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Implications of proposed changes to sections 174 and 280C in bipartisan tax extenders legislation

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The U.S. House of Representatives on January 31, 2024, passed H.R. 7024 [PDF 236 KB], the "Tax Relief for American Families and Workers Act of 2024," bipartisan legislation that would address scheduled changes in business taxation under the "Tax Cuts and Jobs Act,[1]" among other provisions.

It remains uncertain whether the bill will be passed by the Senate where opposition has arisen and 60 votes are needed for passage. The Senate is scheduled for recess from February 10 – 25 and is not expected to consider the bill until after it returns at the earliest. Any amendments to the bill, either in committee or on the floor, could complicate final passage and would, at least, require re-passage by the House.

In the meantime, this article discusses the proposed changes to section 174, section 280C and proposed temporary section 174A, and addresses common questions taxpayers have regarding the proposed changes to those provisions.

Overview – Section 174 proposed changes

The proposed legislation ("H.R. 7024" or the "bill") would modify section 174 (as amended by the "Tax Cuts and Jobs Act" (TCJA)) to defer mandatory capitalization of domestic specified research or experimental (SRE) expenditures until tax years beginning after December 31, 2025. Foreign SRE expenditures would still be subject to mandatory capitalization and recovered over a period of 15 years.

The bill proposes a new section 174A which would provide temporary rules for domestic SRE expenditures that would not be subject to capitalization under section 174(a), as noted above. Section 174A would apply to amounts paid or incurred in tax years beginning after December 31, 2021, and prospectively through tax years beginning before January 1, 2026. Section 174A provides that taxpayers shall be allowed a deduction for any domestic SRE expenditures that are paid or incurred by the taxpayer during the tax year. However, taxpayers would, under this proposal, be permitted three different options to capitalize domestic research and experimental expenditures:

- Treat the SRE costs as section 174A(a) expenses and amortize ratably over a 10-year period with a section 59(e) election.[2]

- An election under section 174A to charge such expenditures to capital account and amortize ratably over a period of not less than 60 months (beginning with the month in which the taxpayer first realizes benefits from such expenditures). This election is made no later than the due date (including extensions) of the tax return in which the election is applicable. Once elected, the taxpayer must continue to follow such method for all subsequent tax years unless authorized by the Secretary to change to a different method or period. Note that this election differs from the capitalization provisions

[1] Pub. L. No. 115-97, December 22, 2017, commonly referred to as the "Tax Cuts and Jobs Act."
[2] Note that the bill precludes the ability to make a Section 59(e) election for Section 174 costs (i.e., foreign SRE costs).

under the current rules in section 174, as a taxpayer's amortization under section 174A(c)(1)(B) would begin in the month in which it first realizes benefits from such expenditures rather than the midpoint of the tax year in which the expenditures are paid or incurred. As such, any taxpayer who previously filed a tax return for a tax year beginning after December 31, 2021, and capitalized and amortized domestic SRE costs under section 174(a) in such return but wishes to make a capitalization election under section 174A(c) for that tax year will need to retroactively adjust the amount of amortization claimed in the applicable tax years for such capitalized costs.

OR

- An election under section 174A to charge domestic research or experimental expenditures to capital account. The election may be made in the time and manner as the Secretary may provide. This suggests that taxpayers who wish to make this election will have to await guidance from the IRS to determine the proper procedures for making the election outside of the proposed elective transition rules provided in the bill.

Consistent with present law section 174, section 174A would not apply to expenditures to acquire or improve land or property used in connection with the research or experimentation which is subject to depreciation or depletion allowances under sections 167 or 611 (however, depreciation and depletion allowances may be considered SRE expenditures). Additionally, the provisions of section 174A would not apply to any expenditure paid or incurred for the purposes of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas). Further, the bill specifies that amounts paid or incurred in connection with the development of software are treated as SRE expenditures.

Frequently asked questions

How does a taxpayer account for the retroactive date back to 2022 or 2023 if a return has already been filed?

