

CCH® AnswerConnect

Virtual **Coffee Talk**

A discussion of the latest tax updates

Managing Section 174 in Uncertain Times

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Miller & Chevalier

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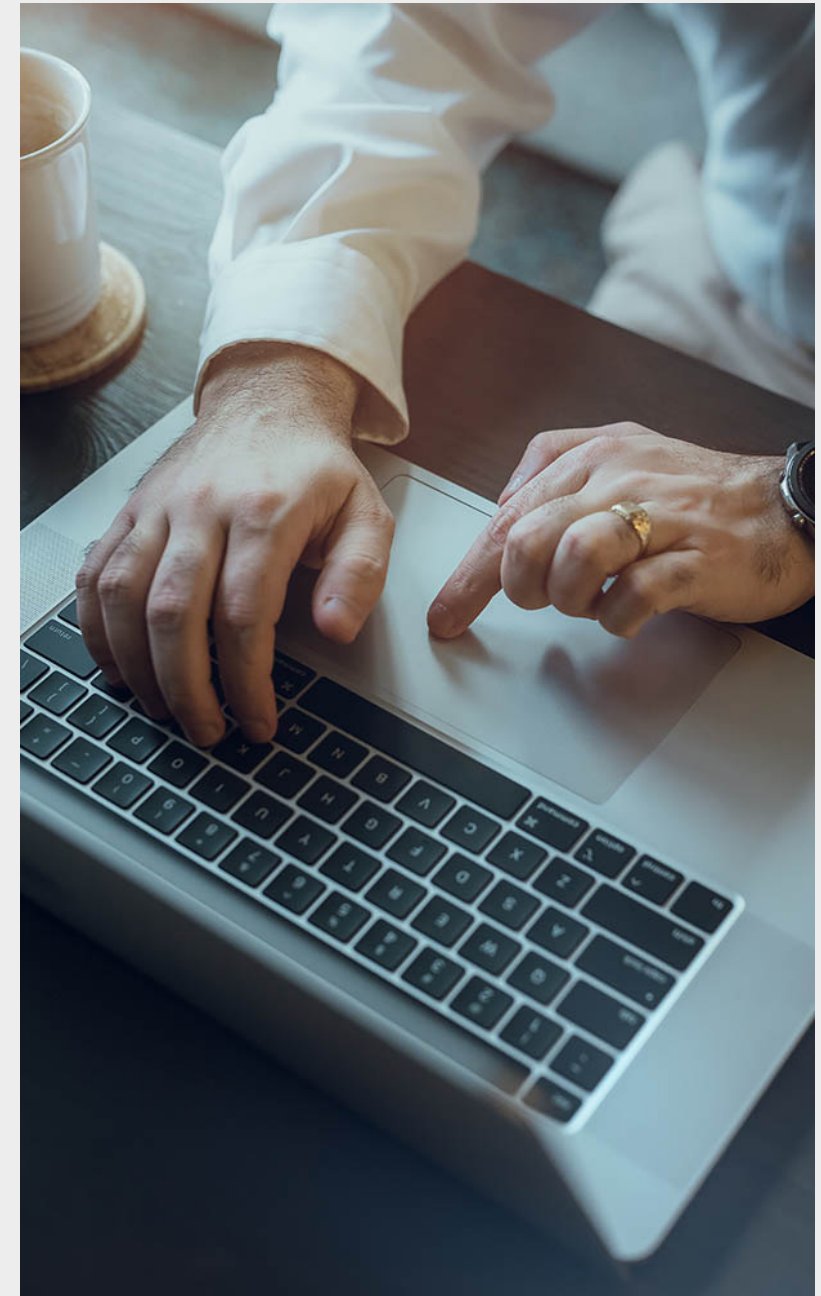
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Today's speakers



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Agenda

- Recap of Section 174 Changes
- Identifying and Calculating Section 174 Expenses
- Key Questions Regarding Section 174
- Predicting Future Trends in Section 174 IRS Audits
- Additional Information in CCH[®] AnswerConnect



Recap of Section 174 Changes



Basic Changes to Section 174

- This revenue raiser from the TCJA requires research and experimentation (“R&E”) expenditures to be capitalized and amortized.
- Effective for tax years beginning on or after 1/1/2022, the amortization period is:
 - 5 years for R&E performed in the U.S.*
 - 15 years for R&E performed outside the U.S.*
- Taxpayers do not need to file Form 3115 but a statement is required per Rev. Proc. 2023-8.
- Software development costs are deemed to be Section 174 expenditures.
- The deduction is not accelerated even if the property is sold or abandoned.

