

CCH® AnswerConnect

Virtual **Coffee Talk**

A discussion of the latest tax updates

Unpacking the Latest Section 174 Guidance

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Sept. 28, 2023



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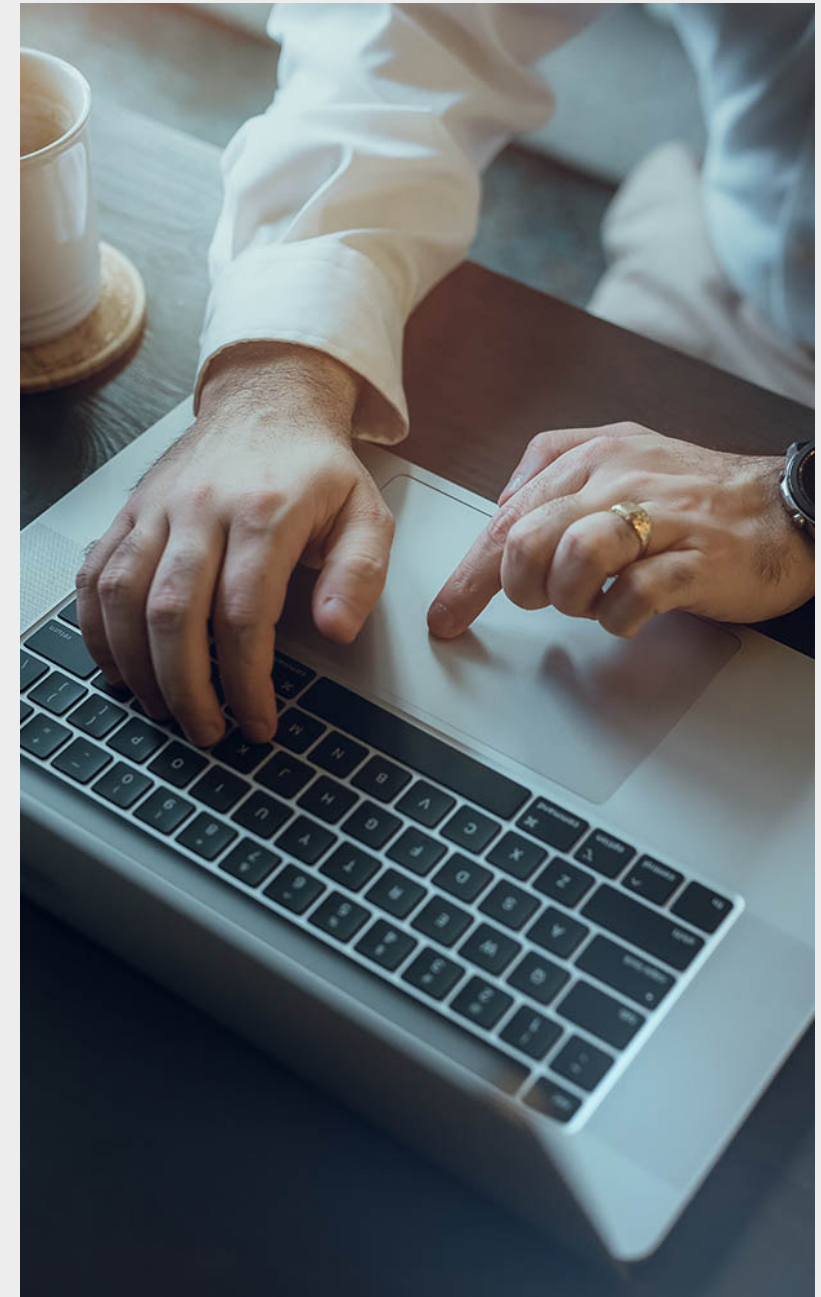
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Today's speakers



Kevin M. Jacobs
Managing Director
Alvarez & Marsal Tax, LLC



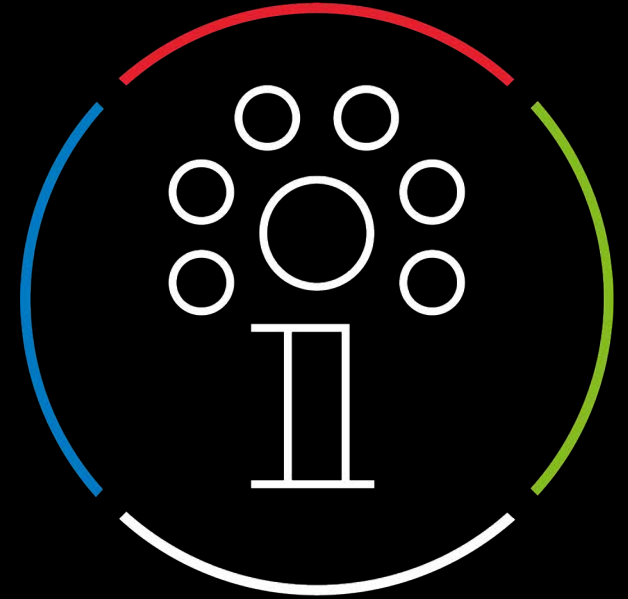
Kathleen King
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Kevin DeYoung
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Agenda

- Recap of Section 174 Guidance
- Identifying and Calculating SRE Expenditures
- Clarification on Software Development Activities
- Research Performed Under Contract
- Other Clarifying Provisions and Next Steps
- Additional Information in CCH[®] AnswerConnect



Recap of Section 174 Guidance



Overview of Section 174 Changes and Guidance



- This revenue raiser from the TCJA requires research and experimentation (“R&E”) expenditures to be capitalized and amortized.
- Notice 2023-63 was published on September 8, 2023 to provide interim guidance on key issues arising from the changes.
- The guidance also introduced several new terms and definitions that will likely generate more questions.
- The interplay between Section 41 and Section 174 has increased but it is uncertainty whether these changes will ultimately impact research credit determinations.

