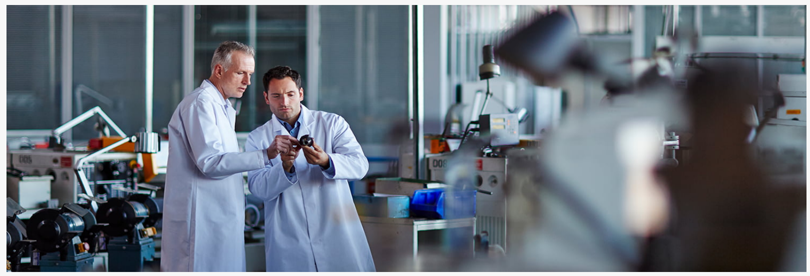
How to Handle Research and Experimental Expenses Under Section 174

LONG BEACH, CALIFORNIA, UNITED STATES, August 7, 2023 /EINPresswire.com/ -- Internal Revenue Code (IRC) Section 174 now requires taxpayers to capitalize and amortize research and experimental (R&E) expenditures beginning in tax year 2022.


Section 174

Before the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, businesses could choose between immediately deducting R&E expenses and amortizing the costs over five or more years, depending on the nature of their business. The TCJA changed this ruling, requiring taxpayers to capitalize R&E expenditures after December 31, 2021, and amortize them over five years for domestic costs and 15 years for foreign costs.

Despite the lobbying and bipartisan support for revisions to the Section 174 requirements, no changes have been made to alleviate the rule to capitalize and amortize R&E costs as of this writing.

If a business incurs R&E expenses, they may have questions about Section 174 and how recent changes impact their organization. Understanding the current landscape of Section 174 and working with a tax professional can help ensure a compliant tax return and take advantage of available credits to offset the impact of capitalization and amortization in future years.

What are Section 174 Expenses?

Section 174 relates to the costs incurred when companies develop or improve a process or product. For income tax purposes, R&E expenses are defined under Section 1.174-2(a) as laboratory or experimental expenses incurred by taxpayers in connection with their trade or business.

It applies to expenses linked to the development or enhancement of a product, including:

- Pilot models

- Techniques
- Formulas
- Inventions
- Processes
- Patents
- Similar properties

The TCJA added Section 174(c)(3), which specifies that any expenses paid or incurred for developing software are also R&E expenses subject to capitalization.

R&E expenses are the direct costs of R&E factored in, but they also include the indirect costs connected to developing or improving a product. Some expenses are specifically included in Section 174 and are not qualified research expenses for R&E tax credit purposes.

These indirect R&E expenses can include:

- Attorney fees related to filing and completing patent applications
- Depreciation or depletion of property used in connection with R&E
- Employee wages and benefits
- Supplies, computer leasing, and contract research costs
- Pilot model expenditures
- Facility expenditures such as rent and utilities
- Travel expenditures
- Foreign research expenditures
- Additional overhead expenditures

The following expenses are excluded from the definition of R&E costs under Section 174:

- Ordinary testing or inspection of materials or products for quality control
- Efficiency surveys
- Management studies
- Consumer surveys
- Advertising or promotions
- Acquisition of another’s patent, model, production, or process
- Research in connection with literary, historical, or similar projects
- Expenditures for the acquisition or improvement of land directly related to activity

What is the Current Amortization Rule for Section 174?

After December 31, 2021, taxpayers can no longer deduct R&E expenses in the year incurred. Instead, R&E expenses must be capitalized and amortized over five years or 15 years for foreign expenses.

Amortization begins at the midpoint of the first year when the costs are incurred, using a half-year convention. This results in businesses only being able to deduct 10% of domestic costs that year.

What Recent Changes Have Occurred Regarding Tax Filing Under Section 174?

Because this is a change in accounting method, Form 3115, Change in Accounting Method, would normally be required. However, on December 29, 2022, the IRS issued Rev. Proc. 2023-11, which offers guidelines for filing with R&E expenses under the new Section 174. For the 2022 tax year only, the IRS is offering a shortcut for notification of a new accounting method instead of requiring filers to complete Form 3115. Taxpayers can include a notice with their 2022 original return indicating they are amortizing Section 174 expenses.

