yes (Full EE Cost)
2	Expenses incurred for materials or supplies used in research	Yes	Yes
3	Extraordinary utilities used in research facilities	Yes	Yes
4	Computer Lease/Rental Expenses, *e.g.*, cloud computing costs	Yes	Yes
5	Contract research expenses	Yes (at 65%)	Yes
6	Payments to research consortia or nonprofit research organizations	Yes	Yes
7	Non-taxable employee benefits	No	Yes
8	Depreciation & amortization expense	No	Yes
9	Allocable overhead expenses	No	Yes
10	Utilities	No	Yes
11	Rent	No	Yes
12	Patent expenses	No	Yes
13	Purchases for depreciable property used in R&D activities	No	No
14	Land, including improvements to land	No	No
15	Construction of property of a character subject to depreciation	No	No
16	Mineral, ore deposit, oil, gas exploration costs	No	No

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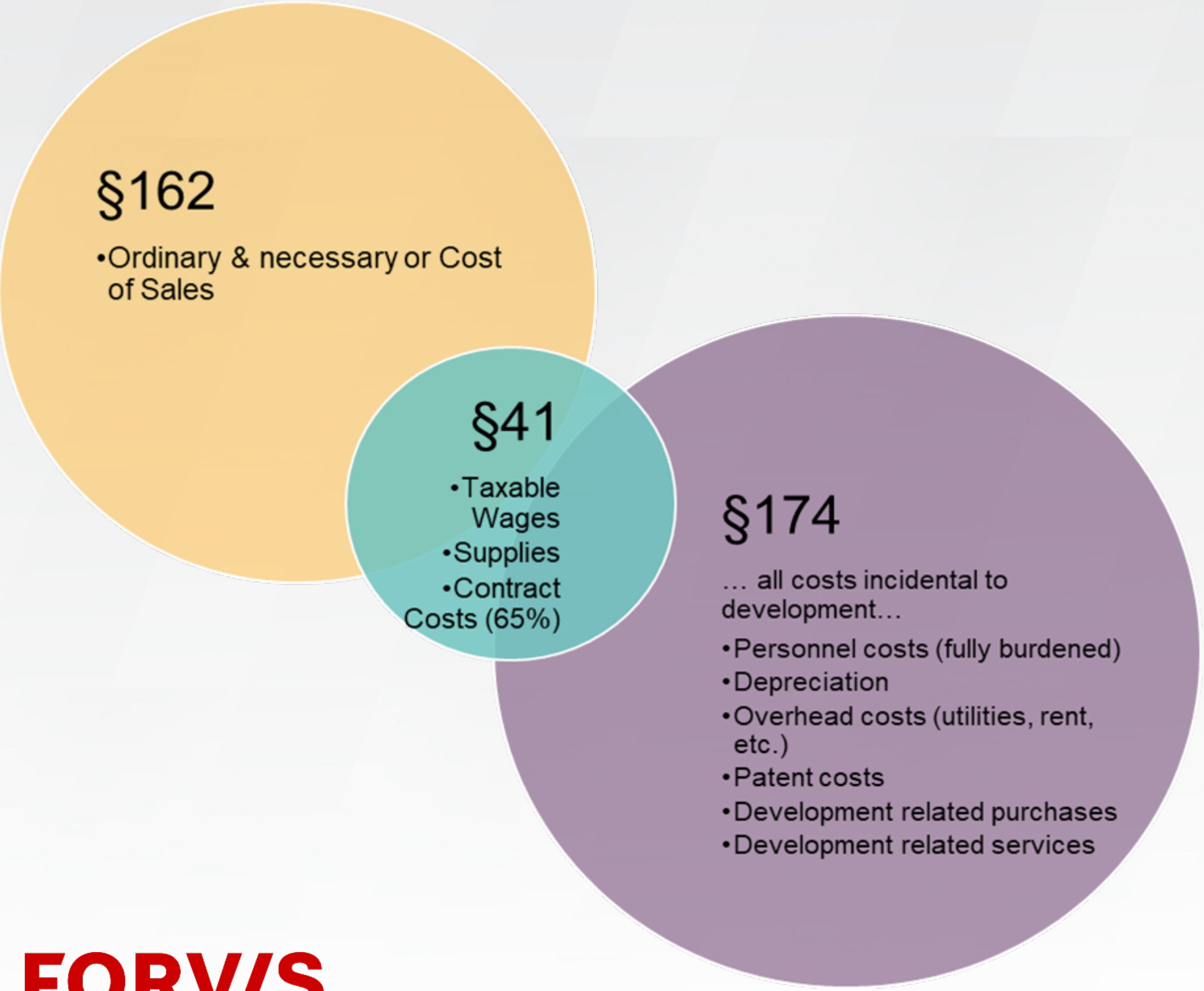
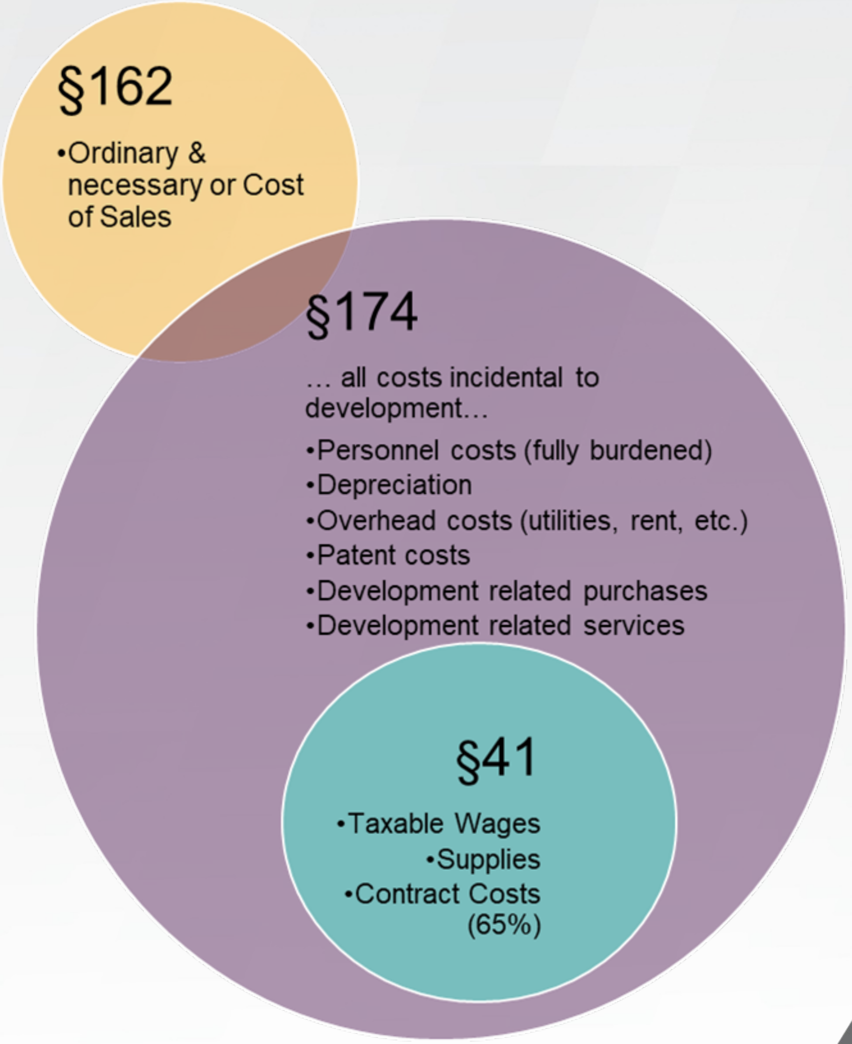
Interplay Between Section 174 & 41

Prior to 2022 Tax Year



2022 Tax Year & Later



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Section 280C(c)