The bill, in its current form, would provide elective transition rules to help taxpayers retroactively apply the proposed section 174A provisions:

- For the first tax year beginning after December 31, 2021, a late election under section 174A is available to either capitalize and amortize domestic SRE expenditures over a period of not less than 60 months or to capitalize the expenditures to a capital account. The election is made by filing an amended return for the first tax year beginning after December 31, 2021, within one year of the date of enactment (unless otherwise provided by the Secretary). Such an election would allow taxpayers who previously filed returns for tax years beginning after December 31, 2021, in which they capitalized domestic SRE costs to continue capitalizing such costs under proposed section 174A and to adjust the amortization expense reported, as noted above. Note that the late election is only available for the taxpayer's first tax year beginning after December 31, 2021, so a taxpayer who had a short tax year or who has otherwise already filed a tax return for the second tax year beginning after December 31, 2021, would not be eligible for this late election unless either the proposal is changed prior to enactment or, once enacted, future guidance issued by the Secretary expands the applicability of the election.

- For taxpayers who adopted a method of accounting under section 174, as amended by the TCJA but prior to amendments made by the bill, for their first tax year beginning after December 31, 2021, an election is available to treat the application of section 174A as a change in method of accounting for the taxpayer's immediately succeeding tax year. Taxpayers are allowed a catch-up adjustment to taxable income under section 481(a) on a modified cut-off basis. If a taxpayer makes this election, it may also elect to account for the catch-up adjustment ratably over two tax years. Note that the method change election provided in the proposed legislative text is only available for a taxpayer's second tax year beginning after December 31, 2021; therefore, taxpayers who had a short tax year or who have otherwise already filed a tax return for the second tax year beginning after December 31, 2021, would not be eligible for this election. If this transition rule is not modified prior to enactment, the Secretary

will need to issue guidance to permit such method changes and address any other method changes under section 174A for future tax years.

What are the anticipated state income tax implications of the bill's changes to section 174?

For state corporate income tax purposes, the changes to section 174 and the enactment of proposed section 174A would be generally incorporated as follows:

- **Rolling conformity states**: Follow federal treatment in HR 7024. Note that rolling conformity states could selectively decouple from the effects of HR 7024.

- **Static conformity states with conformity dates after January 1, 2022, but prior to enactment of H.R. 7024 and with no special provisions addressing section 174**: Continue to capitalize and amortize domestic R&E expenditures pursuant to the version of Section 174 enacted by TCJA. Note that static conformity states regularly update their Internal Revenue Code ("IRC" or "Code") conformity dates, which could change the answer in any such state.

- **Other states**:

    - Conformity to a pre-TCJA version of the Code: immediately deduct all R&E expenditures (unless taxpayer has made a state-specific election to do something different where allowable).

    - Conformity to a post-TCJA version of the Code but specific conformity to pre-TCJA Section 174: immediately deduct all R&E expenditures (unless taxpayer has made a state-specific election to do something different where allowable).

    - States with specific modifications related to the treatment of R&E expenditures: treatment depends on the final enacted language of the bill and the nuances of each state's rules regarding R&E expenditures.

For other tax types (e.g., individual income tax), states may adopt a different IRC conformity date than the conformity date adopted for corporate income tax purposes, and thus the treatment of section 174 expenditures may differ.

Other implications associated with conformity or nonconformity to section 174 (e.g., section 280C) need to be considered on a state-by-state basis.

Are retroactive section 59(e) elections available for 2022 (or 2023 if returns have already been filed before the bill is signed into law)?