** Applies at the midpoint of the year of expenditure so only ½ of the amortization is allowed in the first year.*

Future Guidance

- Proposed Section 174 regulations are expected to be released later this year
- Will they address key technical questions:
 - What is the definition or scope of R&E activities?
 - What are costs “incident to the development or improvement of a product?”
 - What is software development?
 - How should R&E costs be accounted for in contract arrangements?

2023 Legislative Actions on Section 174

Senate Bill 866 was referred to the
Senate Finance Committee
on March 16.

House Bill 2673 was introduced in the
House on April 18 and referred to the
House Ways and Means Committee.

There has been little movement on these bills since they were introduced

Polling question #1

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

- A. No, I think amortization is here to stay
- B. Yes, it will be eliminated before the end of 2023
- C. Yes, but it won't happen until 2025 (after the election)
- D. Not a complete reversal, but changes will be made



Identifying and Calculating Section 174 Expenses



Getting Started



Start with financial statement R&D, research credit workpapers, and capitalized software



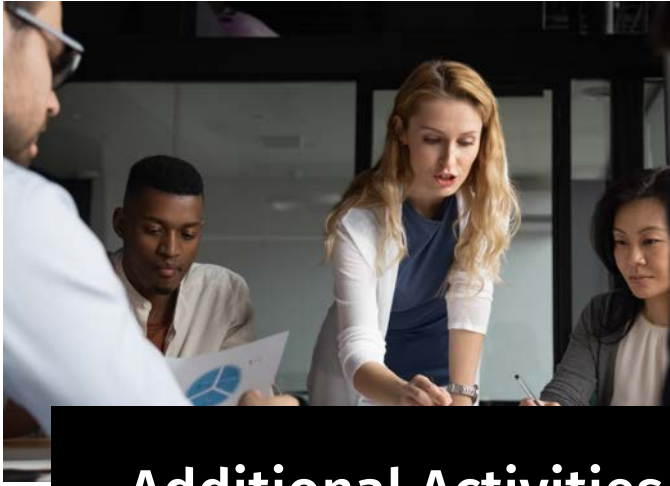
Identify additional expenditures



Assess new activities or business areas

Research Credit Workpapers as a Guidepost

Is it possible to have Sec. 41 costs that are not Sec. 174 costs?



