

VIRTUAL COFFEE TALK

Section 174 R&D Deduction

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Kevin Deyoung, Wolters Kluwer

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Agenda

1 Summary of Upcoming Changes to Section 174

2 Section 174 Expenditures and Activities

3 Effect of Section 174 on Other Tax Provisions

4 Approaches to Manage the 174 Change

5 Latest on Legislative Changes

Summary of Upcoming Changes to Section 174

- This revenue raiser from TCJA requires research and experimentation (“R&E”) expenditures to be capitalized and amortized.
- Effective for tax years beginning on or after 1/1/2022, amortization period is —
 - 5 years for R&E performed in the U.S.
 - 15 years for R&E performed outside the U.S.
- Awaiting further guidance, but it is likely an accounting method change that will require a Form 3115.
- Software Development costs deemed to be Section 174 expenditures.
- The deduction is not accelerated even if property is sold or abandoned.

Illustration of 174 Deductions in 2021 v. 2022

Assumes same amount of 174 expenses in both tax years **	Total	Deductible in 2021	Deductible in 2022
Section 174 Expenditures	\$1,000,000	\$1,000,000	\$100,000

The impact is significant in the first year due to the midyear convention.



POLLING QUESTION

Do you think that Congress will revert to the pre-TCJA standard for Section 174 costs?

- ☐ **No, I think amortization is here to stay**
- ☐ **Yes, it will be eliminated before the end of 2021**
- ☐ **Yes, but it won't happen until after 2021**
- ☐ **Not a complete reversal, but changes will be made**

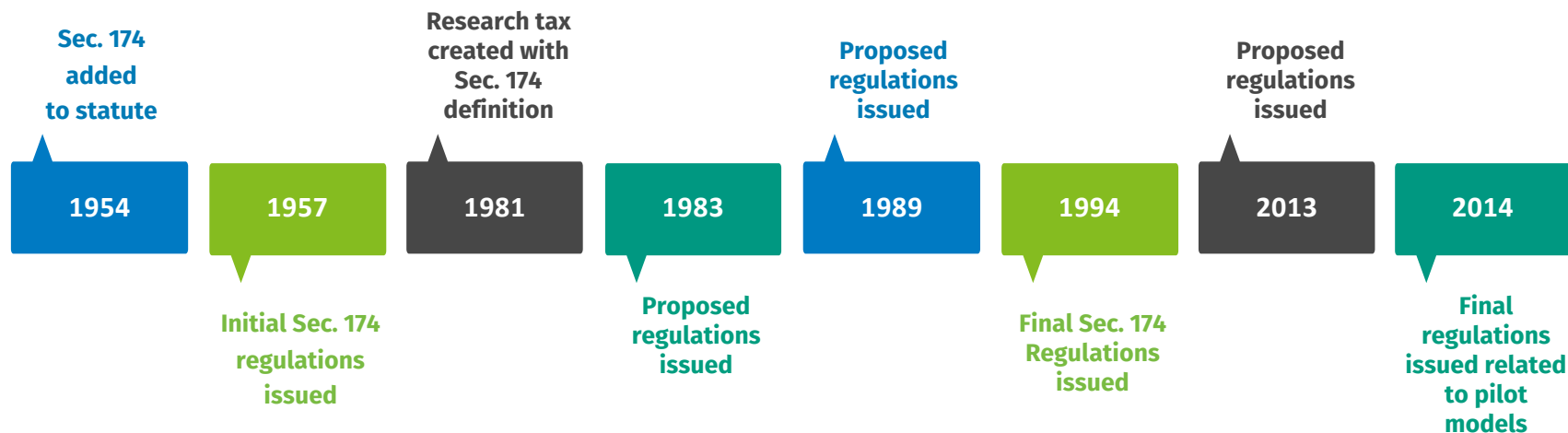
Other Factors to Consider on Section 174

- Recent LB&I Directive on Centralized Risking of Research Issues included both Section 41 and 174. Guidance refers to —
 - “research **activities** constitute research and development within the meaning of IRC Sec. 174”;
 - “whether **expenditures** connected with the research credit ... are eligible for treatment as research or experimental expenditures under IRC Sec. 174”.
- R&E costs are important to the determination of other tax provisions.
- M-3 Line 35 — Section 174 Expenditures.