Effective Dates and Forthcoming Guidance



- Taxpayers may choose to rely on the notice prior to the publication of the forthcoming regulations provided the taxpayer relies on all rules in sections 3 through 9 of the notice.
- The notice specifically references expected changes to the following provisions that are impacted by the Section 174 changes —
 - Section 460
 - Section 482
- Comments should be submitted by November 24, 2023.

Introduction of New Terms



- SRED Product / SRED Expenditures / SRED Activities
- Foreign Research
- Upgrades and Enhancements (related to software)
- Research Provider
- Research Recipient
- Financial Risk
- "Subject to protection under applicable domestic or foreign law"

Polling question #1

Do you need to make significant changes to your workpapers with the new section 174 guidance?

- A. Yes, my prior interpretations do not match the latest guidance
- B. No, my current method is generally within the scope of the guidance provided
- C. Not sure, we did not have time to analyze and implement the IRS guidance on the current return



Identifying and Calculating Section 174 Expenditures



Notice Applies Section 174 Expense Continuum

The notice provides a non-exhaustive list of included expenses



Low Likelihood



High Likelihood



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Production/
Operations

Sales and
Marketing

General and
Admin

Direct
Material and
Facility Costs
for R&D

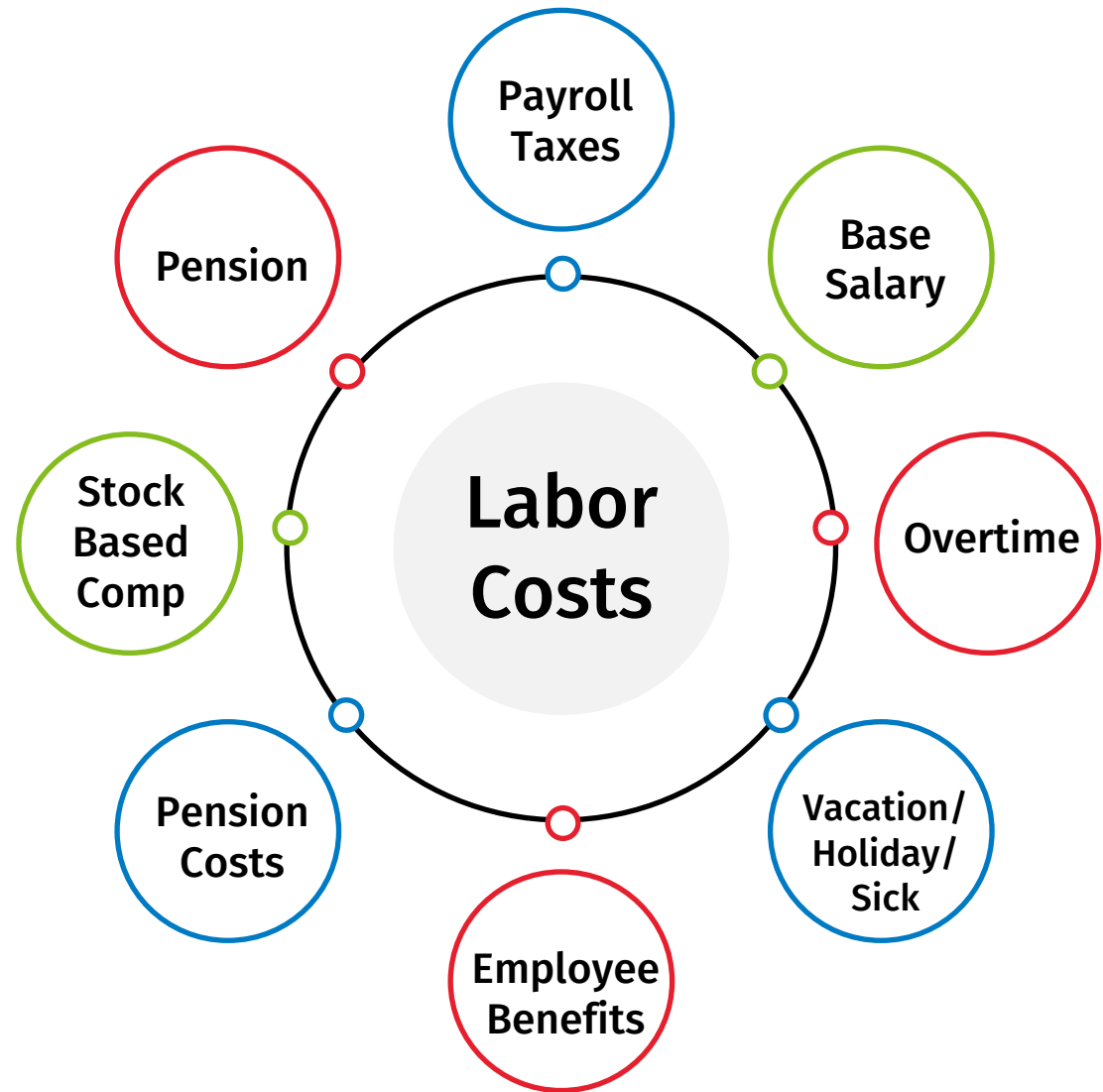
Salaries and
Benefits for
R&D
personnel

Section 174 Expense — Labor Costs

What makes an expense
“incident to” research?

