
TAX
IN MOTION

The latest on section 174: What you need to know now

Thursday, Nov. 9, 2023

With you today

Kate Abdoo

Principal
RSM US LLP

David Hudson

Senior Director
RSM US LLP

Nick Gruidl

Partner
RSM US LLP

Agenda

- Old and new section 174 rules
- Overview of Notice 2023-63
- Impact of Notice 2023-63 on contract research
- Impact of Notice 2023-63 on dispositions and other taxpayer transactions
- Impact of Notice 2023-63 on long-term contracts
- Proposed regulations and additional procedural guidance

Learning objectives

By the end of this presentation, participants will be able to:

1. Identify how and when the Notice may be relied upon
2. Evaluate the impact of the Notice on the identification of R&E expenditures
3. Assess the impact of relying on the Notice for 2023 when inconsistent methodologies were used for the 2022 tax return

Section 174: Overview

- Prior rules (costs paid/incurred in tax years beginning before 2022)
  - Flexibility to choose between deducting or capitalizing/amortizing research and experimental (R&E) costs
  - Flexibility to determine treatment of software development costs
- New rules (costs paid/incurred in tax years beginning in 2022)
  - Requires capitalization and amortization of specified research and experimental costs
    - Five years for domestic R&E costs (half-year convention)
    - 15 years for foreign R&E costs (half-year convention)
    - Activity-based determination
  - Includes software development costs
  - Limits on recovering unamortized costs upon disposition

New section 174 rules: impact on 2022 returns

- Accounting method change for 2022 returns
  - Rev. Proc. 2023-11
  - Statement in lieu of Form 3115
- Required taxpayers to identify specified R&E expenditures
  - Presumption that specified R&E costs are the same costs that would have qualified under prior rules
  - Taxpayers may not have distinguished between section 162 and section 174 costs in the past
- Many unanswered questions
  - Extent of indirect costs and scope of wage costs
  - How to account for short periods
  - Contract research
  - Impact of taxpayer transactions

New section 174 rules: finally, some guidance!

Notice 2023-63

- Released on Sept. 8, 2023
- Notice of intent to issue proposed regulations under section 174
- Provides interim guidance that may be relied on prior to issuance of proposed regulations
  - If taxpayers choose to rely on the notice, they must apply all provisions (can't cherry-pick)
- Includes areas where IRS is seeking additional comments

Applicable section 174 amortization period

- Domestic research = 60 months
- Foreign research = 180 months
- Treatment of short taxable years
  - Based on the number of months in the short period
  - If a short period includes a partial month, the entire month is included in that period
    - Include in first short period
    - Cannot include same month in two periods
- Short taxable year as the first year
  - Midpoint is the first day of the midpoint month
  - Even number of months
  - Odd number of months

New section 174 rules: Notice 2023-63

Scope of specified R&E expenditures (SREs)

- Labor costs
- Materials and supplies
- Cost recovery allowances
- Patent costs
- Certain operation and management costs
- Travel costs

Allocation of costs

- Must allocate on the basis of a cause-and-effect relationship between the cost and the benefits provided to the SRE activities
- Must be consistent for each type of cost
- Examples: time-based allocation or square footage allocation

New section 174 rules: Notice 2023-63

Excludable costs

- G&A service costs
- Interest on debt to finance SRE activities
- Costs to input content into a website
- Website hosting costs
- Costs to register an internet domain name or trademark
- Costs listed in Treas. Reg. section 1.174-2(a)(6)(i)-(vii)
- Amortization of SRE expenditures
- Amortization of R&E costs paid/incurred in tax years beginning before 2022

Notice 2023-63: software development costs

Software development includes a computer program, a group of programs, and upgrades and enhancements

Upgrades or enhancements: modifications to existing computer software that result in additional functionality or materially increase speed or efficiency of the software

- No definition of material increase
- Look to tangible property regulations for guidance?

Notice 2023-63: software development costs

Includible costs

- Planning the development of computer software (or upgrades or enhancements to computer software)
- Design costs
- Costs to build a model
- Writing source code and converting it to machine-readable code
- Testing costs and related modification costs, but only up until the point of time that:
  - The software is placed in service (if developed for use by the taxpayer in its trade or business); or
  - Technological feasibility has been established, product masters have been produced and the software is ready for sale or licensing to others (if developed for sale or licensing to others)
- Production of product masters (if developed for sale or licensing to others)

Notice 2023-63: software development costs

Excludable costs

- Software developed by a taxpayer for use in its trade or business
  - Training
  - Maintenance activities
  - Data conversion activities
  - Installation and other costs to place the software in service
- Software developed for sale or licensing to others
  - Activities that occur after the software is ready for sale or licensing to others

