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Answers to Your Burning R&E Expenditure and R&D Tax Credit Questions

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BACKGROUND

There are two recent developments that significantly impact businesses' entitlement to tax benefits for the cost of research and experimental (R&E) expenditures. First, for amounts paid or incurred in taxable years beginning on or after January 1, 2022, taxpayers are faced with the reality that R&E expenditures are no longer deductible but must be capitalized and amortized under §174,[1] as amended by the 2017 Tax Cuts and Jobs Act (TCJA).[2] More specifically, domestic R&D expenses must be amortized over five years and foreign R&D expenses must be amortized over 15 years.

The second development, effective January 10, 2022, involved the IRS beginning to require taxpayers who claim the R&D tax credit under §41 in a refund claim to include specific and detailed information concerning the taxpayer's entitlement to the claimed refund. According to a Field Attorney Advice 20214101F (FAA 20214101F), for a taxpayer's refund claim and for the §41 R&D credit to be valid, the taxpayer must, at a minimum, identify all business components to which the §41 R&D credit claim relates for that year. For each business component, the taxpayer must do the following: (1) identify all R&D activities performed; (2) identify by name, title, or position each individual who performed each R&D activity (the IRS has special rules for aggregating information where a group of individuals worked together on R&D activities); and (3) identify all of the information each individual sought to discover.

In addition, FAA 20214101F provides that the taxpayer must also provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year. This information may be provided on IRS Form 6765, *Credit for Increasing Research Activities* (such items, collectively, the "five items of information").

The IRS instructs taxpayers to provide the facts in a written statement rather than through the production of documents. Moreover, if a taxpayer does provide documents, such as a tax credit study, the taxpayer is instructed to specify the exact page(s) that support a specific fact. Finally, the taxpayer must provide a dec-

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With over 20 years of R&D credit experience, Jamie Overberg specializes in executing and managing all aspects of the R&D tax credit as well as a wide range of tax minimization strategies and financial reporting requirements under ASC 730, ASC 740, and Fin 48.

Lawrence (Larry) A. Sannicandro, a partner at McCarter & English, LLP, focuses his practice on federal and state tax controversies, including representation in audits, administrative appeals, collection matters, summons proceedings, criminal tax investigations and prosecutions, and litigation in the U.S. Tax Court, federal district and appellate courts, and state tax tribunals.

As managing director of Global Tax Management's R&D Tax Credit Services practice, Jonathan Forman leads the development and delivery of services that help large and multinational corporations take advantage of available federal, state, and international R&D tax incentives to reduce their tax liability. Jonathan has been involved with R&D for more than 20 years in both technical and taxation capacities, bringing a scientific, IT, and business background to GTM's R&D Tax Credit practice.

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] Pub. L. No. 115-97.

laration, signed under penalties of perjury, verifying that the facts provided are accurate. For this purpose, the signature on the taxpayer's claim for refund usually satisfies this requirement.

In FAA 20214101F, the IRS instructs its employees to reject any refund claim involving the §41 R&D tax credit that does not include the five items of information with the claim. On January 3, 2022, the IRS issued changes to the Internal Revenue Manual[3] and Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions[4] adopting a one-year transition period during which taxpayers will be allowed 45 days within which to perfect a refund claim that does not include the five items of information.

Below, four distinguished tax professionals provide answers to frequently asked questions on trending topics in the R&E and R&D space.

[3] LB&I-04-0122-0001 (Jan. 10, 2022) (interim guidance for IRMs 4.46.3, 4.10.11, 4.1.1).

[4] Available at https://www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions.

R&D AND R&E Q&A

1. What is the impact of the mandatory capitalization of R&E expenditures to corporate tax departments? Such as in their quarterly tax provision calculations and estimated tax payments?

Hogan Humphries: The end result has been impacts to the quarterly tax provision calculations, as well as increases in estimated tax payments for some taxpayers, but the main impact to corporate tax departments has been trying to determine how much time and effort to invest into these changes. Most corporate tax departments are taking the view that these changes will eventually be repealed or deferred and that the effects of mandatory capitalization will never be reported on a tax return. As a result, they are trying to get a reasonable estimate for the tax provision and estimated payments without spending an exorbitant amount of time and effort on this issue. As we have had conversations with our clients some have been surprised at the broad implications of the §174 changes.

