

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

SECTION 174

PROPOSED REGULATIONS

- Critical issues
 - Software– how to distinguish between “upgrade or enhancement” and bug fixes and maintenance (Section 5 of Notice 20263)
 - “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.”
 - “U pgrades and enhancements” are defined as “modifications to existing computer software that
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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 2023-023
 - 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.”

PROPOSED REGULATIONS

- Critical issues
 - Treatment of costs incurred by parties in a contract research services arrangement (Section 6 of Notice 2023-063; Notice 2023-12)
 - 174(d) Issues

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, RP 202311, RP 20249, RP 202423, RP 202434
- 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
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NOTICE 2024-12

- Notice 2024-12 relaxes the reliance rules in Notice 2023 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 (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 2001 for software development costs incurred in tax years beginning after December 31, 2021

SECTION 41

Form 6765 Changes- Procedural Issues- Exam Trends

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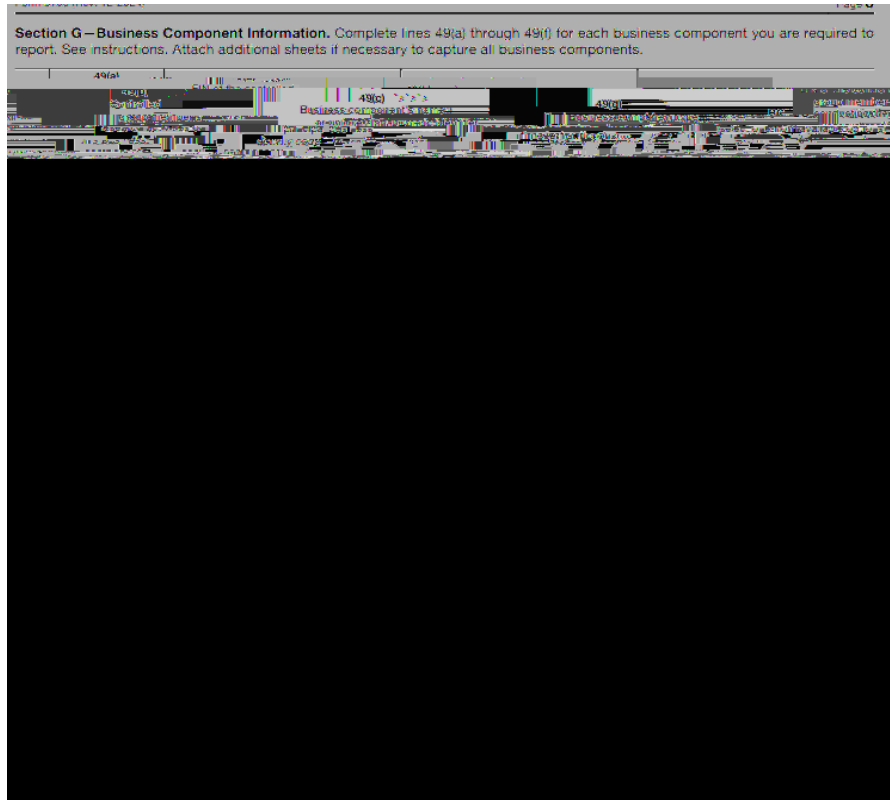
WHY IS THE FORM 6765 CHANGING?