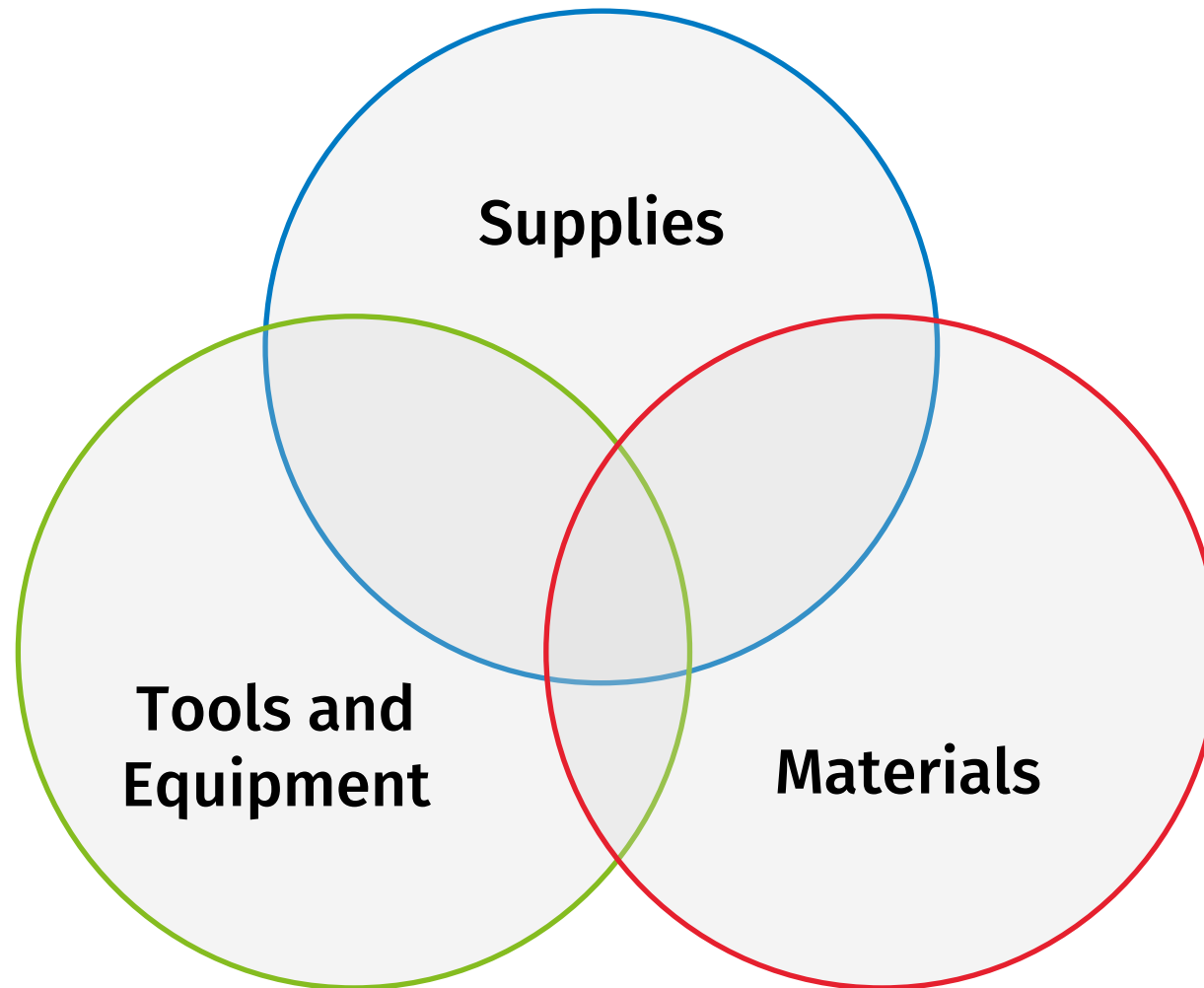


Includes full-time, part-time,
and contract employees.