Jamie Overberg: Beginning January 1, 2022, all companies — from multi-billion-dollar corporations to small business owners — began capitalizing §174 expenses, spreading the amortization of those expenses either five or 15 years. These changes hit first quarter estimates. Taxpayers lost current year deductibility in 2022 and these changes were reflected on Q1 financial statements and Q1 estimates. The change may be having a huge financial impact on all taxpayers and primarily impacts:

- Businesses making use of §174 expense deductions;
- Businesses claiming R&D credits;
- Companies preparing income tax provisions;
- Companies who make quarterly estimated tax payments; and
- Multinational companies with Base Erosion and Anti-Abuse Tax (BEAT) and Global Intangible Low-Taxed Income (GILTI) consequences.

More specifically, amortization could cause a loss entity to be taxable or increase taxable income for a profitable entity. For companies in a loss situation, §174 capitalization will be deemed profitable and will have to pay tax. This could mean a startup company may have to pay taxes when they have not yet turned the corner.

Entities who have generated taxable losses and have therefore put off calculating an R&D tax credit due to those losses may want to consider calculating these credits. An R&D tax credit may offset some of the potential taxes resulting from the disallowed §174 expenses.

2. What are some of the outstanding technical issues that have not been addressed by Treasury or IRS guidance surrounding the change to §174?

Hogan Humphries: There are several issues that need to be addressed, but I believe the most pressing technical issue has to do with determining whether capitalization is required if the taxpayer is not able to exploit the results of the research in its trade or business. This is especially prevalent with large multinational corporations where development expenses may be fully reimbursed through various types of intercompany agreements.

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The other main issues are related to how wide of a net should be cast in determining the types of costs that are incident to research and experimentation and how broadly software development is defined. The new rules state that all expenses associated with the development of any software shall be treated as R&E expenditures. This appears to eliminate any uncertainty requirement from the §174 regulations[4] and leaves open the possibility that even simple software development, such as a simple script written by an IT department, may be considered software development and require capitalization.

Lastly, there is some confusion over whether an accounting method change will be required to implement these new provisions and it would be helpful to have procedural guidance from the IRS on how to implement these changes.

Jamie Overberg: In a letter to the IRS, we at TaxOps requested guidance that identifies cost categories for §174(a) expenditures. The regulations apply general standards to costs incidental to the development or improvement of a product. Section 174 further focuses on the nature of activities that fall under R&E expenditures, rather than clarifying specific categories for expenditures. We recommend that the regulations delineate the various categories of expenses, both direct and indirect, that fall under the definition of R&E expenditures.

The regulations exclude eligibility of certain expenditures including ordinary testing for quality control, management studies, and advertising and promotions, among others. While interpretive guidance suggests that allocable indirect costs and overhead may be §174 eligible, we recommend clarifying the incidental costs to develop or improve a product per Reg. §1.174-2.

3. Is there any indication when the IRS or Treasury will issue "guidance addressing amortization" as laid out in the Priority Guidance Plan for 2022–2023? (Notice 2022-21).

Hogan Humphries: The IRS has indicated that they are working on two forms of guidance to addresses these issues. One will most likely be in the form of most likely automatic method change procedures for taxpayers to switch their method of accounting to the new capitalization method required by new §174 and the other guidance will address substantive issues. The IRS indicated at a recent American Bar Association meeting that the procedural guidance should be issued prior to year-end. Timing of any other guidance is uncertain and may be dependent on whether Congress repeals or further defers the §174 changes.

Jamie Overberg: We have requested additional guidance within the comment period.

4. What are the prospects of legislation from either the House of Representatives or the Senate in the current congressional session that would restore the previous §174 treatment of R&E expenditures to allow a deduction or deferred expenses? What about legislation that extends the effective date of the changes to §174 to 2023 or 2024?

Hogan Humphries: There is broad bipartisan support for either a permanent fix or at least a deferral of the §174 capitalization requirement. The biggest issue doesn't appear to be whether the issue will be remedied but primarily a question of when. The current consensus appears to be that there will be a tax extenders bill in December that will reverse mandatory §174 capitalization at least temporarily but that still means that corporate tax departments will be dealing with changes to their tax provision calculation and increased estimated tax payments for the remainder of the year. Many taxpayers would prefer to see mandatory capitalization repealed or expended sooner rather than later.

5. How would you define the scope of R&E projects and expenses under §174? As relates to costs alone, is there an argument under the Code or through current IRS guidance to narrow the scope of these expenses now that it is less advantageous?