- 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 predefined format to improve information received for 1603.9(p)-et1603.5
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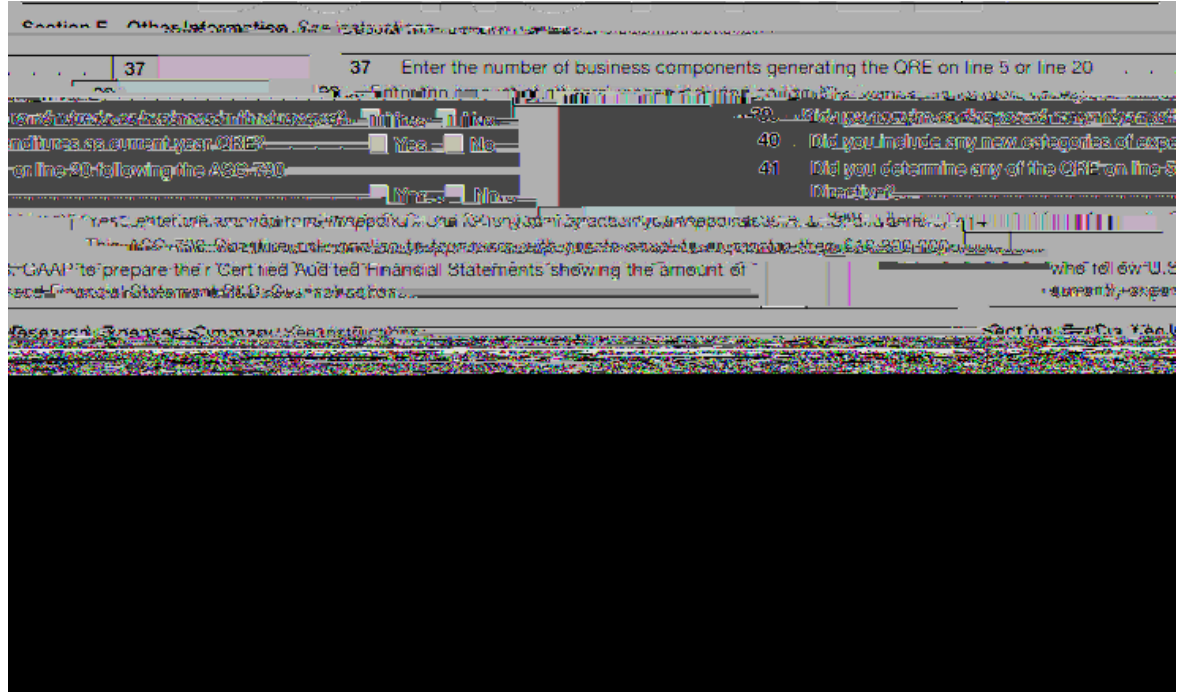
UPDATED DRAFT FORM 6765

- Initial draft Form 6765 was released in September 2023, including the addition of 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 yeard.
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UPDATED DRAFT FORM 6765- SECTION G



UPDATED
DRAFT
FORM 6765



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

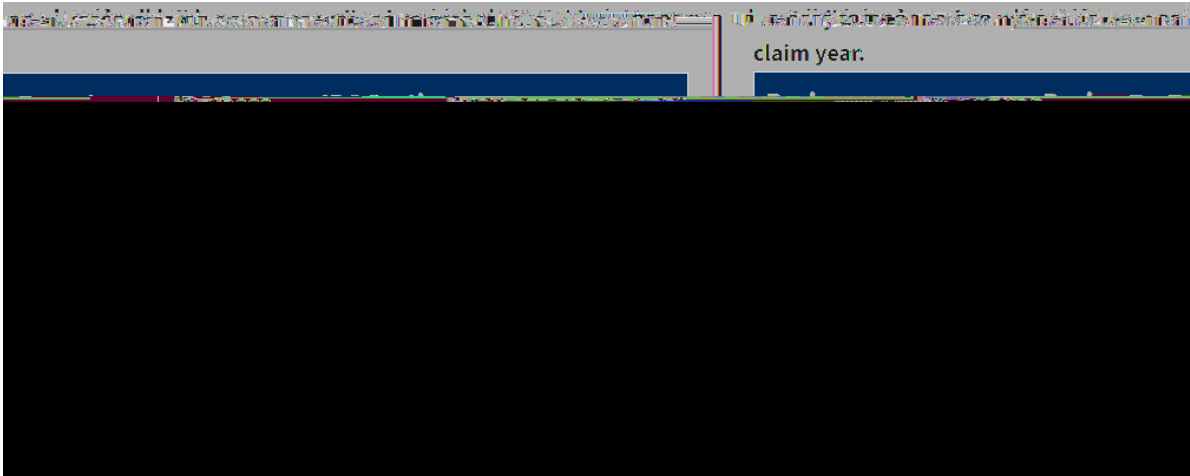
- No guidance for taxpayers using statistical sampling to determine QREs
- No guidance for determining whether a taxpayer acquired or disposed of a major portion of a trade or business
- No guidance for determining whether a taxpayer has a “new category” of expenses included in QREs
- No clarity regarding 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 12, 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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SECTION 280C ELECTION/REVOCAATION

- 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

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
 - 18(m)19(ec)225
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IDR TRENDS