Additional Activities

- Foreign Research*
- Internal Use Software
- Funding

** Foreign research will need to be separately tracked*



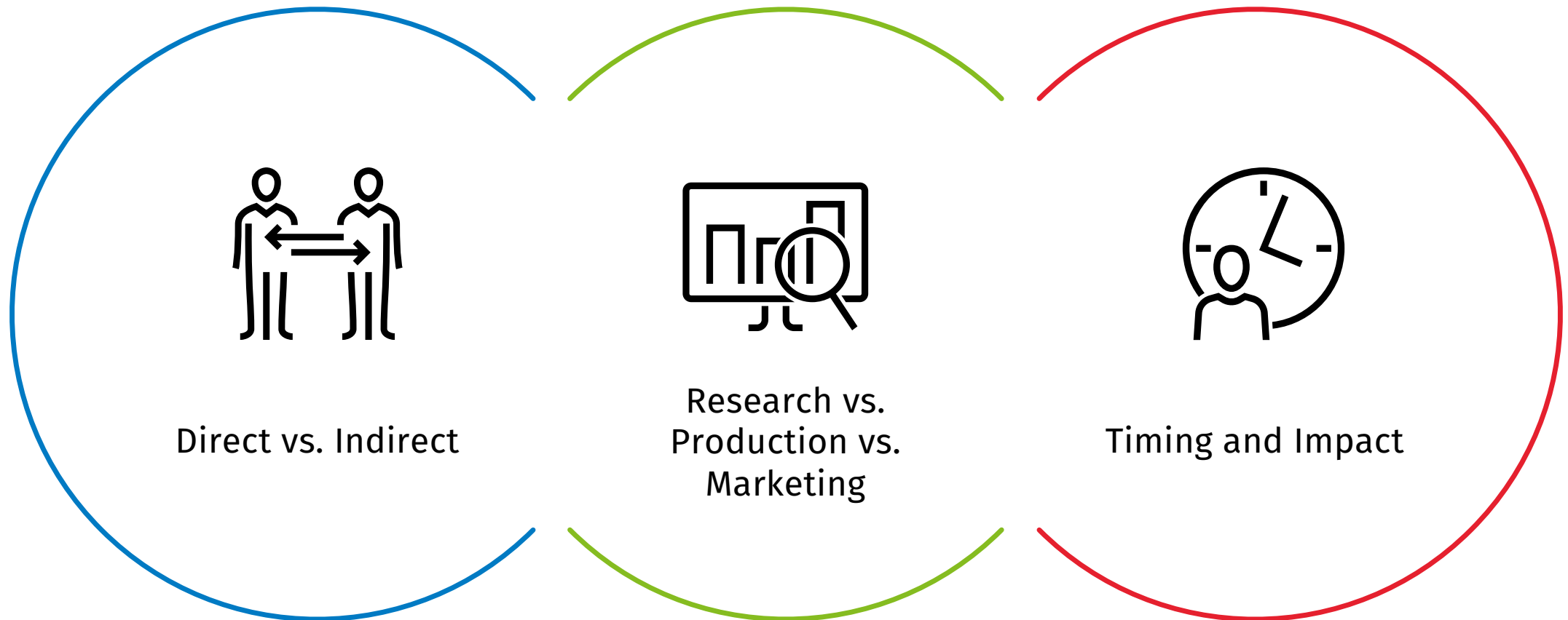
Additional Expenses

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

Identifying Section 174 Activities

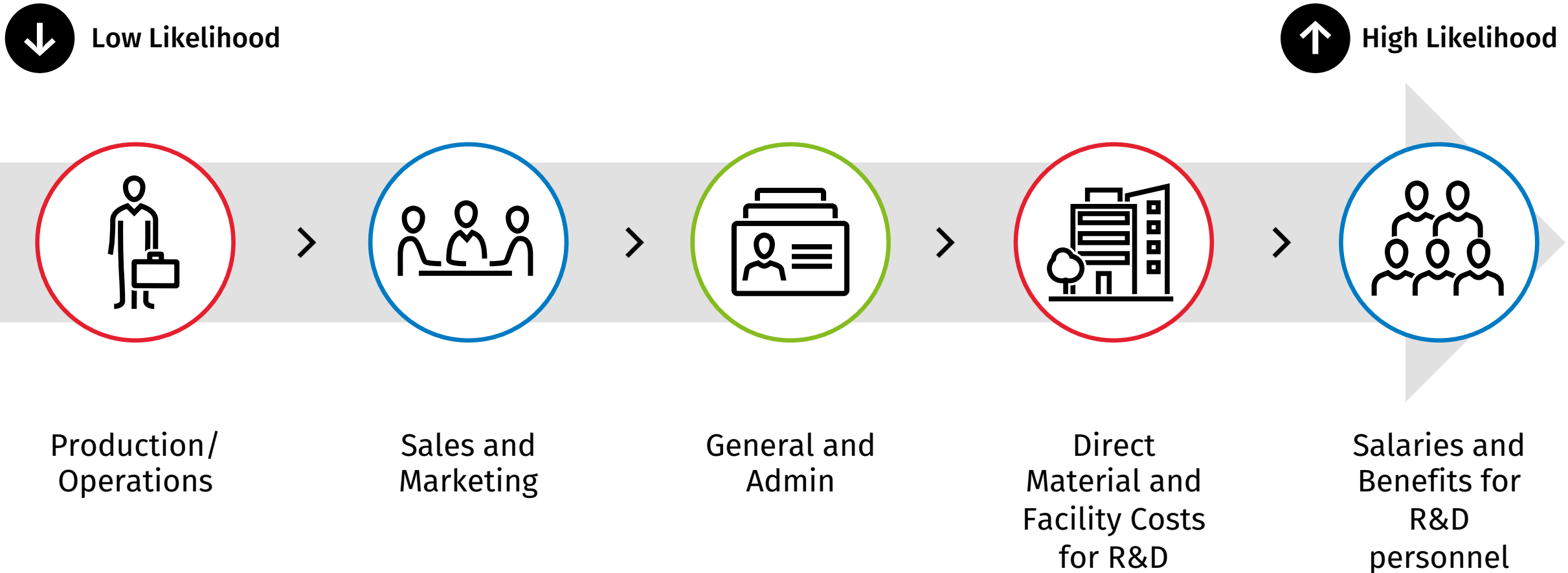
Key Area of Focus

What makes an activity “incident to” research?



