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In this article, the authors examine significant developments with the section 174 amendments and how they affect common transfer pricing arrangements.

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For tax years beginning in 2022, section 174 will require that specified research and experimental (SR&E) expenditures be capitalized. This is a significant development — the prior version of section 174 permitted those expenses to be deducted in the year they were incurred. Under the amended statute, domestic SR&E expenditures are amortized over five years, while foreign SR&E is subject to an extended 15-year period, both amortization periods beginning with the midpoint of the tax year in which such expenditures are paid or incurred.

Not all research and development costs are SR&E expenditures that are subject to section 174. SR&E expenditures are defined as research or experimental expenses paid or incurred by the taxpayer in connection with the taxpayer's trade or business.

The change to section 174 was introduced by the Tax Cuts and Jobs Act, with a delayed effective date applying to costs incurred in tax years beginning on or after January 1, 2022. The amendment served as a pay-for when scoring the bill's revenue impact, and because of its delayed effective date, some commentators suggested that Congress would revisit section 174 and remove the capitalization requirement before it became effective. Although the House included an extension of expensing in its version of the Build Back Better Act (H.R. 5376), the Senate hasn't acted on it, and it remains uncertain whether Congress will amend the code and once again permit current deductibility, either as a prospective change or with retroactivity to January 1. Regardless, the new version of section 174 is now law, and taxpayers need to determine how it affects them and how to address it.

I. Section 174 and Transfer Pricing

Several common transfer pricing arrangements involve R&D activities that may give rise to SR&E expenditures. These arrangements include:

- provision of contract R&D services by a U.S. entity;
- provision of contract R&D services by a foreign entity;
- provision of contract R&D together with manufacturing of products that use the developed intangible property (IP); and
- cost-sharing arrangements (CSAs) with sharing of intangible development costs (IDCs) that include R&D expenses.

The changes to section 174 don't affect the transfer pricing of these transactions. For example, if the transfer pricing for contract R&D service is based on the comparable profits method using comparable uncontrolled R&D service providers, we wouldn't expect that approach to change solely because of this development. Importantly, the comparable companies' operating results that are referenced under the CPM are based on financial statement line items

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that aren't affected by the section 174 change. However, while the transfer pricing analysis won't change, the tax impact of R&D services charges may change significantly.

A. Contract R&D Service Provider

Payments made by an IP owner to another party for R&D services performed by that party are clearly within the scope of section 174.[1] However, the application of section 174 to expenses incurred by R&D service providers is unclear. The definition of SR&E expenditures could be interpreted to include a contract R&D service provider's costs of providing services.

If the new section 174 does mandate capitalization for R&D service providers, it would mean that a U.S. subsidiary providing contract R&D services to a foreign parent would have to amortize its R&D expenses rather than deduct them in the current year. Particularly in the early years of the new statute's application, this timing difference could result in significantly increased taxable income for the service provider.

Further, this could also create significant timing issues for companies that use controlled foreign corporations as contract R&D service providers by increasing the amount of "tested income" of those CFCs, and thereby the global intangible low-taxed income of the U.S. shareholders. Suppose that a foreign subsidiary (ForCo) provides contract R&D services to its U.S. parent (USCo). ForCo's contract R&D expenses for 2022 are $150x, and USCo pays ForCo an arm's-length markup of 10 percent on its costs, resulting in gross income of $165x. ForCo therefore has taxable income of $15x in its jurisdiction of residence. However, if its $150x of costs were capitalized under section 174, they would be subject to amortization over the 15-year period specified for foreign research under section 174(a)(2)(B). If ForCo's expenses were subject to section 174, ForCo's tested income for 2022 would be $160x (that is, $165x of gross income minus $5x of amortization),[2] even though ForCo's foreign taxable income is just $15x.

