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TCJA Changes to R&E Related Code Sections Kick In

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INTRODUCTION

When large portions of the §174[1] regulations were finalized in 1994 in T.D. 8562,[2] it was noted that ''Congress enacted section 174 not only to encourage research, but also to avoid the difficult tax accounting questions that would arise regarding research expenditures in the absence of special tax accounting rules.''[3] The historically taxpayer-friendly treatment of research and experimentation (R&E) costs, and other incentives like the §41 research and development (R&D) tax credit, has fostered the development of countless new and improved products and manufacturing processes in the United States.

The Tax Cuts and Jobs Act (TCJA)[4] signed into law on December 22, 2017, represented the culmination of a lengthy process in pursuit of business tax reform that had played out over the course of more than 20 years. The bill passed through a legislative process known as ''reconciliation,'' which allows spending or revenue bills to pass with a simple majority in the Senate if they do not increase the federal budget deficit outside a 10-year budget window. To offset the impact of provisions that decreased estimated revenues, other provisions were included in the bill to increase estimated revenues. One such provision mandated the amortization of R&E expenditures for tax years beginning after December 31, 2021. Prior to this, tax law allowed R&E expenditures to be deducted as incurred.

There was optimism that mandatory amortization of R&E expenditures would be either postponed or fully repealed before the December 31, 2021 deadline, and accordingly that taxpayers would be able to continue to deduct R&E expenditures as incurred for tax years beginning in 2022 and beyond. In fact, such a provision has been included in each version of the Build Back Better Act (BBBA), including the version passed by the House.[5] However, as the BBBA's future remains uncertain, this article highlights issues taxpayers must consider now that the scheduled changes to the treatment of R&E expenditures have taken effect beginning January 1, 2022.

SECTION 174 RESEARCH AND EXPERIMENTAL EXPENDITURES

The TCJA provides that specified R&E expenditures under §174 paid or incurred in tax years **beginning after December 31, 2021,** must be capitalized and amortized ratably over five years for research conducted in the United States, and 15 years for re-

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] 59 Fed. Reg. 50,159–50,161 (Oct. 3, 1994).

[3] *See* H. Rep. No. 83-1337, 83d Cong., 2d Sess. (1954).

[4] Pub. L No. 115-97, 131 Stat. 2054 (2017).

[5] *See* H.R. 5376, 117th Cong. (passed House Nov. 19, 2021).

search conducted outside of the United States,[6] beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

Under §174(d) as revised, ''If any property with respect to which specified research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment and such amortization deduction shall continue with respect to such expenditures.''

The application of this rule is treated as a change in the taxpayer's method of accounting initiated by the taxpayer and made with the consent of the Secretary of the Treasury. This rule is applied on a cutoff basis to specified R&E expenditures paid or incurred in tax years beginning after December 31, 2021 (thus there is no adjustment under §481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2022). Whether or not taxpayers will need to file Form 3115, *Application for Change in Accounting Method*, is unclear at this time.

Reg. §1.174-2 provides a general definition of R&E expenditures, and it does not appear that this definition would change under the new law, except that software development will now be explicitly treated as specified research. As described in current Reg. §1.174-2(a), §174 expenditures are costs:

> . . . incurred in connection with[7] the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

The IRS had a long-standing rule of administrative convenience that permitted taxpayers to treat the costs of developing software in a manner similar to §174 expenses, whether or not the particular software was patented or copyrighted or otherwise met the requirements of §174.[8]

Rev. Proc. 2000-50 also provided an alternative method of amortizing software development costs over 36 months from the placed in-service date of the software under §167(f)(1). The TCJA effectively terminates both this rule of convenience and this alternative amortization method for software development expenses otherwise eligible for deduction under Rev. Proc. 2000-50, and now requires capitalization of these software development expenses over at least five years from the date of completion of development activities.

GUIDANCE FROM THE IRS AND TREASURY IS IN PROGRESS

The Treasury/IRS Priority Guidance Plan (often referred to as the ''Business Plan'') for 2021–2022 includes as item 17 under the General Tax Issues category ''Guidance addressing amortization of research and experimental expenditures under §174.'' This reference indicates that guidance responsive to the aforementioned statutory changes is in progress.

CONFORMING AMENDMENTS TO §41 AND §280C

The TCJA also made conforming amendments to §41 and §280C that take effect for tax years beginning after December 31, 2021.

Changes to §41(d)(1)(A) by the TCJA

After the changes made by TCJA, §41(d)(1)(A) provides that:

[6] For this purpose, the term ''United States'' includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

[7] In contrast to the §174 ''in connection with'' standard, §41(a) requires that qualified research expenses be incurred ''in carrying on'' any trade or business of the taxpayer (with an exception for in-house research expenses incurred with the principal purpose of using the research results in the future conduct of an active trade or business of the taxpayer or an affiliate, see §41(b)(4)).

[8] *See* Rev. Proc. 2000-50, and its predecessor, Rev. Proc. 69-21.

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§41(d)(1) In General — The term ''qualified research'' means research—

(A) with respect to which expenditures **may be treated as specified research or experimental expenditures under section 174**, [emphasis added]

(3) Controlled Groups — Paragraph (3) of subsection (b) shall apply for purposes of this subsection.

Changes to §280C(c) by the TCJA

After the changes made by the TCJA, §280C(c) provides that:

(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.

