UNITED STATES

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Recent changes to section 174 of the US Internal Revenue Code

Mark Martin and Thomas Bettge of KPMG in the US describe changes to section 174 of the US Internal Revenue Code and what this may mean for entities that provide contract research and development services to related parties.

Until recently, section 174 of the US Internal Revenue Code permitted taxpayers that incurred research expenses to deduct them in the current year.

The 2017 Tax Cuts and Jobs Act amended this provision to require that specified research and experimental (SR&E) expenditures be capitalised and amortised, but delayed the effective date of this amendment, which applies to tax years beginning January 1 2022 or later.

Although the US House of Representatives proposed extending current year expensing for research costs as part of the Build Back Better Act, this has not come to fruition, and new section 174 is now effective. The amortisation period is five years for domestic SR&E expenditures and 15 years for foreign SR&E expenditures.

The application of new section 174 raises numerous issues, but one key question is how it applies to providers of contract research and development (R&D) services, particularly when they are providing those services to an affiliated entity.

Not all R&D expenses are SR&E expenditures that are subject to new section 174 – the latter are defined as "research or experimental expenditures which are paid or incurred . . . in connection with the taxpayer's trade or business."

The application of this definition to an entity that owns intangible property (IP) and pays a related party for R&D services is fairly straightforward: the cost of obtaining such services is an expense the IP owner incurs in connection with its business, and thus it is required to capitalise and amortise that cost under new section 174. Economically, this makes sense. The IP owner will generally enjoy the benefit of the R&D services (namely, enhanced IP value) over an extended period, which justifies capitalisation.

Less clear is how this definition applies to the affiliated service provider. Assume that the service provider has no ownership in the IP and performs no activities other than the provision of contract R&D services. In one sense, the expenses the service provider incurs in performing those activities could be understood as expenses incurred in connection with its business of providing R&D services, which would seem to make them SR&E expenditures subject to new section 174. Yet this defies economic sense.

Where the income from the R&D services is recognised in the year the services are performed, the contract R&D service provider has no ongoing benefit from the services it provided that would warrant capitalisation. Moreover, the affiliated service recipient that owns the IP is already required to capitalise the cost of those services (including any profit component paid to the service provider).

On the other hand, Treas. Reg. § 1.174-2(a)(3) defines research and experimental expenditures subject to section 174 by reference to 'products' which are in turn defined as IP "to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license."

While a contract R&D service provider does provide services connected to the development of an IP product, that IP product is not used by the service provider in its business or held by the service provider for sale, lease, or license. Rather, it is the service recipient that owns the IP product and employs it in its business. This regulation therefore supports a conclusion that a service provider's expenses are not SR&E expenditures subject to section 174.

Why does this matter? Assume for a moment that new section 174 does apply to the costs of R&D service providers. If the service provider is a US entity, it would be required to amortise its R&D costs, rather than deduct them. Over time, the effects of the change to section 174 may smooth out, but in the early years of new section 174, this could substantially increase the service provider's taxable income.

If on the other hand the service provider is a controlled foreign corporation of a US parent, the US parent could have significant global intangible low-taxed income (GILTI) inclusions because, for purposes of determining the service provider's tested income, the amortization deductions allowable under new section 174 would be taken into account rather than the full amount of the provider's R&D costs.

New section 174 does not directly affect transfer pricing (TP), but it does have important implications for a number of TP structures, including cost sharing arrangements as well as the R&D service provider arrangements addressed in this article.

The application of the new statute to service provider arrangements remains unclear. In any given case, the taxpayer will need to consider the facts and circumstances, weigh the authorities, and consider all the issues associated with the determination of whether expenses are subject to section 174.

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