Ayming Tax Update

Section 174 Impact Analysis

FURTHER TOGETHER

CHANGES TO SECTION 174 MAKE CLAIMING THE RESEARCH CREDIT MORE IMPORTANT THAN EVER

Accounting For Research Expenses Is Now Required

As part of the tax reforms made through the Tax Cuts and Jobs Act ("TCJA") passed in 2017, Section 174 of the Tax Code was amended such that taxpayer's options on how they account for and deduct research expenses were removed for tax periods beginning on or after January 1, 2022.

Prior to 2022, taxpayers had the option to simply include research expenses with other deductions or account for them separately. Under either option, they could deduct the full value of the expense (pending limitations unrelated to Section 174). Many taxpayers did not separately account for research expenses and generally deducted them in other categories.

Section 174 research expenses are much more broadly defined than Section 41 research expenses that qualify for a credit. Taxpayers may have Section 174 expenses even if they do not have Section 41 expenses.

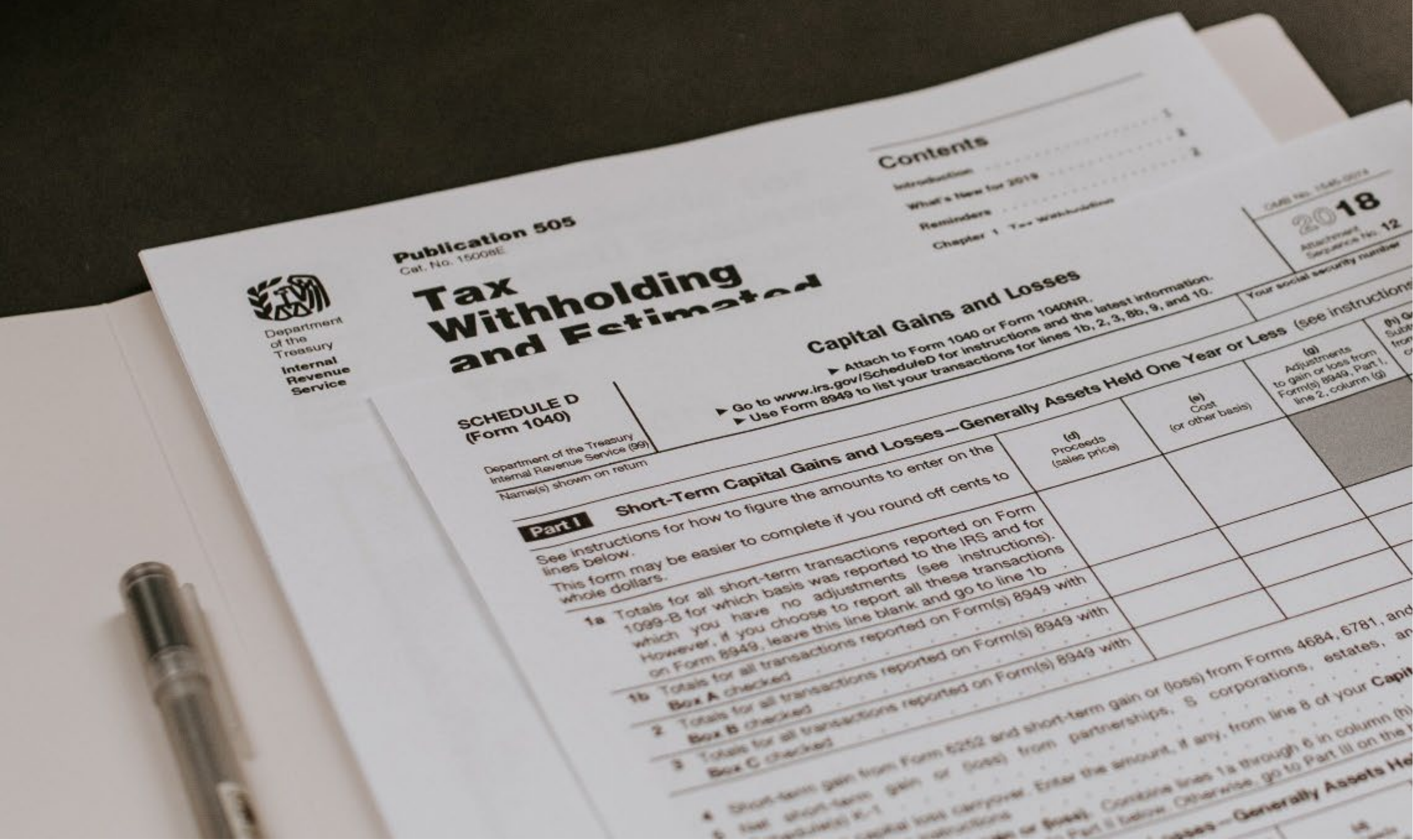
Even those who claimed the Section 41 research credit, a subset of Section 174, often simply grouped those expenses with other deductions, or reported only the value of Section 41 expenses separately. With the TCJA changes, those options are no longer available.

Taxpayers must now separately account for Section 174 expenses and amortize them over five years. Taxpayers who take advantage of the Section 41 credit will need to account for both Section 41 and Section 174 expenses.

Previous 174 Treatment Vs. Current 174 Treatment

Pre 2022	Post Jan 1, 2022
Options	No Option
• Generally account for & deduct • Separately account for & deduct • Capitalize & amortize • Capitalize indefinitely	• Required separate accounting • Required capitalization & amortization of the deduction

The ramifications of Section 174 are likely significant, and taxpayers need to have a plan. Below, we share the high-level business impacts and explore options for compliance and risk mitigation.



BUSINESS IMPACT

Expect Increased Taxable Income & Taxes Due

Taxpayers can expect an increase in their taxable income and taxes due in year one of the amortization schedule, as this change reduces the amount of deductible expenses as the amortization schedule phases in.

	2022	2023	2024	2025	2026	2027
Year	1	2	3	4	5	6
2022	$100,000	$200,000	$200,000	$200,000	$200,000	$100,000
2023		$100,000	$200,000	$200,000	$200,000	$200,000
2024			$100,000	$200,000	$200,000	$200,000
2025				$100,000	$200,000	$200,000
2026					$100,000	$200,000
2027						$100,000
Total Deduction Available	**($100,000)**	**($300,000)**	**($500,000)**	**($700,000)**	**($900,000)**	**($1,000,000)**

Assuming $1m in R&D expenses each year

R&D Tax Credit is More Important Than Ever

Amortization is only required for research expenses. The Section 41 research credit remains available at 100% of value. Taxpayers performing activities as defined by Section 174 and corresponding Treasury Regulations are required to amortize the costs regardless of whether they will take the Section 41 credit on their 2022 return or, have taken the R&D Tax Credit in the past. The amortization requirement will most certainly increase tax liability for many American companies. Further, companies previously in a net operating loss may suddenly find themselves owing tax, taking the Section 41 research credit now more important than ever.

Compliance

Taxpayers must account for their research expenses. Section 174 has a broader definition of research expense than that of Section 41. Taxpayers relying on the analysis performed for the R&D Tax Credit to establish 174 expenditures may not be in compliance.

FURTHER GUIDANCE

The IRS recently issued guidance related to changes in accounting methods for this new requirement. However, further guidance surrounding other changes, including any updated or new tax return forms and instructions have not been provided at this time.

Essentially, taxpayers need a cost segregation of all research expenses. Ayming can assist to identify how much of the R&D expenses can be qualified under Section 41 to support the credit calculation and conduct proper due diligence analysis of the required accounting of Section 174 expenses.

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If you have questions or need help complying with these new tax filing requirements contact us.

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