The notice must include the following elements:

- Name and EIN or SSN
- Date when the accounting methods changed
- Automatic accounting method change number (#265)
- Description of expenditure type included in the change
- Total R&E expenditures paid or incurred during this year
- Declaration of changing accounting method to the capitalization and amortization required under Section 174, and it must state that the change is on a cut-off basis.

What is the Credit for Increasing Research (R&D) Under Section 41?

The R&D tax credit is a tax incentive provided by the IRS to encourage companies to invest in research and development activities. It was established under Section 41 of the IRC.

The R&D tax credit allows eligible businesses to claim a tax credit for a percentage of their qualified research expenses (QREs) related to developing or improving products, processes, software, or other innovative technologies. The credit generally equals 20% of the increase in QREs over a base amount or 14% of the QREs that exceed 50% of the average QREs for the previous three years.

To qualify for the credit, a company must meet the criteria, including having expenses related to R&E activities, conducting technological research, and attempting to develop new or improved products or processes. The credit is available to businesses of all sizes. The credit primarily benefits startups and small businesses investing heavily in R&D.

How does the R&D Tax Credit Impact Section 174?

Section 280C limits the amount of deductions a taxpayer can claim for expenses related to the research credit under Section 41. This section prevents taxpayers from receiving a double benefit from the same costs.

Previously, Section 280C required businesses claiming the credit to reduce their deductible credit-eligible expenses by the credit amount. So, if your company claimed the credit, you would have to reduce the deductible expense by the same amount unless certain elections are made.

Under new rules, the deduction disallowance only applies when the research credit amount is larger than the current year Section 174 amortization expense. If this occurs, the capitalized asset must be reduced by the amount of the excess tax credit. Taxpayers may elect to reduce their research credit instead of reducing the capitalized asset.

Does Section 174 Impact the R&D Tax Credit?

Section 174 does not directly impact the R&D tax credit amount, except that eligible R&D tax credit expenditures are defined with reference to Section 174.

Qualified research expenses (QREs) for R&D tax credit purposes include wages, supplies, and contract research expenses paid or incurred in connection with qualified research activities. Qualified research activities generally include items treated as Section 174 expenditures but must also involve a technological process of experimentation to develop new or improved business components.

Since Section 41 expenses are a subset of Section 174 expenditures, businesses may have more expenses capitalized under Section 174 than qualified for tax credits under Section 41.

Working with a qualified business tax professional can ensure a company gets the total Research Credit available to reduce as much tax liability as possible under current Section 174 rules.

Does Section 174 Impact Software Development?

Yes. Amortizable Section 174 expenses include software development costs.

Do States Treat Section 174 Differently?

Tax treatment varies by state. States that enforce an income tax typically follow the federal guidelines outlined in Section 174. However, it is not always the case. For example, California does not conform to the federal changes made by the TCJA, and California does not require the capitalization of R&E expenses. For California purposes, taxpayers can still elect to amortize their R&E expenses, but it is not mandatory. State conformity is a complex issue. Work with a tax professional to ensure a business is following the correct state treatment.

Will Capitalization Under Section 174 be Deferred or Eliminated?

As of this writing, it is uncertain whether capitalization under Section 174 will be deferred or eliminated. There is bipartisan support in Congress to restore full deductibility of R&E expenses, but Congress has been unable to include Section 174 changes in recent bills.

How Should Taxpayers Approach Current Section 174 Rules?

2022 is the first year your business must capitalize and amortize R&E expenses. Because of limited IRS guidance, working with a skilled business tax advisor and accountant can help maximize R&D credit to offset tax liability on this year's tax form and beyond.

Maximize Your Research Credit to Offset R&E Capitalization and Amortization

Use financial professionals to stay current on all developments regarding tax credits and incentives. They can ensure compliance with the most recent IRS procedures while maximizing research credits to lower tax liability.

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