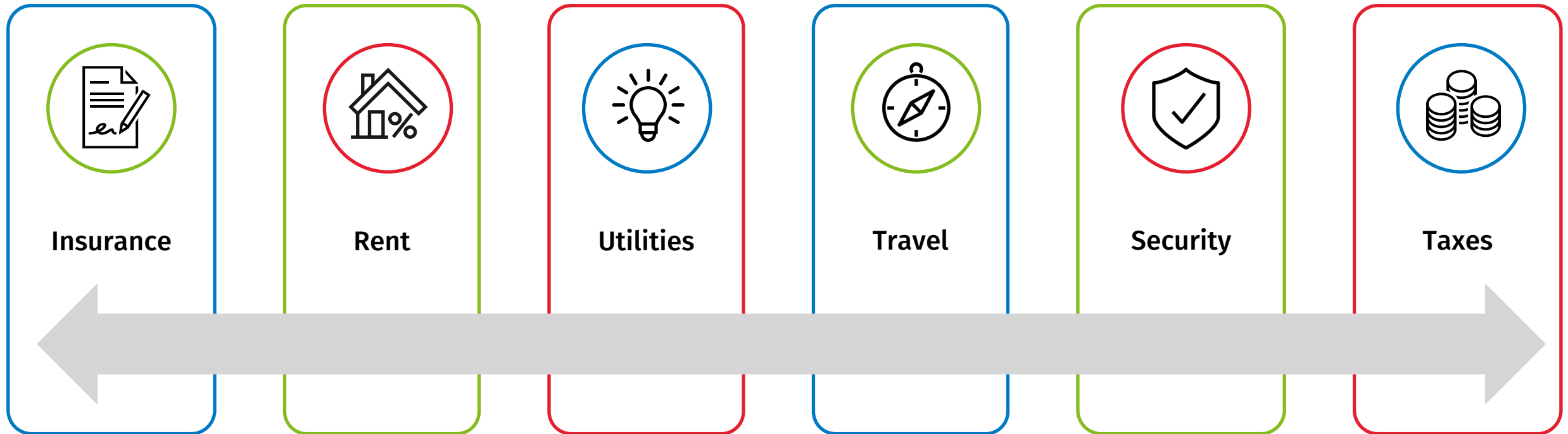
Section 174 Expense — Materials and Supplies

What makes an expense “incident to” SRE activities?



Section 174 Expense — Certain Mgmt. & Operations Cost

What makes an expense “incident to” SRE activities?



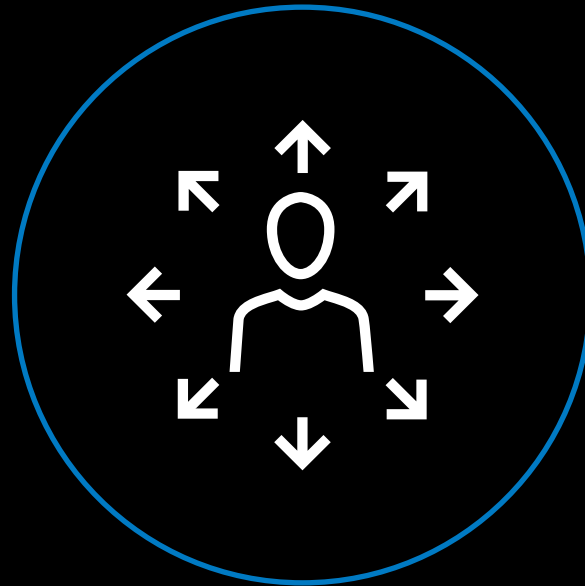
Costs that are **Not** Treated as SRE Expenditures

G&A costs are excluded if they only indirectly support or benefit SRE activities

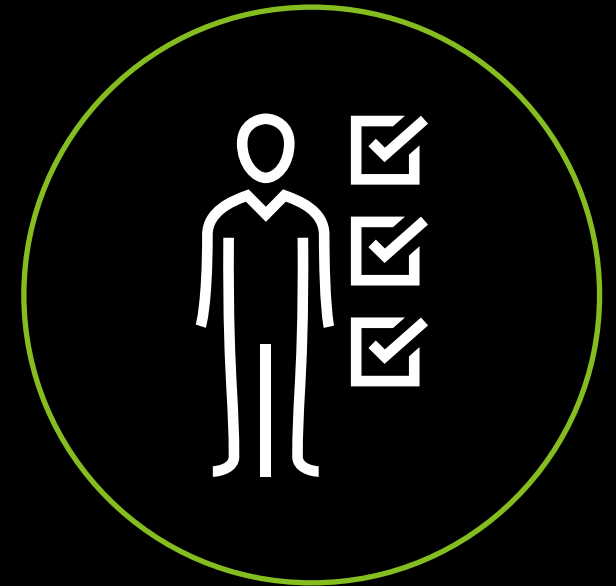


Allocation Methods for Section 174 Expenditures

There is no one size fits all rule
with the variety of industries



Flexible



Consistent *

** May be an accounting method if modified*

Polling question #2

When do you expect the proposed regulations to be issued?

- A. Before December 31, 2023
- B. Early (Q1) 2024
- C. Mid 2024 or later



Clarification on Software Development Activities



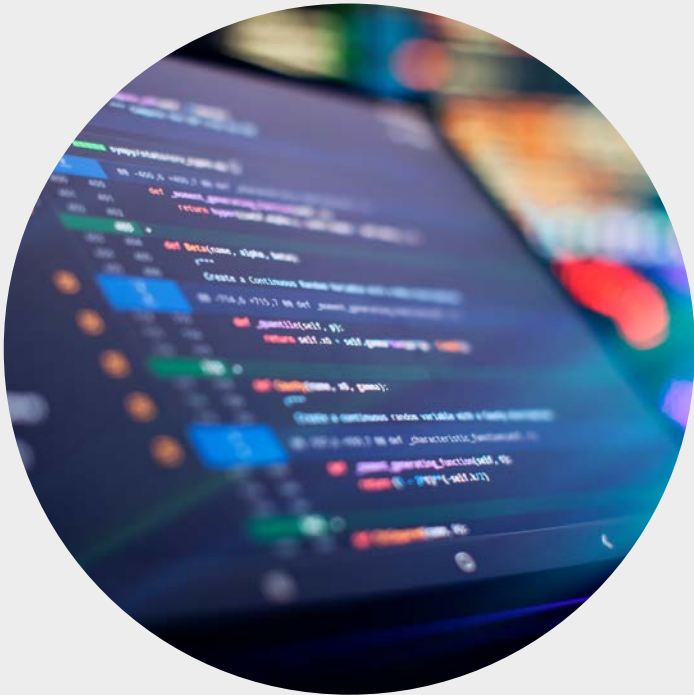
Specified Research or Experimental ("SRE") Expenditures



