Preparing for the Required Capitalization of Research & Development Costs: A Practical Perspective

August 31, 2022

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Meet the Presenters

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Objectives

- Awareness of the new requirement to capitalize Section 174 research & development costs & interplay with the research credit
- Understand the wide-ranging implications of the capitalization requirement for our clients
- Learn practical strategies to model & evaluate potential impact

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Agenda

- Headlines & overview
- Defining R&E costs
- Overview of Section 174 changes & interplay with R&D credit
- Process to measure
- Modeling & planning considerations
- Tax accounting method implications
- Areas of uncertainty
- Ways FORVIS can help
- Legislative outlook
- FAQs

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Headlines

- What changed?
  - Taxpayers now required to capitalize & amortize Section 174 research & development costs
- Who does this change impact?
  - All U.S. taxpayers, regardless of size & industry, who perform research & development activities
- When are these changes applicable?
  - These rules are now effective for tax years beginning on or after January 1, 2022
  - Businesses need to address these issues now
- Why are these changes significant?
  - Taxpayers no longer have a choice & must capitalize all Section 174 research & development costs
  - Taxpayers will need to evaluate the impacts to estimated tax payments & quarterly tax provision calculations

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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
- "*<u>Incident</u>* 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 R&D *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
- G&A related to taxpayer's business (accounting, finance, HR, legal)

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Section 174 – What Has Changed Post-TCJA?

	Prior to 2022	Future (for tax years starting after 1/1/22)
R&E Expenditures	• **May** deduct as incurred, under 174(a) OR • Elect to capitalize & amortize over 60 months after being PIS, under 174(b) OR • Elect to amortize R&E expenditures over 10 years under 59(e)	**Shall** be amortized over 5 years.
Foreign Research	Same treatment	Amortize over 15 years for foreign research
Recovery of costs	Write-off when abandoned/disposed	TP cannot recover costs of disposed/abandoned R&D earlier than end of the required amortization period
Amortization Convention	Amortization begins with the month that the TP realizes benefit from expenditures	**Mid-year** in which the specified R&D expenditure is paid or incurred
Software Development	Utilized 2000-50 to expense immediately, OR Amortize for: - 5 years starting when development is completed, or - 36 months from date software is placed in service	Specifically included in definition of 174 expenditure, therefore must be capitalized

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Interplay Between Section 174 & 41

IRC Code Sections → **Section 174 (Tax Treatment)**

IRC Code Sections → **Section 41 (Research Credit)**

- Section 174 governs the definition of research & experimentation ("R&E") expenditures & governs the tax accounting treatment
- Section 41 allows taxpayers to claim a credit for certain expenditures related to research & development performed in the United States
- R&D credit eligible expenditures are a subset of Section 174 eligible expenditures
  - To qualify for the R&D Credit (Section 41), expenditures must meet the definition of Section 174 & only certain Section 174 costs are eligible for R&D Credit