Section 174 Expense Continuum

What makes an expense “incident to” research?



Calculating Section 174 Expenditures

Key Challenges Identifying and Calculating Section 174 Expenses



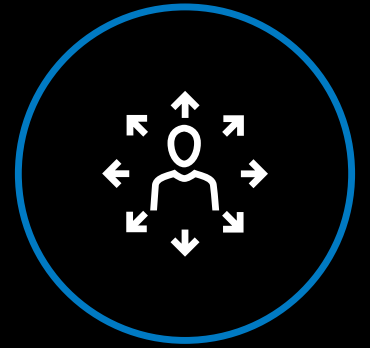
Mixed Use Department
and Accounts



Foreign Research



Allocations



Interplay with
other provisions

Identify additional activities and expenses

- Obtain general ledger detail for R&D, engineering, and technology organizations
- 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
- For 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

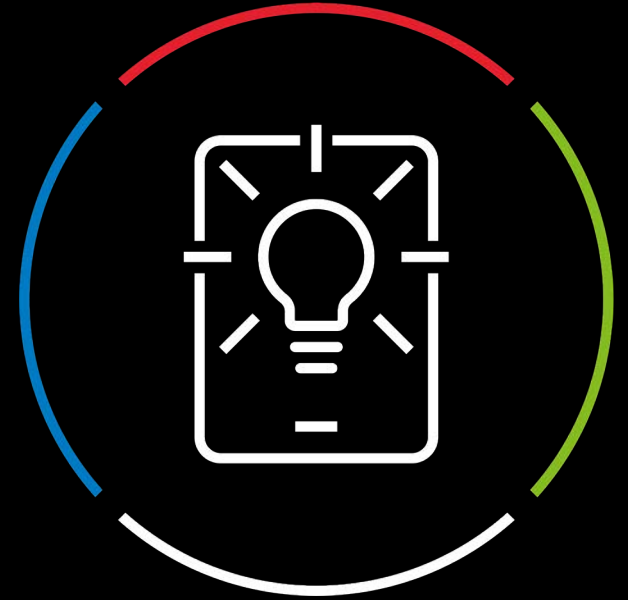
Polling question #2

What has been the most challenging aspect of the transition to amortization under section 174?

- A. Identifying new activities
- B. Identifying new expenditures
- C. Tracking the amortization costs
- D. No significant challenges encountered



Key questions regarding Section 174



Key areas requiring further guidance



What is the definition or scope of R&E activities?

What are costs “incident to the development or improvement of a product?”

What is software development?

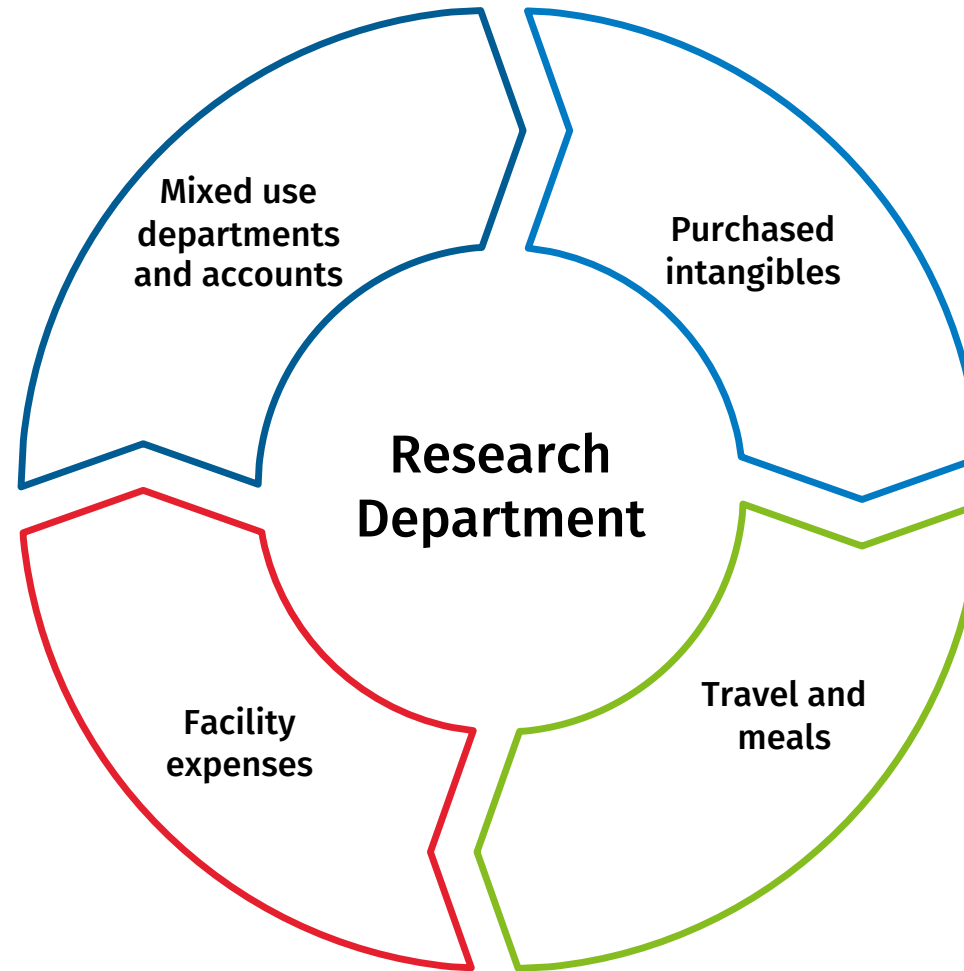
- How should R&E costs be accounted for in contract arrangements?
- How does the Section 174 change impact other tax calculations?