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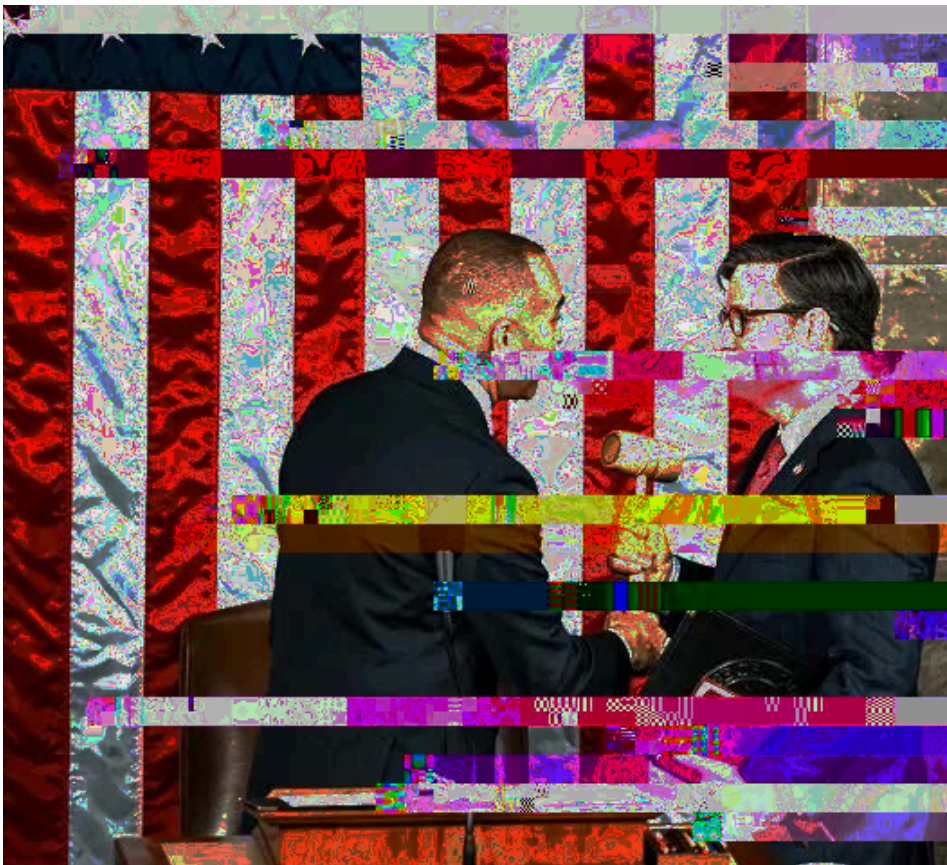


INSIGHTS FROM WASHINGTON: OUTLOOK FOR FEDERAL R&D TAX LEGISLATION

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: 357-0
 - August 2024: Republican Senators filibustered
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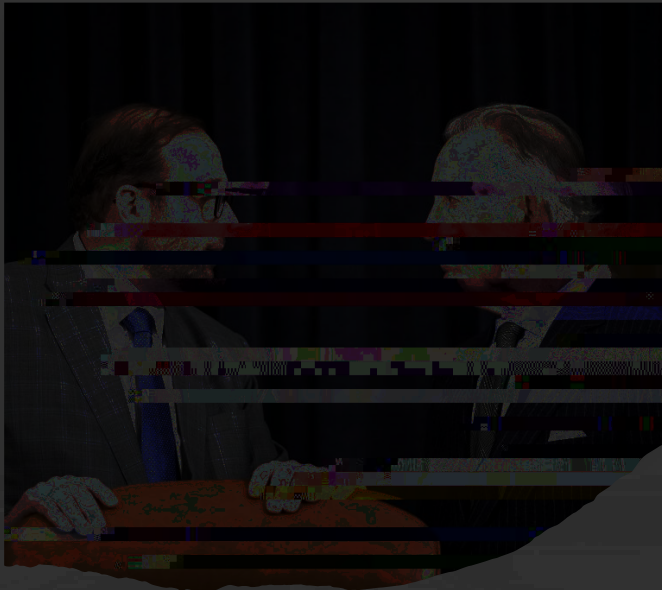
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H.R. 7024, TAX RELIEF FOR AMERICAN FAMILIES AND WORKERS ACT OF 2024