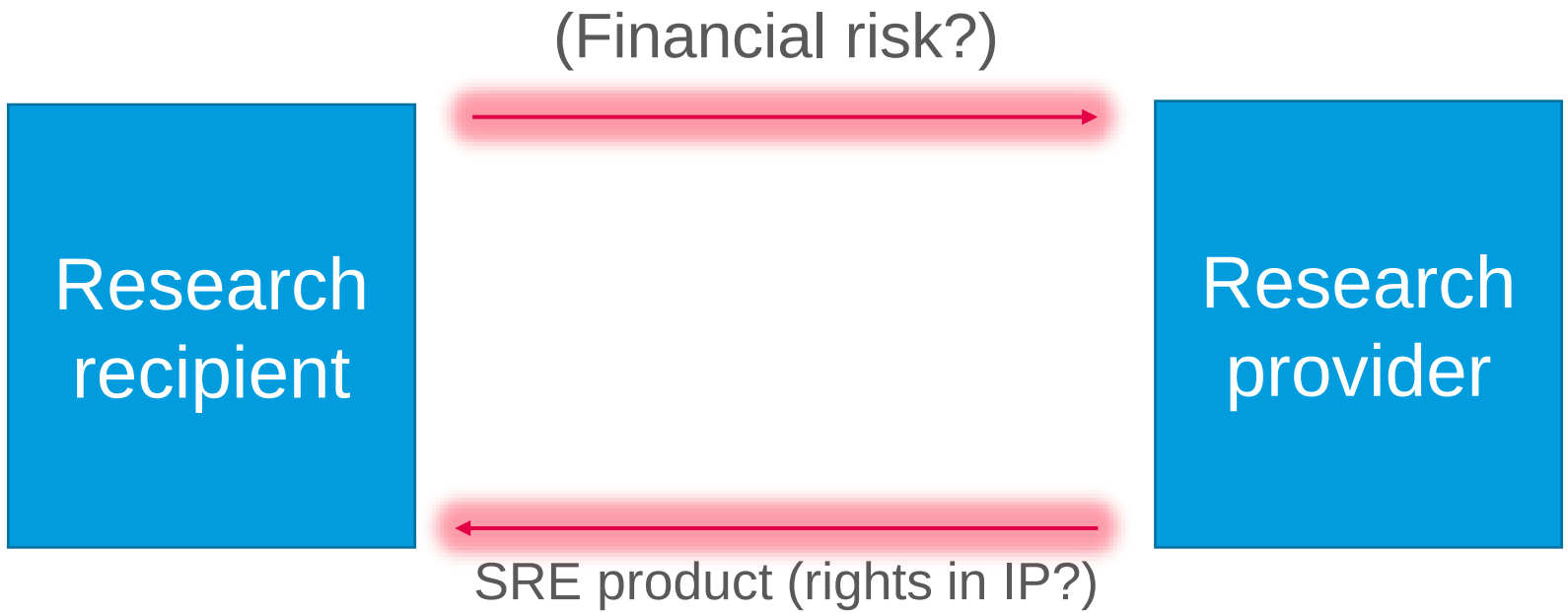
Notice 2023-63: contract research

Section 6 of the Notice

- The Notice provides that the treatment of costs paid or incurred by the research recipient is governed by the principles set forth in Treas. Reg. section 1.174-2, which basically says that section 174 applies not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another.
- **So, who must capitalize their costs when two parties are involved in a contract research arrangement?**

Notice 2023-63: contract research

Section 6 of the Notice looks to “risk” and “rights” under the contract.



Notice 2023-63: contract research

Section 6.04 of the Notice

- If the research provider bears financial risk under the terms of the contract with the research recipient, then costs paid or incurred by the research provider that are incident to the SRE activities performed by the research provider under the contract are SRE expenditures.
- In this case, under the Treasury regulations, the research recipient's costs are likely treated as a payment for the results of the research that would be subject to section 263(a).

Notice 2023-63: contract research

Section 6 of the Notice

- What is financial risk?
- It is determined by looking to which party will bear the financial burden for unsuccessful research.
- Taxpayer must look to the terms of the contract that govern when payments must be made, for example, payments terms, requirements, milestones, warranties, limitations of liability, etc.

Notice 2023-63: contract research

Section 6 of the Notice

- Be aware that financial risk may be shared or “shifted” within a single contract.
- For example, milestone payments may be nonrefundable and tied to events that are not success based, or limitations of liability may limit what amount a research provider is at risk for.
- Thus, one party may be at risk for a portion of the contract payments and another party may be at risk for another portion.

