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Selected GILTI Implications of Potential R&D Expense Amortization

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The 2017 Tax Cuts and Jobs Act (TCJA)[1] included a springing revenue raiser in the form of changes to the research and development (R&D) cost recovery rules under §174.[2] Whereas pre-TCJA §174 permitted a taxpayer to deduct R&D expenses on a current basis, post-TCJA §174 requires amortization of these expenses over a five-year period (15 years in the case of research conducted outside the United States, Puerto Rico, or any U.S. possession).[3] The TCJA provided for this amortization treatment to apply for amounts paid or incurred in taxable years beginning after December 31, 2021.[4] Thus, for calendar-year taxpayers, the new amortization regime took effect at the beginning of 2022.

There is no reason to believe that the Congress enacted the new regime based on any actual tax policy concerns relating to the treatment of R&D expenses, as opposed to simply using the new provisions as a gimmick to raise revenue within the relevant 10-year budget window without creating any immediate adverse tax effects for affected taxpayers around the time of enactment.[5] Presumably the intent was that forestalling the application of the new amortization regime would become another bipartisan "tax extender" to be re-upped periodically. Indeed, the "Build Back Better" legislation currently pending in Congress includes a proposal to postpone the application of the new regime until taxable years beginning after December 31, 2025.[6] It is also possible that such a postponement could be enacted as part of other legislation, such as an appropriations bill or a year-end extenders package.

In the meantime, however, taxpayers need to contend with the various tax implications of amortizing expenses that previously had been immediately deductible. Even if the new capitalization regime ends up being postponed with retroactive application to the beginning of 2022, the *possibility* of R&D expense capitalization likely will remain a part of the tax code for the foreseeable future as the Congress adds this to the collection of cans that it periodically kicks down the road, often in suspenseful and/or tardy fashion. Thus, taxpayers need to think through how the capi-

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[1] Pub. L. No. 115-97 (Dec. 22, 2017).

[2] Although the technical term of art under §174 is "research and experimental" expenditures, this article uses the more widely used "research and development" (R&D) terminology, intending the same meaning.

All section references are to the Internal Revenue Code, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[3] §174(a) (post-TCJA), §41(d)(4)(F).

[4] Pub. L. No. 115-97, §13206(a).

[5] The Joint Committee on Taxation scored the provision as raising $119.7 billion in the 2022–27 portion of the 2018–27 budget window. *See* Joint Comm. on Tax'n, *Estimated Budget Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act'* (JCX-67-17) (Dec. 18, 2017).

[6] *See, e.g.*, H.R. 5376, as passed by the House on November 19, 2021, §138516. The Joint Committee on Taxation has scored this provision as losing approximately $4 billion in the 2022–31 budget window, as there is little overall difference within the 10-year window between immediate deduction and five-year expensing for the first five years — in both cases the costs are fully recovered within the 10-year window. *See* Joint Comm. on Tax'n, *Estimated Budget Effects of the Revenue Provisions of Title XIII — Committee on Ways and Means, of H.R. 5376, the 'Build Back Better Act,' as Passed by the House of Representatives* (JCX-46-21) (Nov. 19, 2021).

talization regime may affect various positions from a tax compliance and financial reporting perspective, even if that regime may seem unlikely to apply at the end of the day. This article considers one issue in particular, involving the determination of global intangible low-taxed income (GILTI) under §951A in the context of common multinational R&D arrangements.

A U.S. shareholder's GILTI inclusion is a function of the relevant controlled foreign corporation's (CFC's) tested income as determined under §951A(c)(2)(A). In order to determine tested income, deductions that are allowable and properly allocable to gross tested income items are taken into account, under rules similar to the subpart F expense allocation rules of §954(b)(5), generally treating CFCs as though they were domestic corporations for this purpose.[7] Thus, to the extent that R&D expense amortization is allowed to take effect, in addition to considering the direct impact on U.S. corporations with respect to their own R&D expense deductions, taxpayers need to consider the GILTI impact of amortization with respect to the R&D expenses of CFCs.

The timing of deductions for GILTI tested income purposes can be particularly important in view of the strictly annual nature of the GILTI determination and the general lack of carryover mechanisms under present law to smooth the operation of the GILTI regime over multi-year periods. As discussed in a previous article, planning under the GILTI regime is a precarious business — taxpayers need to "stick the landing" each year or else lose the ability to use valuable tax attributes.[8] If the new R&D amortization regime forces a CFC to recover its R&D expenses over a five- or even 15-year period, then its GILTI tested income may be inflated in the years in which the expenses are incurred, resulting in incremental GILTI tax relative to prior years.

