# In the vault with KPMG

## State tax treatment of IRC 174 within the banking industry

**Speaker 1:**

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**Elizabeth L'Hommedieu:**

Hi everyone and welcome to today's podcast. I'm Liz L'Hommedieu, a principal in the KPMG Banking and Capital Markets Tax practice. Joining me today are my colleagues, Stefanie Humphrey and Justin Hill. Stefanie is a partner in the KPMG Accounting Methods practice within our Banking and Capital Markets Tax practice. And Justin is a State and Local Tax Partner. Stefanie and Justin, thank you both for joining.

**Stefanie Humphrey:**

Thanks for having us.

**Justin Hill:**

Thank you, Liz.

**Elizabeth L'Hommedieu:**

So today we're going to talk about the state tax treatment of certain research and development expenses, specifically those covered in IRC section 174. On our last podcast, you may recall we discussed 174, which requires a capitalization of certain research and development expenses for banks. That's typically software expenses. Stefanie, you want to give us a quick summary of that before we jump into the state impacts?

**Stefanie Humphrey:**

Yes, absolutely. As you mentioned, section 174 generally defines research and development expenditures. With regard to banks, it's going to be costs related to the development of software specifically. Historically, those costs were always permitted to be either currently deducted or capitalized and amortized over a period of five or more years. There was a lot of flexibility for taxpayers around this provision, in prior years, with 2017 tax reform, that included a provision that required capitalization of section 174 costs for costs that were incurred in tax years beginning after December 31, 2021. Beginning in calendar year 2022, the new law requires capitalization and amortization of these costs over either five years if the work is performed domestically or 15 years if the work is performed outside the US. It was expected that Congress would act to appeal or delay the timing before the first effective year but that has not occurred. So we're now faced with determining what these amounts are for 2022 tax returns.

**Elizabeth L'Hommedieu:**

Great, thanks Stefanie. So, we're preparing our 2022 tax returns. We are capitalizing certain expenses under 174 for federal tax purposes. Justin, I want to talk about what the states are doing, because I think not all states are going to follow those federal capitalization rules. Can you just give us some background in general on which states are conforming and which ones aren't?

**Justin Hill:**

Sure Liz. Most states are going to follow new section 174, which states generally conform to in one of three ways. The first is rolling conformity. These states conform with the code in effect for the current year when section 174 was changed. These rolling conformity states automatically conformed to the new changes and the second way states conform is through fixed date conformity. These states adopt the Internal Revenue Code as of a specific date. So, these states did not automatically conform to the TCJ section 174 changes. And the last way

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we see states conform is through what we call selective conformity. These states conform to select Internal Revenue Code provisions but not all the provisions, in the Code and only as of a certain date. In most cases, these select conforming states do not automatically adopt legislative changes. States conform with the Code in these ways but they can also decouple from or not follow certain provisions.

Liz, as you mentioned previously, section 174 was modified in 2017 with a 2022 effective date. So, I'm going to refer to the TCJ version of section 174 as the new section 174 and the prior version as old section 174 mainly because states that do not conform to the new section 174 may still follow the pre-TCJ version of the rule. It's important for us to distinguish between the two from a state perspective. Some examples of rolling conformity states include Alabama, Illinois, and Massachusetts. As mentioned, these states automatically conformed to new section 174 when it was enacted in 2017. An example of a fixed conformity state is Texas, which happens to be my home state; it conforms to the code in effect for the tax year beginning on January 1, 2007 for most provisions. As a result, Texas does not conform to new section 174.

California is also another state with a pre-TCJ conformity date that does not conform to new section 174. Some other examples are Georgia, Indiana, Mississippi, Tennessee, and Wisconsin. These states have specifically decoupled from the new section 174 for corporate income tax purposes and Mississippi is decoupled from 2023 prospectively. So, these seven states, California, Georgia, Indiana, Mississippi, Tennessee, Texas, and Wisconsin, clearly do not conform to new section 174. However, there are also a handful of states in which conformity section 174 is less clear. For example, in Kentucky, for taxpayers beginning on or after January 1, 2022, references to the code within the Kentucky income tax law mean Internal Revenue Code in effect on December 31, 2021 because new section 174 is not in effect until January 1, 2022 and Kentucky's conformity date refers to the code in effect on December 31, 2021. It's possible that the amortization rules of new section 174 fall outside the Kentucky conformity date.

