New 9-8-23 IRS Guidance on 174: Some Silver Linings

On Sept. 8, 2023, the IRS issued guidance (Notice 2023-63) consisting of 45 pages detailing the proposed rules for Section 174 R&D. In short, while these rules will force some Small Business Innovation Research (SBIR) companies to amortize expenses for some or all of their contracts, the new definition of R&D will, at the same time, protect other companies from major amortization burdens. The IRS intends to propose regulations in line with the guidance, which would be applicable for taxable years ending after Sept. 8, 2023. While 2022 tax returns will be spared, businesses must now anticipate their tax liability for 2023.

Unfortunately, it doesn't appear that Congress will repeal this legislation anytime soon.

As we approach the final quarter of 2023, owners of SBIR companies have to make difficult business decisions now in time to build and execute a path that will safeguard their businesses' futures. Should the business pause some or all of its contracts? Should the business shift focus from SBIR contracts toward consulting or service engagements? Will the new regulations pose a significant threat to the survival of SBIR companies, or are they just another challenge to navigate?

The Bad

- The IRS is proposing that even if the taxpayer has no financial risk (e.g., CPFF contracts), and if the taxpayer has rights to use or otherwise exploit the technology, then the specified research and experimental (SRE) expenditures must be amortized.

- The proposed changes state that Section 174 overrules Section 162 (ordinary and necessary business expenses) and Section 471 (cost of goods and services sold). This eliminates the common practice of recording engineering-related costs as deductions under either of these sections.

- Because SRE expenditures are prohibited from treatment under Sections 162 and 471, they interact differently with Section 41. Previously, taxpayers could claim R&D tax credits on ordinary and necessary research expenses not recorded under Section 174. This path will be lost with the change.

- Taxpayers must now evaluate whether expenses are SRE expenditures regardless of claiming the credit.

The Good

For some businesses, these rules contain silver linings. SBIR businesses may find their required amount of amortization lower than initially anticipated. Specifically, the new guidance has redefined what qualifies as R&D on your 2023 tax return. As a result, activities and expenses that were considered eligible R&D expenses in 2022 might not be recognized as such anymore.

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For some, a reasonable interpretation of how the new rules are applied to the SBIR company's facts and circumstances will mean amortization will be only 10% to 20% of what they feared.

Obviously, these proposed rules are new — the comment period is open until Nov. 24, 2023. As they stand, the proposed regulations can be interpreted in a variety of reasonable ways. So, how can SBIR companies navigate this landscape effectively? They can put their stake in the ground now — document which of their expenses do and do not rise to the level of SRE expenditures based on their reasonable interpretation of the proposed regulations. By taking a proactive approach companies can avoid giving the IRS a blank slate to craft its own narrative in determining the regulations' meaning.

Taxpayers for Whom the Proposed Rules Provide a Shield

CPFF Classified Contracts. These projects might have neither financial risk nor constructive rights to deem the contract a Section 174 contract. For some SBIR companies, exploitation of the rights either has to be approved by the grantor of the contract or deemed infeasible due to its classified nature; in both instances, a reasonable interpretation of the new rules might suggest that the contract does not rise to the level of being an SRE expenditure contract.

Some Costs Excluded. The interim guidance outlines a list of costs that are not permitted or required to be treated as SRE expenses. Among these are costs paid or incurred by general and administrative services departments such as payroll, HR, and accounting that provide only indirect support to SRE activities. Additionally, interest on debt to finance SRE activities and amortization of amounts previously capitalized under Section 174 are not considered SRE expenditures as per the notice.

Pure Research Contracts. Contract arrangements focused on basic research where the work doesn't yield an SRE product often mean the contractor doesn't carry financial risk or rights to use or exploit a product. As a result, the party that is paying for and receiving the benefits of the research would have to capitalize under Section 174. The notice specifically states that "mere know-how gained by a research provider" does not give rise to an SRE product. For example, an aerospace manufacturer may hire a research provider to study the properties of a composite material that the manufacturer is considering for future designs. The outcome of the research may not be a product but rather an augmentation of knowledge or skills. Such an arrangement would not trigger the requirements to capitalize costs under Section 174 for the research provider.

Redefining Financial Risk. Paragraph 3 of Section 6.02 states, "The term financial risk means the risk that the research provider may suffer a financial loss related to the failure of the research to produce the desired SRE product." Mature SBIR companies likely have a fact pattern that means while they have firm-fixed-price contracts few or none contain technological financial risk. So, while these companies will have business risks (such as underbidding the

project), they might not have the technological financial risks as defined by the proposed Section 174 rules.

Know-How and Data Rights

Starting with these proposed rules, know-how is no longer an eligible intellectual property (IP) right for the purposes of determining whether the taxpayer has Section 174 SRE expenses. Section 6.02, paragraph 4 states, “Mere know-how gained by a research provider through the performance of research services for a research recipient that is not subject to protection under applicable domestic or foreign law does not give rise to an SRE product in the hands of the research provider.”

Data rights may not rise to the level of providing the ability to exploit the research if the research provider is unable to realistically exploit the SRE product. Again know-how does not mean exploitable IP rights.

SRE/174 Contracts Do Not Automatically Mean 100% Amortization

Having a contract that has either technological financial risk due to failure to produce the desired SRE product or exploitable IP rights does not mean *all* costs associated with the contract must be amortized. A careful examination of the underlying activities may determine only 20% to 75% of the costs are SRE costs.

For instance, if the proof of concept was established either during the proposal stage or Phase 1, it is not unreasonable to expect to find that only 20% of your Phase 2 contract must be amortized as SRE expenses.

Where Do We Go from Here?

Regrettably, difficult decisions need to be made now. To start building your plan, you need to understand how much of your 2023 expenses are going to require amortization.

The newness of the rules yields a range of reasonable interpretations. SBIR companies have the opportunity to establish their stance based on these guidelines and their own unique facts and circumstances. The alternative is to give the IRS a blank slate to dictate rules to companies.

The last silver lining is that with business returns all filed firms like ours can now divert all resources to performing Section 174 audits. These audits will determine the reasonable position, considering the proposed rules changes on why not all expenses rise to the level of SRE expenses. This allows owners to protect the business they have toiled for so long to build.

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