The transition rules in the bill allow a taxpayer to make a late election under section 59(e)(2)(B) to capitalize and amortize domestic SRE expenditures over 10 years for the taxpayer's first tax year beginning after December 31, 2021. Eligible taxpayers may effectuate the late election by filing an amended income tax return within one year of the date of enactment. The proposal defines an eligible taxpayer for purposes of this election as any taxpayer that does not elect the application to treat the adoption of section 174A as a method change for its second tax year beginning after December 31, 2021, and that filed an income tax return for the first tax year beginning after December 31, 2021, before the earlier of (1) the due date for that return and (2) the date of enactment. If this transition rule is not modified prior to enactment, taxpayers who had a short tax year or who have otherwise filed a tax return for their second tax year beginning after December 31, 2021, would not be eligible for this late election and will need to await IRS guidance as to how to make the retroactive section 59(e) election for those tax years.

Is pre-TCJA Section 174(b) restored and can it be applied retroactively?

Prior to amendment by the TCJA, section 174(b) permitted taxpayers to capitalize research or experimental expenditures and amortize them over a period not less than 60 months. Additionally, Treas. Reg. § 1.174-1 previously provided that pre-TCJA costs which were not treated as deductible or amortized over 60 months must be charged to a capital account. While the bill would not propose to restore pre-TCJA Section 174(b) or Treas. Reg. § 1.174-1, it does provide new section 174A(c), which permits capitalization and amortization over a period not less than 60 months (beginning in the month in which the taxpayer realizes the benefit) and section 174A(d), which permits capitalization to a capital account (in a manner prescribed by the Secretary). Amortization of amounts subject to the section 174A(d) election would presumably be under section 167. These capitalization elections are available for amounts paid or incurred in tax years beginning after December 31, 2021, through tax years beginning before December 31, 2025. The late election provisions are described above.

What is the impact of section 280C for 2022? For 2023 and beyond?

The bill proposes a transition rule allowing taxpayers to make or revoke an election under section 280C(c)(2) to claim a reduced research credit under Section 41 for the taxpayer's first tax year beginning after December 31, 2021. The late election is filed by amending the return for the taxpayer's first tax year beginning after December 31, 2021, within one year of the date of enactment. For 2023 and prospectively, the rule is simply to reduce the domestic SRE expenditures by the amount of the gross credit or make the reduced credit election (i.e., the language that applies post-2022 provides “the domestic research or experimental expenditures otherwise taken into account under section 174 or 174A (as the case may be) shall be reduced by the amount of the credit allowed under section 41(a)”). The bill notes that the amendments made to section 280C shall not be construed to create any inference with respect to the proper application of section 280C for tax years beginning before January 1, 2023; however, it appears taxpayers will not need to account for any additional benefits realized as a result of not making a reduced research credit election for such years.

What and when are the financial accounting impacts?

Accounting Standards Codification (ASC) Topic 740 requires the determination of income tax expense (benefit), income taxes receivable (payable) and deferred tax assets (liabilities) to be based upon currently enacted tax laws and rates. The effects of changes in tax laws or rates are generally reflected for financial accounting under U.S. generally accepted accounting principles in the interim period that includes the date of enactment; in other words, for U.S. federal income tax principles, the period the president signs legislation into law. As such, taxpayers should not take into account any impacts of H.R. 7024 in their financial statements until such date that a bill is signed into law by the president. If enactment occurs after a reporting date, but prior to issuance of the financial statements, an entity should consider whether disclosures of the change in tax law are warranted, even though the impact is reflected in a future interim period.

What and when are the impacts on estimated tax payments?

For estimated tax purposes, taxpayers have a choice to make payments based on the tax liability reported on the tax return for the current year, use the annualization method, or, for its first quarterly payment, use its prior year’s tax liability as long as the reported tax was at least $1 and the return was for a tax year of 12 months. If an amended return is filed for 2022, it will not affect the estimated tax payments required to be made for 2022. For 2023 and if the bill becomes law as drafted, estimated tax payments based on the current year’s tax liability and the annualization method should reflect the full change to expensing (or elective capitalization) of domestic SRE expenditures for the year.