This may be true until Kentucky updates its conformity date. So it's really important to look closely at the actual language used in the state conformity provisions. And Liz, one other important point here: we're really in the state legislative session season. So, conformity with section 174 is a fluid issue. I know we work with you and Stefanie all the time on conformity updates and relaying this information to our clients. It's really a weekly update. We've had a few states recently decouple; there's proposed legislation in New Jersey right now addressing section 174. So we're really having to follow the decision closely.

**Elizabeth L'Hommedieu:**

Thanks Justin, appreciate that this is real-time information, but I have to say if I'm summarizing everything you just said, it sounds like a bit of a mess. This is giving me very much some bonus depreciation vibes where we've got those states that are conforming, those states that have decoupled, those states that are somewhere in the middle, or particularly unclear. That's a lot for a taxpayer to follow. I also want to just pick up on something you mentioned, conformity, specifically for corporate income taxpayers. I assume that this conformity could differ depending on the taxpayer type?

**Justin Hill:**

That's right, Liz. So conformity can differ among taxpayer types. One example we've seen in Pennsylvania conforms to new section 174 for corporate taxpayers, but it doesn't incorporate the provisions of section 174 in its personal income tax law. It's important to keep in mind taxpayer type when evaluating conformity issues. For this discussion, we will be focused mostly on the treatment for corporate taxpayers.

**Elizabeth L'Hommedieu:**

I would just add that it's important within the banking group to understand what entity has these expenses because in some states, while the 174 provisions may apply to the corporate income taxpayer, if those expenses sit at the bank entity, it's possible that that entity is filing a different tax type. And I'll take Pennsylvania, for example, where the bank itself files a bank shares tax based on equity. So, these provisions related to how you compute 174 on an income base really don't apply. So, I think we've got another layer of complexity in there with the financial institution groups and understanding where those expenses sit.

**Justin Hill:**

That's a great point Liz.

**Elizabeth L'Hommedieu:**

Stefanie, I want to think back to our previous podcast. We talked a lot about some of the legislative uncertainty. Is it possible still that we could see a repeal of 174 or another deferral?

**Stefanie Humphrey:**

That's a great question. I would say, unfortunately, the legislative outlook is still really unclear. Many continue to believe that Congress will act at some point to at least defer the provision. Also unclear, though, is whether that would be a retroactive deferral or maybe a 2023 and future deferral. So, there's just not a lot of clarity at this point about what will occur. There is support to change the provision and defer or repeal it entirely. But at this point it's unclear how and when that might occur.

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And then if it does occur, we do expect that the IRS will issue some transition guidance to taxpayers to help them comply with whatever the change is that would apply at federal level. But that remains to be seen based on whatever Congress does action-wise.

**Elizabeth L'Hommedieu:**

And then this begs a question to me: if Congress defers or potentially repeals section 174 for the future, then what happens with the states? Do they automatically follow or are we going to be in a similar mess that you just described?

**Justin Hill:**

I wish that was the case. I wish they would automatically follow, but unfortunately if federal tax reform either eliminates or pushes back the effective date for mandatory capitalization, you'd still have state issues in certain states with fixed date conform to the code and would not automatically adopt the federal change. Even with the [IRS] putting out transition rules, it would still be a difficult situation for taxpayers to deal with. And in a lot of cases, you would need a legislative update or change at the state level to get back to the following the federal treatment.

**Elizabeth L'Hommedieu:**

Okay. So, in the meantime, we'll keep everyone updated on what the states are doing under current law and of course keep everyone updated on what Congress does for the future of 174. Now I want to turn to estimated payments. And I'm assuming that if we think about 174, and particularly with respect to the conformity issues that could have a big impact on state income tax estimated payments and attribute tracking for taxpayers. Justin, you want to talk to us about what taxpayers are doing to be prepared?

**Justin Hill:**

There were a lot of surprises, especially in 2022, for taxpayers with estimated payments. You think about the states that conform and follow this amortization result, and states that don't conform and allow for the current expensing, that can result in big differences in estimated payments in the states. And so we've dealt with that for 2022. I think most taxpayers are on a good path. They're focused on 2023 estimated payments now, but you still have the attribute tracking issue and there's still going to be some fluctuations in your 174, especially as states conform or decouple as the year goes on. And I think the modeling is really the key here, in states to model that out year by year, closely track any legislative changes that could impact at the state level. And then also just tracking your state attributes. Similarly, you mentioned the bonus depreciation issue, this is very similar in tracking some of these attributes at the state level. Can be a lot of effort as compared to the federal level just because so many jurisdictions are involved.

