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The Honorable Lily L. Batchelder
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Via email

RE: Regulatory Guidance for Capitalization of Section 174 Expenditures

Dear Ms. Batchelder:

The 2017 Tax Cuts & Jobs Act (“TCJA”)¹ changed the tax treatment of research and experimental (“R&E”) expenditures under section 174² effective for tax years beginning after December 31, 2021. Taxpayers must now capitalize and amortize R&E 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. Absent Congress returning section 174 to its pre-TCJA treatment of R&E expenditures, there is an urgent need for guidance delineating the scope of section 174 R&E expenditures.

On behalf of Tax Executives Institute, Inc. (“TEI”), I urge the U.S. Department of the Treasury (“Treasury”) and Internal Revenue Service (the “Service”, together with Treasury, the “Government”) to consider as soon as possible the recommendations offered below for regulatory guidance should section 174 remain in its post-TCJA form. TEI is happy to further discuss the recommendations below with the Government as any guidance under section 174 works its way through the regulatory process.

¹ Pub. L. 115-97.

² All “section” references herein are to the Internal Revenue Code of 1986, as amended (the “Code”).

About Tax Executives Institute

TEI was founded in 1944 to serve the needs of business tax professionals.³ Today, the organization has 57 chapters in North and South America, Europe, and Asia. As the preeminent association of in-house tax professionals worldwide, TEI 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 Comments & Recommendations

There is a dearth of guidance defining the scope of R&E expenditures due to their historic tax treatment as currently deductible and the concomitant lack of need to distinguish such expenditures from other section 162 deductions. Further, the extensive guidance delineating the scope of qualified research expenditures (“QREs”) eligible for the credit under section 41 (the “R&D credit”) is of limited use because of section 174’s broader reach. Taxpayers have of course capitalized R&E expenditures for purposes of computing their quarterly financial statement tax provisions and quarterly estimated tax payments for 2022 as required by the post-TCJA language of section 174. Among the challenges in applying current section 174 to these calculations, other than the lack of regulatory guidance, is the difficulty in estimating costs that must be capitalized under section 174 because most taxpayers’ research and development efforts vary considerably from year to year.

To comply with section 174 capitalization, taxpayers may conduct studies similar to those undertaken to support the R&D credit. R&D credit studies require interviewing and obtaining detailed information from those undertaking the R&D activities (e.g., engineers and scientists). Further, R&D credit studies are typically conducted after year-end when actual cost information is available to compute the credit. These studies are completed to support the R&D credit claimed on the tax return, which many taxpayers file on the October 15 extended due date (for calendar year taxpayers). Therefore, the best available information to use as a starting point for computing taxpayers’ 2022 section 174 costs may be their R&D credit studies from the 2020 tax year (because the 2021 R&D credit studies lag the due dates for quarterly tax provisions and estimated tax payments in 2022). However, as noted above, these studies do not include all costs that must be capitalized under section 174. Finally, section 174 interacts with numerous other code sections which, at a minimum, adds a fair amount of complexity in preparing quarterly income tax provisions and certainly at year-end.

For the reasons described above, TEI recommends that Treasury issue guidance providing two alternative safe harbors when computing section 174 costs for income tax purposes:

1. **ASC 730 Safe Harbor:** For those reporting companies that disclose R&D expenditures under ASC 730, provide that taxpayers may use the audited financial statement numbers and report

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 Internal Revenue Code of 1986, as amended (the “Code”).

them as section 174 costs on their tax returns. We acknowledge that the definition of R&D expenditures for GAAP purposes differs from what may be considered R&E expenditures under section 174, but an ASC 730 safe harbor would eliminate the need to conduct a separate section 174 study and reduce compliance costs.

2. **QREs Safe Harbor:** Provide that taxpayers may use a percentage (100%+) of QREs plus software development costs, to the extent not otherwise included in QREs, as their section 174 costs on their tax returns. Presumably many taxpayers incurring R&E expenditures also claim R&D credits.⁴ Given that QREs are a subset of section 174 costs, permitting section 174 costs to be estimated as a fixed percentage of a taxpayer's QREs for the same year is a practical and efficient approach – both for taxpayers preparing returns and the Service auditing returns.

The ASC 730 Safe Harbor may be helpful in computing quarterly tax provisions as well for those public companies who disclose R&D expenditures on their Form 10-Qs.

A QRE Safe Harbor is a logical extension of the R&D credit study process. However, it may not be helpful in computing quarterly tax provisions because, as noted, R&D studies are typically conducted after year-end. Accordingly, for estimated tax payments, TEI recommends that Treasury permit use of an estimate for section 174 costs rather than actual section 174 costs as it is simply not practical to conduct a quarterly study of such costs. TEI recommends that the section 174 costs as reported on the most recently filed income tax return be utilized for the quarterly estimated payments.

As a transition measure for 2023 estimated tax payments, since section 174 costs were not required to be separated from other deductions prior to January 1, 2022, the section 174 costs for 2023 estimated tax purposes should be deemed to be zero prior to that effective date. Said differently, taxpayers would not take into account section 174 costs as part of their estimated tax payments until Q4 2023, the period in which the 2022 tax year returns are due and filed with section 174 costs separated from other deductions.

Finally, TEI recommends the Government provide relief from underpayment penalties for taxpayers who may have underpaid their 2022 estimated taxes because of the application of section 174 until Treasury and the Service issue substantive guidance.

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TEI appreciates the opportunity to provide recommendations on the calculation of section 174 expenditures required to be capitalized and amortized. TEI's recommendations were developed under the aegis of its Federal Tax Committee, whose Chair is Julia Lagun of Comerica Bank, and led by Betty Mak of Maxar Technologies, Inc., a Vice Chair of the Committee. Should you have any questions

⁴ For those taxpayers incurring R&E expenditures outside the United States, we recommend allowing taxpayers to base the QREs Safe Harbor on a regime similar to the U.S. R&D tax credits *e.g.*, the Scientific Research and Experimental Development program in Canada.

regarding this letter, please do not hesitate to contact Ms. Mak at Betty.Mak@Maxar.com, or Benjamin R. Shreck of the Institute's legal staff at bshreck@tei.org or 202.464.8353.

Respectfully submitted,



Wayne G. Monfries
International President
TAX EXECUTIVES INSTITUTE

Copies to: Krishna Vallabhaneni, Tax Legislative Counsel, U.S. Department of the Treasury
William M. Paul, Principal Deputy Chief Counsel and Deputy Chief Counsel (Technical),
Internal Revenue Service