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TCJA Changes to R&E-Related Costs: Section 174 Update

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INTRODUCTION

When large portions of the §174[1] regulations were finalized in 1994 in T.D. 8562,[2] it was noted that ''Congress enacted §174 not only to encourage research, but also to avoid the difficult tax accounting questions that would arise regarding research expenditures in the absence of special tax accounting rules.''[3] The historically taxpayer-friendly treatment of research and experimentation (R&E) expenditures and other incentives, like the §41 credit for increasing research activities (also known as the R&D tax credit), has fostered the development of countless new and improved products and manufacturing processes in the United States.

The Tax Cuts and Jobs Act (TCJA),[4] signed into law in 2017, represented the culmination of a lengthy process in pursuit of business tax reform that had played out over the course of more than 20 years. The bill passed through a legislative process known as ''reconciliation,'' which allows spending or revenue bills to pass with a simple majority in the Senate if they do not increase the federal budget deficit outside a 10-year budget window. To offset the impact of provisions that decreased estimated revenues, other provisions were included in the bill as so-called ''revenue raisers.'' One such provision mandated the capitalization and amortization of R&E expenditures for tax years beginning after December 31, 2021. Prior to this, tax law allowed R&E expenditures to be deducted as incurred, deferred and amortized, or capitalized and depreciated.

There was optimism that mandatory amortization of R&E expenditures would be either postponed or fully repealed before the December 31, 2021 deadline, and accordingly taxpayers could potentially continue deducting R&E expenditures as incurred for tax years beginning in 2022 and beyond. However, on December 23, 2022, Congress completed an omnibus spending bill, the Consolidated Appropriations Act of 2023 (CAA),[5] which ensured that the government is funded through the fiscal year ending September 30, 2023, but excluded any changes to the §174 rules requiring capitalization and amortization of R&E expenditures.

The IRS on December 12, 2022, released guidance by way of Rev. Proc. 2023-8, which was modified and superseded by Rev. Proc. 2023-11 shortly thereafter on December 29, 2022. Although some hope remains that the current session of Congress may retroactively withdraw this requirement, the complexities and uncertainty of passing such legislation are such that taxpayers are bound by the law as it is currently written. This article highlights §174-related issues that taxpayers must now consider for their tax return, financial

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] 59 Fed. Reg. 50,159–50,161 (Oct. 3, 1994).

[3] H. Rep. 1337, 83d Cong., 2d Sess. (1954).

[4] Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017).

[5] Pub. L. No. 117-328 (Dec. 29, 2022).

statement provision, and quarterly estimated tax payments for tax years beginning after December 31, 2021.

SECTION 174 SPECIFIED RESEARCH AND EXPERIMENTAL EXPENDITURES

The TCJA provides that specified R&E expenditures under §174 paid or incurred in tax years *beginning after December 31, 2021*, must be capitalized and amortized ratably over five years for research conducted in the United States and 15 years for research conducted outside of the United States,[6] beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

Under §174(d) as revised, ''If any property with respect to which specified research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment and such amortization deduction shall continue with respect to such expenditures.''

The application of these rules is treated as a change in the taxpayer's method of accounting initiated by the taxpayer and made with the consent of the Secretary of the Treasury. Depending on the year a taxpayer makes this change, the rule is applied either on a cut-off basis or through a modified §481(a) adjustment to specified R&E expenditures paid or incurred in tax years beginning after December 31, 2021 (thus there is no adjustment under §481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2022).

Making the Method Change

Making the Change in the First Taxable Year After December 31, 2021

In accordance with Rev. Proc. 2023-11, for the first taxable year beginning after December 31, 2021, the requirement to file a Form 3115, *Application for Change in Accounting Method*, is waived and a taxpayer can instead file a statement with its tax return to effect the change in method of accounting.[7] The statement is treated the same as a Form 3115 for purposes of the automatic consent procedures of Rev. Proc. 2015-13.[8] ''The statement must include the following information for each applicant:

> (A) the name and employer identification number or social security number, as applicable, of the applicant that has paid or incurred specified research or experimental expenditures after December 31, 2021;
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> (B) the beginning and ending dates of the first taxable year in which the change to the required §174 method takes effect for the applicant (year of change);
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> (C) the designated automatic accounting method change number for the change (which is number 265);
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> (D) a description of the type of expenditures included as specified research or experimental expenditures;
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> (E) the amount of specified research or experimental expenditures paid or incurred by the applicant during the year of change; and
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> (F) a declaration that the applicant is changing the method of accounting for specified research or experimental expenditures to capitalize such expenditures to a specified research or experimental capital account, and amortize such amount over either a 5-year period for domestic research or 15-year period for foreign research (as applicable) beginning with the mid-point of the taxable year in which such expenditures are paid or incurred in accordance with the method permitted under §174 for the year of change. Also, the declaration must state that the applicant is making the change on a cut-off basis.''[9]

It should be noted that a taxpayer does not receive audit protection with respect to expenditures paid or incurred in taxable years beginning on or before December 31, 2021.[10]

Making the Change Later Than the First Taxable Year After December 31, 2021

If the year of change is later than the first taxable year beginning after December 31, 2021, a Form 3115 must be completed to effect the method change. ''A taxpayer must include on an attachment to Form 3115:

> (A) a description of the type of expenditures included as specified research or experimental expenditures;

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

[7] Rev. Proc. 2023-11, §3.02(4)(a)(ii).

[8] *Id.*

[9] *Id.*

[10] Rev. Proc. 2023-11, §3.02(7).

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(B) the taxable year(s) in which the specified research or experimental expenditures subject to the change were paid or incurred by the applicant; and

(C) a declaration that the applicant is changing its method of accounting for specified research or experimental expenditures to capitalize such expenditures to a specified research or experimental capital account, and amortize such amount over either a 5-year period for domestic research or 15-year period for foreign research (as applicable) beginning with the mid-point of the taxable year in which such expenditures are paid or incurred in accordance with the method permitted under §174 for the year of change. Also, the declaration must state that the applicant is making the change with a modified §481(a) adjustment that takes into account only specified research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021.''[11]

Furthermore, a taxpayer does not receive audit protection with respect to expenditures paid or incurred in taxable years beginning after December 31, 2021 if such change is made for the taxable year immediately subsequent to the first taxable year in which §174 becomes effective.[12]

Updated Treatment of Software Development Expenditures

Reg. §1.174-2 provides a general definition of R&E expenditures, which did not change under the new law, except that §174(c)(3) now provides that software development costs will be explicitly treated as specified R&E expenditures. As described in current Reg. §1.174-2(a), §174 expenditures include all costs incident to development.

As provided in Rev. Proc. 2000-50, the IRS had a long-standing rule of administrative convenience that permitted taxpayers to treat the costs of developing software in a manner similar to §174 expenses, whether or not the particular software was patented or copyrighted or otherwise met the requirements of §174.[13] Rev. Proc. 2000-50 also provided an alternative method of depreciating software development costs over 36 months from the placed-in-service date of the software under §167(f)(1). The TCJA effectively terminates both this rule of convenience and this alternative depreciation method for software development expenses otherwise eligible for deduction under Rev. Proc. 2000-50 and now requires amortization of these software development expenses over at least five years with a midpoint rule.

Expenses That Should Be Included Under §174

While a full and exhaustive list of what should be capitalized under §174 is outside the scope of this article, what follows is a list of items that taxpayers should consider for capitalization and amortization under §174. A taxpayer who is quantifying qualified research expenditures (QREs) for the §41 R&D tax credit may consider using §41 QREs as a starting point for §174 expenditures (i.e., §174 expenditures will typically be greater than or equal to §41 QREs) because one of the requirements for inclusion of QREs under §41 is that the expenditures qualify under §174.

— **Internal Labor.** Portion of employee salaries related to their direct and incidental involvement in R&E activities.

o While §41 QRE amounts are based on W-2, Box 1 wages, *§174 amounts are based on fully burdened salaries and/or hourly rates and should generally be higher than the §41 amounts*.

o While §41 QRE amounts only include activities of employees directly performing, supervising, and/or supporting qualified research, *§174 amounts also include personnel costs incidental to R&E activities and might be higher than the §41 amounts*.

— **Supplies.** Non-depreciable supplies used in R&E activities.

— **External Labor.** Third-party contractors performing R&E activities on taxpayer's behalf.

o While §41 excludes activities performed outside of the United States, *§174 also includes foreign research and should be higher than the §41 amounts*.

o While §41 generally only allows 65% of qualified external labor (''contract research'') to be included, *§174 includes 100% of external labor costs and should be higher than the §41 amounts*.