Notice 2023-63: contract research

Section 6 of the Notice

- Generally, a contract in which the research recipient reimburses the research provider's costs regardless of the success of the research places the risk on the research recipient.
- But that is not the end of the analysis . . .

Notice 2023-63: contract research

Section 6.04 of the Notice

Even if the research provider does not bear financial risk under the terms of the contract, if the research provider has a right to use any resulting SRE product in its trade or business or otherwise exploit any resulting SRE product through sale, lease or license, then costs paid or incurred by the research provider that are incident to the SRE activities performed by the research provider under the contract are SRE expenditures of the research provider, **regardless of whether the research recipient is required to treat its costs as SRE expenditures**.

Notice 2023-63: contract research

Section 6 of the Notice

- The term “SRE product” means any pilot model, process, formula, invention, technique, patent, computer software or similar property (or a component thereof) that is subject to protection under applicable domestic or foreign law.
- Mere know-how gained by a research provider through the performance of research services that is not subject to protection under applicable domestic or foreign law does not give rise to an SRE product in the hands of the research provider.

Notice 2023-63: contract research

Section 6.04 of the Notice

A research provider will not be treated as having a right to use the SRE product in the trade or business of the research provider or otherwise exploit the SRE product through sale, lease or license if such right is available to the research provider only upon obtaining approval from another party to the research arrangement that is not related to the research provider within the meaning of section 267 or section 707.

Notice 2023-63: contract research

Section 6.04 of the Notice

- Section 174 does not apply to a research provider that does not bear the financial risk for the research or retain any protectable rights in the research results.
  - In that case, the research recipient's costs are subject to section 174. The research provider's costs are effectively treated as the costs of providing services.
- Section 174 does apply to a research provider that does not bear the financial risk for the research, but does retain a right to use or otherwise exploit any resulting SRE product through sale, lease, or license.
  - In that case, the both parties' costs are subject to section 174.

Notice 2023-63: contract research

Section 41 research credit—research provider

The research credit has “funding” rules to ensure that not more than one party to a contract may claim a research credit for the costs incurred to perform the research.

Section 1.41-4A(d)(1) provides that research does not constitute qualified research to the extent it is funded by any grant, contract or otherwise by another person, but amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see Treas. Reg. section 1.41–2(e)(2) related to contract research expenses) are not treated as funding.

Notice 2023-63: contract research

Section 41 research credit—research recipient

An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that:

- (i) Is entered into prior to the performance of the qualified research,
- (ii) Provides that research be performed on behalf of the taxpayer, and
- (iii) Requires the taxpayer to bear the expense even if the research is not successful.

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. **The previous sentence applies only to that portion of a payment which is contingent on the success of the research.**

Notice 2023-63: contract research

Section 41 research credit

Thus, the rules under section 41 apply **similar** principles to Notice 2023-63 to determine which party to a contract bears risk.

But the section 41 rules contemplate only one party being able to claim the research credit for any one dollar of cost.

Treasury Regulation section 1.41-4A(d)(2) provides that if a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenses.

Notice 2023-63: contract research

Section 41 and section 174 comparison

Thus, sections 174 and 41 can result in seemingly disparate results!

Compare the following examples.

The extent of the rights retained by the research provider may affect the analysis.

Notice 2023-63: contract research

Section 41 and section 174 comparison

Example 1: Research provider does not bear the financial risk for the research, but does retain a right to use or otherwise exploit the SRE product.

Research provider's costs are subject to section 174, but are not eligible for section 41

Research recipient's costs are subject to section 174, and are eligible for section 41

Notice 2023-63: contract research

Section 41 and section 174 comparison

Example 2: Research provider does not bear the financial risk for the research and does not retain rights to use or otherwise exploit the SRE product.

Research provider's costs not subject to section 174 or eligible under section 41

Research recipient's costs subject to section 174 and are eligible under section 41

Notice 2023-63: contract research

Section 41 and section 174 comparison

Example 3: Research provider bears the financial risk for the research and retains a right to use or otherwise exploit the SRE product.

Research provider's costs are subject section 174 and eligible under section 41

Research recipient's costs are not subject to section 174, and are not eligible under section 41

Notice 2023-63: contract research

Section 41 and section 174 comparison

Example #4: Research provider bears the financial risk for the research, but does not retain a right to use or otherwise exploit the SRE product.