If the change is made as an accounting method change in 2023, and the annualization method is used, the section 481(a) adjustment is treated as an “extraordinary item” that can either be taken into account on (1) the first day of the 2023 tax year, or (2) the date the Form 3115 is filed with the IRS. In all future years, any

portion of the section 481(a) adjustment related to this change is treated as an extraordinary item occurring on the first day of the tax year. Because the Form 3115 resulting from the enactment of section 174A would not be filed during the year of change (except for some fiscal year taxpayers), the section 481(a) adjustment can either be taken into account on the first day of the 2023 year (which will generally maximize the benefit of current expensing on the estimated tax liability) or ignored for 2023 if the annualization method is used based on the filing of Form 3115 after year-end.

For 2024, if the annualization method is used, each quarterly estimated tax period should reflect the impact of the change in 2024 and any portion of the section 481(a) adjustment taken into account for 2024 should be treated as an extraordinary item on the first day of the tax year.

Does this change the requirement in any way that amounts must be treated as an SRE to be credit eligible or are we back to "may be" language?

The bill proposes a corresponding update to section 41(d)(1)(A) to add domestic research or experimental expenditures to the definition of qualified research expenditures. The “may be” language in section 41(d)(1)(A) was not changed by TCJA.[3] It continues to be a best practice that taxpayers must treat all qualified research expenses under section 41(b) as domestic SRE expenditures under section 174 or proposed section 174A, as applicable.

Summary of taxpayer options under H.R. 7024

The below table summarizes the different options taxpayers are provided for treating domestic SRE expenditures under the proposed legislation.

Option	Procedural requirements
1. Retroactive full expensing	Amend 2022
2. 2023 method change with one-year spread	Form 3115 for 2023[4]
3. 2023 method change with two-year spread	Form 3115 for 2023
4. Retroactive section 59(e) election	Amend 2022. Taxpayer may select the dollar amount to amortize ratably over 10-years and use one of the other options for remaining domestic SRE expenditures. No half-year convention is available for amounts capitalized under Section 59(e).
5. Retroactive section 174A(c) election	Amend 2022 and amortize over 60 months or longer, beginning in month benefits begin (this differs from amortization that would have been claimed on the original 2022 return under present law Section 174).
6. Section 174A(c) election as method change with one-year spread	Form 3115 for 2023

[3] Pre-TCJA Section 41(d)(1)(A) provided “with respect to which expenditures *may be* treated as expenses under section 174” and post-TCJA Section 41(d)(1)(A) provides “with respect to which expenditures *may be* treated as specified research or experimental expenditures under section 174” (emphasis added).

[4] Consistent with prior guidance under present law Section 174, it seems reasonable to anticipate that the IRS might issue guidance permitting a statement in lieu of a Form 3115 to be filed with an electing taxpayer’s tax return for its second tax year beginning after December 31, 2021.

Option	Procedural requirements
7. Section 174A(c) election as method change with two-year spread	Form 3115 for 2023
8. Retroactive section 174A(d) election	Amend 2022, and charge to capital account and depreciate under section 167. Scope requires IRS guidance. Mostly applicable to software development—36 months or bonus depreciation.
9. Section 174A(d) election as method change with one-year spread	Form 3115 for 2023. Scope requires IRS guidance. Mostly applicable to software development—36 months or bonus depreciation.
10. Section 174A(d) election as method change with two-year spread	Form 3115 for 2023. Scope requires IRS guidance. Mostly applicable to software development—36 months or bonus depreciation.

Contact us

For more information, contact a KPMG tax professional:

Hogan Humphries | hhumphries@kpmg.com

Carol Conjura | cconjura@kpmg.com

Joseph Hainly | jhainly@kpmg.com

Colleen O'Connor | colleenmoconnor@kpmg.com

David Kalman | dkalman@kpmg.com

Matthew Yokitis | myokitis@kpmg.com

Natalie Tucker | natalietucker@kpmg.com

Catherine Fitzpatrick | cfitzpatrick@kpmg.com

Greg Sweigart | gsweigart@kpmg.com

Rachael Moore | rachaelmoore@kpmg.com

Alexander Fox | ajfox@kpmg.com