OR



Computer Software

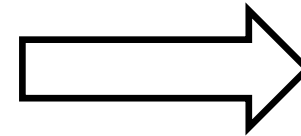


- The notice generally follows the guidance Rev. Proc. 2000-50 guidance on the definition of computer software
 - A computer program or routine is designed to cause a desired function(s) and the ***documentation required to describe and maintain that program***
- Computer software includes **upgrades and enhancements** (modifications to existing software)
- Computer software includes any ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software.

Software Development Activities

Include:

- Planning the development of software (including gathering requirements)
- Designing the computer software
- Building of model of the software
- Writing source code
- Testing
- Modifications to address defects



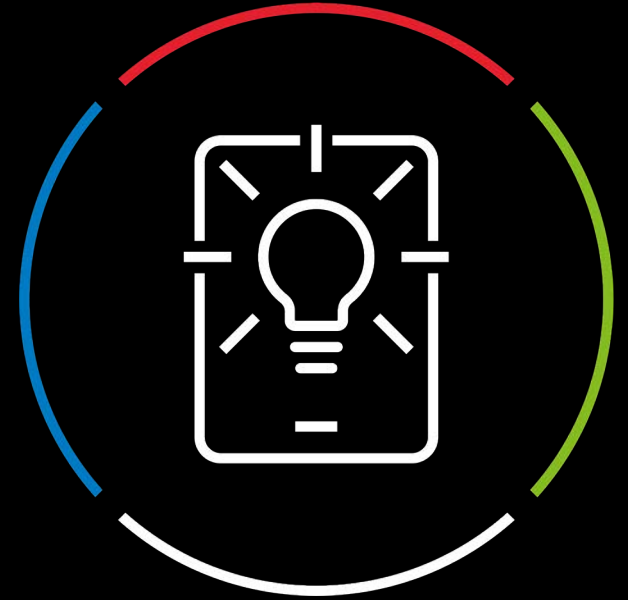
But ... only until the point in time software is placed in service (IUS) or technological feasibility is established, and software is ready for sale.

Software Development Activities

Exclude:

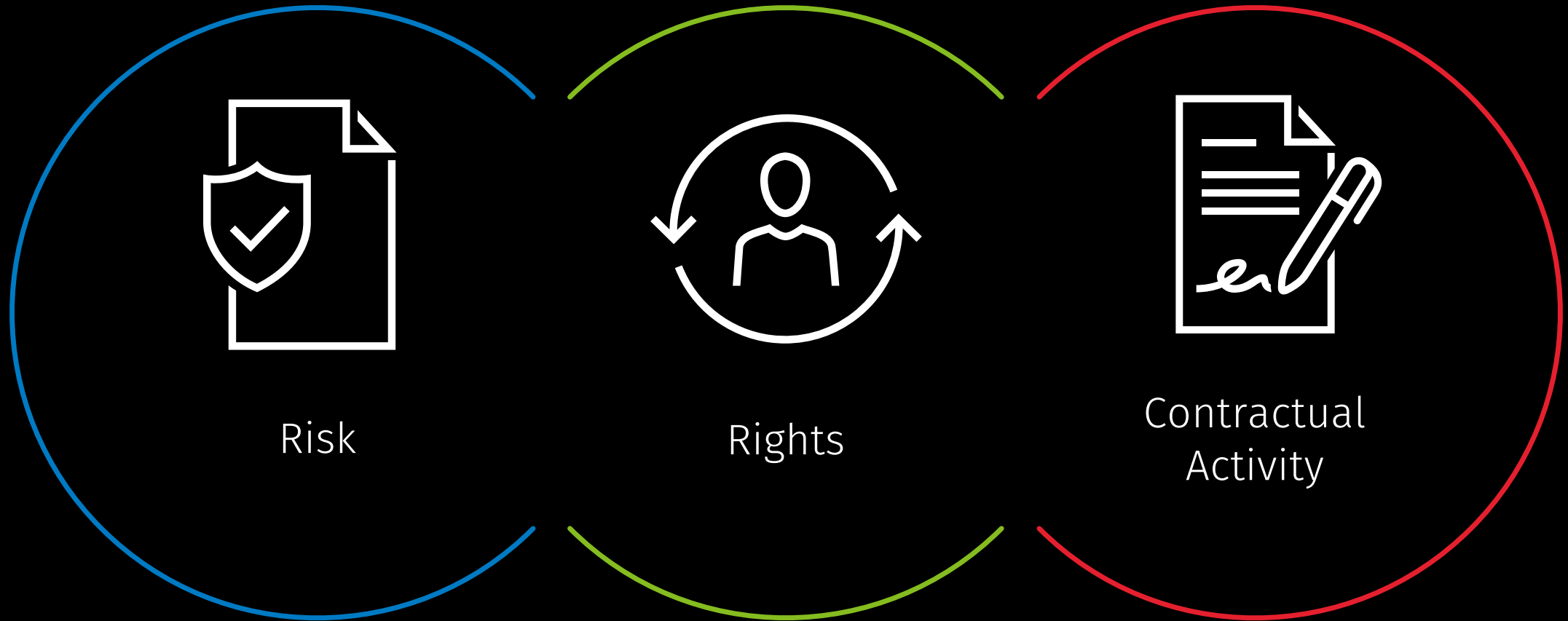
- ❌ Data Conversion
- ❌ Software Installation (including Configuration)
- ❌ Training
- ❌ Business reengineering
- ❌ Maintenance (not upgrade or enhancement)
- ❌ Data or information base
- ❌ Distribution activities
- ❌ Customer support

Research Performed Under Contract



Analyzing Research Performed Under Contract

When are costs incurred for research performed under a contract with SRE expenditures?