Research provider's costs are subject to section 174, but are not eligible under section 41

Research recipient's costs are not subject to section 174, and are not eligible under section 41, i.e., neither party can claim the research credit for these costs

Notice 2023-63: Section 208C

- Notice 2023-63 does not address the impact of section 280C. However, the notice does ask for comments related to:
  - Section 280C(c)(1)(B) and the definition of “amount allowable as a deduction”

- Section 280C(c)—section 174 and section 41
  - Prior to 2022, section 280C(c) **required** an adjustment to either a taxpayer’s research credit or its section 174 deductions, to eliminate the “double benefit” of getting both a deduction and tax credit for the same expenditure.
  - Historically, most taxpayers elected the reduced credit election under section 280C(c) to preserve the section 174 deductions for state income tax purposes.
  - The Tax Cuts and Jobs Act changes to section 280C(c) that came into effect in 2022 will likely change the election most taxpayers will want to make under section 280C(c), such that they will be able to claim their full research credit and their full section 174 amortization deduction each year.

- We will see what Congress does in the future . . .

Section 174: M&A considerations

- Section 174(d) denies a write-off of unamortized section 174 costs prior to the expiration of the five-year or 15-year period
- M&A-related issues occur on both the buy and sell side of transactions where the target has unamortized section 174 costs
- Notice 2023-63 answers a few questions but not many
- How broad should we read the notice and apply the statute?
  - Could be read so broad as to assume section 174(d) turns off section 165
  - IRS chose not to address any partially taxable transactions or transactions involving transfers to and from partnerships
  - Who was the primary audience of the notice? Seems like the biggest companies in the world with billions in section 174 costs.

Notice 2023-63: what did the IRS answer?

- No write-off as a result of a section 381 transaction
- Write-off in a section 331 liquidation
  - Including a target in a section 338(h)(10)
- Seller of assets does not sell the costs nor is simply a sale of assets enough to trigger a write-off
- Transferor in a section 351 transfer does not transfer the costs
- Buyer does not amortize any of seller or transferor's costs

Notice 2023-63: what did the IRS leave unanswered?

- **No guidance on transfers to and from partnerships**
  - This includes many partially taxable transactions that make up the majority of private equity fund M&A that we advise on
- **Guidance is not clear on whether a disposition of all assets is sufficient to generate a write-off**
  - Notice is not explicit in the asset sale example
  - Sale of all assets by a corporation but no liquidation under section 331
- **Treatment in a sale of partnership interests**
  - No clear guidance but notice supports position that no value allocated to the property when determining section 751 recapture
- **Section 382: no guidance on section 174 amortization as a recognized built-in loss**

Notice 2023-63: long-term contracts under section 460

- Section 460 generally requires long-term contracts to be accounted for using the percentage of completion method (PCM)
  - Revenue is recognized as allocable contract costs are incurred
  - Allocable contract costs are deducted as incurred
  - Allocable contract costs may include section 174 costs
- IRS's historical position is that the full amount of costs are included in the numerator of the PCM calculation in the year the costs are incurred
  - Results in an acceleration of revenue without corresponding deduction of costs
- Notice 2023-63 provides that only the amortization of SRE expenditures is included in the numerator
  - Taxpayer-favorable
  - Results in matching of revenue and expenses, in line with intent behind section 460
- Open question: what portion of the SRE expenditures should be included in the denominator?

Section 174: proposed regulations and additional procedural guidance

- Status of proposed regulations
  - Anticipated to apply to taxable years ending after Sept. 8, 2023
  - Likely won't be issued until early 2024
- Additional procedural guidance
  - May be issued before the end of 2023
  - Issues that need to be addressed include:
    - Impact to taxpayers that are deviating from 2022 treatment
      - Retroactive change?
    - Prior five-year method change scope limitation
    - Audit protection for prior-year treatment
    - Impact on section 460 long-term contract methods