That would result in a substantial GILTI pickup for USCo in the early years of the new statute's application. Also, because of the difference in the amount of ForCo's taxable income in its country of residence and for U.S. tax purposes, the decreased current-year deductions for determining ForCo's tested income jurisdictions may result in ForCo not qualifying for high-tax election or having excess capacity in the GILTI basket. Further, although the amount of the expenses incurred in a given year will ultimately be deducted over the 15-year period, companies that treat GILTI as a permanent item won't be able to book a deferred tax benefit for the future deductibility of these expenses, thereby inflating the company's effective tax rate on account of the lack of current deductibility of such expenses.

Whether the expenses incurred by a contract researcher *with no ownership interest in the IP that is developed* are SR&E expenditures within the meaning of section 174 or deductible under section 162(a) isn't entirely clear. The regulations under section 174 define SR&E expenditures with reference to IP products that are used by the taxpayer in its trade or business, as well as IP products held for sale, lease, or license,[3] and thus support the conclusion that R&D expenses borne by a party that merely provides contract R&D services aren't SR&E expenditures.

This makes economic sense — in the foreign example above, the service recipient (USCo) is required to capitalize the $165x paid to ForCo under new section 174. As a matter of economic principle, the entity that owns the IP and will benefit from it over a longer term (that is, USCo) should capitalize and amortize its SR&E expenditures. Because new section 174 already requires this of the service recipient/IP owner, it doesn't make economic sense for the related service provider (ForCo) to also capitalize its $150x of expenses that represent the same R&D

[1] Reg. section 1.174-2(a)(10).

[2] Under new section 174(a)(2)(B), the 15-year amortization period that applies to foreign SR&E expenditures begins in the midpoint of the year the expenditures are paid or incurred, resulting in a lower amortization deduction in the first year.

[3] Reg. section 1.174-2(a)(3).

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work when the income earned for those expenses is recognized in the year received.

B. Contract R&D and Manufacturing

Frequently, an affiliate that performs contract R&D services on behalf of a related IP owner will also perform other functions, including manufacturing. This manufacturing function may be performed on behalf of the IP owner on a contract basis or may be performed on the manufacturer's own behalf. In the former scenario, the manufacturer may receive a fully paid, royalty-free license from the IP owner to manufacture products for the IP owner. In the latter scenario, the affiliate would generally pay a license fee to the IP owner for the right to use the IP to manufacture products on its own account. In either case, when the contract R&D service provider uses the IP that it develops for manufacturing, whether that provider's expenses are governed by section 174 is less straightforward because the service provider may be viewed as having some rights in the IP. Nonetheless, there is a strong argument that when the R&D service provider/manufacturer doesn't have an ownership interest in the IP, new section 174 doesn't require capitalization.

C. R&D Expenses in a CSA

SR&E expenses in a CSA under reg. section 1.482-7 are subject to a different analysis. Because both parties to a CSA have a divisional interest in the cost-shared IP, each party must capitalize its share of the SR&E expenditures under section 174. The corollary to this is that if a CSA participant incurs IDCs in excess of its reasonably anticipated benefits share, these excess costs are offset by a cost-sharing transaction (CST) payment to be received from another participant under the CSA that is deemed to reduce the first participant's deductible costs under reg. section 1.482-7(j)(3)(i).

Reg. section 1.482-7(j)(3)(i) likewise requires that a recipient of a CST payment take into account as consideration received the amount by which the CST payment exceeds the recipient's deductions for the year that are associated with its IDCs. Interestingly, the amount of that excess is treated as consideration received "for use of the land and tangible property furnished for purposes of the CSA by the payee." This suggests that the drafters of the regulation assumed that the costs of R&D activities would be currently deductible, and thus, any excess of the CST payment over the recipient's IDC-related deductions would generally be attributable to contributions to the intangible development activity that are subject to depreciation, like land and tangible property. The interaction of this rule with new section 174 appears to be an unintended consequence.

