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December 9, 2022

The Honorable Ronald L. Wyden, Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Michael D. Crapo, Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Richard E. Neal, Chairman
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Kevin P. Brady, Ranking Member
Committee on Ways and Means
United States House of Representatives
1139 Longworth House Office Building
Washington, D.C. 20515

RE: Capitalization of Research & Experimental Expenditures under Section 174

Dear Sirs:

On behalf of Tax Executives Institute, Inc. ("TEI"), I am writing to call your attention to the urgent need for Congress to adopt the legislative changes proposed below concerning research and experimental expenditures under section 174 for amounts paid or incurred in taxable years beginning after 2021. As the preeminent association of in-house tax professionals worldwide, TEI represents a cross-section of the business community and is well positioned to provide practical, consensus-based input on significant issues of corporate tax policy and administration. TEI members

possess deep experience with the day-to-day application and consequences of the federal tax laws and thus represent a valuable source of balanced, objective information for policymakers during this critical time.

About TEI

TEI was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 57 chapters with nearly 6,000 members representing 2,800 of the leading companies across North and South America, Europe, and Asia. TEI represents a cross-section of the business community and is dedicated to the development of sound tax policy, compliance with and uniform enforcement of tax laws, and minimization of compliance and administrative burdens to the mutual benefit of taxpayers and government.

Discussion

TEI appreciates Congress' passage of the CHIPS and Science Act of 2022, as well as the Inflation Reduction Act of 2022 in the summer session. At the same time, however, TEI members expressed disappointment that these laws did not include a provision to repeal or (at least) delay the mandatory capitalization of research and experimental expenditures under section 174. These new rules impact taxpayers in a wide spectrum of industries. The impact is particularly significant and material for businesses whose success depends on innovation. Further, mandatory capitalization under section 174 exacerbates the financial challenges faced by taxpayers in these uncertain economic times, marked by rising interest rates with a possible recession looming ahead.

As the end of the 2022 calendar year quickly approaches, prudent taxpayers can no longer take a wait-and-see approach and must develop concrete action plans to prepare their section 174 computations (and related corollary effects) for financial statement audits. The following discussion articulates taxpayers' experiences thus far and why it is imperative for Congress to act before the end of the 2022 calendar year to postpone at least temporarily, if not repeal, the mandatory capitalization of expenditures under section 174.

Background

The Tax Cuts and Jobs Act ("TCJA") of 2017 provides that, effective for tax years after 2021, R&E expenditures are no longer deductible in the year incurred but must be capitalized and amortized. Until recently, many held out hope that the mandatory capitalization would be repealed or at least postponed given the broad bipartisan support on this issue. Further, while this provision has been effective for nearly 11 months, neither Treasury nor the Service has issued any guidance. It is therefore particularly appropriate, at a minimum, that Congress extend the effective date of these rules at least until 2023, but ideally repeal the capitalization requirement altogether, or preferably extend the effective date beyond 2023. An extension would allow Treasury and the Service additional time to provide guidance on the technical gaps identified by taxpayers and tax practitioners in section 174 (such as the scope of section 174 costs and the definition of software development costs), as well as its interactions with other code

provisions including: (i) sections 41, 162, 167, 168, 263(a), 263A; (ii) the BEAT, FDII, and GILTI regimes; and (iii) various foreign tax credit provisions and regulations.

TEI Comments

TEI members are employed by companies across diverse industries including aerospace, banking, energy, health care/ life science/ pharmaceuticals, telecommunications, and technology. The success of most, if not all, of these businesses depend heavily on product and process innovations through research and experimental (“R&E”) activities. The requirement to capitalize R&E expenditures creates a disproportionate tax burden on these innovative businesses. For example, start-up companies typically struggling with cash flows and otherwise generating net operating losses (NOLs) instead find themselves generating taxable income and therefore incurring a cash tax cost. Similarly, other companies already producing taxable income are spending significantly more of their cash on income taxes than they would have under prior law. Importantly, the tax burden of section 174 capitalization diverts cash away from these companies’ core business activities and harms their competitiveness.

The mandatory R&E capitalization rules under current section 174, as a stand-alone provision, would be merely a “timing difference” for many companies. However, the TCJA introduced many new interrelated provisions to the Internal Revenue Code. Changes in the treatment of one item may require re-computations of other tax provisions. Taxpayers find the application of section 174 creates permanent book-to-tax adjustments (e.g., under the GILTI and FDII regimes) leading to changes in their effective tax rates that vary significantly from statutory rates. These variances can be unmanageable and create observable erratic distortions of a company’s performance, which in turn adversely impacts investor confidence. TEI members believe these are unintended results not taken into account by Congress when these rules were enacted.

Further, SEC reporting companies must account for income taxes based on the law enacted as of the balance sheet date. For calendar year taxpayers, if Congress does not repeal or delay the mandatory capitalization of R&E expenditures under section 174 so the President can sign it into law on or before December 31, 2022, then companies’ 2022 financial statements must take into account the full impact of these rules, even if the legislation changes in 2023 to allow for deductions of R&E expenditures retroactive to January 1, 2022.

Recommendation

As described above, section 174 may have a very material and pervasive impact on many taxpayers. Therefore, TEI respectfully – and strongly – urges Congress to repeal, or at least delay the effective date by two years to 2024, of the mandatory capitalization of R&E expenditures before December 31, 2022, or until clearer distinctions can be made concerning the interplay and impact section 174 mandatory capitalization also has numerous other code sections (listed earlier).

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This letter is the work of several TEI standing committees under the aegis of TEI's Federal Tax Committee, whose Chair is Julia Lagun. Principal responsibility for drafting TEI's comments was exercised by Betty Mak, one of the Federal Tax Committee's Vice Chairs, along with Benjamin R. Shreck of TEI's legal staff.

TEI would welcome the opportunity to engage with members of Congress or their staffs to discuss any of our comments in further detail. To that end, please do not hesitate to contact Mr. Shreck at 202.464.8353 or bshreck@tei.org. I encourage you, your colleagues, and your staffs to view TEI as an important, unbiased resource in your ongoing tax policy deliberations on this and other tax matters.

Respectfully submitted,



Wayne G. Monfries
International President
TAX EXECUTIVES INSTITUTE

Copies to: Thomas H. Barthold, Joint Committee on Taxation