# R&E changes from TCJA effective for tax years beginning after December 31, 2021

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# Introduction

The "Tax Cuts and Jobs Act" (TCJA)[1] was signed into law on December 22, 2017.

The TCJA 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.

This article highlights research and experimentation (R&E) considerations that had a delayed effective date per the TCJA and are scheduled to take effect for tax years beginning after December 31, 2021.

# Section 174 research and experimental expenditures

The TCJA provides that specified R&E expenditures under section 174 paid or incurred in tax years **beginning after December 31, 2021,** must be capitalized and amortized ratably over a five-year period for research conducted in the United States, and 15 years for research conducted outside of the United States[2] 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.

In the case of retired, abandoned or disposed property with respect to which specified R&E expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment or disposal, but instead must continue to be amortized over the remaining amortization period.

The application of this rule is treated as a change in the taxpayer's method of accounting initiated by the taxpayer and made with the consent of the Treasury Secretary. This rule is applied on a cutoff basis to specified R&E expenditures paid or incurred in tax years beginning after December 31, 2021 (thus there is no adjustment under section 481(a) for R&E expenditures paid or incurred in tax years beginning before January 1, 2022). Whether or not a Form 3115, *Application for Change in Accounting Method*, will need to be filed by taxpayers is unclear at this time.

Treas. Reg. § 1.174-2 provides a general definition of R&E expenditures, and it does not appear that this definition would change under the new law, except that software development will now be specifically treated as specified research. As described in current Treas. Reg. § 1.174-2(a), section 174 expenditures are costs:

> …incurred in connection with[3] the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent

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[1] P.L. 115-97, 131 Stat. 2054 (2017).

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

[3] In contrast to the section 174 "in connection with" standard, section 41(a) requires that qualified research expenses be incurred "in carrying on" any trade or business of the taxpayer (with an exception for in-house research expenses incurred with the principal purpose of using the research results in the future conduct of an active trade or business of the taxpayer or an affiliate, see section 41(b)(4)).

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> application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

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 section 174 expenses, whether or not the particular software was patented or copyrighted or otherwise met the requirements of section 174. See Rev. Proc. 2000-50 and its predecessor Rev. Proc. 69-21.

Rev. Proc. 2020-50 also provided an alternative method of amortizing software development costs over 36-months from the placed in-service date of the software under section 167(f)(1). The TCJA terminates both this rule of convenience and this alternative amortization method for software development expenses otherwise eligible for deduction under Rev. Proc. 2000-50 and now requires capitalization of these software development expenses over at least five years from the date of completion of development activities.

# Conforming amendment to sections 41 and 280C

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

## Changes to sections 41(d)(1)(A) by the TCJA

**After** the changes made by TCJA, section 41(d)(1)(A) provides that:

> 41(d)(1) IN GENERAL. — The term “qualified research” means research—
>
> > (A) with respect to which expenditures **may be treated as specified research or experimental expenditures under section 174**, [Emphasis added]

## Changes to section 280C(c) by the TCJA

**After** the changes made by the TCJA, section 280C(c) provides that:

> 280C(c)(1) IN GENERAL.— If—
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> > (A) the amount of the credit determined for the taxable year under section 41(a)(1), exceeds
> >
> > (B) the amount allowable as a deduction for such taxable year for qualified research expenses or basic research expenses,

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the amount chargeable to capital account for the taxable year for such expenses shall be reduced by the amount of such excess.

(2) ELECTION OF REDUCED CREDIT.—

(A) IN GENERAL.— In the case of any taxable year for which an election is made under this paragraph—

(i) paragraph (1) shall not apply, and 280C(c)(2)(A)(ii) the amount of the credit under section 41(a) shall be the amount determined under subparagraph (B).

(B) AMOUNT OF REDUCED CREDIT.— The amount of credit determined under this subparagraph for any taxable year shall be the amount equal to the excess of—

(i) the amount of credit determined under section 41(a) without regard to this paragraph, over

(ii) the product of—

(I) the amount described in clause (i), and

(II) the maximum rate of tax under section 11(b).

(C) ELECTION.— An election under this paragraph for any taxable year shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on such return, and shall be made in such manner as the Secretary may prescribe. Such an election, once made, shall be irrevocable.

(3) CONTROLLED GROUPS.— Paragraph (3) of subsection (b) shall apply for purposes of this subsection.

Section 280C as amended by the TCJA removed previous references in old section 280C(b)(2), to a "Similar rule where taxpayer capitalizes rather than deduct expenses." This is because after the changes to section 174 by the TCJA, the only permissible method of treating R&E costs is capitalization and amortization (over five years if the activities are conducted in the United States or over 15 years if the activities are conducted outside the United States or its possessions).

## Will taxpayers benefit from a reduced credit election after the TCJA changes?

Whether or not to make a section 280C(c)(2)[4] election to claim a reduced rate of credit in lieu of a reduction in deductions is often a complex decision when a taxpayer considers its total tax position, e.g., 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 section 280C(c)(1) by its terms might not apply.

For example, if for 2022 a taxpayer is a 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 section 41(c)(2) of 50% of the current credit determination year qualified research expenses

[4] In contrast to the current version of section 280C, the reduced credit election under new section 280C is section 280C(c)(2) as opposed to section 280C(c)(3).

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(QREs); then the resulting gross research credit without a section 280C(c) election would be 10% of the total current year QREs.

The taxpayer's section 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%) and the amount of the credit determined under section 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 section 280C(c)(1) does not apply.

If section 280C(c)(1) does apply, taxpayers that have traditionally elected the reduced credit because the reduced credit minimized total tax liability for the current year may find that because 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).

## Estimated tax and financial statement considerations

Taxpayers will need to factor the effective date of the TCJA changes in their estimated tax payments and financial statements. From a big picture perspective, even taxpayers that currently claim the section 41 R&D credit may know the "floor" of their section 174 activities, but they should reassess their determinations for several reasons. New section 174 is broader both qualitatively (e.g., because foreign R&E is also a section 174 cost) and quantitatively (e.g., because the R&D credit is based on W-2 wages versus burdened salary under section 174. Also, the R&D credit only allows 65% of qualifying contract research while section 174 applies to 100% of qualifying contract research), and there are potential "ripple effects" of changes to section 174 amounts (e.g., ability to utilize foreign tax credits, etc.).

## Legislative outlook

The outlook for a possible deferral of the TCJA changes as part of the proposed "Build Back Better Act" (BBBA) remains uncertain as of the date of this article.

## Conclusion

Absent a legislative change, these TCJA changes will need to be factored in to estimated tax payments, tax returns, and financial statements for tax years beginning after December 31, 2021.

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