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Tax Reform: And the Winner Is … R&D

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Tax reform changed the playing field for taxpayers engaged in research and development ("R&D") activities. This article highlights new and modified provisions of the tax law that taxpayers engaged in R&D activities should consider, whether or not the taxpayers claimed the R&D tax credit in the past.

Introduction

On December 20, 2017, the House passed H.R. 1 (originally known as the "Tax Cuts and Jobs Act") by a vote of 224 to 201, and H.R. 1 was signed into law by the president on December 22, 2017 (the "Act").[1] The new law represents the culmination of a lengthy process in pursuit of business tax reform that has played out over the course of more than 20 years.

The Act includes substantial changes to the taxation of individuals, businesses in all forms and industries, multinational enterprises, and others. Overall, it provides a net tax reduction of approximately $1.456 trillion over the 10-year "budget window" (according to estimates provided by the

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[1] P.L. 115-97, 131 Stat. 2054 (2017).

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Joint Committee on Taxation ("JCT") that do not take into account macroeconomic/dynamic effects).[2] KPMG has prepared a report on the Act that examines the provisions in the new tax law and provides observations.[3]

Having recognized that research is the life blood of the U.S. economy,[4] Congress decided not to modify the section 41 [5] research credit, and it remains a permanent tax benefit for taxpayers that lowers the effective tax rate, which positively affects earnings per share. The research credit is one of the few tax incentives that has "proven to be effective in promoting policy goals important in the American economy,"[6] and neither the House nor the Senate version proposed to revise the research credit. This is in contrast to other credits and incentives that were repealed or revised by the Act. For example, the Act repealed the domestic manufacturing deduction under section 199.

Furthermore, as discussed below, the use of the research credit to offset certain tax liabilities is not immediately subject to limitations that are imposed on other tax incentives. For example, the use of some business credits like the alcohol fuels credit determined under section 40(a) cannot reduce the base erosion anti-abuse tax ("BEAT"), while the research credit can reduce BEAT for years beginning before January 1, 2026.

This article highlights considerations for the R&D[7] tax credit that may be affected by the following provisions of the Act and should be considered by taxpayers engaged in R&D activities:

- Reduction in the corporate tax rate and section 280C
- Alternative minimum tax
- Modified net operating loss deduction
- Section 174 research and experimental expenditures

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[2] See the following documents for further information: Pub. L. No. 115-97 (H.R. 1, as signed into law on December 22, 2017); H.R. Conf. Rep. No. 115-466 (the conference agreement); CBO, Cost Estimate for the Conference Agreement on H.R. 1 (Dec. 15, 2017); JCT, Estimated Budget Effects of the Conference Agreement for H.R. 1, JCX-67-17 (Dec. 18, 2017); JCT, Distributional Effects of the Conference Agreement for H.R. 1, JCX-68-17 (Dec. 18, 2017); JCT, Macroeconomic Analysis of the Conference Agreement for H.R. 1, JCX-69-17 (Dec. 22, 2017).

[3] *See* Tax Reform–KPMG Report on New Tax Law, available at www.kpmg.com/us/new-tax-law-book.

[4] *See* H.R. Conf. Rep. No. 100-1104, vol. II, at 88 ("The conferees believe that research is the lifeblood of our economic progress and that effective tax incentives for research and development must be a fundamental element of America's competitiveness strategy.").

[5] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[6] Unified Framework for Fixing our Broken Tax Code, at 8 (Sept 27, 2017).

[7] The terms "R&D" and "research and development" are used throughout this article. The authors appreciate that section 174 uses the term research and experimental expenditures ("R&E") and section 41 refers to the Credit for increasing research activities. The references in this article to R&D refer to both sections 174 and 41.