**Elizabeth L'Hommedieu:**

Yes, agreed. It could be some effort, but I do think the modeling is key, like you said, and in fact, I think it's my understanding that some states may allow for a state-only election; California comes to mind. So, I don't know, is that something that taxpayers should be considering? And I'm guessing that your answer is going to focus on modeling perhaps. Do you want to talk us through that, Justin?

**Justin Hill:**

That's right. So, states will not allow taxpayers to elect capitalization or immediate expensing for section 174 expenses. The state treatment will depend on whether that state conforms or doesn't conform to the new section 174 amortization rules. However, California and Wisconsin are two exceptions to this general rule. As we previously discussed, these states do not conform to new section 174 amortization rules and will require an immediate expensing of section 174 cost. The taxpayers can make a state-specific election to capitalize cost in these states. So, you may want to do this to use state NOLs or credits, for example, or if you are expecting apportionment changes in the future year, you may want to capitalize, and you can do this in California and Wisconsin, but taxpayers should be aware that there is procedural process in each of these states to do that. So, taxpayers may need to file forms even before the state tax return is due and seek approval. And for Wisconsin, such an election is binding on future years. It's an opportunity out there, at the state level, conformity trumps and you're not able to elect a different treatment except in a few circumstances.

**Elizabeth L'Hommedieu:**

It does sound like understanding your attributes by state and doing some of this modeling is important, particularly if you wanted to make an election that required something before your return is filed. Stefanie, in our last episode we talked about lack of clarity around how we handle costs related to contract R&D. Is this also an issue from a state perspective?

**Stefanie Humphrey:**

Yeah, great question Liz. Quick recap on the federal issue. The way that I would think about it is if there are multiple taxpayers that have a right to use research in their business, there is potential that there would be a double capitalization issue where each of those taxpayers may need to capitalize their costs incurred on section 174-type activity. Now, from a federal perspective, we overcome that in a consolidated group, but we are focused on that issue more from a foreign affiliate perspective or between entities outside of the consolidated group. From a state perspective, we'd have to view that a little bit differently. So, Justin, you want to give us a little overview on the state view?

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**Justin Hill:**

As you know, these separate reporting states don't follow the federal consolidated return rules, generally speaking in particularly to 1.1502-13. So, the analysis in separate reporting states would be very similar to that of a payment between a US company and a foreign affiliate or another nonconsolidated group member. In other words, the issue would be whether R&D costs are ordinary necessary expenses under section 162 and currently deductible. Alternatively, are research and experimental expenses within the meaning of section 174 subject to amortization. And you need to look at this without applying again the consolidated return rules. So specifically 1.1502-13. This is one step where we have worked together with many taxpayers recently just to figure out the treatment from a state perspective.

**Stefanie Humphrey:**

Yeah, agreed. I think, the separate return issue is one that probably wasn't top of mind for many taxpayers initially, but as they sort of tease out the double capitalization considerations with their affiliates globally, this issue certainly comes up quickly and needs to be considered as we look to tax return filings in particular for 2022.

**Elizabeth L'Hommedieu:**

Those are great points. And just one more added complexity I wasn't even thinking about from the state perspective. So I know we've covered a lot. Is there anything else you guys want to discuss before we conclude?

**Justin Hill:**

One thing I did want to highlight is the disparate treatment between foreign and domestic R&D expenses. So, as we've been talking about, domestic R&D expenses are amortized over 5 years and foreign research expenses are amortized over 15 years. And while Congress is free to set different standards for domestic and foreign commerce for state tax purposes, we spend a lot of time thinking about the foreign commerce clause and implications there under the foreign commerce clause. States are not permitted to discriminate against foreign commerce even inadvertently through conformity to the Internal Revenue Code. So, this is an area I think taxpayers should consider the discriminatory result under section 174 and whether states may constitutionally be required to allow for five-year amortization for foreign R&D expenditures, which is the same amortization period as per domestic expenditures. An area that we've been focused on lately, Liz, and one we haven't received much guidance at the state level, but an important one nonetheless.

**Elizabeth L'Hommedieu:**

Yeah, thanks for bringing that up. And I think that's just one more place to model whether that would have a material impact to you on a state filing if there was a difference between 5- and 15-year amortization. Thank you both, Stefanie and Justin, for talking us through this topic today and sharing your insights. It was a great discussion and I look forward to some more of those real-time updates on the state conformity as we work through the state legislative season. And to our audience, thank you for joining us today. This is Liz L'Hommedieu on behalf of KPMG Banking and Capital Markets Tax practice. I look forward to talking again soon.

**Speaker 1:**

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