In the vault with KPMG

Tax treatment of research and development expenses

This is a transcript of *In the vault with KPMG*, a banking industry podcast series. In this episode, **Elizabeth L'Hommedieu**, deputy National Tax leader for Banking & Capital Markets, is joined by **Michael Fishman** and **Stefanie Humphrey**, both Tax partners in the Accounting Methods practice at KPMG, to discuss the tax treatment of research and development expenses, covered in IRC section 174.

Elizabeth L'Hommedieu:

Hi everyone and welcome to today's podcast. I'm Liz L'Hommedieu, a principal in the KPMG Banking & Capital Markets Tax practice. And joining me today are my colleagues Stefanie Humphrey and Mike Fishman, both partners in the KPMG Accounting Methods practice, working with our banking and capital markets clients. So Stefanie and Mike, thank you for joining me. I'm glad to have you here today.

Michael Fishman:

Thanks for having us, Liz.

Stefanie Humphrey:

Glad to be here.

Elizabeth L'Hommedieu:

Today we're going to talk about something super exciting, the tax treatment of research and development (R&D) expenses, which is covered in IRC section 174. Now if you've been paying attention, there's been a little bit of drama around 174 and a lot of waiting over it in the past few years. So today I want to talk through where we stand on this now that the legislative dust has settled. So Stefanie, why don't I start with you and we'll get right to it. What is section 174 and why do our banking clients care?

Stefanie Humphrey:

Sure, thanks Liz. So, section 174 defines research and development, or research and experimentation, expenditures for our banks. That is generally going to be costs that are related to their software development activities. Historically, most taxpayers deducted these costs. However, Liz, as you mentioned, there's been some drama around this, and for tax years beginning in 2022, those rules have changed. Most calendar-year clients have made estimates for the new rules as of the end of the year, but we are now at the stage of needing to consider what needs to be done for a tax return.

Elizabeth L'Hommedieu:

Okay, so why don't we start with what changed? Do you want to take this one, Mike?

Michael Fishman:

Sure, it's a great question and you actually have to go back a handful of years when the Tax Cuts and Jobs Act (TCJA) was passed in 2017, mandatory capitalization of section 174 costs was put into the law. But knowing that it was bad policy, Congress expected that some future Congress would come along and change the provision. That hasn't happened. And so, for tax years beginning after December 31st, 2021, so in other words for our country or taxpayers, but 2022 mandatory capitalization of your research expenditures is now the law of the land. So that means for domestic (R&D), that's a 5-year immunization period and anything offshore is actually 15 years. Now R&D for tax purposes is pretty broad to begin with. And section 174 under the new law actually went on to remove what is generally considered to be the technical uncertainty requirement as it relates to software development. So now software development includes all costs related to the development of software regardless of whether or not the uncertainty criteria is met.

Elizabeth L'Hommedieu:

So, if I recap this, banks historically took software development costs and expensed them, although they may have had some flexibility whether they were to choose between dispensing and capitalizing. TCJA, comes through and says it's required that these expenses be capitalized and amortized. Nobody necessarily likes that new rule and expects it'll probably be changed sometime within that five-year period for it to roll in and become effective. But it didn't change. And so here we are, they've expanded the definition of what might qualify as the software development expense and now banks can't deduct that but need to capitalize and amortize it. Have I got that right so far?

Michael Fishman:

You've said that very well, Liz, and that's exactly right. Prior to TCJA, there was a lot of flexibility. I would say most currently expense their R&D expenses, but for various reasons some chose to capitalize. And now, as you stated, mandatory capitalization is a requirement.

Elizabeth L'Hommedieu:

And no one necessarily wanted this change. And do we think it's going to change back again? Is this something temporary or is this for the long haul?