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- Orphan drug credit and section 280C(b)(3)
- International considerations

Reduction in Corporate Tax Rate and Section 280C

The new law eliminates the progressive corporate tax rate structure, reducing the maximum corporate tax rate from 35 to 21 percent. This reduction is intended to make the U.S. corporate tax rate more competitive with the rates imposed by other countries. Consistent with the overall theme of the new law, this provision lowers tax rates in exchange for the elimination of certain tax benefits, such as section 199 and "base broadening" provisions like the BEAT and the tax on global intangible low-taxed income ("GILTI").

The lower corporate rate indirectly increases the net research credit benefit upon applying section 280C. The reduced credit is net of the highest tax rate that prior to tax reform was 35 percent. Because the new rate is 21 percent, the reduced credit is now 21.5 percent higher.

Consider the following example:

Rate	35% rate	21% rate
R&D credit	$100,000	$100,000
Addback (or reduction under section 280C(c)(3)	$(35,000)	$(21,000)
Net credit	$65,000	$79,000

In this example, the taxpayer's net R&D credit is increased because the amount of credit it "adds back" is less.

As described below, note that a "blended" tax rate under section 15 would apply to tax years of fiscal year taxpayers that include the effective date of the rate change (December 31, 2017). The actual benefit of applying section 280C would differ based on the blended rate computation of each taxpayer.

Effective Dates for Fiscal Year Filers—Section 15

Section 15 provides special rules for determining how certain "rate changes" apply to corporate taxpayers whose tax years straddle relevant effective dates (e.g., fiscal year filers in the case of law changes that are effective as of the beginning or end of the calendar year). As a result, fiscal year taxpayers will not realize the full benefit of the rate reduction until 2019.

The new law does not repeal or modify section 15, but does include a provision explicitly indicating that section 15 does not apply to the temporary changes to the section 1 rates that would be in new section 1(j). The provision permanently reducing the section 11 corporate rate, however, does not reference

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section 15. Thus, section 15 presumably would apply to the C corporation rate change without modification. The potential application of section 15 to other changes made by the new law (such as how it might apply to the repeal of the corporate alternative minimum tax) is not completely clear and administrative guidance may be needed.

Alternative Minimum Tax

Corporations

The new law repeals the corporate alternative minimum tax ("AMT") effective for tax years beginning after December 31, 2017. Under prior law, corporate taxpayers could not use the research credit to offset AMT, unless they met the definition of an "eligible small business" under section 38(c)(5), i.e., non-publicly traded corporations, partnerships, and S corporations with an average gross receipts for the prior three years of less than $50 million. *With AMT repeal, businesses that historically paid AMT will now be subject to regular tax that can be offset with the research credit, with certain limitations (e.g., under section 38(c), the general business credit (one of which is the R&D credit) can offset the first $25,000 of tax plus up to 75 percent of the tax in excess of $25,000. Thus, if the regular tax liability is greater than $25,000 the credit cannot completely offset regular taxes).*

Corporate AMT Carryover and Refund

Under the new law, any corporate AMT credit carryovers for tax years after 2017 can be used to offset regular tax liability (after reduction by certain other credits). In addition, for tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50 percent of the excess AMT credit carryovers are refundable[8] (a proration rule exists with respect to short tax years). Any remaining AMT credits will be fully refundable in 2021.

Under this provision, companies may want to reexamine their prior year research activities to ensure an appropriate amount of research credit was claimed. In particular, companies who were subject to AMT in prior years may not have claimed the research credit because the credit was available only against regular tax. With this new provision, companies have the opportunity to claim the research credit for prior years because tax reform makes it easier and clarifies how taxpayers can use the AMT credit and R&D credit carryforwards to offset taxes in the future.

Furthermore, any AMT credit carryovers that are refunded will provide corporations with additional working capital they can invest into their businesses, including R&D.

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[8] Refund payments processed on or after October 1, 2017, and on or before September 30, 2018, will be reduced by the 2018 fiscal year 6.6 percent sequestration rate pursuant to the Balanced Budget and Emergency Deficit Control Act of 1985. A sequestration reduction rate will likely be applied to refunds processed in subsequent tax years also. *See* IRS, Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations, https://www.irs.gov/businesses/effect-of-sequestration-on-the-alternative-minimum-tax-credit-for-corporations.