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

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
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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	-82.7	-19.8	15.1	30.3	23.9	15.8	7.4	1.5	--	--	-8.5

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 Billion

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QUESTION PRESENTED

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

Assume:

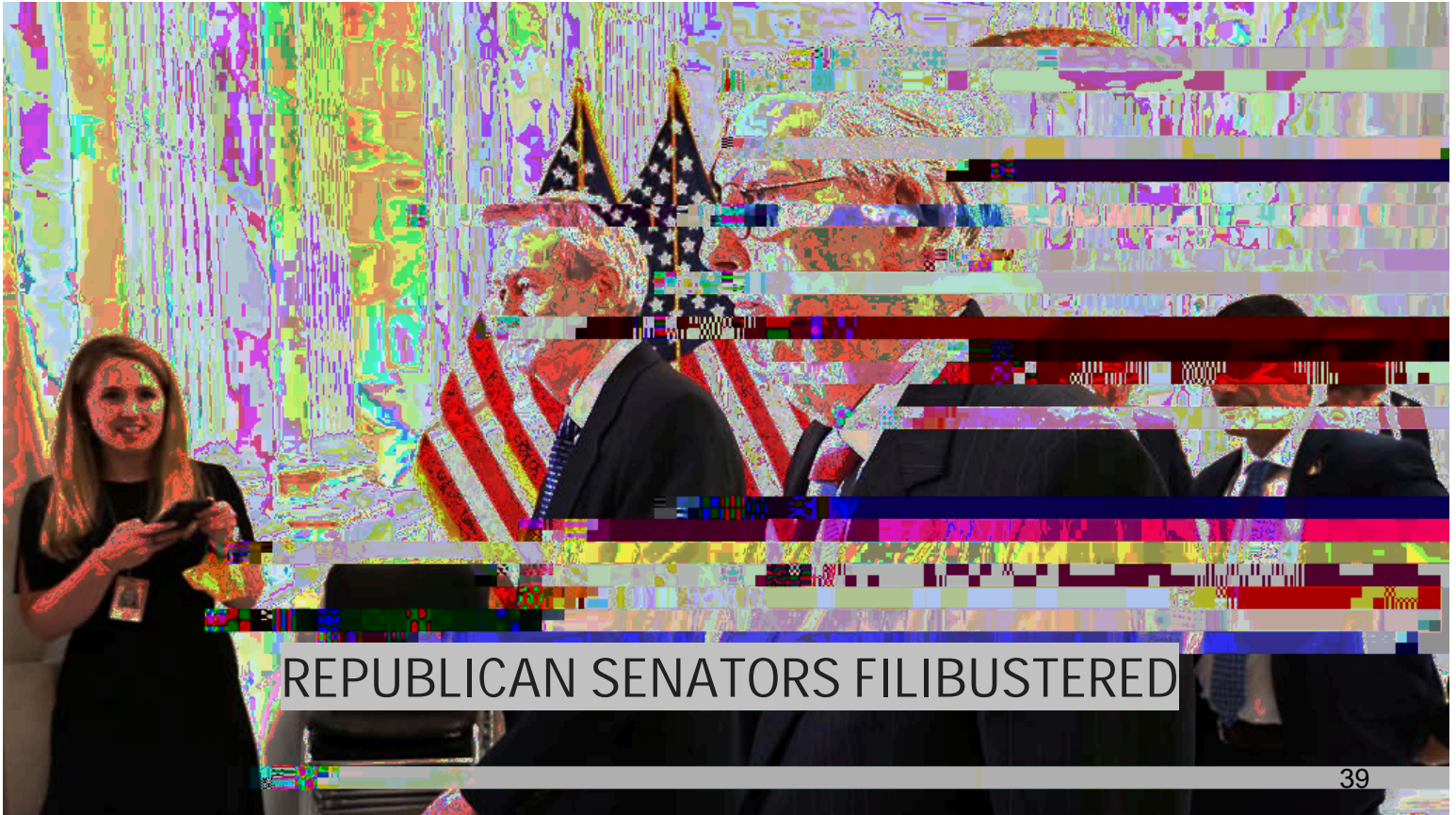
- Four-year domestic only 174 expensing restoration: \$8.5 B
- Permanent Section 280C(c) haircut restoration: \$40+ B

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 tradeoff is worth it
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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?

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?

FILIBUSTER & RECONCILIATION



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?

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)