Michael Fishman:

That is a great question. So many people expected that Congress would pass an extender bill before the end of the year. We all know now that that didn't happen. And so the question is, will an extenders bill still make its way through Congress and if it does, will a deferral or potential repeal, but more likely deferral of this provision, be included? I would say the likelihood of an extender bill passing is still relatively promising. There's a number of provisions well beyond the section 174 that would have to be included in an extenders bill. The bigger question is will it be retroactive? Some still believe that Congress will pass an extenders bill prior to when corporate tax returns are actually going to have to be filed. That is looking less and less likely because as the year goes on, many taxpayers particularly partnerships, are already starting to file their tax returns. And so now it's becoming just administratively more challenging. But that doesn't mean that a retroactive deferral won't be passed. And so we're all watching anxiously to see what happens.

Elizabeth L'Hommedieu:

So given the way my bets have turned out recently on what legislative proposals have gone through, I don't think I want to weigh in on the probability of that, but so for now it's here. So why don't we talk about what types of costs qualify or have to be included in this 174 capitalization. Stefanie, can you talk us through that?

Stefanie Humphrey:

Yeah, so the definition of section 174 expenditures and the types of costs that qualify is really quite broad. The regulations in section 174 say that all costs incident to the development are included as section 174 costs. Generally, that's understood to include fully loaded direct costs incurred on a project or a qualifying activity as well as some reasonable amount of eligible overhead. The other challenge is that when I say reasonable amount of eligible overhead, that is not defined in 174 or in the regulations. There are other areas of the Code that we could look to for that, but there is no real definition or methodology to apply to allocate overhead. So it leaves open a lot of uncertainty. Mike also mentioned earlier, and really most relevant for banks, is that the new provisions under 174 say that all costs related to software development are considered to be 174 and that the definition that required technical uncertainty does not apply to software development activity. So as you can imagine, when you put all of those pieces together, all costs related to software development, all cost incident to that development, including some amount of overhead, the definition really becomes quite broad. And the cost pool is probably a lot broader than many taxpayers might have originally imagined when they thought about R&D-type expenses within their organization.

Elizabeth L'Hommedieu:

And I think at least historically, when a lot of our banking clients thought about R&D, they thought about the research credit. So, can you talk a little bit about how the change in 174 impacts other provisions? I know it's not often we get a code section that works in a vacuum. So where are the impacts that we should be focused on? Are there any other traps for the unwary or opportunities with this change?

Stefanie Humphrey:

Yes, absolutely. So, you're right that historically we have really thought about R&D costs within the context of the credit itself. It seems clear that 174 costs are a lot more broad than what would be includable in the credit. And we can talk through that in more detail in a moment, but I think in general we would expect that because software development is not very clearly defined, it's going to include costs such as cost related to minor enhancements, potentially even as broad as bug fixes. So, there's really a question around when banks think about their potential pools of costs, traditionally they might think of change the bank-type activity as eligible. But it's very possible that enhancements and minor efforts like minor enhancements would be included in run-the-bank categories of spend.

Stefanie Humphrey:

So that's one area that's likely not been investigated in the past that would need to be considered and reviewed. For purposes of this broad provision, there's also really a lack of clarity around how we would handle costs related to contract R&D service providers. So, when a particular entity is doing R&D work under a contract that they're ultimately going to hand over to either an intercompany, related party, or even a third party, there's really not any clarity in the regulations as they currently stand for how that would be treated, and which entity might have 174 costs. So that's a really clear area that we need some technical guidance to define how taxpayers should view those types of activities.

Michael Fishman:

And Stefanie, I'll just add on to your comments there. You mentioned it a couple of times that there's a lack of guidance. We know that the service has this on their priority guidance plan. We hope that we'll get some clarification for now. A lot of these unknowns really means that companies need to spend the time to invest in a methodology and to come up with reasonable positions. For example, do maintenance activities and bug-fix activities and run-the-bank activities include software development? Certainly, many of those activities may not be software development, but many might be. And that's what we're recommending to our clients right now is you've likely already completed a provision estimate and now you need to move on to starting to plan for a number that's actually going to hit a tax return. And that's where companies are moving to currently.