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Individuals

For individuals, the AMT remains in place; however, the Act temporarily increases the AMT exemption amounts and the phase-out thresholds for individuals. For 2018, the amounts are as follows.

Filing status	Exemption amount	Phase-out threshold
Married taxpayers filing a joint return (or for a surviving spouse)	from $86,200 to $109,400	from $164,100 to $1,000,000
Married taxpayers filing a separate return	from $43,100 to $54,700	from $82,050 to $500,000
For all other individual taxpayers	from $55,400 to $70,300	from $123,100 to $500,000

The increased exemption amounts and phase-out thresholds are scheduled to sunset after December 31, 2025. *Until then, and based upon the limitation of certain itemized deductions (e.g., property tax deduction capped at $10,000), fewer individuals will be subject to the AMT, and thus more individuals, including owners of pass-through businesses, may benefit from the research credit.*

Optional 10-Year Writeoff of Certain Tax Preferences

The preference items and other AMT-related provisions under sections 55 through 59 were not repealed. Of significance to R&D is section 59(e), which allows taxpayers the option to elect to capitalize part or all of its R&D expenses[9] and amortize the costs over 10 years. Depending on each taxpayer's facts, the election may provide a beneficial planning tool. For example, the election could increase taxable income, which in turn could allow carryover net operating losses ("NOLs") or other tax attributes to be more fully utilized.

It appears that post 2017, corporations may still be able to make section 59(e) elections to capitalize some or all of their R&D expenditures over a 10-year period. Corporations may wish to make post-2017 section 59(e) elections with collateral impact on sections 59A (BEAT) and 163(j) (limitation on deduction for interest). A corporation with domestic NOLs and foreign source income covered by foreign tax credits may want to consider using section 59(e) to eliminate the domestic NOL and free up the foreign tax credit or other tax attributes.

Modified Net Operating Loss Deduction

The new law limits the NOL deduction for a given year to 80 percent of taxable income, effective with respect to losses arising in tax years *beginning* after December 31, 2017.

The new law also repeals the prior law carryback provisions for NOLs; the statutory language indicates that this provision applies to NOLs arising in tax years *ending* after December 31, 2017, although it

9 Section 59(e) refers to section 174(a) expenditures.

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permits a new two-year carryback for certain farming losses and retains present law for NOLs of property and casualty insurance companies.

In addition, the Act provides for an indefinite carryforward of NOLs arising in tax years *ending*[10] after December 31, 2017, as opposed to the prior 20-year carryforward.

Consequently, corporations with NOLs arising after 2017 will have regular tax liability that can be reduced by the research credit.

Section 174 Research and Experimental Expenditures

The new law provides that specified research or experimental ("R&E") expenditures under section 174 paid or incurred in tax years *beginning after December 31, 2021,* should be capitalized and amortized ratably over a five-year period for research conducted in the United States, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified R&E expenditures that are attributable to research conducted outside of the United States[11] would be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the tax year in which such expenditures are paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

In the case of retired, abandoned, or disposed property with respect to which specified R&E expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule is treated as a change in the taxpayer's method of accounting initiated by the taxpayer, and made with the consent of the Secretary. This rule is applied on a cutoff basis to R&E expenditures paid or incurred in tax years beginning after December 31, 2021 (thus there is no adjustment under section 481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2022).

Section 1.174-2 provides a general definition of R&E expenditures, and it does not appear that this definition would change under the new law.

