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The New Section 174 Mandatory Capitalization Regime: Implementation Considerations for Engineering and Construction Companies

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Section 174 describes the tax treatment for costs of developing or improving a product or process used in a taxpayer's trade or business, otherwise known as research and experimental costs. The TCJA provision requiring mandatory capitalization of section 174 costs for tax years beginning after December 31, 2021, presents a number of issues for taxpayers within the engineering and construction ("E&C") industry. This article will discuss some of these issues and possible implications.

Who Has Section 174 Costs?

Taxpayers in the E&C industry often engage in research and development activities as a necessary part of fulfilling a contract with a customer. Research and development activities for purposes of section 174 include any activity intended to discover information to resolve uncertainty concerning a product or process. For example, a structural engineer using CAD software to optimize the design of a new building would be considered a research and development activity under section 174. When research and development services are performed on behalf of another party, the obvious question is: Which party should take these into account as section 174 costs?[1]

The regulations under section 174 contemplate that a taxpayer would be able to exploit the results of research in its trade or business or for the pursuit of profit. Further, the regulations also stipulate that when research results in the manufacture of depreciable property, the payor (i.e., the party paying

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[1] 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").

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another to perform research services on its behalf) must be at risk financially to treat expenses as section 174 costs. They are silent however on whether or not the payee (i.e., the party providing research services on behalf of another) also must be financially at risk to treat expenses as section 174 costs. If section 174 does not apply, then costs are likely deductible under section 162 as incurred. Because of the project-based nature of the E&C industry, a one size fits all approach is unlikely to work as contract terms are highly variable depending on the customer and the type of project. Detailed review of contracts may be required to understand the rights and risks of both parties. For example, does the contract contain acceptance criteria for milestones such that payment is contingent on success of the work performed? Who has the rights to the intellectual property developed as part of the project, or as is often the case, are they shared?

Long-Term Contracts with Section 174 Costs

The interplay between section 460 and section 174 is also of particular interest to taxpayers in the E&C industry. Section 460 describes the tax accounting rules for long-term contracts, which are generally contracts for the construction of non-inventoriable tangible property where the project will end in a year after the year the contract is entered into. The purpose of section 460 is to match recognition of income from the contract with the expenses incurred to fulfil the contract. Under section 460 the amount of income recognized in a given period depends on a percentage of completion ("PCM") ratio equal to contract costs incurred to date over expected total contract costs. If section 174 costs associated with a particular project are amortized, the question becomes whether this affects the PCM ratio.

The IRS position in FAA 20205301F is that amortization does not alter when section 174 costs are incurred for purposes of determining contract costs incurred to date. This has the effect of accelerating the recognition of contract revenue and creating a mismatch of income and expenses under the contract. However, for other cost recovery allowances like depreciation, a taxpayer has generally only been required to include deductible amounts in contract costs incurred to date (i.e., amounts claimed as depreciation), which would appear to be inconsistent with FAA 20205301F. If amortization of section 174 costs is treated as simply another type of cost recovery allowance, then capitalization would lead to a deferral of income recognition.

On the other hand, interest look-back calculations would not be affected because total contract cost would be the same, only the timing of deductions would change. Expenses for independent research and development activities, which are research and development activities unrelated to any particular project, are not included in either the numerator or denominator.

Section 174 Costs and the Research Credit

The interplay between section 41 and section 174 is another consideration. Section 41 provides a federal income tax credit for increasing research expenditures. The alternative simplified credit, which is the one used by most taxpayers due to its relative simplicity, is based on a percentage of the amount of qualified research expenses ("QREs") in the current year that exceeds 50 percent of the prior three-year average of QREs. Corporate taxpayers should be aware of the rule for controlled groups of corporations whereby all members of the group are treated as a single taxpayer when determining QREs. A controlled group of corporations for purposes of the section 41 credit is a group of

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corporations where the common parent directly or indirectly owns more than 50 percent of each subsidiary. Because of the controlled group rules, taxpayers should inquire whether costs that are section 162 deductions for a subsidiary could qualify as a QREs from a controlled group perspective. However, note that Treasury and the IRS have not yet issued guidance addressing this issue.