Section 174 Activities and Expenditures



Evolution of Section 174



*** TCJA changes treatment of Section 174 expenditures for tax years after 12/31/21.**

Section 174 – R&E Activities

- Expenditures which represent research and development costs in the experimental or laboratory sense
 - Intention to **discover information**;
 - **Uncertainty** concerning the development or improvement of a product or process.



Software Development

- Amount paid in connection with the development of any software **shall be treated** as a research or experimental expenditure.
 - “any amount paid or incurred in connection with the development of any software”.
- Rev. Proc. 2000-50 will likely be revised.
 - What activities constitute development?



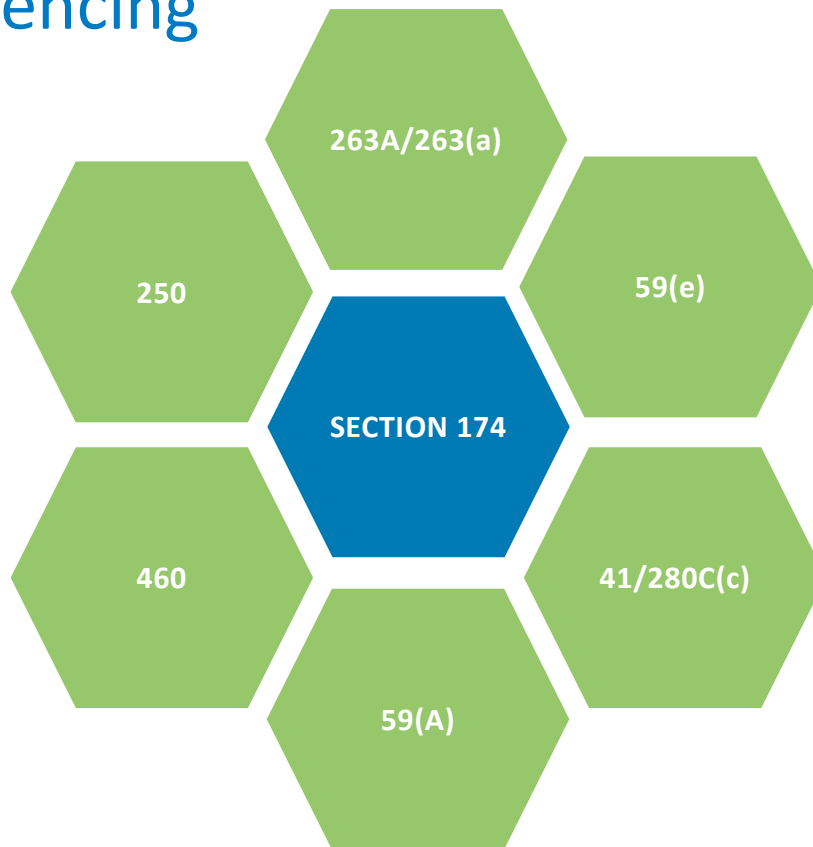
Section 174 Expenditures

- Much broader than Sec. 41 (research credit) — Section 174 includes **all** costs incident to the development or improvement of a product.
- FAS 2 expenses:
 - Materials, equipment, and facilities
 - Personnel costs
 - Contract services
 - Indirect Costs
- Tax guidance specifically references depreciation and patent costs

Effect on Other Tax Provisions



Code Sections Referencing Section 174





POLLING QUESTION

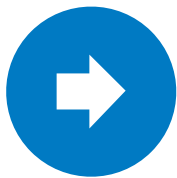
What do you think will be the most challenging aspect of the upcoming changes to Section 174?