Hogan Humphries: I would broadly define both the expenses and costs and note that unlike the R&D tax credit there is not a funding exclusion nor is there a restriction that the costs only be incurred in the United States. One of the main arguments to narrow the scope of §174 is to argue that a taxpayer does not have the rights to exploit the results of their research in their trade or business, then expenses could be more appropriately categorized as §162 expenses. Beyond that, a detailed project by project analysis will be needed to determine which types of activities and costs can be potentially excluded from §174.

[4] *See* Reg. §1.174-2.

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Jamie Overberg: Without further guidance from the IRS, we as tax specialty advisors need to operate within currently understood parameters of the law. Accordingly, the scope of project and expenses fall under the ''uncertainty test'' and as defined under §174 are more expansive than under §41. Wages, supplies, outside contract (at 65%) and leased computer costs are eligible for research tax credits. The items to be capitalized under §174, however, include many more costs, such as computer expenses, office expenses, professional fees (including 100% of contract labor and temporary help), R&D travel expenses, rent, salaries and benefits, utilities, and miscellaneous expenses.

Jonathan Forman: Certain costs — e.g., noncore R&D costs — can, by overlapping definition, be classified in different ways. Historically this hasn't been an issue as they were deductible. Now, however in order to claim an R&D tax credit on the costs, they must be treated under §174. One exception now is software development costs which used to be treatable under Rev. Proc. 2000-50, is now considered ''specified'' R&E and must be treated as an R&E expenditure under §174.

6. Is there interplay (if any) between the changes to the §163(j) interest deduction and §174 R&E expenditures? How does this affect corporate filing and quarterly tax provision calculations of corporate tax departments?

Hogan Humphries: In the event that the requirement to capitalize §174 expenses increase a taxpayer's taxable income, there could be an interplay with §163(j). As with any changes, taxpayers should model the effects of changes to taxable income in determining their §163(j) interest deduction and consider possible method changes to increase adjusted taxable income.

7. What practice pointers can you provide corporate tax departments in implementing the R&E expenditure changes from §174 into their filing practices and procedures?

Hogan Humphries: At this point, it is hard to recommend that taxpayers implement changes to their filing practices and procedures given the belief that Congress will eventually pass legislation to extend or repeal mandatory capitalization. If they have not already, corporate tax departments should keep management informed about increased estimated tax payments and should consider possible methods to identify §174 costs if Congress doesn't act. Barring exceptions for short year returns or other unusual situations, the first tax returns reflecting mandatory capitalization of §174 expenses won't be filed until 2023. The hope is that Congress will restore immediate expensing of §174 expenses by then.

Jamie Overberg: Every company that has R&E expenditures under§174 are required to capitalize all R&D costs. This includes departmental and personnel costs associated with R&D, such as software engineering, design engineering, project management, and all other departments that support R&D. Whereas under §41, only some of those costs may be applied to the credit calculation. Some companies are using their ASC 730 number, and then adjusting out foreign costs and already capitalized items as their §174 number, resulting in a faster §174 determination. While not necessarily wrong, it might result in a more taxable outcome than necessary. Work with your financial statement auditor to see the amount of support they would like to have for this determination.

8. California has chosen not to conform and require capitalization, which impacts the provision and tax payment of taxpayers in California. How does state-by-state conformity, or lack thereof, impact the provision and tax payments?

Hogan Humphries: Taxpayers should be conducting a state-by-state analysis of their situation to determine the impact for each state on their overall provision and estimated payment situation.

Jamie Overberg: If a state does conform to federal §174 law, then that state will be capitalizing more §174 expenses and will be more taxable. For those states like California, who do not conform, taxpayers will be taxed similar to prior years and will see not see the additional taxable income due to this issue.

On a state-by-state basis, taxpayers in conforming states, may be subject to more taxation and will need to make additional quarterly payment amounts. For taxpayers in loss situations in conforming states — they will have tax payments due where they might never have been taxable before. In other words, taxpayers could be paying state taxes in a state where they would not have had to if the state conforms to the current federal rules of capitalizing §174 costs.

This is a two-step process to account for nonconformance. A business must evaluate their state's overall impact relative to federal liability and then, determine which states might require quarterly payments. Businesses can check into state conformity issues themselves or ask their tax provider.

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If a state chooses not to conform, then then the taxpayers in those states will, all other things being equal, be taxed similar to prior years and no change to payments and taxpayers will not have to make any further payments.

Jonathan Forman: Separate calculations must be done for state purposes. This is similar to research credits where certain states (e.g., TX, CT) don't conform to federal guidelines, and require separate calculations.

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9. What is the effective date of the IRS's requirement to include the additional information for a §41 R&D tax credit claim and what are the consequences for failing to provide this information?

