

## DECODING THE NEW IRC SECTION 174 PROVISIONS – WHAT IT MEANS FOR BUSINESSES



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### I. Introduction

United States is one of the world's leading innovation hubs, and extensive research and development (R&D) is core to enabling this standing. R&D expenditure across industries, such as technology, healthcare, consumer discretionary, energy, and industrial sectors, can vary widely year-to-year, impacting a company's profitability. To ease taxpayers' economic pressure concerning R&D expenses, they were encouraged to adopt an expense deduction framework.

Under the historic tax law, taxpayers could either deduct or capitalize & amortize research and experimental expenditure ("R&E expenditures") under IRC Section 174. The Tax Cuts and Jobs Act (TCJA) made significant changes to treating R&E expenditures under IRC section 174 in a bid to augment federal tax revenue in the short term. As per the changes, for tax years beginning after December 31, 2021, taxpayers no longer have an option to expense off R&E expenditure. Taxpayers will now be required to capitalize & amortize all R&E expenditures paid or incurred in connection with their trade or business, representing costs in the experimental or laboratory sense. The approach will apply irrespective of whether these costs qualify for the R&D credit and whether or not the taxpayer is claiming the R&D credit.

Although there has been ongoing discussion to defer the capitalization of IRC Section 174 costs by Congress, the new IRC section 174 has become effective beginning from tax year 2022. Accordingly, taxpayers should consider the impact of changes in deductibility of R&E expenditures to determine estimated taxes for tax year 2022.

### II. Old provisions of IRC Section 174

Per the previous provisions of IRC section 174, taxpayers had an option to deduct expenses incurred towards R&E expenditure entirely, or they could capitalize and amortize certain specific R&E expenses over five years. The old provisions of IRC section 174 are applicable for amounts paid or incurred in taxable years beginning before January 01, 2022.

### III. New provision - Capitalization of R&E expenditure

The changes provided in the new IRC section 174 removes the option provided for deducting R&E expenditure in the year incurred and requires capitalization and amortization of R&E expenditure. The R&E expenditure incurred by taxpayers on R&E activities in the US is now required to be capitalized and amortized over five years and R&E activities in foreign countries is now required to be capitalized and amortized over 15 years.

Let's take a closer look at the impact of this notable change:

#### Breaking down R&E Expenditures

IRC regulations 1.174-2(a) define R&E expenditures as expenditures incurred in connection with a taxpayer's trade or business, representing research and development costs in the experimental or laboratory sense.

The term includes all costs incidental to developing or improving a product, process, formula, invention, computer software, or technique.

Expenses that qualify as R&E expenditure include;

1. Salaries,
2. Heat, light, and power
3. Models
4. Laboratory materials

The definition of R&E expenditure does not include the following;

1. Ordinary testing or inspection of materials for quality control
2. Efficiency surveys
3. Management studies
4. Consumer surveys
5. Advertising or promotions
6. Acquisition of another's patent, model, production, or process
7. Research in connection with literary, historical, or similar projects

The challenge for taxpayers in complying with this new rule change stems from the fact that the activities and costs defined under IRC section 174 are much broader than the definition of research credit under IRC section 41.

As per the provisions of the new section, any amount paid or incurred in connection with the development of any software will be treated as a research or experimental expenditure. This open ended statement does not provide clarity whether software development costs incurred for non-experimenting purposes would now be considered as 174 costs. Additionally, software developed primarily for internal use may now also be considered as IRC section 174 costs subject to the amortization rule.

#### **IV. Changes to IRC Section 280C – Reduced Credit**

IRC section 280C has been amended, becoming effective for tax years beginning post-December 31, 2021. The amended IRC section 280C removes the former requirement of a corresponding reduction to the IRC section 174 deduction by an amount equal to the research credit claimed in such tax year. The amended IRC section 280C requires that if the amount of the research credit determined for the taxable year exceeds the amount allowable as a deduction for such taxable year, the amount chargeable to a capital account for the taxable year for such expenses shall be reduced by the amount of the excess.

The taxpayer can still make an election to apply a reduced rate of credit rather than reducing the IRC section 174 cost capitalization. From the perspective of domestic regular income taxes, many taxpayers might decide not to make an election for a reduced rate of credit if the R&D credit is less or not significantly higher than the amount allowable as a deduction for such a taxable year. However, further analysis and modelling will be essential to evaluate whether a reduced credit election will be advantageous or disadvantageous to the taxpayer.

#### **V. Some special considerations – Matters that require more clarification from the IRS:**

##### **1) Contract Research Expenses**

R&E expenditure incurred by a service provider under a contract, on behalf of and at the economic risk of a customer, is called contract research. A person is said to have borne the economic risk when the payments are to be made to the service provider irrespective of the research outcome.

As per provisions of the old IRS regulations 1.174-2(b)(3), expenditures paid or incurred for research carried on in taxpayer's behalf by another person or organization (i.e., payor's behalf) are R&E expenditures only if the research is undertaken upon the taxpayer's order and at the taxpayer's risk. However, the new regulations under 174 have not yet been issued, and it remains unclear from the service provider's point of view as to whether the service provider is required to be "at-risk" to consider the cost as IRC section 174 Costs.

## 2) Controlled Foreign Corporation (CFC) performing R&D services

Generally, CFCs are remunerated for undertaking R&D services by the taxpayers. In such cases, IRS may capitalize both the payment to CFC and the R&E expenditure incurred by CFC (as part of GILTI computation).

In the absence of clarity and guidance from the IRS, the above aspects remain unclear and uncertain for taxpayers.

## VI. Conclusion

The new provision is a far cry from the erstwhile full-expensing approach. If taxpayers lack clarity in navigating the new guidelines on the tax treatment of R&D expenses, it could potentially raise the cost of investment, reduce economic output, and eventually impact R&D decisions.

Additionally, the changes require thoughtful consideration to appropriately and correctly identify R&E expenditures and classify them as IRC section 174 costs for capitalization and amortization. The impact of these new rules on taxable income, cash taxes, estimated tax payments, tax rate, international & state tax provisions can be significant, and taxpayers should be prepared to provide documentation to the IRS substantiating the computation of their IRC section 174 costs.

KNAV's professionals can help you evaluate the impact of the changes and can assist in implementing the accounting method change of capitalizing and amortizing IRC section 174 expenses for tax years beginning after December 31, 2021.



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