What is the scope of Section 174 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



What costs are “incident to” R&E?



What is considered software development?



Treasury officials have emphasized the need for new guidance (Rev. Proc. 2000-50 is no longer available)

- Significant changes in technology
- Lack of definition of “Software Development”
- Inconsistent treatment with Section 197?

Evaluation of information technology charges

Common Information Technology Charges

Salaries and non-taxable employee benefits

External Services - Non-Development

Software 3rd Party License Fees

Training/ Help Desk Service / Documentation

Servers, Computers, and Other Hardware

Testing - QA/System Monitoring

Data Conversion / Migration / Configuration

Vendor Evaluation of 3rd Party Solutions

External Services - Development

Cloud Costs

3rd Party License Fees (Engineering Use Only)

Other Direct Costs (Utilities, Training, etc.)

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

- Treasury anticipates addressing how Section 174 requirements apply to multiple parties in research contracts:
 - Performance of services
 - Specified contractual rights

What are other effects of Section 174 changes?

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



Polling question #3

Do you believe that your workpapers are sufficient if your section 174 amortization is audited?

- A. Yes
- B. No
- C. Maybe, but it's hard to gauge without IRS guidance



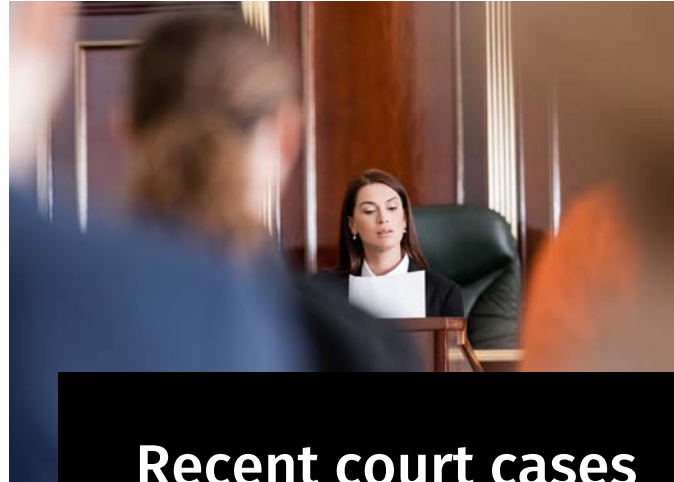
Predicting future trends in Section 174 IRS audits