- The TCJA made a conforming amendment to Section 280C that made it applicable only if the amount of the Section 41 credit exceeds the amount allowable as a deduction under Section 174. As it will be rare for the credit to exceed the amount allowable as a Section 174 deduction, many taxpayers may benefit from not making the Section 280C election.
  - Was this intentional?
  - Can the IRS issue guidance that contradicts the statute?
- The Tax Relief for American Families & Workers Act of 2024 includes a provision
  - Proposes a Transition rule allowing taxpayers to make or revoke an election under Section 280C(c)(2) to claim a reduced credit under Section 41 for the first tax year beginning after 12/31/21.
  - For 2023 & later, goes back to the pre-2022 rules

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IRS Guidance

Notice 23-63 & 24-12

IRS Notice 2023-63

- Provides current IRS positions on Sec. 174 issues needing further guidance for taxpayers to follow
  - IRS requested comments on their proposed positions in the Notice
  - This is not formal authoritative guidance
  - This will, in some form or fashion, make its way into Proposed Regulations

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IRS Notice 2023-63

- Key issues discussed:
  - Clarity on definitions found within Sec. 174
  - Methodologies for computing Sec. 174 ‘incidental’ costs
  - Definition & discussion of ‘software development’
  - Disposing of R&D-related property
  - Research performed under contract
  - Long-term contracts
  - Cost sharing arrangements

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174 Allocation Methodology

- Direct costs (labor, materials, outsourced R&D, computer hosting)
- Costs incident to development or improvement of a “product”
  - Operating (rent, utilities, overhead)
  - Depreciation/amortization of property used to perform research
  - Patent-related expenses
  - Travel
- Allocation methods “reasonable & consistent”
  - Specific identification of costs incident to development
  - Qualified wages as percentage of total wages / (R&D headcount / total headcount)
  - R&D square footage as a percentage of total square footage

Allocation Methodologies

IRS Notice 23-63

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174 Allocation Methodology

- Notice 23-63
  - “cause-and-effect relationship between the costs and the SRE activities” or another relationship **that reasonably relates the costs to the benefits provided to the SRE activities**.
  - Apply the allocation method *for each type of cost* on a consistent basis
    - Example: labor costs may be treated as a percentage of time vs. depreciation/utilities may be calculated based on square footage.

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Notice 23-63 Example – Case Study

- **Departments Incident to Development**
  - **Research Department –** fully dedicated to the Specified Research Expenditure (SRE) activity.
  - **Engineering Department –** provides direct support services (20%) to the Research Department with respect to the research project by collaborating with the Research Department to develop the new product.
  - **Legal Department –** provides direct support services (10%) to the Research Department with respect to the research project by preparing patent applications for the new product.

- **Departments NOT Incident to Development**
  - **Accounting Department –** provides indirect support services to the Research Department by paying Research Department invoices & accounting for research costs but does not directly support any aspect of the research project.
  - **Manufacturing Department –** does not provide any support services to the Research Department.
  - **Personnel Department (HR) –** provides indirect support services to the Research Department by hiring research personnel & preparing their paychecks but does not directly support any aspect of the research project.

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Notice 23-63 Example – Case Study

Cost Type	Research	Engineering	Legal	SRE
% of Time Dedicate to SRE Activity	*100%*	*20%*	*10%*	
Depreciation on Facility*	20,000	20,000	20,000	26,000
Depreciation on Computers, Furniture, etc.	150,000	100,000	20,000	172,000
Materials and supplies	50,000	40,000	10,000	59,000
Labor costs	600,000	200,000	100,000	650,000
Electricity**	50,000	10,000	10,000	53,000
Other Utilities & Overhead*	10,000	10,000	10,000	13,000
Other Miscellaneous Overhead	50,000	50,000	50,000	65,000
Total Costs	930,000	430,000	220,000	1,038,000
Allocated SRE Costs	**930,000**	**86,000**	**22,000**	**1,038,000**

*Portion of depreciation / overhead attributable to each department based on square footage of department.

**Allocable costs identified based on kilowatt-hours used for each department

Practical Takeaways

1. How is the percentage of time dedicated to SRE activities determined?
2. How are depreciation percentages determined?
3. How are electricity allocations determined?