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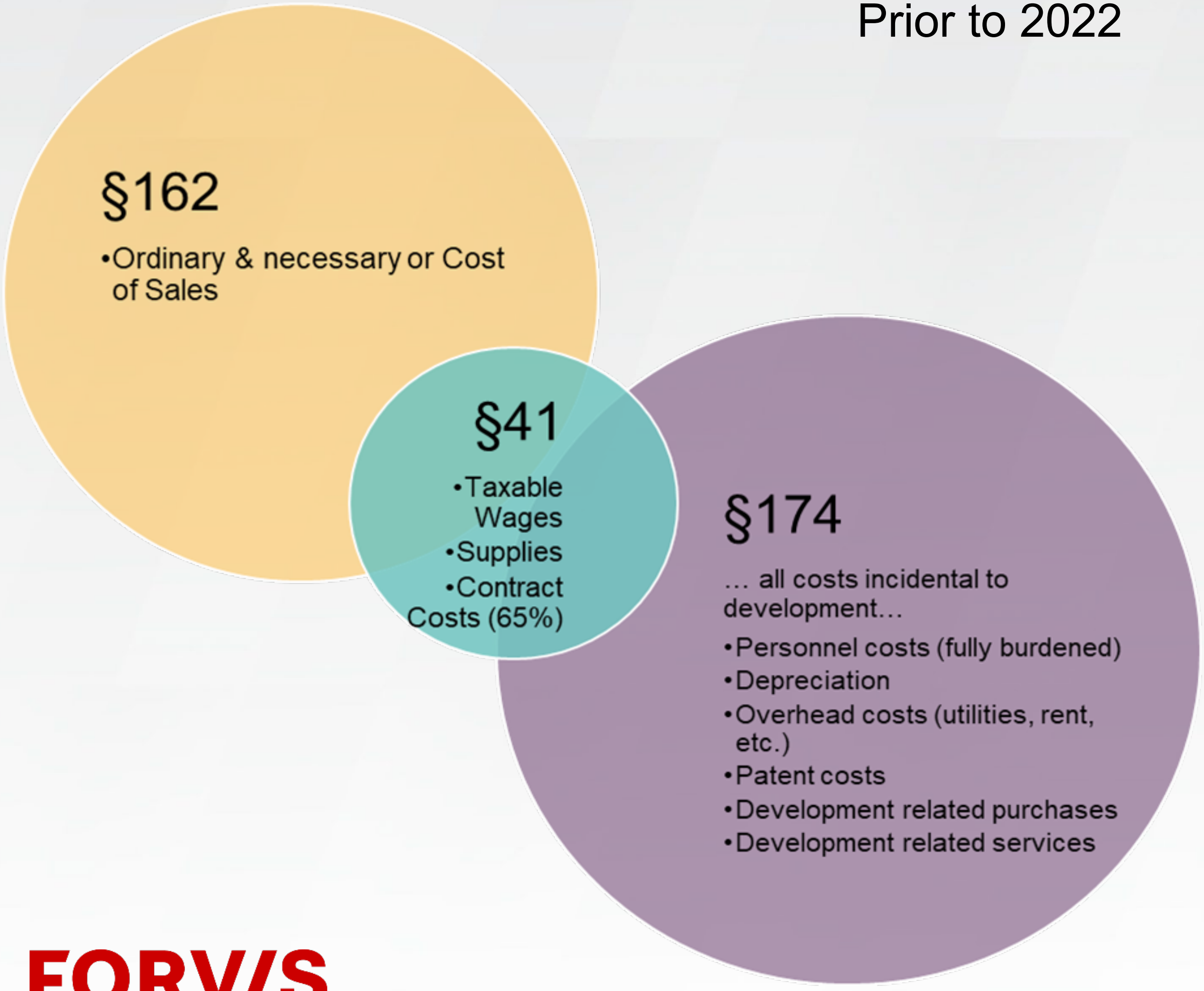
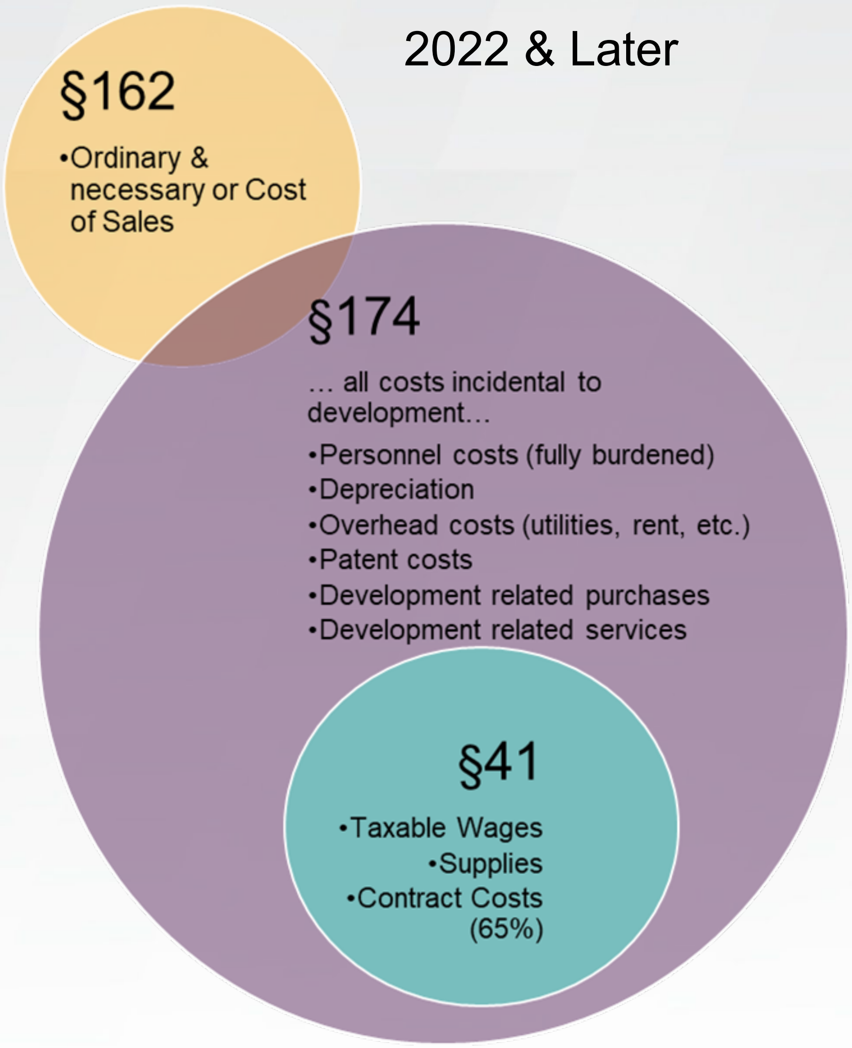
Interplay Between Section 174 & 41