(2) Election of reduced credit.

(A) In General — In the case of any taxable year for which an election is made under this paragraph—

(i) paragraph (1) shall not apply, and

(ii) the amount of the credit under section 41(a) shall be the amount determined under subparagraph (B).

(B) Amount Of Reduced Credit — The amount of credit determined under this subparagraph for any taxable year shall be the amount equal to the excess of—

(i) the amount of credit determined under section 41(a) without regard to this paragraph, over

(ii) the product of—

(I) the amount described in clause (i), and

(II) the maximum rate of tax under section 11(b).

(C) Election.— An election under this paragraph for any taxable year shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on such return, and shall be made in such manner as the Secretary may prescribe. Such an election, once made, shall be irrevocable.

Section 280C as amended by the TCJA removed previous references in old §280C(b)(2) to a ''Similar rule where taxpayer capitalizes rather than deduct expenses.'' This change is appropriate because after the changes to §174 by the TCJA, the only permissible method of treating R&E costs is capitalization and amortization (over five years if the activities are conducted in the United States or over 15 years if the activities are conducted outside the United States or its possessions or Puerto Rico).

Will Taxpayers Benefit From a Reduced Credit Election After the TCJA Changes?

Whether or not to make a §280C(c)(2) election to claim a reduced rate of credit in lieu of a reduction in deductions is often a complex decision when a taxpayer considers its total tax position, factoring in U.S. federal taxes, foreign taxes, and state and local taxes. From the perspective of domestic regular income taxes, many taxpayers might decide not to make an election for a reduced rate of credit because §280C(c)(1) by its terms might not apply.

For example, if for 2022 a taxpayer is a calendar year taxpayer, has only U.S.-based qualifying R&D activities, uses the traditional/regular research credit calculation method, and has a base amount pursuant to §41(c)(2) of 50% of the current credit determination year qualified research expenses (QREs), then the resulting gross research credit without a §280C(c) election would be 10% of the total current year QREs.

The taxpayer's §174 deduction related to these costs would be 10% of the current credit determination year QREs (100%/5 = 20% and applying the midpoint rule = 10%) and the amount of the credit determined under §41(a)(1) (which mathematically is 10% of current credit determination year QREs) will not exceed the amount allowable as a deduction for such QREs (which is also mathematically 10% of current credit determination year QREs). In this instance §280C(c)(1) does not apply.

If §280C(c)(1) does apply, taxpayers that have traditionally elected the reduced credit because the reduced credit minimized total tax liability for the current year may find that because of mandatory capitalization, the full credit now provides a lower total tax liability for the current year (but may increase tax liability in future years).

ESTIMATED TAX AND FINANCIAL STATEMENT CONSIDERATIONS

With the potential for larger tax bills for taxable years beginning after December 31, 2021, many tax-

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payers have questions related to their required estimated tax payments for the year. Section 6655 imposes a penalty on the underpayment of estimated tax and to avoid such a penalty a taxpayer must make four timely payments, each equal to 25% of the required annual payment. For calendar year corporations, these quarterly payments are due on April 15, June 15, September 15, and December 15.

To meet their estimated tax payment obligations and avoid penalty under §6655, the required annual payment can be determined using one of three[9] available methods: (1) based on 100% of the tax shown on the return for the taxable year, (2) using the annualization method, or (3) based on 100% of the tax shown on the preceding year's tax return. Option one is virtually impossible to precisely calculate at the time the estimated payments are due as the actual tax liability will most likely not be accurately determined until after year-end. Option three is only available for large corporations for the first required installment.[10]

Many companies elect to utilize the annualization method to compute the estimated tax payments as this method can generally provide taxpayers with certainty that they will not be subject to penalty as the calculation is based on facts known at the end of the annualization period. Taxpayers that use the annualization method should include Form 2220, *Underpayment of Estimated Tax by Corporations*, with their tax return to establish that the required quarterly payments were made.

Taxpayers should work with their tax advisors to evaluate potential increases to the required installment payments under the annualization method. As part of this process, taxpayers are reminded that §174 is broader than the §41 R&D credit both qualitatively (e.g., because foreign R&E is also a §174 cost), and quantitatively (e.g., W-2 wages versus burdened salary as well as 65% versus 100% of contract research), and that there are potential ''ripple effects'' of changes to §174 amounts (e.g., ability to utilize foreign tax credits, etc.). Taxpayers should also consider how these changes affect the income tax provision on their financial statements, as current tax law must be used to calculate the current tax provision.

LEGISLATIVE OUTLOOK

The outlook for a possible deferral of the TCJA changes as part of the proposed ''Build Back Better Act'' (BBBA) or other legislation remains uncertain as of the date of this article.

CONCLUSION

The authors remain cautiously optimistic that either a retroactive delay in the effective dates of these TCJA changes, or an outright repeal, may be passed by Congress and enacted into law in the near future. In the meantime, absent a legislative change, these TCJA changes need to be factored into estimated tax payments, tax returns, and financial statements for tax years beginning after December 31, 2021.

[9] The adjusted seasonal installment method is also available, but this method is not commonly used.

[10] A large corporation is generally one that had $1 million or more of taxable income in any of the three preceding tax years. In addition, if a taxpayer elects to use last year's tax liability to calculate the first annual installment, any reduction will be recaptured by increasing the amount of the next required installment by the amount of such reduction.

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