The IRS had a long-standing rule of administrative convenience that permitted taxpayers to treat the costs of developing software as deductible section 174 expenses, whether or not the particular software was patented or copyrighted or otherwise met the requirements of section 174. See Revenue Procedure. 2000-50 and its predecessor Revenue Procedure 69-21. The new law terminates this rule of

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[10] Compare to the effective date for the 80 percent limitation, which is tax years *beginning* after December 31, 2017. However, the conference report's explanatory statement and the JCT revenue table for the conference agreement describe the effective date for the carryover and carrybacks differently, indicating that the provision applies to losses arising in tax years *beginning* after December 31, 2017. Note that the statutory language takes precedence.

[11] For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

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convenience and requires capitalization of software development expenses otherwise eligible for expensing under Revenue Procedure 2000-50.

The new requirements to capitalize section 174 R&E expenditures paid or incurred in tax years beginning after December 31, 2021, and the capitalization period of five years for U.S. research and 15 years for foreign research may provide an incentive for a company to keep or move its research to the United States. This will not only result in a shorter amortization period, but also may enhance the research credit.

Additional considerations include intercompany reimbursements of R&E expenditures under a qualifying cost sharing agreement or through cost plus arrangements, which may affect the accounting treatment under these transfer pricing provisions. Although cost sharing generally nets costs, cost-plus arrangements generally account for the payment for R&D services as a revenue item. This may create a mismatch between the revenue and expense for tax reporting purposes.

Orphan Drug Credit and 280C

The new law reduces the "orphan drug credit"[12] to 25 percent of qualified clinical testing expenses ("CTEs") for the tax year versus the prior law rate of 50 percent of CTEs, and allows an election of a reduced credit under section 280C(b)(3).

The provision is effective for amounts paid or incurred in tax years beginning after 2017. The election to reduce the credit under new section 280C(b)(3) provides a similar election method as the research credit, meaning the election must be made by the due date of the tax return (including extensions) and the election is irrevocable for that tax year.

In addition, as discussed above, special rules apply to corporate taxpayers whose tax years straddle the effective date. Taxpayers should be mindful of section 15 and apply the blended rate for purposes of the section 280C computation.

International Considerations

Mandatory Repatriation

The new law includes a transition rule to implement the participation exemption regime. This transition rule provides that the subpart F income of a specified foreign corporation ("SFC") for its last tax year beginning before January 1, 2018, is increased by the greater of its accumulated post-1986 deferred foreign income (deferred income) determined as of November 2, 2017, or December 31, 2017 (a measuring date). A taxpayer generally includes in its gross income its pro rata share of the deferred income of each SFC with respect to which the taxpayer is a U.S. shareholder. This mandatory inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer's share of

[12] Section 45C (Clinical Testing Expenses for Certain Drugs for Rare Diseases or Conditions).

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the foreign earnings and profit ("E&P") deficit of each SFC with respect to which it is a U.S. shareholder and the taxpayer's share of its affiliated group's aggregate unused E&P deficit.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's mandatory inclusion at a 15.5 percent rate to the extent it is attributable to the shareholder's aggregate foreign cash position and at an eight percent rate otherwise.

With the mandatory repatriation, many multinational corporations may be subject to additional tax. *General business credits, such as the research credit, would be available to offset the tax liability. Therefore, companies may want to re-examine their prior year research activities to ensure an appropriate amount of research credit was claimed. In addition, it may be possible to do further planning to reduce the amount of E&P and mandatory repatriation tax.*

Global Intangible Low-Taxed Income

New section 951A requires a U.S. shareholder of a controlled foreign corporation ("CFC") to include in income its "global intangible low-taxed income" or GILTI in a manner similar to subpart F income. The new law allows a deduction for corporate shareholders equal to 50 percent of GILTI, which would be reduced to 37.5 percent starting in 2026. In general, GILTI is the excess of a U.S. shareholder's "net CFC tested income' over its "net deemed tangible income return," which is defined as 10 percent of its CFCs' "qualified business asset investment," reduced by certain interest expense taken into account in determining net CFC tested income.

Similar to other amounts calculated under subpart F, the GILTI would be included in a U.S. shareholder's income each year without regard to whether that amount was actually distributed by the CFC to the U.S. shareholder during the year.