Prior to 2022



2022 & Later



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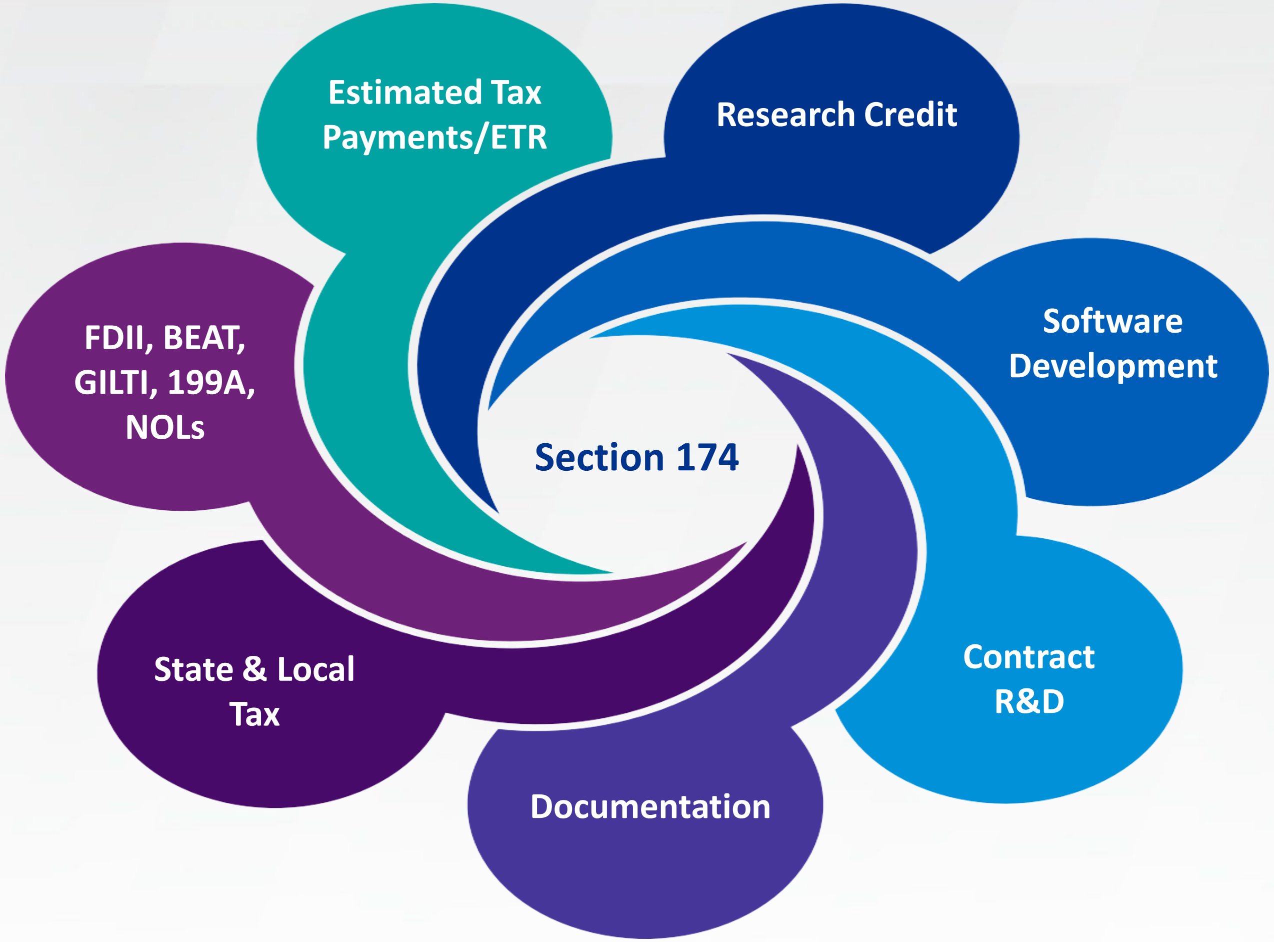
Modeling & Planning Considerations – A Holistic View