Disputes likely to continue



**IRS announces
“Research Issues”
campaign**



**Recent court cases
raise more questions
for taxpayers**



**Renewed focus
on Research Credit
Claims**

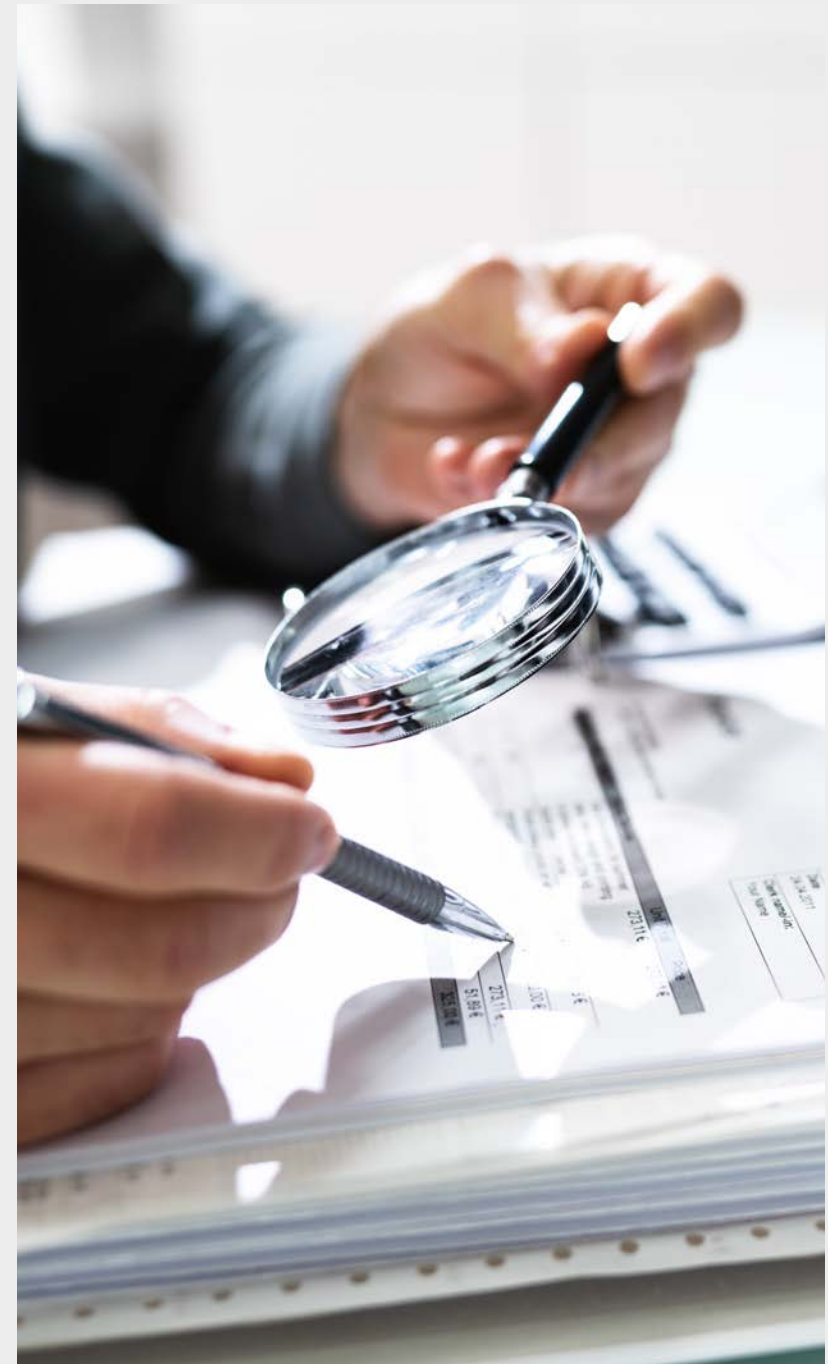
Seen in the Field — IRS Audit Techniques

- Increasing scrutiny on Section 41 will likely lead to a focus on Section 174 expenditures
 - *Little Sandy Coal* IDRs
 - Stat Sampling in IRS Audits
- IRS officials have indicated that they generally expect Section 174 activities will be greater
- Basic documentation requirements
 - Methodology memorandum
 - Detailed workpapers that show determination of costs
 - By “product”?