With you today

Kate Abdoo

Principal
RSM US LLP

Kate.Abdoo@rsmus.com

David Hudson

Senior Director
RSM US LLP

David.Hudson@rsmus.com

Nick Gruidl

Partner
RSM US LLP

Nick.Gruidl@rsmus.com

THANK YOU FOR YOUR TIME AND ATTENTION

RSM

RSM US LLP

+1 800 274 3978

rsmus.com

RSM Canada LLP

+1 855 420 8473

rsmcanada.com

Appendix

Notice 2023-63: request for comments

- Comments requested on all provisions of the Notice
- Specific items not addressed in the Notice but for which IRS requests comments include:
  - Scope of section 174:
    - Whether additional guidance is needed regarding identifying expenditures allocable to SRE activities and allocating such expenditures to SRE activities.
    - Whether simplified methods or safe harbors should be provided for identifying expenditures allocable to SRE activities and allocating such expenditures to SRE activities. If so, what methods or safe harbors should be provided? Are special methods needed for government research contracts?
  - Software development
    - The definition of computer software is based on section 2 of Rev. Proc. 2000-50 and Treas. Reg. section 1.197-2(c)(4)(iv). Is there a more appropriate definition under the Financial Accounting Standards Board Accounting Standards Codifications (ASCs) or an appropriate industry standard that should be used instead? If so, what ASC or industry standard definition should be used? Additionally, to what extent should ASC guidance or an appropriate industry standard be used to determine activities that are software development activities, and costs that are software development costs, for purposes of section 174
    - What examples of costs that are, or are not, software development costs would be helpful to include in the forthcoming proposed regulations?
    - Are special rules and examples needed to determine what activities related to developing a website would be software development?

Notice 2023-63: request for comments

- Specific items not addressed in the Notice but for which IRS requests comments include:
  - Research performed under contract
    - Should the rules for determining whether a party to a research contract has SRE expenditures under section 174 be similar to the funded research rules under section 41(d)(4)(H)?
    - Are special rules needed for service or manufacturing production contracts with the government, including section 460 long-term contracts?
    - Are there other factors that should be considered in determining whether a party to a research contract has SRE expenditures?
    - Are special rules or safe harbors needed to determine if research performed under a contract is foreign research (for example, where a research recipient pays the research provider for research that is performed by the research provider both inside and outside the U.S.)?
    - Are special rules needed for contracts with related foreign research providers and recipients?

Notice 2023-63: request for comments

- Specific items not addressed in the Notice but for which IRS requests comments include:
  - Disposition, retirement or abandonment of property
    - What, if any, changes to the rules in section 7 of this notice are appropriate to address potential abuses?
  - Long-term contracts under section 460
    - In the case of SRE expenditures allocable to long-term contracts accounted for under the PCM set forth in section 460, do estimated total allocable contract costs include all SRE expenditures that directly benefit or are incurred by reason of the performance of the long-term contract or, alternatively, only that portion of the SRE expenditures expected to be amortized during the term of the contract? Under the first alternative, a taxpayer would be required to report any remaining portion of the contract price not previously reported by the tax year following the tax year in which the contract is completed, notwithstanding that some portion of the SRE expenditures remain unamortized.

Notice 2023-63: request for comments

- Specific items not addressed in the Notice but for which IRS requests comments include:
  - Other issues
    - Whether general requirements governing record retention under Treas. Reg. section 1.6001-1 are adequate for purposes of substantiating expenditures under section 174.
    - Whether the definition of a pilot model under Treas. Reg. section 1.174-2(a)(4) should be amended
    - Whether and how section 59(e) applies to section 174 expenditures.
    - Under what circumstances should unamortized SRE expenditures continue to be amortized or accelerated with respect to property that is contributed to, distributed from, or transferred from a partnership?
    - Under what circumstances should unamortized SRE expenditures continue to be amortized or accelerated with respect to property of a partnership that is a party to a merger, consolidation, division, or liquidation, or that otherwise terminates under section 708 and the regulations thereunder? Is there potential for abuse as a result of allowing a deduction for unamortized SRE expenditures in the final year of a partnership that liquidates or otherwise terminates? If so, what rules are appropriate to address such abuse?
    - Should special rules apply to start-up companies or small taxpayers? If so, how should section 174 be applied in such cases?

Notice 2023-63: request for comments

- Specific items not addressed in the Notice but for which IRS requests comments include:
  - Other issues
    - Sections 280C(c)(1)(B) and 56(b)(2)(A) each refer to an "amount allowable as a deduction" for qualified research expenses or basic research expenses (in the case of section 280C(c)(1)(B)), and section 174(a) (in the case of section 56(b)(2)(A)). On the one hand, section 174(a)(1) (as amended by the TCJA) does not allow a deduction for qualified research expenses or basic research expenses because such expenses are required to be charged to capital account. On the other hand, section 174(a)(2) allows an amortization deduction with respect to the capitalized amount of such expenses. Should the "amount allowable as a deduction" references in sections 280C(c)(1)(B) and 56(b)(2)(A) be interpreted to refer to the amortization deduction allowed under section 174(a)(2) or to $0, which is the deduction allowed for the qualified research expenses or basis research expenses under section 174(a)(1)? The Treasury Department and IRS request comments on this interpretation and how to resolve any potential issues that might arise by applying the same interpretation to both sections 280C(c)(1)(B) and 56(b)(2)(A).