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Prioritizing Next Steps

01 **ESTIMATE 174 COSTS**
(PERFORM ANALYSIS TO QUANTIFY RANGE OF POTENTIAL 174 COSTS)

02 **MODEL FINANCIAL STATEMENT IMPACT (QUARTERLY & YEAR END) – (INCLUDING RESIDUAL TAX IMPACT ON ETR)**

03 **MODEL ESTIMATED TAX PAYMENT IMPACT OR OVERALL TAX LIABILITY IMPACT IF ELIGIBLE FOR SAFE HARBOR**

04 **CONSIDER IMPLEMENTATION CONSIDERATIONS AND OPERATIONS IMPACT**

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Example – Estimating Section 174 Costs
Starting with Financial Statement R&D

$20M		$15M		$30M		$5M		$70M
F/S "Core" R&D & Engineering Department Expenses	+	Section 41 QREs	+	Overhead/ Incidental Allocation	+	Software Development Expenses	=	Sec. 174 Expenses
				Most likely to be unknown				3.5x F/S R&D Expenses

- ASC730 (GAAP R&D) does not rely on the "uncertainty" standard when defining book R&D expenses
- Procedures to quantify Section 174 expenses would be largely focused on identifying a methodology for the allocation of overhead/incidental expenses.

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Example – Process to Evaluate Section 174 Costs
Starting with Section 41 Research Credit Costs

Wage Expenses + Contract Research + Costs associated with NQ Section 41 projects + Overhead/ Incidental Allocation + F/S Costs & Non-U.S. = Sec. 174 Expenses

Costs associated with NQ Section 41 projects: Most likely to be unknown

Overhead/ Incidental Allocation: Most likely to be unknown

- Costs included for Section 174 purposes include those associated with projects that both qualify for the Section 41 research credit & potentially those that do not
- Tax departments will need to look beyond project ledgers to identify additional indirect costs

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Key Modeling & Planning

- Taxable income, estimated tax payments, financial statement effective tax rate, DTA
- Impacts to “R&E” allocation/apportionment for FDII & FTC
- Interaction/coordination with BEAT & GILTI
- Impact on 163(j) interest limitation & 199A deduction
- NOL position, carryforward attributes, valuation allowances

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Business Planning Considerations

- **Evaluate the types of costs treated as Section 174**
- Evaluate Section 174 cost pool to determine which may not meet the uncertainty criteria
    - All software development costs by default Section 174 costs
    - Non-Section 174 costs will not be eligible for the credit
    - Non-Section 174 costs related to production activities may need to be capitalized to inventory & recovered as COGS
    - Consistency in identification of Section 174 vs. non-Section 174 costs & domestic vs. foreign for similar activities

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Business Planning Considerations

- **Consider Modifications to Third-Party Contract Terms**

- Require contractors to identify the location of resources performing contract research
    - Clear identification of location of resources utilized useful in tracking domestic vs. foreign expenditures

- Revising contracts to reflect asset acquisition rather than research & development
    - Contract language: Instead of developing software on behalf of, business is now acquiring already developed software
    - Must not bear risk of development

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Business Planning Considerations

- **Consider On-Shoring Development**
- Relocation of foreign R&D to U.S. to shorten amortization period
    - Consider broader business ramifications
- Given time to implement, longer-term strategy as costs will still not be immediately recovered
- If research performed by related foreign party, onshoring R&D could potentially reduce BEAT
- Carefully evaluate where R&D is being performed
    - Example: Company producing prototype components in China, but prototype is built & tested in U.S.

