

How Big is the Permanent Tax Benefit in the Pending Tax Bill for Research Credit?

March 14, 2024

Congress perhaps made an unintended drafting error in the Tax Cuts and Jobs Act [1] (TCJA) when it required a taxpayer to decrease its deduction for research and experimental expenditures. The apparent drafting error is in IRC §280C(c)(1), which provides that if a taxpayer's research credit for a taxable year exceeds the amount allowable as a deduction for research expenditures for the taxable year, the amount of research expenses chargeable to capital account must be reduced by the excess and not by the full amount of the credit.

H.B. 7024 (1-17-24) [2] proposes to correct the drafting error for tax year 2023 and expressly states that the amendment made for taxable year 2023 should not be construed to create an inference with respect to the proper application of the drafting error for taxable year 2022. [3] The "no inference" congressional language could be interpreted as inviting the IRS to attempt an administrative fix of the drafting error.

Background of Research Expenditure Deduction and Credit for Increasing Research Activities: Beginning with the Internal Revenue Code of 1954, a taxpayer engaging in research activities in the experimental or laboratory sense in connection with its trade or business could elect to deduct the cost of its research currently rather than capitalizing the cost to the project for which the research was conducted. The Economic Recovery Tax Act of 1981 added a credit for the cost of research incurred in carrying on a trade or business. The manner in which the deduction and credit operated permitted a taxpayer both to deduct and credit the same research dollar.

Pre-TCJA (2017) law: The Omnibus Budget Reconciliation Act of 1989 ended the possibility deducting and crediting the same research dollar. If a taxpayer currently deducted its research expenditures, the taxpayer had to decrease its deduction by the amount of the research credit that it claimed for the taxable year.[4] The policy reason for the decrease was that a taxpayer should not be entitled to a deduction and a credit for the same dollar expended for research. Put another way, if the government "pays" for research by allowing a credit, the taxpayer did not really pay for the research and should not be entitled to deduct the amount for which the government paid.

TCJA Amendment: The TCJA now requires a taxpayer to capitalize research expenditures paid or incurred in the taxable year and claim an amortization deduction for the expenditures ratably over a five-year period.[5] The TCJA also amended IRC §280C(c)(1), the provision that prevents a taxpayer from receiving a credit and a deduction for the same dollar of research expenditure. The amendment provides that if the research credit amount for the taxable year exceeds the amount allowable as a deduction for the taxable year for qualified research expenses, the research expenses chargeable to capital account for the taxable year must be reduced by the excess.[6] This might have been a drafting error. The research credit for the taxable year might not exceed an amortization deduction for the year.[7] If for a taxable year the credit does not exceed the amortization deduction, a taxpayer could reasonably conclude that no reduction in the amount of capitalized research expenditures is required. The taxpayer would be interpreting the deduction for qualified research expenses as meaning the amount of the amortization of the capitalized expenses.

The IRS might have an opposing interpretation. The phrase, "the amount allowable as a deduction for such taxable year for qualified research expenses" in IRC §280C(c)(1) could be interpreted as always equaling zero because the TCJA amendment requiring amortization of research expenditures for the taxable year nullifies the "deduction ... for qualified

Continued

research expenses.” In other words, there were no “deductible” qualified research expenses for the year after enactment of the TCJA for purposes of IRC §280C(c)(1). [8] The result would be that the capitalized research expenses are decreased by the amount of the credit.