Hogan Humphries: January 10, 2022.

Jonathan Forman: The additional information is only required — currently — for amended returns for refund. The effective date is January 10, 2022, with a grace period until January 9, 2023. During the grace period, taxpayers are given 45 days to perfect a refund claim if it is deemed insufficient. After January 9, 2023, no additional time will be provided.

Larry Sannicandro: The IRS takes the position that the five items of information must be provided with any formal or informal claim for refund involving the §41 R&D tax credit that is postmarked on or after January 10, 2022. Importantly, the term ''claim for refund'' has a broad application. In FAA 20214101F, the IRS correctly notes that refund claims may be made on an original tax return or an amended tax return (as well as on other IRS forms). And, while the IRS's guidance is not a model of clarity, it is reasonable to expect the five items of information are required for both original ***and*** amended tax returns claiming the §41 R&D tax credit.

That said, beginning on January 10, 2022, and continuing through January 1, 2023, the IRS states that it will advise taxpayers of a deficient refund claim involving the §41 R&D tax credit by issuing Letter 6426C or Letter 6428. The letter issued during this transition period will supposedly specify which of the five items of information are missing and give the taxpayer 45 days to perfect the refund claim. The term ''perfect'' means taxpayers are given an opportunity to provide missing information that the IRS considers to be required to process the claim for refund. The date by which a taxpayer must provide the missing information will supposedly be stated on the letter sent to the taxpayer. The information may be sent by fax or mail. Upon the expiration of the 45-day perfection period, if the information is not provided, then the IRS will reject the entire claim for refund.

After the transition period, taxpayers should expect IRS employees to reject any refund claim involving the §41 R&D tax credit that does not include the five items of information with the claim. These requirements, however, are subject to change.

For claims for refund postmarked before January 10, 2022, the IRS has said that the five items of information are not required to be provided with a claim for refund involving the §41 R&D tax credit.

10. What should a practitioner do if they filed a §41 R&D refund claim before the effective date but did not supply the information required by the IRS as set forth in FAA 20214101F?

Hogan Humphries: Given the backlog in processing of information at the IRS, I would be patient and give the IRS time to process the amended return and issue the refund check. It may be helpful to pull account transcripts and/or contact the IRS to determine whether the claim has been processed and the ultimate disposition.

Jonathan Foreman: There are no new/additional requirements for filings done prior to January 10, 2022. The practitioner should treat the filing just as any filing prior to the change.

Larry Sannicandro: I agree with Jonathan that the substantiation requirements should not apply to claims for refund postmarked before January 10, 2022. But taxpayers should still expect the IRS to scrutinize refund claims involving the §41 R&D tax credit, regardless of when the claim is actually made.

11. What are the possible consequences to taxpayers of failing to provide the information requested by the IRS in FAA 20214101F?

Hogan Humphries: For now, we have seen the IRS issue letters to taxpayers stating that they cannot process the claim within the required information. Presumably, if the required information is not provided, the IRS will not process the refund claim.

Jonathan Foreman: Their refund claim will be rejected. There is no appeal process if this is the case. If the taxpayer combines the research credit refund claim with additional refund claims on the same amended return, all refunds will be rejected, not just the research credit refund.

Larry Sannicandro: After the transition period, IRS employees should reject any refund claim involving the §41 R&D tax credit that does not include the five items of information with the claim. But these procedures are subject to change.

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12. What procedural challenges, if any, should practitioners consider making if a refund claim has been disallowed for insufficiency?

Hogan Humphries: Unfortunately, the IRS has purposely set up this process to prevent taxpayers from having access to the IRS Independent Office of Appeals. Taxpayers may need to consider resorting to litigation to determine whether the IRS has the authority to require this information.

Jonathan Forman: During the grace period (January 10, 2022 – January 9, 2023), the IRS will inform ''of a deficient claim for refund through Letter 6426C or 6428. The letter will indicate which of the five items of information are missing and provide 45 days to perfect the filing.''[5] After the grace period, there will be no available procedural options if the statute of limitations has expired. If, however, there is still time on the statute of limitations, the taxpayer can refile with the additional information included. Beyond this, taxpayers can challenge the procedure in court.