Taxpayers that have made an election under section 280C(c) to reduce the amount of credit claimed under section 41 rather than reduce the amount of tax deductions taken with respect to QREs incurred during the tax year should revisit that decision. A reduction in the credit is only required under the amended statute if the amount of credit exceeds the amount allowable as a deduction for QREs incurred in the current tax year.

Consistency Issue with Previous Positions

Many taxpayers would likely wish to minimize the amount of section 174 costs and avoid mandatory capitalization, but taxpayers should consider what impact this may have on previously taken positions. If a taxpayer has historically claimed costs as QREs for purposes of the section 41 credit and in 2022 begins treating those costs as section 162 deductions, this may lead to questions about the inclusion of those costs as QREs under examination. Similarly, a taxpayer that has made a section 59(e) election for all or a portion of its section 174 costs in prior years should be wary of treating equivalent costs as section 162 deductions. Section 59(e) is an optional election for taxpayers to amortize qualified expenditures instead of having those expenditures treated as a minimum tax preference. It does not apply to costs that are deductible under section 162, so an inconsistent treatment in a mandatory capitalization year could lead to an IRS challenge with respect to either of the positions taken.

Taxpayers also must be mindful that the definition of section 174 expenses is more expansive than the definition of credit eligible QREs, and is not limited to wages, supplies, and 65 percent of contract research. The existing regulations indicate that incidental costs including depreciation and other overhead relating to the research activity must be included in the scope of costs subject to mandatory amortization, and that activities intended to remove uncertainty in the design of a product are included, even if it is certain that the taxpayer’s activities will lead to an appropriate design. With respect to software development activities, the uncertainty test is turned off by statute, expanding the reach of mandatory amortization even further.

Foreign Tax Considerations

Mandatory capitalization also presents taxpayers with foreign operations a number of issues to consider. Under section 174, costs incurred outside of the United States are subject to a 15-year amortization period rather than a 5-year amortization period if incurred domestically. Mandatory capitalization will also affect foreign tax credit, base erosion and anti-abuse tax (BEAT), and global intangible low-taxed income (GILTI) computations. For instance, tested income for a controlled foreign corporation would likely increase from capitalization of section 174 costs whereas capitalization of section 174 costs would likely reduce the amount of base erosion payments for BEAT purposes. These impacts could be significant if the taxpayer has large offshore engineering centers.

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Accounting Method Change Procedures

Revenue Procedure 2023-8 as amended by Revenue Procedure 2023-11 provides taxpayers with automatic procedures to change from deducting to capitalizing section 174 costs. These procedures permit a statement with the return in lieu of Form 3115 if the taxpayer timely implements the change for the first effective year. However, audit protection is denied for costs incurred during the first effective year for any change that is made in the year immediately following the first effective year. For estimated tax purposes, however, the change would not have to be taken into account for the first effective year, but only to the extent the taxpayer is able to rely on the annualization method for a particular installment of its estimated tax.[2] Under the regular method, based on the tax shown on the return for the first effective year, estimated tax installments would need to be based on the mandatory amortization method.

Impact on Financial Statements

For financial statement purposes, tax provisions must now include the impact of mandatory capitalization on federal and state income tax liabilities. It should be noted that not all states conform to current federal law (currently, California, Wisconsin, Texas, and Tennessee), and capitalization of section 174 costs would not be required in those states, creating a new state adjustment. The capitalization of these costs will create a deferred tax asset that will unwind as incurred section 174 costs are amortized.

While there is still much uncertainty about implementing the new rules in the absence of additional guidance from Treasury and the IRS, taxpayers should consult with their tax advisors on the issues discussed in this article. Depending on the positions taken, a reserve for an uncertain tax position may be necessary.

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[2] Section 1.6655-2(f)(3)(vii)(Example 11).

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