- ☐ Identifying new activities
- ☐ Identifying new expenditures
- ☐ Tracking the amortization costs
- ☐ I don't expect these changes to a challenge

Approaches to Manage the 174 Change



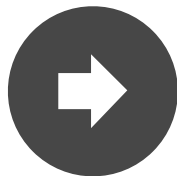
Identifying Section 174 Expenses



Start with Research Credit Workpapers



Identify Additional Expenditures



Assess New Activities or Business Areas

Updating Research Credit Workpapers for 174



ADDITIONAL ACTIVITIES

- Foreign*
- Internal Use Software
- Funding

** Foreign research will need to be separately tracked.*



ADDITIONAL EXPENSES

- Salaries, Non-Taxable Benefits and Fringe
- Materials, Facilities, and Equipment Costs
- Indirect Costs

Identify Additional Activities and Expenses

- Obtain general ledger detail for R&D/Engineering/Technology Organization
- Focus on large expense accounts
 - Confirm whether cost accounts relate to Section 174/R&D Activities
 - Look for likely non-qualifying activities such as Q&A, help desk support, and training
- The software development assessment should consider external cloud costs, infrastructure costs, and other IT costs
 - Review financial statement workpapers for internally developed software
 - Analysis should consider capital and expense items

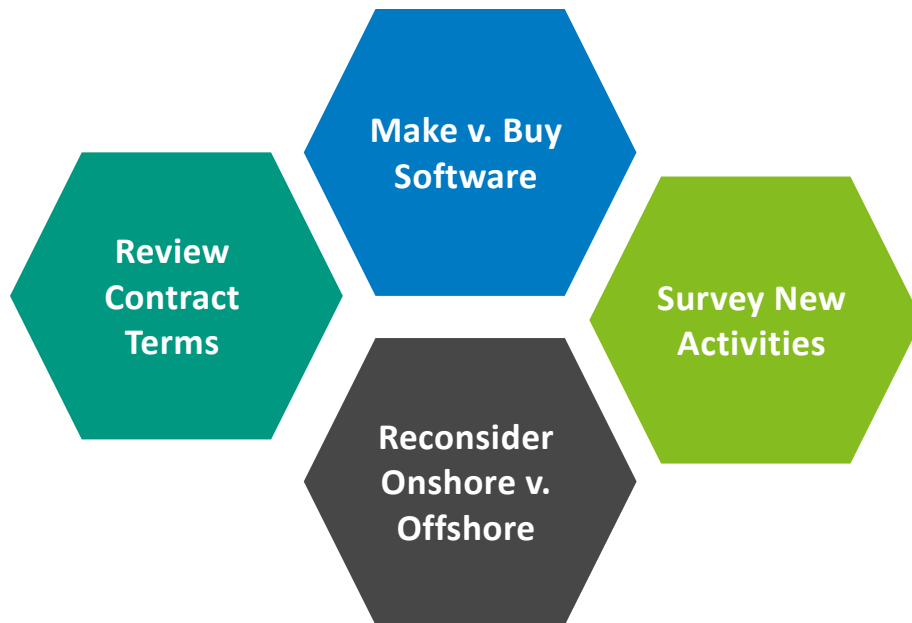
Estimate the Potential Impact

Three “easy” approaches to determining the impact

1. Adjust for Section 41 workpapers for known differences (e.g., 35% on Contract Research, Foreign, Funding)
 - Apply gross-up factor for additional expenditures
2. Review Available R&D/Technology Budgets and Plans
 - How much?
 - Where?
3. Use headcount as a proxy for base costs.
 - Apply gross-up factor for additional expenses.



Longer Term Planning Considerations



Other Conforming Changes



- Effect on other TCJA provisions (especially those limited or determined based on taxable income).
- Adjustment to 280C(c).
- Impact on state research credits (especially those that apply Section 174 definition).
- Potential accounting method changes.



