Tax in tech: Refine plans for 163(j)

Transcript

CHRISTOPHER SUMMER: Hello, my name is Chris Summer. I'm an international tax partner with Grant Thornton and leader of our Tax Practices Technology Industry Initiative. Today, we're discussing limits on interest deductibility under U.S. tax law and some planning and mitigation strategies around it. I'm joined by Trevor Salzmann, a senior manager at our Corporate Tax Solutions group. Trevor, welcome to the podcast.

TREVOR SALZMANN: Thanks Chris. Thanks for having me.

SUMMER: So, Trevor, 163 J goes back a long time. However, before the 2007 Tax Cuts and Jobs Act, only international folks really focused on it. With TCJA, Congress amended 163(j) to broaden the applicability and align our limitations with other mainline tax jurisdictions. So, Trevor, for our more recent tax years, this seems like it's becoming more of a problem for my clients in the technology industry.

SALZMANN: Yeah, Chris, so especially looking back at 2022, you see that a lot of companies in the tech space have had to deal with the aftermath of the Section 174 add-back. That's the add-back for research and experimentation expenditures. A lot of companies that maybe were still either driving a loss or maybe utilizing NOLs are finding themselves sooner than maybe expected in a cash tax position. This, coupled with the more restrictive interest limitation deduction, is really starting to cause problems — especially if they are highly levered companies and so between these two provisions, a lot of companies have maybe been interested in tax planning they otherwise wouldn't have been.

SUMMER: I think that's right. When I looked through my clients in this industry, there are two kind of trends. Number one is: Companies that have been very acquisitive, they've been able to fund those acquisitions through debt historically, and that debt's now, A, as you pointed out, got a high interest rate on it, and B, becoming more and more limitation on that interest. Coupled that with, the add-back for what would previously have been deductible 174 research and experimentation. Now, you've got companies that have never been taxpayers, didn't expect to be taxpayers, having to pay tax on a U.S. Federal and sometimes a US state level too. And it's really becoming burdensome for them because they just… this all flipped on them fairly quickly. And so now, companies are left to try to figure out how to make the best of the situation, how they might be able to drive additional benefit from some of this interest that they're paying. So, Trevor, I think when we're looking at this, are there areas within the interest deductibility or the interplay of that with some of the capitalization provisions that that companies might want to consider?

SALZMANN: Yeah, absolutely. So, companies felt the pain from that section 174 add-back in 2022. This required capitalization of R&E expenditures. There's a lot of uncertainty — just specifically what costs actually constituted R&D expenditures? It's obvious that certain direct costs that go into software development probably are R&E expenditures that need to be capitalized. There is significant question around some of the overhead expenses and how far would one really look and what cost might need to be allocated. Hey, maybe interest expense is one such item of corporate overhead that might need to be allocated and capitalized into R&E. It wasn't really clear. Nobody's really had to think about this all that much. And so, what we saw was that, you know, in certain fact patterns, many companies felt that that interest expense might need to be an item of overhead that is capitalized into that. And you know, looking at the 163(j) rules and the regulations under that: If something is capitalized, if interest is capitalized rather, interest expense needs to be limited. And so, you know, we saw many companies this year looking to include that as a 174 expense. The recovery on that is a little bit longer than maybe they'd like. Obviously, it's 5 to 15 years, so some serious planning and thought needs to be put into whether that's something that's attractive, you know, from a cash tax planning perspective. But you know, in certain instances the amount was large enough and you know, maybe there was an effective tax rate benefit there from, you know, moving that interest out of that limited bucket.

SUMMER: Right. The IRS has provided some guidance around this. So can you talk a little bit about where the Treasury and IRS stand?

SALZMANN: Yeah, absolutely. You know, it's interesting. We were getting ready to file a bunch of returns around September and all of a sudden this notice 2023-60 comes out and includes a list of costs that are not permitted or required to be capitalized as specified research expenditures. One of those costs being interest expense. So this guidance was very helpful to kind of preview the IRS's initial positions on a lot of these items as it relates to 174. But at this point, it is only a notice and taxpayers have been commenting on this and we are waiting on proposed regulations and then final regulations that will follow that. You know, we'll see if that if perhaps, their position on interest expense changes.

SUMMER: So proposed regulations forthcoming. Some discussion on those final regulations. After that, we've got a little bit of time and we'll get more guidance as this issue continues to head down the road.

So, taking aside that, what other planning opportunities should companies be considering when they look at interest expense?

SALZMANN: You know, maybe it's worth just going back into your 163(j) calc and making sure all the mechanics there are right. Additionally, making sure that all the items there are actually required to be included there and are actually for federal tax purposes, interest expense. Beyond that, you know a lot of times we go through the exercise with the companies just kind of thinking about: What are my major cash outlays, what am I investing in? What is the does the cash that I have on hand going to — and trying to understand maybe there is an asset there where maybe there is some other kind of elective capitalization, or maybe required capitalization, of interest expense — of course, if that interest expense is required to be capitalized and no longer is in that limited bucket. And so really just understanding what are the items of tangible property or intangible property that my business is investing in. And you know once we identify those areas of spend, you know seeing what avenues do we have? Or, what requirements do we have, to maybe capitalize some of this interest into the asset?

SUMMER: That makes sense. And then also when you're looking at this, we also need to think about not just the tax return aspect, but the financial statement aspect too, right. So companies now may have a interest expense carry forward that maybe has evaluation allowance against it because they haven't been able to use it or maybe they've got this building 163(j) carry-forward that needs to be evaluated for evaluation allowance, so it's a good time to start looking through some of these opportunities, seeing what planning strategies may be available to you that you might consider to factor into those valuation allowance discussions — in addition to cash tax planning tax benefits, the ETR component of this is meaningful to companies as well.