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Current Accounting Method Change Guidance

- Complying with §174 capitalization is an accounting method change
- Rev. Proc. 2022-14, Sec. 7.01 – R&D Costs
  - Does not apply to
    - Costs incurred post-12/31/2021
    - Software

Currently, must file Advance Consent to change methods to comply with §174 capitalization

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Anticipated Accounting Method Change Guidance

- IRS has said they will issue
  - Procedural guidance before year-end
    - Automatic method changes
    - Will be cut-off method changes
  - Substantive issues

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Additional Guidance Needed
Examples

- Funded Research/Contract R&D
    - How are R&D costs treated when contractor performs R&D services for a client & contractor not at risk & retains no IP rights?
- Definition of Section 174 expenses – “Incident to” the development or improvement of a product
    - How wide of a net to cast?
    - Further delineation of “direct” & “indirect” costs along with examples of “incident to”
- Technology/Software
    - New rules state all expenses associated with the development of software shall be treated as R&D expenditures
        - Eliminate uncertainty requirement under Section 174 regulations?
        - Simple software development, *e.g.,* simple script writing, or software installation required to be capitalized?
    - Interaction & application to Revenue Procedure 2000-50

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Additional Guidance Needed
Examples (Cont.)

- UNICAP – How should R&D capitalization be treated? Section 263A provides that UNICAP rules do not apply to amounts “allowable as a deduction” under Section 174. Is Section 174 amortization a production cost subject to UNICAP or does the Section 263A exclusion apply to the “deduction” for amortization?
- IRS LB&I ASC 730 Directive
    - Inconsistency between costs captured under ASC 730 & those subject to LB&I “safe harbor” directive

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Legislative Update – The Elusive "Technical Fix"

- Broad bipartisan support for permanent fix or deferral
  - Challenge is finding the right vehicle
  - Number of failed potential vehicles – American Rescue Plan (2021), American Innovation & R&D Competitiveness Act (2021), American Innovation & Jobs Act (2021), America Competes Act/U.S. Innovation & Competition Act (2021/2022), Chips & Science Act (2022), Inflation Reduction Act (2022)

- Current Consensus: Tax extenders bill likely post-midterm elections in December during lame duck session that will reverse mandatory capitalization at least temporarily
  - Tax departments will be dealing with changes to provision calculations & increased estimated payments for the remainder of the year

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How the FORVIS 174 Team Can Help Clients

- FORVIS has multi-functional teams to assist clients with analyzing the federal, state, & international tax impact of these new requirements, as well as helping manage cash taxes

- Develop process & methodology to identify, quantify, & track full depth & breadth of Section 174 activities & expenditures
  - Leveraging financial statement R&D
  - Leveraging Section 41 R&D credit studies

- Model the impact on taxable income & estimated tax payments for current & future years

- Model financial statement impact (DTA) & residual tax rate impact (FTC, GILTI, BEAT, 163(j), NOLs, carryforward attribute usage, valuation allowances)

- Evaluate state tax conformity & state cash tax impact

- Model the interplay & overlap with Section 41 research credit

- Review contracts with non-U.S. providers, recategorize costs between 15-year & 5-year amortization periods

- Prepare Form 3115, Application for Change in Method of Accounting (cut-off basis)

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FAQ: What impact will the Section 174 changes have on the Section 41 credit?

- The changes to the recovery period for R&D expenses under Section 174 do not directly impact the Section 41 credit other than any expenses that are factored into the Section 41 credit must now be treated as Section 174 costs
- The TCJA made a conforming amendment to Section 41 to make certain the research credit will continue to be available for qualifying Section 174 expenses, even if they are capitalized, provided the other three parts of the four-part test for qualified research are met

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FAQ: How are software development costs defined?

- Revised Section 174 states that research & development expenditures include “any amount paid or incurred in connection with the development of any software”
- Currently, there has been no additional guidance provided on how software development costs will be defined. However, given current language, as well as how software development costs are defined under Revenue Procedure 2000-50, it is anticipated the definition will be fairly broad
- Treasury could potentially define software development costs in a narrower way, if it believes this is consistent with Congressional intent for including software development costs in the revised statute

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FAQ: Should taxpayers consider purchasing software rather than building internally?

- Taxpayers that develop software internally whether the software is used internally or sold, lease or license will need to capitalize & amortize over 5- or 15-years any expenses paid or incurred in connection with the development of the software
- Purchased software is amortizable over 36 months pursuant to Section 167(f)(1) & is eligible for bonus depreciation, which is currently scheduled to begin phasing down in 2023

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FAQ: Will this Section 174 change have an impact on other TCJA provisions?