That could result in potentially significant income inclusions for CSA participants. Assume that a U.S. entity (U.S. participant, or USP) has entered into a CSA with its foreign affiliate (foreign participant, or FP) and that USP and FP each have a reasonably anticipated benefits share of 50 percent. In the first year of the CSA, USP incurs IDCs of $200x, which are SR&E expenditures subject to section 174, and FP incurs no IDCs and thus makes a $100x CST payment to USP. Under prior section 174, USP was permitted to deduct its $200x of SR&E expenditures, but reg. section 1.482-7(j)(3)(i) would reduce that deduction by the amount of the CST payment, leaving USP with a $100x deduction.

Under new section 174, USP has deductible expenses of only $20x,[4] which are reduced to $0 by the CST payment, leaving an excess of $80x. The language of reg. section 1.482-7(j)(3)(i) may require that USP include this excess in income, perhaps as a deemed lease payment. However, other authorities on the character of payments, such as the common law reimbursement doctrine, may militate against this result, and further consideration is recommended.

D. Issues With Identifying Section 174 Expenses

Many taxpayers that incur SR&E expenses may not have had to identify the full extent of their expenses subject to section 174 because the tax accounting treatment of expensing would have applied whether the expenses were deductible under section 162(a) or 174(a) before the TCJA. Taxpayers with research activities

[4] Under new section 174(a)(2)(B), the five-year amortization period that applies to the $200x of domestic SR&E expenditures begins in the midpoint of the year the expenditures are paid or incurred, such that a 10 percent amortization deduction is available in years 1 and 6 while 20 percent amortization deductions are available in years 2 through 5.

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conducted in the United States may claim a research credit under section 41 for these activities. The amount of the credit is a function of several variables, including the amount of expenses. The pool of expenses eligible for the research credit is narrower than the definition under section 174, including only wages, supplies, and 65 percent of contract research expenses that meet other requirements.[5]

However, the definition of research and experimental expenses under section 174 is broader and includes all expenses that are "incident to" the development or improvement of a product, and this would include not only direct labor for engineers and materials but also indirect costs, including an allocable portion of overhead associated with the research activity.[6] Because of the prior current deductibility of both section 174 and 162 expenses, as well as limitation of the credit to U.S. activities and a smaller pool of those expenses, many taxpayers will need to undertake a more comprehensive review of their expense accounts to properly identify the entire pool of costs now subject to amortization.

Under prior law, the IRS, as an administrative safe harbor, provided in Rev. Proc. 2000-50, 2000-2 C.B. 601, that the costs of developing software so closely resemble research and experimental expenditures that they warrant similar treatment, on an optional basis, without regard to whether these expenses would meet the uncertainty and other requirements of section 174. Under the TCJA amendment, all software development expenses are now automatically included in the definition of section 174(a) expenses by statute.[7]

II. Associated Issues

Whether expenses are capitalized and amortized under section 174 or deducted under section 162 has several implications, including:

1. the effect on the taxpayer's ability to claim a research credit under section 41;
2. the allocation and apportionment of the costs under section 861;
3. the potential effect on the taxpayer's U.S. tax liability arising from the base erosion and antiabuse tax, GILTI, and foreign-derived intangible income effects;
4. the effect on the taxpayer's foreign tax credit limitation; and
5. the effect on the taxpayer's section 163(j) limitation.

If a contract R&D service provider previously deducted its R&D expenses on a current basis as permitted under the prior section 174, the taxpayer needs to determine whether taking the position that those expenses aren't subject to new section 174 and instead are currently deductible under section 162 would constitute an accounting method change that requires IRS consent under section 446(e). Taxpayers that prefer to apply new section 174 at the level of the contract R&D provider and later wish to switch to section 162 treatment must consider whether the duty of consistency complicates or prevents their doing so.[8] ■

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[5] Section 41(b).

[6] Reg. section 1.174-2(a); *see also* reg. section 1.174-4(c), Example (indicating that the pool of section 174 expenses includes such expenses as heat, light, power, attorney fees, and depreciation on a building used in the research).

[7] Section 174(c)(3).

[8] The information in this article is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only and does not necessarily represent the views or professional advice of KPMG LLP.

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