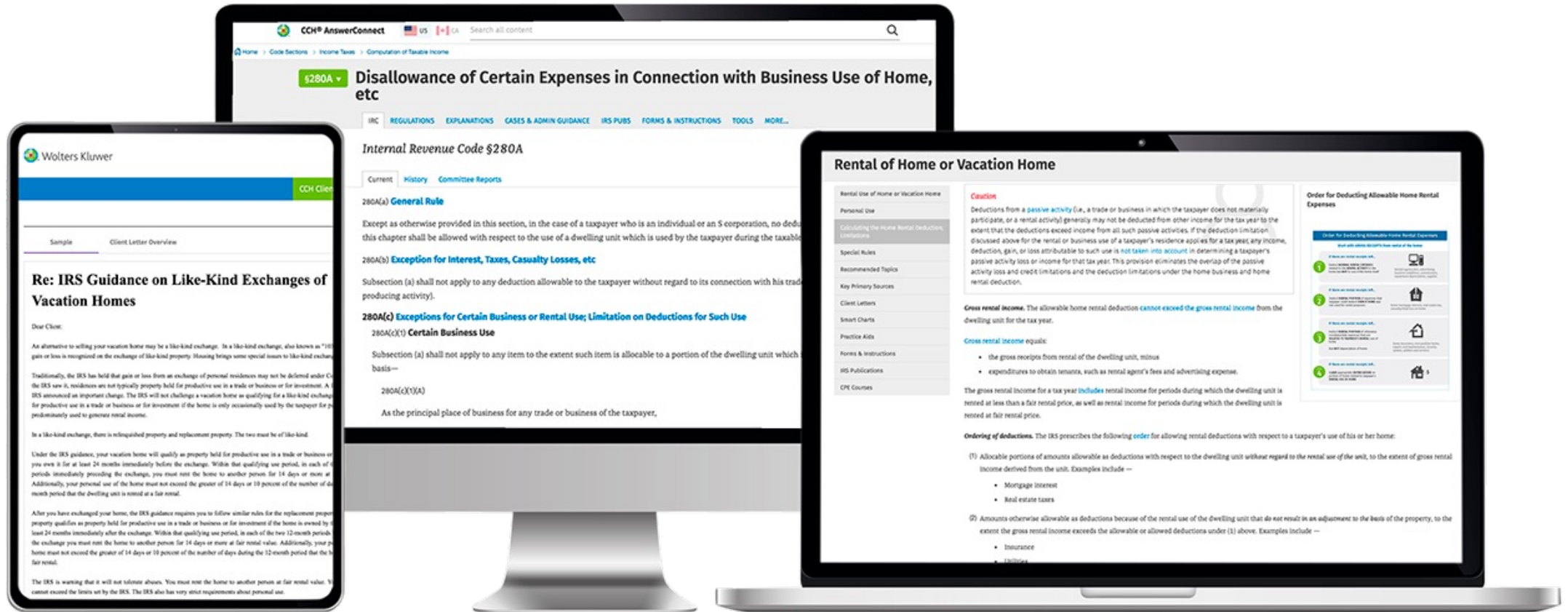


Other Section 174 controversy aspects

- IRS is likely to take the position that if an expense **could** be claimed under Section 174, it **must** be claimed under Section 174 and amortized, even if it could also qualify as a Section 162 deduction or COGS
 - Likely to lead to litigation on the characterization of research expenses as Section 162 business expenses, an issue not in serious dispute since Section 174 was first enacted
 - Taxpayers could preserve Section 162/COGS alternative argument with the protective claim
- IRS may be less likely to contest qualified research expenditures (QREs) on Section 174 grounds
 - Taxpayers should watch for whipsaw situations
- IRS may disallow a Section 174 amortized deduction in a subsequent year even if it never challenged that deduction in a previous year
- Taxpayers must maintain records substantiating research expenses for many years after the tax year when the expenses are incurred



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Additional information in CCH[®] AnswerConnect



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Polling question #4

Would you like a more in-depth demo or further details on the resources and tools available in CCH[®] AnswerConnect?