Stefanie Humphrey:

But I think feeling like you have enough information to substantiate the pool of 174 costs you've identified is going to be really critical. I think it's also to consider the landscape and sort of the overall modeling impact of 174 to a taxpayer's whole tax picture. You know, in general, I think most taxpayers and practitioners thought of this provision as having a timing impact only. So slowing down the timing of when you get these deductions but not eliminating them entirely, just deferring them over a period of time. Taxpayers do need to consider the interplay of this with provisions such as GILTI and BEAT and expense allocations for foreign tax credit purposes and to the extent applicable to our banking clients fit as well. Those are all items that 174 may create a permanent impact from an effective tax rate perspective. And so that really significantly impacts the considerations and the risk profile risk assessment that a taxpayer might do to think through how to get their arms around and identify the pool of 174 costs. Taxpayers should also really consider the state implications of 174 considering states that decouple from the provision entirely considering the impact on states where they file separate company returns and considering the amortization period from a state return perspective and the impact on those returns is really critical to getting an understanding of the overall tax impact of the provision.

Elizabeth L'Hommedieu:

You raise a really good point on the state side and we will have a separate podcast on that so we can get a little deeper into that topic. But for now, let's end on a good note. You guys have both been telling me that taxpayers may have a bigger R&D credit starting in 2022 because of the nuances of this new mandatory capitalization under section 174 and the interplay between the two. So can you walk us through?

Michael Fishman:

That's right Liz. And this is a bit unexpected to some taxpayers that haven't focused on this nuance of section 280C. You may recall this is the election where taxpayers, instead of claiming a gross credit, can claim a net credit instead and avoid reducing their R&D deductions by the amount of the credit. A lot of words there. But for years and years, as long as I've been doing this, which is more than a couple of decades now, we've been telling taxpayers who want to make the 280C election and claim the reduced credit, there was a change to the 280C rules as part of the overall TCJA changes that accompanied the mandatory capitalization rules and, as rewritten, taxpayers will only reduce the deductible amount of the research credit. So the gross credit claimed exceeds the amount of the research deduction for the qualified research expenses for that year.

Michael Fishman:

Again, a lot of words there, but to restate that in short, unless your credit is bigger than your deduction, you no longer have to apply 280C. So let's give an example. So if a taxpayer had a net credit in the past of $10 million, their credit could actually go up to over $12.7 million for the exact same amount of qualified research expenses. It's a potentially significant upside. And remember, the credit is a permanent item. Liz, one more thing that I want to point out is that beginning in 2022, costs that qualify for the research credit must be treated as specified research expenses. That's really important because historically we might not have focused on that as much. It wasn't part of the law that it had to actually be treated as a specified research amount that is new in 2022. So again, just make sure that if you are planning to claim a research credit on certain costs that you are in fact also treating that as a 174 cost.

Elizabeth L'Hommedieu:

Okay, Mike. So, what I take from that is that if we are claiming a research credit for something, it needs to be part of the bucket that we are amortizing under 174 and we should not make the 280C election going forward, starting with 2022. Although historically, we told everyone to make that election.

Michael Fishman:

Liz, I would say that's generally going to be true. Like anything you want to consult with your tax adviser and make sure you think through all the implications. But the general rule of thumb historically was to make the 280C election and the general rule of thumb post-TCGA change is not to make the 280C election. But again, everybody's facts and circumstances are different. But that would be the general take, the general rule.

Elizabeth L'Hommedieu:

Well said. And thank you for caveating my broad statement. So Stefanie and Mike, I really appreciate both of you talking us through this topic today and sharing your insights. Look forward to having you back to go into more detail, and to our audience, thank you for joining us today. This is Liz L'Hommedieu on behalf of the KPMG Banking & Capital Markets Tax practice. I look forward to talking again soon.

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