For any amount of GILTI that is includible in a U.S. corporate shareholder's income, the new law provides for a limited deemed credit for 80 percent of the foreign taxes attributable to the tested income of the CFCs. *After the use of the deemed foreign tax credit (see section 26), general business credits, such as the research credit, may be used to lower the total U.S. tax liability.*

These rules are effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

Base Erosion and Anti-Abuse Tax

The new law imposes a new base-erosion-focused minimum tax or BEAT that in many cases would significantly curtail the U.S. tax benefit of cross-border related-party payments made by large multinationals.

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least $500 million of annual domestic (including effectively connected amounts earned by foreign affiliates) gross receipts (over a three-year averaging period), and have a "base erosion percentage" (discussed below) of three percent or higher for the tax

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year (or two percent for certain banks and securities dealers, which are also subject to a higher BEAT rate, as discussed below). The provision also applies to foreign corporations engaged in a U.S. trade or business for purposes of determining their effectively connected income tax liability.

The targeted base erosion payments generally are, among others, amounts paid or incurred by the taxpayer to foreign related parties for which a *deduction is allowable*, and also include amounts paid in connection with the acquisition of *depreciable or amortizable* property from the foreign related party. The new law also specifically includes cross-border reinsurance payments as base erosion payments.

BEAT Computation

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount. This amount equals the excess of 10 percent of the taxpayer's modified taxable income ("MTI") for the year (five percent for 2018),[13] over an amount equal to the pre-credit regular income tax liability reduced (but not below zero) by any credits, other than the research credit and a certain amount of "applicable section 38 credits" that includes the section 42(a) low-income housing credit, the section 45(a) renewable energy production credit, and section 48 energy credit. Applicable section 38 credits are only included to the extent of 80 percent of the lesser of the credits or the base erosion tax amount otherwise computed.

The BEAT formula allows taxpayers to retain, at least initially, the benefit of the research credit and some benefit for the three categories of applicable section 38 credits. The following examples may help illustrate the formula's application using the 10 percent BEAT rate.

- MTI is $400 (so 10 percent of MTI = $40), regular tax liability is $30, no credits. The BEAT liability is $10 ($40 - $30 regular tax) and a combined tax of $40.
- Based on the same facts, the taxpayer reduces regular tax liability to $20 by taking $10 of carried forward section 45M(a) energy efficient appliance credit. The BEAT liability is $20 ($40 - $20 post-credit regular tax), maintaining a total combined tax liability of $40, so the carried forward section 45M(a) credit has not reduced the total tax liability.
- Regular tax liability is reduced to $20 due to $10 of R&D credit. The BEAT liability is still $10 (regular tax liability before the application of R&D credits), the total combined tax liability is $30, so the R&D credit has reduced the total tax liability.

Note however that the pre-credit regular income tax liability cannot be reduced to below zero, which means the research credit and the applicable section 38 credits may offset the BEAT only if there is a

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[13] For tax years beginning after 2025, 10 percent is increased to 12.5 percent of MTI. Banks and registered securities dealers are subject to a one percentage point higher BEAT rate in every year: 6 percent for 2018, 11 percent for 2019-2025, and 13.5 percent thereafter.

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regular tax liability. Furthermore, for tax years beginning after 2025, the research credit and the applicable section 38 credits cannot be used to offset BEAT.

Conclusion

Although the Act did not change the R&D credit provisions, benefits of the credit have been enhanced as a result of lower tax rates, modified NOL limitations, and the ability to use the credit to offset international tax implications that flow from tax reform. The impact of capitalization of 174 expenditures will create higher tax liabilities compared with the current expense treatment, but this is a timing difference that reverses and flattens out over time, e.g., five years as amortization "catches up" to capitalization.

This tax law supports investment in the United States and, through incentives such as the R&D credit, taxpayers will generally be able to reap the same or better tax benefits of investment in product and process development.

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