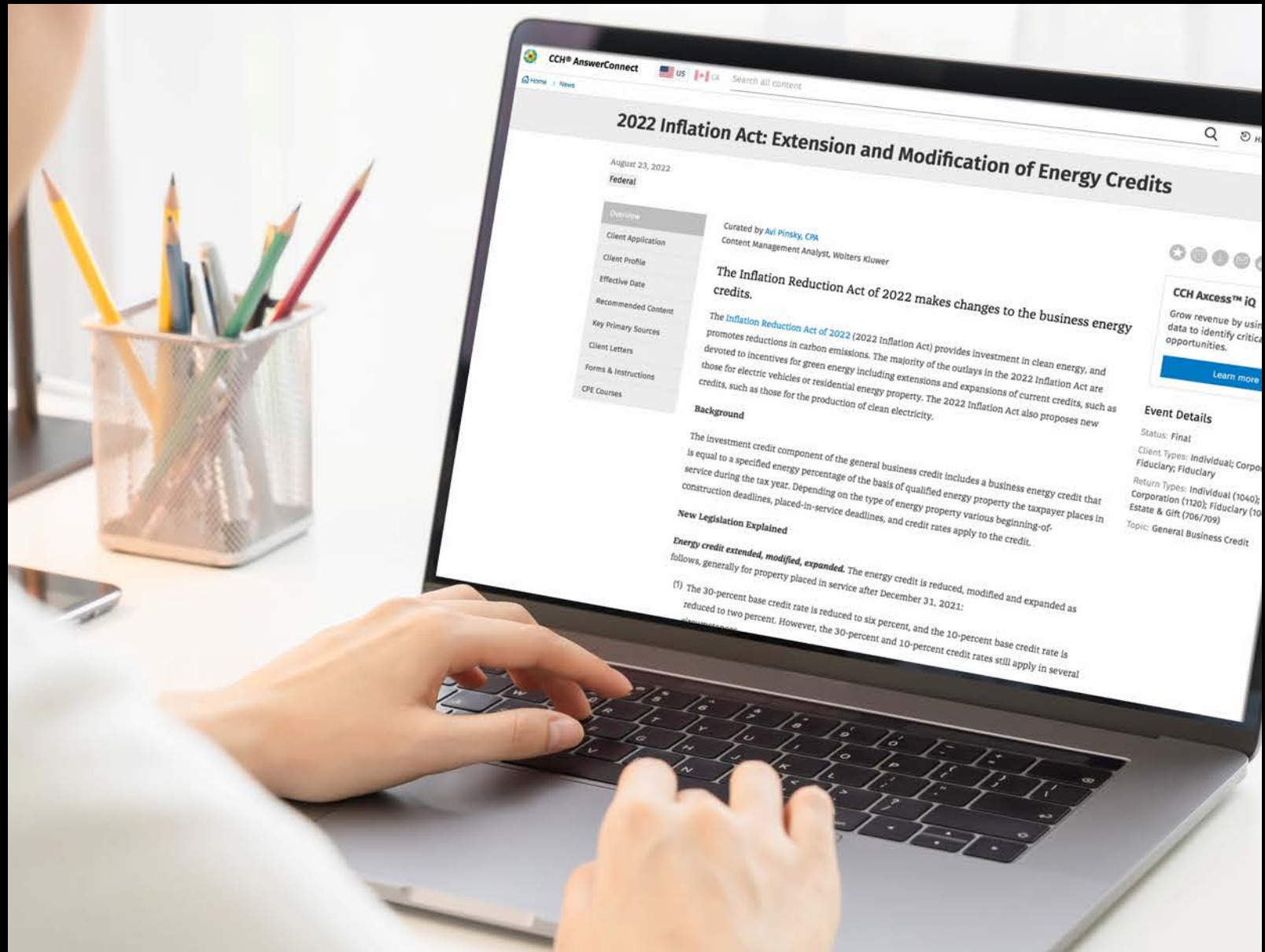
- A. Yes
- B. No



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Thank you for attending the Virtual Coffee Talk — *Managing Section 174 in Uncertain Times*

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Kevin M. Jacobs

Kevin M. Jacobs is a Managing Director with Alvarez & Marsal Taxand, LLC 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.

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.

Note: Alvarez & Marsal employs CPAs but is not a licensed CPA firm.



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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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Robert J. Kovacev

Robert J. Kovacev's practice focuses on federal tax controversy and tax litigation. He combines extensive first-chair litigation skills with substantive tax knowledge to represent taxpayers in high-profile, high-stakes tax disputes against the Internal Revenue Service (IRS), both at the administrative level and in litigation. These disputes include international tax and transfer pricing issues, the research tax credit, the Section 199 domestic production activities deduction, alternative energy tax credits, and the economic substance doctrines. Mr. Kovacev has more than two decades of experience representing clients in Tax Court and in federal district and appellate courts. Recognized by Forbes for having one of the top tax-related Twitter accounts, Mr. Kovacev is a leader in the emerging field of taxation of robotics and artificial intelligence, and he frequently writes and speaks on the topic.

Prior to joining Miller & Chevalier, Mr. Kovacev was a partner at a global law firm. Before entering private practice, he was a senior litigation counsel in the Tax Division of the U.S. Department of Justice (DOJ), where he was lead trial counsel for the IRS in some of the largest and most complex civil tax cases in the nation. In that position, Mr. Kovacev worked closely with the IRS's Large Business & International (LB&I) Division and top management of the Tax Division to shape litigation strategy on high-priority tax enforcement issues. These cases involved cross-border transactions, Section 482 disputes, Section 199 deductions, research credits, foreign tax credits, corporate reorganizations and acquisitions, and IP valuations, with claimed tax benefits ranging from \$10 million to more than \$1 billion.



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Thank you for joining us today!

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