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Software Development
IRS Notice 23-63

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Software Development Activities per Notice 23-63

- **Includes** … only to *the point in time software is placed in service (IUS) or technological feasibility is established, & software is ready for sale*
  - Software development planning (including gathering requirements)
  - Designing the computer software
  - Building model of the software
  - Writing source code
  - Testing
  - Modifications to address defects

- **Excludes …**
  - Data conversion
  - Software installation (including configuration)
  - Training
  - Business reengineering
  - Maintenance (not upgrade or enhancement)
  - Data or information base
  - Distribution activities
  - Customer support

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Research Performed Under Contract
IRS Notice 23-63

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Research Performed Under Contract

- A service provider must capitalize its R&E costs incurred under contract with respect to an "SRE product" if the service provider either has rights to the research **or** financial risk (Notice 2023-63 Sec. 6)

1. **Financial risk** – risk that the research provider may suffer a financial loss related to the failure of the research
2. **Rights to the research** – ability to use or exploit the results of the research or any resulting SRE product in provider’s trade or business.
   - Law of Contracts
   - Law of Economics

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Notice 24-12

- Recognizes under 23-63, there is a potential interpretation to improperly capitalize if the research provider obtains an SRE product right that
  - (1) is separately bargained for (that is, an <u>SRE product right that arose from consideration other than the cost paid or incurred by the research provider to perform SRE activities under that contract</u>) or
  - (2) was acquired for the limited purpose of performing SRE activities under that contract or another contract with the research recipient.
- Notice 24-12 clarifies that if a research provider that does not bear financial risk under the terms of the contract with the research recipient obtains an "excluded SRE product right" <u>but does not obtain any other SRE product right under</u> the terms of such contract, then the costs are <u>not SRE expenditures</u>.

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Research Performed Under Contract Example – Transactions With Foreign Parent

Foreign Parent pays U.S. Sub to perform lab testing services to support foreign parent's R&D efforts. U.S. Sub makes no sales of products or services other than lab services to foreign parent.

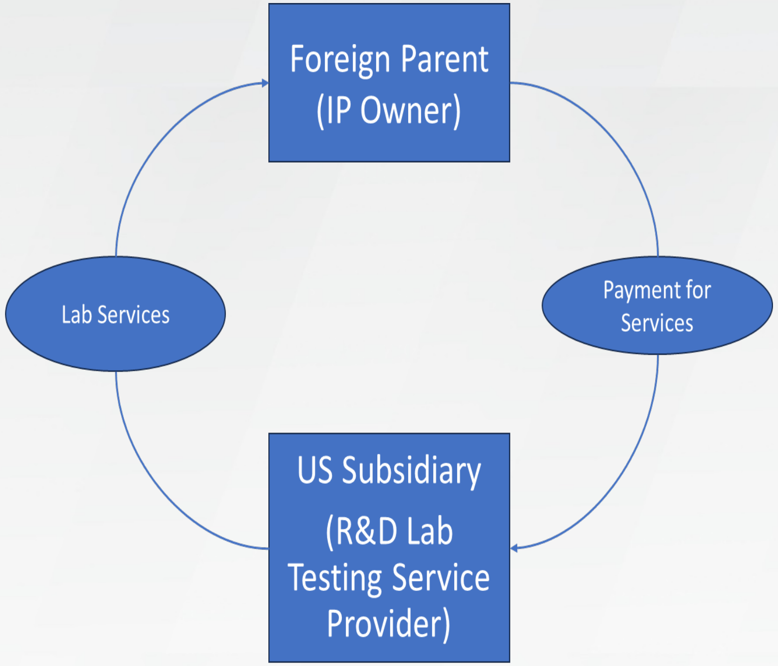
Issues: How does U.S. Sub account for costs incurred in providing lab services? How is U.S. R&D credit allocated between controlled group members?

Analysis: Taxpayers must analyze structure & economics of related-party arrangements to determine if the research is "in connection" with Taxpayer's trade or business.

Results

Section 174: U.S. Sub's cost to perform R&D services is not in connection with Foreign Parent's trade or business & therefore is not considered Specified Research Expenditures (SRE). Therefore, U.S. Sub would not capitalize these costs under Section 174. Foreign Parent would be required to capitalize these costs under Section 174 & amortize over 5 years since the R&E was performed domestically.

