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Internal Revenue Service
1111 Constitution Ave. N.W.
Washington, D.C. 20224

Via electronic submission

RE: TEI Comments on Notice 2023-63

Dear Sir or Madam:

The 2017 Tax Cuts & Jobs Act ("TCJA")[1] changed the tax treatment of specified research and experimental ("SRE") expenditures under section 174,[2] effective for tax years beginning after December 31, 2021. Taxpayers must now capitalize and amortize SRE expenditures instead of deducting them in the year incurred, distinguishing such expenditures from other deductions under section 162 where, under prior law, there was no difference in the current deductibility of such items. Notice 2023-63 (the "Notice"), released on September 8, 2023, provides interim guidance on certain section 174 issues that the Department of Treasury ("Treasury") and the Internal Revenue Service (the "IRS," together with Treasury, the "Government") intend to address in forthcoming regulations. On behalf of Tax Executives Institute, Inc. ("TEI"), I am pleased to provide comments on section 174 and the Notice.

About TEI

TEI was founded in 1944 to serve the needs of business tax professionals.[3] Today, the organization has 56 chapters in North and South America, Europe, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI

[1] Pub. L. 115-97.

[2] All "section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] TEI is organized under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the Code.

has a significant interest in promoting sound tax policy, as well as the fair and efficient administration of the tax laws, at all levels of government. Our nearly 6,000 individual members represent over 2,900 of the leading companies around the world.

TEI is dedicated to the development of sound tax policy, compliance with and uniform enforcement of tax laws, and minimization of administration and compliance costs to the benefit of both government and taxpayers. These goals can be attained only through the members' voluntary actions and their adherence to the highest standards of professional competence and integrity. TEI is committed to fostering a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner. The diversity, professional training, and global viewpoints of our members enable TEI to bring a balanced and practical perspective to section 174.

TEI Comments

TEI appreciates the opportunity to provide comments on section 174 and the Notice. Our comments and recommendations herein respond to some of the questions raised in the Notice and highlight areas and issues requiring further guidance under section 174.

Scope of Section 174

Section 4 of the Notice provides guidance on which expenditures are subject to capitalization and amortization under section 174. TEI appreciates the clarity provided by this section. However, in section 1, the Government indicates that the Notice is not intended to change the rules for determining eligibility for or computation of the research credit under section 41 (the "research credit"). Then, in defining labor costs that are considered SRE expenditures subject to capitalization and amortization under section 174, the Notice specifically excludes severance compensation. As historically severance costs would qualify for the research credit, this carve out appears to be at odds with that treatment and raises the question as to whether severance costs still qualify for the credit. TEI does not understand the rational for this carve-out and requests that the Government consider removing this exclusion from SRE expenditures.

Cost Allocation

Section 4 also provides that taxpayers must allocate costs to SRE activities on the basis of a cause-and-effect relationship between the costs and the SRE activities or another relationship that reasonably relates the costs to the benefits

provided to the SRE activities. One example provided in the Notice multiplies labor costs by the ratio of the hours spent by a person or persons performing, supervising, or directly supporting SRE activities over the total time spent performing all services. As not all taxpayers have project costing or time-tracking systems for their section 174 costs, TEI requests that any reasonable allocation method be allowed. Additionally, it would be helpful for the Government to provide a simplified method for different types of costs based on a single allocation "key," such as labor hours or labor dollars. Some TEI members have been using cost center reports to do these allocations, by either pulling any research and development charged to those cost centers or determining which accounts should be pulled into the calculation. However, such methodologies have been very time intensive for taxpayers and only available for those already tracking costs by cost centers.

Software Development

There are many fine distinctions for determining what constitutes software development under section 5 of the Notice. For example, maintenance activities after computer software is placed in service that do not give rise to upgrades and enhancements are not activities that are treated as software development subject to section 174. Upgrades and enhancements are defined as modifications to existing software that result in additional functionality, or materially increase speed or efficiency. In some cases, it can be difficult to determine which activities constitute basic maintenance and which create new functionality and, in most cases, there are aspects of both.

Similarly, the distinction between installations and upgrades and modifications to purchased software can be difficult to make. Consider the following scenario: a taxpayer purchases a software platform (like SAP) and spends internal and external resources to implement, configure, and customize it. Subsequently, future updates are received from the software platform vendor, and those updates contain some fixes and some enhancements. Presumably the initial purchase is an installation such that the costs associated with it are capitalized to the software and depreciated under section 167(f). But what about the fixes and updates? Are those considered maintenance subject to section 162, development subject to section 174, or additional purchased software subject to section 167(f)? What about the internal and external costs to implement it pursuant to section 162 or section 263A? And what if it is a significant and

particularly costly upgrade, such as an upgrade to SAP S/4 HANA? Does that change the answer? Further clarification of these terms would be valuable for taxpayers.

Additionally, allocating costs between software developed for internal use and software developed for sale or license proves especially difficult as many taxpayers that do not claim the research credit do not track the time their employees spend on these activities. TEI recommends a safe-harbor, which would allow companies that only develop and maintain software for internal use to limit the scope of section 174 to the software development team costs.

Research Performed under Contract

Under section 6 of the Notice, generally the party facing the financial risk under a research contract must capitalize its associated costs. However, the Notice provides that, in the case of a retained right to the research product, service providers could be required to capitalize and amortize their associated costs. These costs paid or incurred by a research provider are considered costs incident to SRE activities if the research provider merely has the right to use any resulting SRE product in its trade or business, regardless of whether such party bears financial risk under the terms of the contract. The right to use is very broad and what it covers could be more specifically delineated in future guidance.