POLLING QUESTION

Do you think your business is likely to change their business (e.g., buy more software) based on the forthcoming changes?

- ☐ **No, this is unlikely to drive significant business changes**
- ☐ **Yes, we will actively look at business changes**
- ☐ **Maybe, but we will wait awhile for legislative action**
- ☐ **Probably, but these businesses will take yrs to implement**

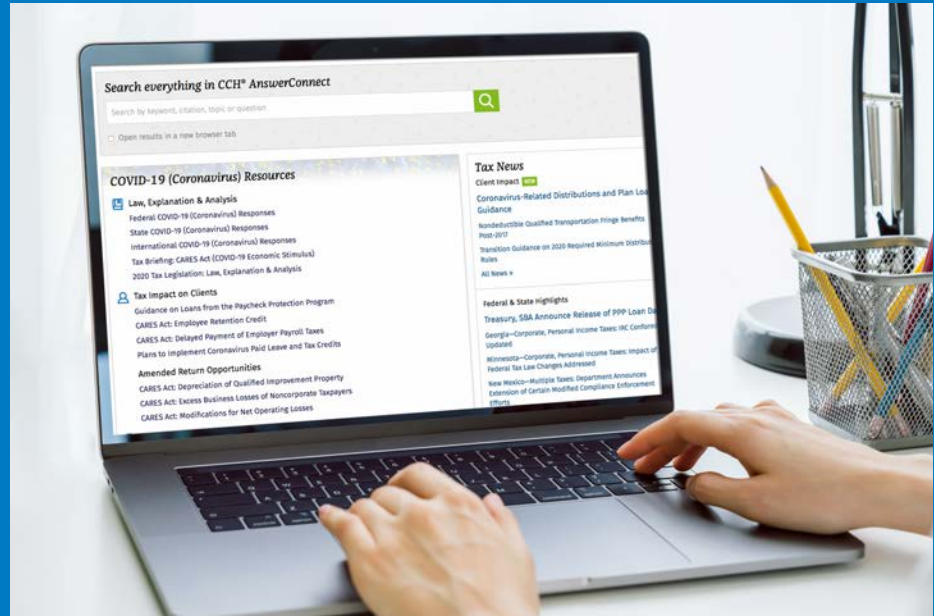
Latest on Legislative Update



Legislative Status

- Green book includes broad references to increasing investments in R&D.
- Despite broad bipartisan support, repeal of the amortization requirement is expensive.
 - Any change will require an increase in revenue.
 - Funding will have to compete with other programs favored by the administration.
- Multiple bills to repeal have been proposed, but no action has been taken.

CCH® AnswerConnect®



POLLING QUESTION

Would you like a more in-depth demo of CCH® AnswerConnect and the resources available to help with analysis of the Section 174?

☐ Yes

☐ No

CCH[®] AnswerConnect

[Register here](#) to try it for free or visit CCHAnswerConnect.com to learn more



Thank you for attending

Virtual Coffee Talk — Section 174 R&D Deduction

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Kevin M. Jacobs

Kevin M. Jacobs is a Managing Director with Alvarez & Marsal Taxand 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 re-organizations 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. Previously, Mr. Jacobs spent more than nine years at law and certified public accounting firms (Ropes & Gray LLP, Latham & Watkins LLP, Dewey Ballantine LLP and Arthur Andersen LLP).

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, including the Supreme Court of the United States, the U.S. Tax Court and the U.S. Court of Federal Claims. He is admitted to the District of Columbia and Florida Bars and is a licensed Certified Public Accountant (CPA) in Florida and Colorado. Mr. Jacobs is a member of several organizations including the American Bar Association and the New York State Bar Association. He is also a frequent speaker on numerous corporate transaction tax matters.

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Kathleen King

Kathleen King is a Managing Director and National R&D Practice Leader with Alvarez & Marsal Taxand 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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