Larry Sannicandro: The IRS's decision to use FAA 20214101F, the Internal Revenue Manual,[6] and Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions to require the five items of information creates numerous tax procedure issues that are likely to be litigated in connection with disallowed claims for refund. For example, the requirements for a valid administrative claim for refund are defined by statute, Treasury regulations, and caselaw. The most relevant of these requirements is set forth in Reg. §301.6402-2(b), which requires an administrative refund claim only to set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the IRS of the exact basis for the claim. A taxpayer could potentially argue that a refund claim involving the §41 R&D tax credit that does not contain the five items of information purportedly required by FAA 20214101F is nevertheless allowable because it meets the specificity requirement of Reg. §301.6402-2(b). As support for this position, in addition to a plain meaning analysis of §6402 and Reg. §301.6402-2(b), the taxpayer could further explain that FAA 20214101F is not entitled to *Chevron* or *Auer* deference[7] because it is not a Treasury regulation.

As another example, §7805(a) imposes upon the IRS the obligation to ''prescribe all needful rules and regulations for the enforcement of [the Code], including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.'' Section 551(4) of the Administrative Procedures Act (the ''APA'') establishes the procedures that federal administrative agencies, including the IRS, must use for rulemaking. And, unless an exception applies, the APA generally prescribes a ''notice-and-comment'' procedure for rulemaking. Specifically, before formulating, amending, or repealing rules, the agency generally must publish a notice of proposed rulemaking and give interested persons an opportunity to comment. The agency, in turn, must consider and respond to significant comments. As we have seen in a number of recent tax cases, such as *CIC Services, LLC v. IRS*,[8] *Mann Construction, Inc. v. United States*,[9] and *Hewitt v. Commissioner*,[10] when the IRS fails to follow the APA's notice-and-comment procedures, courts have held unlawful and set aside the IRS's action. And, when an agency undertakes to act by rulemaking, §553 of the APA ordinarily requires the agency to follow specified procedures that include notice, hearing, and publication procedures.

Against that background, a taxpayer might argue that a court must hold the IRS's requirements unlawful, and set them aside, because the IRS did not comply with the APA in requiring the five items of information through FAA 20214101F, the Internal Revenue Manual,[11] and the IRS FAQ titled Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions, a taxpayer could argue that §706 of the APA requires a court to hold the IRS's requirements actions as unlawful and set them aside. And, if the IRS's substantiation requirements are held inapplicable for failure to comply with the APA, then the taxpayer might argue that the refund claim is allowable because all other substantive and procedural requirements for met for the credit or refund to be made.

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[5] IRS FAQ, Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions, Q&A #7.

[6] LB&I-04-0122-0001 (Jan. 10, 2022) (interim guidance for IRMs 4.46.3, 4.10.11, 4.1.1).

[7] *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 847 (1984); *Auer v. Robbins*, 519 U.S. 452 (1997).

[8] 141 S. Ct. 1582 (2021).

[9] 27 F.4th 1138 (6th Cir. 2022).

[10] 21 F.4th 1336 (11th Cir. 2021).

[11] LB&I-04-0122-0001 (Jan. 10, 2022) (interim guidance for IRMs 4.46.3, 4.10.11, 4.1.1).

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These arguments are by no means exhaustive, and nuances abound, but and we should expect litigation concerning these and other issues.

13. Would the change in the law under §174 make it more advantageous for a corporate tax department to claim the research R&D tax credit under §41 as opposed to the R&E deduction under §174?

Hogan Humphries: The change in the law is likely to make it more likely that a taxpayer will claim the R&D tax credit under §41. One of the requirements for the §41 R&D tax credit is that the expenses must be §174 costs so it generally is not going to be possible to claim a §41 credit while also ignoring §174. Under pre-TCJA law where §174 costs could be immediately expensed; a taxpayer may not have had a tracking mechanism in place to identify their §174 costs. Under post-TCJA law, if a corporate tax department is going to undertake efforts to identify §174 costs, they might as well also identify their §41 costs.

Jamie Overberg: Companies have the option to take the credit or not, and under these rules, the size of the credit will not be any larger than it was before changes to §174 capitalization. Because taxpayers may carry a larger tax burden now, it may be more advantageous for a corporate tax department to claim the R&D tax credit and offset some of that tax liability. So, while the credit is not larger, the impact to the taxpayer's bottom line is more substantial. Facing a larger tax bill, it is time for more taxpayers to go claim the R&D tax credit.

Jonathan Forman: TCJA changed §41(d)(1)(A) to define qualified research in part as ''specified research or experimental expenditures under §174.'' In other words, to be qualified, the cost must be a §174 cost. In other words, this isn't an either/or question. Prior to the change in §174, costs had to be costs that ''may'' be treated as a §174 cost. Therefore, now there is no choice about treatment if the taxpayer wants to claim a research credit on the cost.

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