TEI believes that the determination of which party is required to capitalize its expenses should focus solely on which party bears the financial risk. Under the current language, more than one party to a contract could be required to capitalize the expenses, resulting in double or even triple capitalization. This is an unusual result in general but poses additional challenges for multinational taxpayers. Controlled foreign corporations ("CFCs") frequently perform services, whether engineering, distribution, or otherwise, related to an SRE product on a cost-plus basis. Often these arrangements are covered by an advance pricing agreement, and any residual profit is realized in the United States, where the intellectual property is held. Capitalization by the user and the provider pursuant to the guidance in the Notice results not only in double capitalization but also results in supercharging the GILTI impact as a result of the double capitalization on the tested income of a CFC even when the SRE costs are reimbursed on an arm's length basis. The Government has indicated that the intent was not to treat separately bargained-for rights to use the SRE product or rights to use the SRE product merely for further research, as a right to use the SRE product that should trigger

capitalization under section 174.[4] TEI requests that future guidance use the financial risk standard to make this determination; however, if the right to use standard is maintained, TEI requests that the government further clarify the limitations of this standard and exclude parties with limited use and residual use rights.

Long-term Contracts under Section 460

The Government has acknowledged that the approach in the section 460 regulations would significantly accelerate income recognition without any modification. Some taxpayers have hundreds of long-term contracts with high-dollar values to account for each year; therefore, this mismatch of revenue recognition and related cost deductions significantly impacts these taxpayers' taxable income positions. Section 8 of the Notice proposes a revision to the regulations under section 460 with regard to the percentage-of-completion method ("PCM") used to account for income from long-term contracts when allocable contract costs include SRE expenditures. Despite the proposed revision to the computation of the completion factor under section 460 to account for the timing of the SRE expenditure amortization deductions, there still is a mismatch because taxpayers have to recognize any remaining revenues on the contracts in the year after they are completed under section 460(b)(1), even if SRE expenditures still need to be amortized.

TEI does not believe revisions to the PCM computation are necessary to solve the mismatch problem. Rather, we believe section 460 determines not only the timing of revenue recognition for long-term contracts but also timing of the deductions for costs incurred (including SRE expenditures) in completing long-

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[4] *See* N. Richman, "Contract Research Amortization Rule Has Capital Expenditure Root," 180 Tax Notes Federal 2380 (Sept. 25, 2023). Timothy Powell, Policy Advisor in the Office of Tax Policy, made similar statements as part of a panel on section 174 for the American Bar Association, and co-panelists from the IRS agreed on the intended focus of the "right to use" condition. J. Rohrs, M. Duffy, T. Powell (Tax Policy Advisor, Treasury), J. Hanlon-Bolton (Deputy Associate Chief Counsel (IT&A), IRS), D. Devereux (Branch Chief, Branch 7 (IT&A), IRS), and W. Spiller (Counsel (IT&A), IRS); *Where Do We Stand with Section 174 Capitalization with 2022 (Mainly) in the Rear View?*, Capital Recovery & Leasing Committee, American Bar Association Tax Section Meeting (Oct. 18, 2023).

term contracts.[5] Allowing section 174 to override the timing of expense deductions for long-term contracts will always produce a mismatch of revenue recognition and expense deduction and is contrary to the basic mechanics of the PCM computation. The capitalization and amortization requirements under section 174 should not impact taxpayers already recognizing revenues based on costs incurred (excluding amortization). In fact, a key reason for enacting the capitalization of SRE expenditures was to match the deductions with the future benefit (*i.e.*, revenues) from these activities.[6] However, matching is achieved for long-term contracts under section 460. Therefore, we request that the Government confirm that section 174 does not control costs already subject to section 460.

Start-up Companies and Small Taxpayers

Section 174 places a significant compliance burden on start-ups and small taxpayers. Furthermore, it can place a near insurmountable burden on start-ups from a cost perspective because such companies spend a lot of money upfront for limited revenue, and then are unable to immediately deduct those costs. TEI requests that the Government promulgate special rules for these taxpayers; specifically, future guidance could include a threshold for section 174 similar to the one under section 263A (essentially an exclusion for companies with $25 million or less in gross receipts).

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TEI appreciates the opportunity to comment on Notice 2023-63. TEI's comments were prepared under the aegis of its Federal Tax Committee, whose chair is Julia Lagun. Should you have any questions regarding TEI's comments,

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[5] *See* CCA 201111006 (March 18, 2011)(concluding that a taxpayer cannot apply pre-TCJA section 174 to deduct costs allocable to long-term contracts; rather the taxpayer was required to apply section 460 for determining the timing of deducting costs in those circumstances).

[6] "The Committee recognizes that research and experimentation expenditures have a useful life beyond the tax year in which the expenditures are incurred, and that the tangible and intangible property created through research and experimentation activities provide value to a business beyond a single tax year….For these reasons, the Committee believes research expenses, including software development costs, should be amortized over a period beyond the current year." H.R. Rep. No. 115-409, 115th Cong., 1st Sess., p. 282 (Nov. 13, 2017).

please do not hesitate to contact TEI tax counsel Kelly Madigan at 202.470.3600 or kmadigan@tei.org.

Respectfully submitted,

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