Section 41 Interplay: § 1.41-6(i)(1) all members of a controlled group are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.



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Dispositions, Retirement, or Abandonment of R&D Property
IRS Notice 23-63

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Disposition, Retirement, or Abandonment of R&D Property

1. **General Rules:** property related to SRE expenditures that is disposed of, retired, or abandoned during amortization period must continue to amortize such expenditures over original § 174 amortization period.

2. **Exceptions – Transaction in which corporation ceases to exist**.
    1. Transaction described in § 381(a). (Liquidations or reorganizations) – the acquiring corporation will continue to amortize the unamortized SRE expenditures over the remainder applicable § 174 amortization period beginning with the month of transfer.
    2. Transaction not described in § 381(a).
        1. (a) In general. the corporation is allowed a deduction equal to the unamortized SRE expenditures in its final taxable year.

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Example: Disposition, Retirement, or Abandonment of R&D Property

1. Sale of property with respect to which SRE expenditures were incurred.
   a) Facts
      i. X incurs $100,000 in SRE expenditures in 2023.
      ii. September 30, 2025, X sells SRE property to Y & recognizes gain under § 1001.
   b) Analysis.
      i. 2023, X amortizes $10,000 (10% × $100,000).
      ii. 2024, X amortizes $20,000 (20% × $100,000).
      iii. 2025–2028, X ratably amortizes the remaining $70,000 ($100,000 – $10,000 – $20,000) **notwithstanding Company X's disposition of the assets with respect to which Company X's SRE expenditures were incurred.**
         1. X does not factor its unamortized SRE expenditures into the computation of gain or loss under § 1001.
         2. Y does not amortize any portion of the SRE expenditures originally paid or incurred by Company X.

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Legislative Outlook

Legislative Outlook

- H.R. 7024, The Tax Relief for American Families & Workers Act of 2024
  - Passed 357 to 70 by HR on January 31, 2024
  - Retroactively defers Section 174 capitalization of domestic R&E until tax years beginning on or after 1/1/2026
  - Taxpayers can recapture unamortized basis of domestic R&E through a Section 481(a) adjustment (50% in 2023 and 50% in 2024)
  - Foreign R&E still required to be capitalized and amortized over a 15 year period

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Legislative Outlook

- Senate Reaction to H.R. 7024
  - Strong bipartisan vote in the House puts pressure on the Senate to act
  - Senate Democrats – generally supportive of bill but will likely seek amendments
  - Senate Republicans – expect amendments to CTC
- Potential Procedural Paths In the Senate
  - Once amended, Senate must devote time & resources given competing priorities to advance the bill
    - Consideration as a standalone bill possible but unlikely
    - Attaching amended bill to a moving legislative vehicle
- Hurdles
  - Impeachment of Department of Homeland Security Secretary Alejandro Mayorkas
  - Senate reconvened on 2/26, first order of business will be to conduct an impeachment trial
  - Deadline to deal with funding is March 1st (today)
  - If, by midnight tonight, the government fails to pass an appropriations agreement or a “continuing resolution” (CR) to continue funding the federal government, there will be a partial government shutdown.
  - Heard that Senate leadership set a tentative deadline of March 15th to either pass the bill (either on its own, or as part of a broader package), or to delay the bill indefinitely (meaning it would not become law in 2024).

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State Considerations

IRC Conformity

- Static “Fixed Date” Conformity States
- Rolling Conformity States
- Selective Conformity States

Decoupling States

- California
- Georgia
- Indiana
- Mississippi * (2023 & forward)
- New Hampshire
- New Jersey * (only on NJ QREs where credit was taken)
- Tennessee
- Texas
- Wisconsin

State Impact of Potential Retroactive Changes (Dependent on Passing of Federal Legislation)

- Consideration of IRC conformity provisions in each state will be critical
- How will states react?

Potential Constitutional Challenge

- *Kraft General Foods, Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992)
- Court held that Iowa's inclusion of only dividends from foreign subsidiaries (not domestic) in the state tax base discriminated against foreign commerce
- Could the same argument be made regarding IRC Sec. 174's differing capitalization periods between domestic & foreign SREs?
- What are best practices for taxpayers?