A few of the TCJA provisions that may be impacted by the change to Section 174 may include

- Section 163(j): The creation of additional taxable income increases the interest expense limitation amount & may reduce the amount of interest expense that is Section 163(j) limited in a given year
- Section 59A (Base Erosion & Anti-Abuse Tax, BEAT): The capitalization of Section 174 expenses will increase taxable income & amounts capitalized under Section 174 & recovered through amortization are not subject to BEAT
- Section 250 (Global intangible low-taxed income, GILTI): The capitalization of foreign R&D over 15 years will result in increased tested income
- Section 250 (Foreign-derived intangible income, FDII): Consider modeling the impact to the overall FDII deduction as certain fact patterns could create increased FDII benefit due to Section 174 expenses being apportioned over gross receipts

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FAQ: How will this impact U.S. businesses with CFCs?

- Controlled foreign corporation (CFCs) incurring expenses for R&D, software development, or performing contract R&D may have to capitalize & amortize such costs over 15 years if performed outside the U.S.
- Potential mismatch between contractor income & expenses
- Foreign tax credit limitations could change for CFC owners
- The difference between Section 162 ordinary & necessary business expenses & Section 174 expenses may impact foreign tax credit allocation & apportionment under Reg. Section 1.861-17

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Knowledge Share Resources

- Article: *Mandatory Capitalization of R&E Costs – Are You Ready?*
  - https://www.forvis.com/alert-article/2022/02/mandatory-capitalization-re-costs-are-you-ready
- Article: *All Taxpayers Must Revisit the Tax Treatment of Research & Experimental Expenditures*
  - https://www.forvis.com/article/2022/06/all-taxpayers-must-revisit-tax-treatment-research-and-experimental-expenditures

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Thank You!

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Appendix – Additional Resources

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FAQ: Should I continue to make the Section 280C election?

- Under Section 280C, the research credit determined for the tax year reduces otherwise allowable Section 174 expenditures, unless an election is made to reduce the credit ("reduced credit election") by the applicable tax rate (currently 21%) rather than reducing Section 174 expenses

- The TCJA made a confirming amendment to Section 280C that makes 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

- State tax consequences must be considered

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FAQ: Will I need to file a Form 3115 for the 2022 tax year?

- The TCJA specifies that the amendments to Section 174 shall be treated as a change in method of accounting initiated by the taxpayer & made with the consent of the IRS, implemented on a cut-off basis
- It is anticipated this will be done via an automatic method changed filed on Form 3115
- We are awaiting further procedural guidance from the IRS

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Comparison – Section 174 vs. 41 Activities

Examples of Activities	Allowed Under Section 174	Allowed Under Section 41
Discovery of technological information	Yes	Yes
Discovery of non-technological information	Yes	No
Testing for appropriateness of design	Yes	Yes
Routine testing or quality control inspection	No	No
Research after commercial production	Yes	No – with some exceptions
Research activity that is not new to the taxpayer	Yes	No
Research that is otherwise commercially available	Yes	No
Research related to style, taste, cosmetic factors	Yes	No
Patent (Perfecting, Filing)	Yes	No – with some exceptions

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Comparison – Section 174 vs. 41 Activities (Cont.)

Examples of Activities	Allowed Under Section 174	Allowed Under Section 41
Patent technical research	Yes	No – with some exceptions
Internal-use software that is no highly innovative	Yes	Maybe
Internal-use software that is highly innovative	Yes	Yes
Adaptation of an existing product	Yes	No
Reverse engineering	Yes	No
Routine data collection	Maybe	No
Foreign research	Yes	No
Direct Support	Yes	Yes
Funded research pursuant to contract	Yes (except turn-key contracts)	No

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Comparison – Section 174 vs. 41 Activities (Cont.)

Examples of Activities	Allowed Under Section 174	Allowed Under Section 41
Payments to third-party for direct support of research	Yes	Yes @ 65%
Efficiency surveys	No	No
Management studies	No	No
Consumer surveys	No	No
Acquisition of another's patent	No	No
Advertising and promotions	No	No
Contract research performed prior to the start of trade or business	Yes, if connected to business	No
Research related to social sciences	Yes	No
Literary and historical research	No	No

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Comparison – Section 174 vs. 41 Expense Types

Type of Expense	Allowed Under Section 174	Allowed Under Section 41
W-2 wages	Yes	Yes
W-2 wages sub-all (>80% time performing qualified services	No	Yes
Non-taxable employee benefits	Yes	No
Supplies used in research	Yes	Yes
Contract research	Yes (100%)	Yes (65)
Land	No	No
Improvements to land	No	No
Construction of property subject to depreciation	Yes – If certain requirements met	No
Design and development of pilot models	Yes	Yes

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