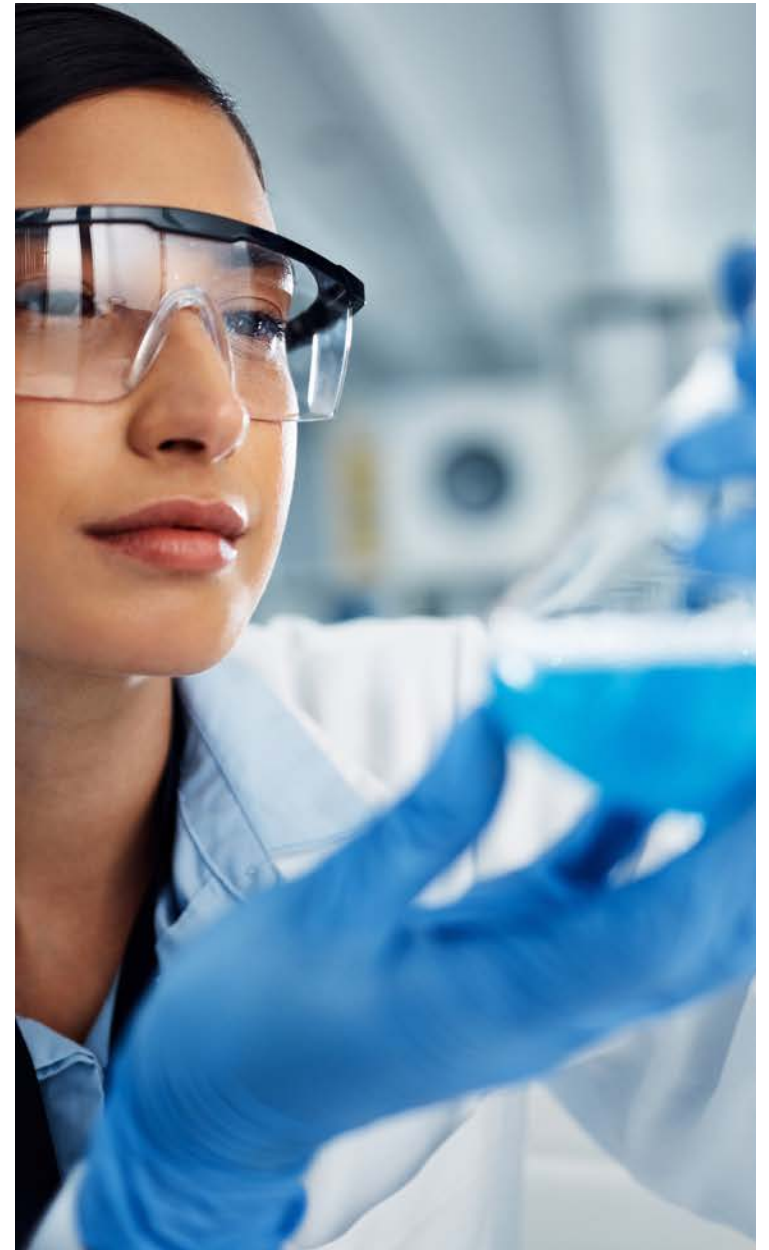
How should R&E costs be accounted for in contract arrangements?

- Risk and rights approach developed to narrow 174 scope to projects that are more in the character of capital v. service
- **Financial risk** (*new term*): Defined as the risk that the research provider may suffer a **financial loss related to the failure of the research** to produce the desired results.
- **SRE Product** (*new term*): any product that is “subject to protection under applicable domestic or foreign law”
- Mere know-how gained through the performance of services is not subject to protection



Treatment of Costs Paid by Research Provider

- If research provider bears financial risk, the costs paid or incurred by the provider are incident to the SRE activities.
- If research provider does not bear financial risk but has right to use or exploit any resulting SRE product, then costs incurred by the research provider are incident to the SRE activities.
- A research provider will not be treated as having a right to use the SRE product if such right is only upon obtaining approval from another party to the research arrangement.



Polling question #3

What has been the most welcome guidance provided by the notice?

- A. Types of costs included and excluded
- B. Software development
- C. Research performed under contract
- D. None — too little, too late



Miscellaneous Questions Addressed by the Notice



- Several examples were provided to evaluate the treatment of property subject to disposition, retirement or abandonment.
- Midpoint calculation was defined to use months to calculate 5- and 15-year amortization.
- The treatment of SRE expenditures under Section 460 are expected to be addressed in future proposed Section 460 regulations.
- The guidance also addresses the application of Section 482 to cost sharing arrangements involving SRE expenditures. Future revisions are expected to Section 1.482-7.