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R&D Credit Updates

What’s New in the R&D Tax Credit World?

- IRS Updates
  - Focused on business component documentation
  - Pre-screening bad claims
    - CCM & Form 6765 changes
  - Receiving additional resources to staff cases
- New cases on pilot models, substantiation, process of experimentation, & other issues

Burden of Proof Gets Heavier

Excerpt from Little Sandy Coal (7th Cir. 2023)

- "Taxpayer asks us to take on faith that the percentage allocations of each nonproduction employee's wages were only for research activities that involved a process of experimentation. But Section 41(d) requires us to walk by sight, not by faith. **Taxpayer has the burden to document that the activities accounted for by the nonproduction wages were elements of a process of experimentation**. The regulations do not require records in any particular form, except that they must be "in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." And the "substantially all" test allows for the fraction to be measured "on a cost or other consistently applied reasonable basis." So flexibility is built into the test. But shortcut estimates of experimentation-related activities will not suffice. **Something more, such as documentation of time spent on such activities, is necessary.**"

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Guidance to Taxpayers From Appeals Court

- "The lesson for taxpayers seeking to avail themselves of the research tax credit is to <u>adequately document that substantially all of such activities were research activities that constitute elements of a process of experimentation</u>. Generalized descriptions of uncertainty, assertions of novelty, and arbitrary estimates of time performing experimentation are not enough."

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** In countries where it allows for these services*

[1]Source: **IAB World Network rankings, based on most recent rankings**

Meet the Presenters

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Adam has over 14 years of experience serving publicly traded and closely held companies in the manufacturing, technology, government contracting, and construction industries. Adam's focus is on R&D Tax Services, and he leads the firm's R&D Tax Credits practice. Adam has extensive experience defending and successfully sustaining R&D tax credits through IRS and state audits.

He is a licensed CPA in South Carolina. He is a member of the American Institute of CPAs, North Carolina Association of Certified Public Accountants, and South Carolina Association of CPAs. He was one of Greenville Journal's "Best & Brightest Under 35." Adam is active in the community and currently serves on Board and Executive Committee of Pendleton Place. He was a United Way of Greenville County Loaned Executive and Corporate Solicitor. He has participated in Moore School of Business Young Alumni Board, PULSE, and Opportunity Greenville.

He is a frequent speaker on R&D tax topics, including the 2023 Tax Executive Institute Annual and Mid-Year Conferences, Morgan Lewis R&D Credit Symposiums, and other R&D tax technical presentations and leadership development courses.

He is a graduate of University of South Carolina, Columbia, with a B.S. degree in accounting and an M.Acc. degree.

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Meet the Presenters

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Jack is the leader of the State & Local Tax (SALT) service line and is based in the firm's Atlanta office. Jack has experience in numerous areas of state and local taxation including corporate income and franchise tax, sales and use tax, and unclaimed property. His experience includes apportionment planning, combined unitary reporting issues, nexus determinations, accounting for income taxes, taxability studies, audit representation, and amnesty/voluntary disclosure negotiations. Jack has served clients in a variety of industries including insurance, healthcare, financial services, manufacturing, retail, and technology.

Prior to joining the firm, he spent several years in both the federal and state & local tax groups of a regional accounting firm. Before Jack began his career in public accounting, he worked in business operations for an information technology firm.
Jack is a member of the American Institute of CPAs, GSCPA, and Institute for Professionals in Taxation®.

He is a graduate of University of Georgia, Athens, and a graduate of Mercer University, Macon, Georgia, with an M.B.A. degree.

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FORVIS National R&D Tax Team

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Audit Defense Specialists – Our Audit Defense Specialists will formulate the methodology to maximize credit sustainability.

Legal Specialists – R&D Tax Credit professionals with a legal background will review your contracts & investigate any funded research.

Project Managers – All throughout the project, Project Managers will ensure a minimally invasive & timely process.

Engineers – Our engineers know the right questions to ask your engineers; facilitate a smooth process to build the R&D story & connect the dots.

CPAs – CPAs in our team will conduct all the credit calculations.

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Questions?

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