— **Rental or Lease of Computers.** Amounts paid or incurred for rental or lease of computers used in R&E activities. Note unlike §41, *§174 does not require the computer to be lo-*

[11] Rev. Proc. 2023-11, §3.02(4)(b)(ii).

[12] Rev. Proc. 2023-11, §3.02(7).

[13] Rev. Proc. 2000-50 and its predecessor, Rev. Proc. 69-21.

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cated off the taxpayer's premises nor that they are the primary user of the computer.[14]

- **Software Development.** Costs related to software development to the extent not already included in the above categories.
- **Overhead Costs.** Overhead costs incidental to R&E activities, including, but not limited to, rent, utilities, supplies, telecommunications, property tax, maintenance/cleaning services, etc.
- **Allocable Depreciation.** Depreciation on property to the extent the depreciated property is used in connection with R&E activities.
- **Patent Costs.** Costs of obtaining patents, such as attorneys' fees expended in making and perfecting a patent application should be included, but not costs of obtaining another's patent or for pursuing or defending a patent infringement suit.
- **Allocable Book-to-Tax Adjustments.** Certain book-to-tax adjustments (''M-Adjustments''), including stock compensation and depreciation related to R&E activities.

Additional Guidance From the IRS and Treasury Is in Progress

The Treasury/IRS Priority Guidance Plan (often referred to as the ''Business Plan'') for 2022–2023 includes as item 19 under the General Tax Issues category ''Guidance addressing amortization of research and experimental expenditures under §174 and related issues.'' This reference indicates that guidance responsive to the aforementioned statutory changes is in progress.

CONFORMING AMENDMENTS TO §41 AND §280C

The TCJA also made conforming amendments to §41 and §280C that take effect for tax years beginning after December 31, 2021.

Changes to §41(d)(1)(A) by the TCJA

After the changes made by TCJA, §41(d)(1)(A) provides that ''The term 'qualified research' means research with respect to which expenditures *may be treated as specified research or experimental expenditures under section 174*'' [emphasis added]. In other words, §174 expenditures can no longer be expensed, consistent with the requirement to capitalize and amortize such expenditures.

Changes to §280C(c) by the TCJA — Will Taxpayers Benefit From a Reduced Credit Election After the TCJA Changes?

Section 280C(c) as amended by the TCJA removed previous references in old §280C(b)(2) to a ''Similar rule where taxpayer capitalizes rather than deduct expenses'' and created a new calculation that taxpayers should evaluate before making a reduced credit election. Whether or not to make a §280C(c)(2) election to claim a reduced rate of credit in lieu of a reduction in deductions (as in pre-TCJA §280C(c)(1) or reduction in the amount capitalized under post-TCJA §174 and §280C(c)(1), is often a complex decision when a taxpayer considers its total tax position, factoring in U.S. federal taxes, foreign taxes, and state and local taxes. From the perspective of domestic regular income taxes, many taxpayers might decide not to make an election for a reduced rate of credit because §280C(c)(1) by its terms might not apply.

For example, a 2022 calendar year taxpayer has only U.S.-based qualifying R&D activities; uses the traditional regular research credit calculation method; and has a base amount pursuant to §41(c)(2) of 50% of the current credit determination year qualified research expenses (QREs), then the resulting gross research credit without a §280C(c) election would be 10% of the total current year QREs. The taxpayer's §174 deduction related to these costs would be 10% of the current credit determination year QREs (100%/5 = 20% and applying the midpoint rule = 10%). The amount of the credit determined under §41(a)(1), which mathematically is 10% of current credit determination year QREs, will not exceed the amount allowable as a deduction for such QREs which is also mathematically 10% of current credit determination year QREs. In this instance post TCJA §280C(c)(1) does not apply and therefore there would be no reduction to the capitalized §174 costs.

If §280C(c)(1) does apply, taxpayers that have traditionally elected the reduced credit to minimize total tax liability for the current year may find that as result of mandatory capitalization, the full credit now provides a lower total tax liability for the current year but may increase tax liability in future years.

CONCLUSION

The authors believe there is a possibility that either a retroactive delay in the effective dates of these TCJA changes or an outright repeal may be passed by Congress and enacted into law. In the meantime, ab-

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[14] *See* Reg. §1.41-2(b)(4).

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sent a legislative change, these TCJA changes need to be factored into tax returns, financial statements, and estimated tax payments/payments with returns for tax years beginning after December 31, 2021.

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