This brings us to the definition of research and experimentation expenses for purposes of §174. The Code does not define the term, but the regulations do, as "expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense."[9] An expenditure meets this definition if it is "for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product."[10] Such an expenditure may be for R&D undertaken directly by the taxpayer for its own benefit, or for R&D that a taxpayer engages a related or unrelated R&D service provider to perform (contract R&D).[11]

One question that has arisen is the scope of R&D expenses that a CFC may need to capitalize under the post-TCJA amortization regime. Clearly the CFC would capitalize R&D expenses that it incurs for its own benefit, regardless of whether the CFC or a related or unrelated service provider carries out the R&D activity (with the amortization period depending on where the work is performed). But what about service costs incurred by a CFC in the course of performing R&D work for an affiliate, rather than as a principal endeavoring to develop intangible property for its own account?

This is a question that did not arise under pre-TCJA §174, which operated only to extend (at the taxpayer's election) current deductibility to certain expenses that were otherwise subject to capitalization under §263 on the basis that they were incurred to develop or increase the value of property in the hope of generating a multi-year stream of income. Under pre-TCJA §174, we never would have needed to ask whether an R&D service provider's expenses constituted R&D expenses under §174, because a service provider's costs incurred in carrying out R&D work for its principal would be deductible on a current basis anyway, as ordinary and necessary business expenses under §162, incurred only to generate service fee income on a current basis.

While the characterization of the expenses of an R&D service provider for §174 purposes is not entirely clear under the statute and regulations, the better view is that only the principal in a contract R&D arrangement incurs §174 expenses, not the service provider. The entire history and purpose of §174 suggest that an expense is an R&D expense only if it has the character of R&D *for the taxpayer* (i.e., as the principal hoping to develop a productive asset). A contract researcher would never have gotten to §174, because its service costs are deductible anyway under §162. Only the principal needed §174 to avoid capitalization under §263, and thus the drafters of §174 and the regulations promulgated thereunder could only have had a principal's expenditures in mind — they may not have definitively delimited the concept

[7] §951A(c)(2)(A)(ii); Reg. §1.951A-2(c)(3). Allowable deductions are generally determined under the rules of Reg. §1.952-2, which generally determines allowable deductions based on what deductions would be allowed if the CFC were a domestic corporation. *See* Reg. §1.952-2(b), §1.951A-2(c)(2).

[8] *See* David G. Noren, *Year-to-Year Tax Volatility Under a Country-by-Country GILTI Regime*, 50 Tax Mgmt. Int'l J. 465 (Sept. 3, 2021). As part of adopting country-by-country application of GILTI, the "Build Back Better" legislative proposals also have included tested loss and foreign tax credit carryover provisions, consistent with some of the suggestions in that article.

[9] Reg. §1.174-2(a)(1).

[10] *Id.*

[11] Reg. §1.174-2(a)(10).

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in this manner, but again this issue would not have occurred to them, as the distinction did not matter for purposes of deductibility.

In enacting the TCJA's R&D amortization provision, the Congress did nothing to suggest that it was expanding the scope of R&E expenses, but instead was simply changing the cost recovery timing of those expenses.[12] In other words, the Congress was simply clawing back a benefit provided by pre-TCJA §174, and should not be interpreted as doing more than that (i.e., deferring deductions that are currently deductible under provisions other than §174).

Thus, when the regulations ask whether an expenditure was incurred to eliminate uncertainty with respect to a product,[13] we should understand the regulations as referring to the business motivation behind the taxpayer's incurring of the expense. A contract R&D service provider generally should be understood as incurring the relevant service costs in order to earn a service fee. Only the principal in the arrangement should be understood as incurring the expense in order to achieve and benefit from the end goal of the R&D project. Hence the allowance of §174 treatment to taxpayers incurring expenses as principals in contract R&D arrangements.[14] While the regulations do not squarely address whether the service provider *also* might be viewed as incurring R&D expenses, again there would have been no reason to address the point prior to the TCJA, as the service provider's expenses were currently deductible anyway. At a minimum it would be odd to require two separate taxpayers to amortize effectively the same asset where one of the taxpayers has no ownership interest in, nor ability to profit from, the exploitation of the asset.

Forcing an R&D service provider to amortize its service costs would mismatch income and expense, and would artificially inflate GILTI tested income. If a CFC providing R&D services in its country of organization for an affiliate were to incur $100 of expenses in the course of performing the services, and were to receive an intercompany cost-plus service fee of $110, the CFC would have $10 of economic income, but $103.33 of GILTI tested income, as the CFC would include the full $110 service fee in income, but then would recover only 1/15th of its expenses ($100/15 = $6.67) in the current year. There is no reason to believe that the Congress would have intended such an absurd result, and as explained above, the existing regulations, understood in the context of the history and purpose of §174, should not be interpreted as requiring any such result.[15]

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[12] *See* H.R. Rep. 115-466, 115th Cong., 1st Sess., at 423–25 (silent on these issues).

[13] Reg. §1.174-2(a)(1).

[14] Reg. §1.174-2(a)(10).

[15] The AICPA has proposed legislation to address this issue squarely. *See* AICPA, Compendium of Tax Legislative Proposals: Simplification and Technical Proposals (Oct. 2021), at 116–17. For the reasons set forth above, this proposal makes good sense and moreover should be considered a mere clarification of existing law.

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