H.B. 7024: On January 31, 2024, the House passed 353 to 70 H.B. 7024, “Tax Relief for American Families and Workers Act of 2024.” Action on the bill is pending in the Senate. The bill restores the current deduction for research expenditures (but only for research performed in the United States), beginning with taxable year 2022,[9] and defers the requirement to amortize research expenditures until taxable year 2026. For taxable years beginning in 2023, the bill requires a taxpayer to decrease the research expenditure deduction for domestic research by the amount of the research credit for the year, thus reinstating, for domestic research, IRC §280C(c)(1) as it had read prior to its amendment by the TCJA. [10]

But for taxable year 2022, the bill does not expressly require a taxpayer to reduce its deduction for research expenditures by the amount of the research credit even though the bill permits the taxpayer to deduct its research expenditures currently for taxable year 2022. Thus, for taxable year 2022, a taxpayer may deduct its research expenditures but must decrease the deduction only by the amount, if any, that its 2022 research credit exceeds its 2022 deduction for qualified research expenditures, which amount may be zero. Moreover, the bill provides that the amendment requiring a decreased deduction for research expenditures for taxable years beginning in 2023 should not be construed to create “any inference” with respect to the proper application of IRC §280C(c) to taxable year 2022.

IRS Notice: In Notice 2023-63 – obviously published before H.R. 7024 – the IRS asks for comments about to interpret the current version of IRC §280C(c)(1). If H.R. 7024 is enacted, the IRS request for comments would appear irrelevant.

Taxpayer Actions: If H.R. 7024 is enacted, taxpayers must consider whether to change their accounting method for research expenditures from amortizing them to currently deducting them. A change would affect many tax calculations, and obviously the only means by which to be certain of the effect is to run the change using various scenarios through the taxpayer’s tax software.

One of the effects to consider if the bill passes is the item discussed in the alert in which the taxpayer reads IRC §280C(c)(1) advantageously for taxable year 2022 and reduces its research expenditure deduction by the amount that the research credit exceeds the deduction for research expenditures for the year, which reduction amount may well be zero. The taxpayer would have a substantial permanent tax benefit by not decreasing its credit and not decreasing its deduction.

If H.B. 7024 is not enacted, a taxpayer might moderate the risk that the IRS will prevail on the interpretation of IRC §280C(c)(1) by electing to decrease its credit under IRC §280C(c)(2).[11] But the taxpayer could be more aggressive by taking the position that it is applying IRC §280C(c)(1) and rarely, if ever, does it have to reduce its deduction for research expenditures. That means that the taxpayer that had historically decreased its credit in order to take the full deduction might not have to do so. That might be a very substantial permanent tax benefit.

Please contact the authors of this Alert or your Miller Canfield attorney if you would like to discuss this alert.

Continued

[1] P.L. 115-97 115th Cong. 1st Sess. (12-22-17).

[2] 118th Cong., 2d Sess.

[3] H.B. 7024, Sec. 201(e)(4).

[4] Instead of decreasing the deduction, the taxpayer could elect to decrease its research credit by multiplying the credit amount by the corporate tax rate. IRC §280C(c)(2). Regardless of whether the taxpayer reduced its deduction or its credit, the federal income tax cost was the same. Many taxpayers elect to reduce the credit so that the full amount of the deduction flows into taxable income of states that conform state taxable income to federal taxable income.

[5] IRC §174(a)(2)(B). The deduction is spread over six taxable years because the taxpayer may deduct for the first amortization year only half of a full year's amortization. If the research is performed outside the United States, the amortization period is fifteen years.

[6] IRC §280C(c)(1).

[7] For example, assume qualified research expenses for the taxable year 2022 of \$1,000 and minimum base amount of \$500. The research credit is \$100 (20% times \$500). The credit does not exceed the amortized deduction - \$100 for the first taxable year.

[8] Of course, there were qualified research expenses identified for the research credit.

[9] Proposed IRC §174A(a). A taxpayer that had capitalized and amortized its research expenditures as required by the TCJA may file an amended return for tax year 2022 and deduct research expenditures paid or incurred for that year. Alternatively, the taxpayer may elect to adjust its taxable income under IRC § 481 by taking a favorable adjustment into account in taxable year 2023. Alternatively, it may elect to make the adjustment over taxable years 2023 and 2024. H.B. 7024, sec. 201(f)(2).

[10] The taxpayer could still elect to decrease its credit in lieu of reducing its deduction.

[11] See supra note 4.