Request for Comments

- Additional guidance on SRE expenditures and allocation methods
- Interplay with Section 41 research credit
- Research performed under contract
- Disposition, retirement or abandonment of property
- Definition of pilot models
- Substantiation requirements
- Application of rules to small taxpayers

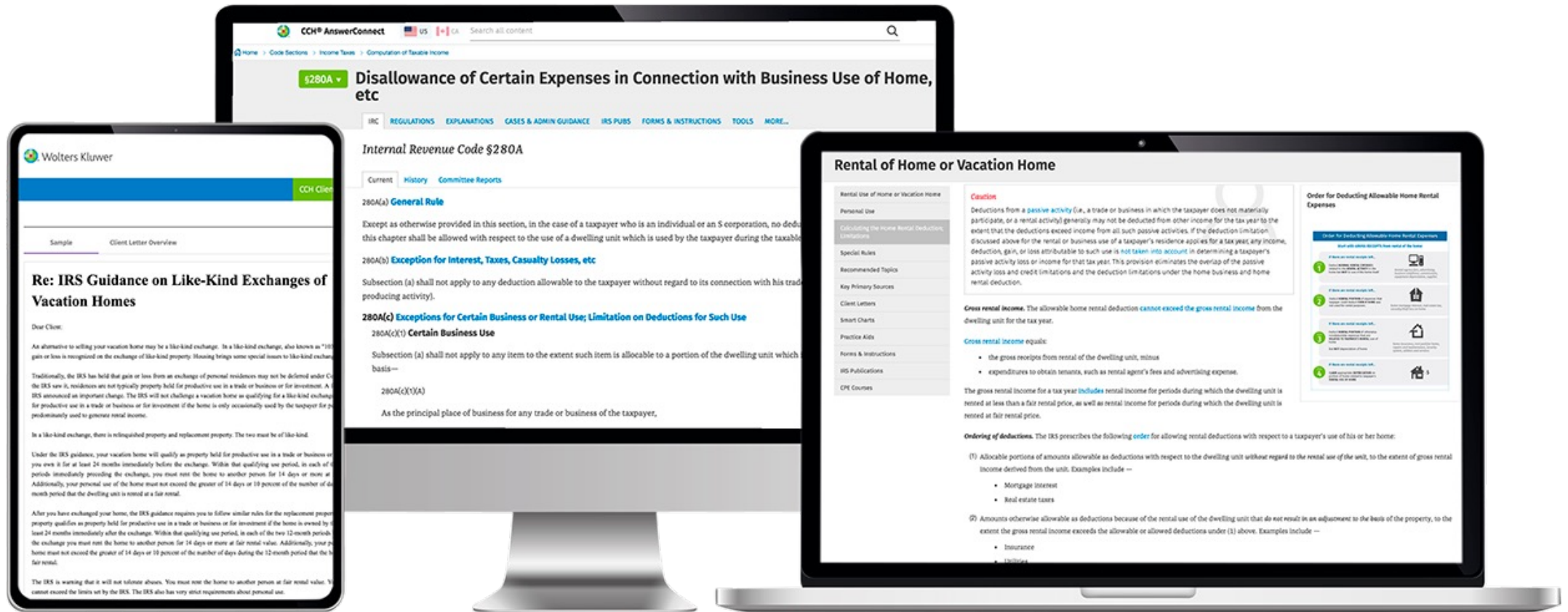


Potential Section 174 Challenges

- IRS may question Section 41 qualified research expenditures (QREs) on grounds of Section 174
 - Preamble states “this notice is not intended to change the rules for determining eligibility for or computation of the research credit under Section 41 and the regulations thereunder”.
- What are the implications if the IRS challenges Section 174 deductions in a subsequent year?
- Taxpayers must maintain records substantiating research expenses for many years after the tax year when the expenses are incurred
 - Will the IRS request documentation for Section 174 in a similar detail being requested on proposed new Form 6765?



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Additional information in CCH[®] AnswerConnect



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Polling question #4

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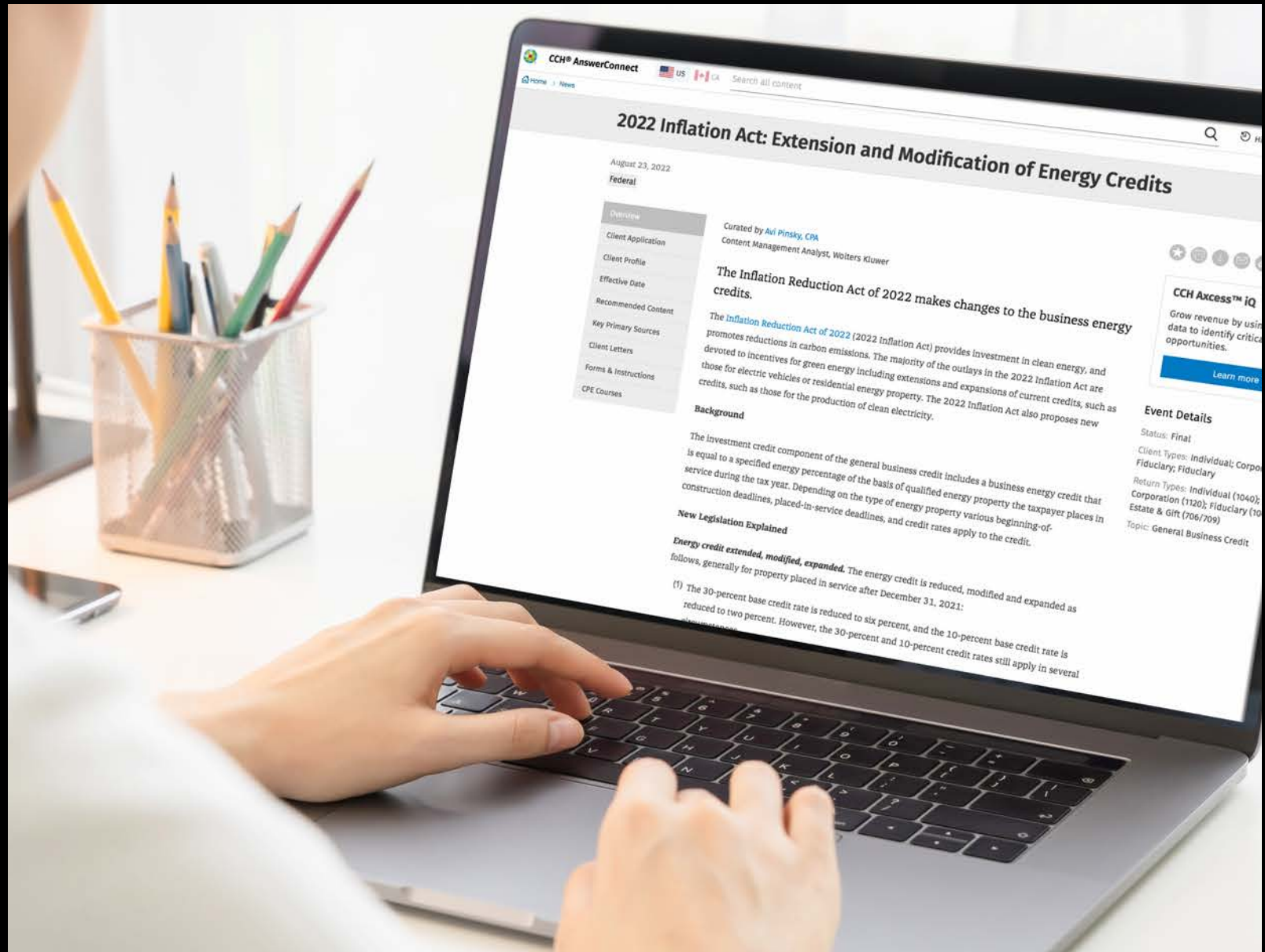
- A. Yes
- B. No



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Thank you for attending the Virtual Coffee Talk — *Unpacking the latest Section 174 guidance*

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Kevin M. Jacobs

Kevin M. Jacobs is a Managing Director with Alvarez & Marsal Tax in Washington D.C. and the National Tax Office Practice Leader. He brings more than 15 years of experience in tax matters in both the public and the private sectors.

Prior to joining A&M, Mr. Jacobs was a Senior Technician Reviewer (TCJA) with the IRS Office of Associate Chief Counsel (Corporate) for more than six years, where he advised on tax issues such as corporate reorganizations and corporation-shareholder issues, earning and profits, recovery and allocation of stock basis, liquidations, redemptions, bankruptcies, spin-offs and consolidated returns.

Mr. Jacobs was the principal Associate Chief Counsel (Corporate) attorney on several regulatory projects including the proposed section 382(h) regulations on built-in gains and losses, the global intangible low-taxed income regulations, and debt-equity regulations. He provided substantial contributions to numerous other guidance projects, such as the limitation on interest deductions regulations, and assisted in overseeing the Corporate Division's response to TCJA, including the coordination with Treasury's Offices of Tax Legislative Counsel and International Tax Counsel.

Mr. Jacobs earned a bachelor's degree in accounting, a master's degree in accounting (with a concentration in taxation), a J.D. (*magna cum laude*) from the University of Florida and an LL.M. in taxation from New York University. He is admitted to practice before multiple courts and to the District of Columbia and Florida Bars. He is also a licensed Certified Public Accountant (CPA) in Florida and Colorado. Mr. Jacobs is a member of several organizations including the American Bar Association, the American Institute of Certified Public Accountants, the International Fiscal Association, and the New York State Bar Association.

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Kathleen King

Kathleen King is a Managing Director and National R&D Practice Leader with Alvarez & Marsal Tax in Washington, D.C. She specializes in assisting clients in the process of claiming, domestic production deductions, documenting and sustaining tax incentives, including research tax credits, domestic production deductions, meals and entertainment deduction, and fixed asset treatment.

With more than 25 years of experience, Ms. King's projects have ranged from targeted consulting engagements designed to address specific issues to large-scale projects utilizing engagement teams working concurrently in multiple locations. She has extensive experience in leading research credit analyses and representing her clients in audits performed by the Internal Revenue Service and state tax authorities at the field and appeals levels.

Ms. King has worked with clients across various industries, including aerospace and defense, food products, manufacturing, pharmaceutical products, retail and software.

Prior to joining A&M, Ms. King was a Senior Manager at KPMG, where she served as a national resource for the Research Credit Services team. Previously, she was a member of Arthur Andersen's national Research Tax Incentives team.

Ms. King earned a bachelor's degree in mineral land management from the University of Colorado and a master's degree in accounting from American University in Washington, D.C. She is a Certified Public Accountant (CPA).

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Thank you for joining us today!

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