

Section 174 Quick Facts

Capitalization and Amortization of Research and Experimental (R&E) Expenditures

Who

Taxpayers incurring any expenses related to product, process, and/or software development will need to analyze how the change in law will impact their treatment going forward.

When

This takes effect for tax years beginning on or after January 1, 2022.

What

The Tax Cuts and Jobs Act (TCJA) of 2017 eliminated the ability to immediately deduct development expenditures. Internal Revenue Code (IRC) Section 174 allows taxpayers to deduct development expenditures incurred in the development or improvement of a product or process over either 5 years (domestic expenditures) or 15 years (foreign expenditures).

A noninclusive list of the types of expenditures that may be affected by Section 174 include the following:

- ▶ Wages, including employee benefits
- ▶ Supplies
- ▶ Contract research expenses
- ▶ Laboratory costs
- ▶ Rent
- ▶ Utilities

Common Misconceptions

All development expenditures incurred are immediately deductible.

Since 2022, these expenses must be capitalized and amortized over 5 or 15 years.

Only expenditures for supplies may require capitalization and amortization under Section 174.

In addition to supplies used in the process of research and development (R&D) expenditures, capital equipment also requires amortization.

Section 174 only applies to activities that qualify for the R&D Tax Credit (Section 41).

While there is overlap, Section 174 covers a broader range of expenses including certain indirect costs not eligible for the R&D credit.



Frequently Asked Questions

What happens if the research project is unsuccessful?

Even if the project fails, the development expenses must still be capitalized and amortized.

Do all software development expenses fall under the scope of Section 174?

Yes, software development costs may be considered research expenditures under Section 174 and be capitalized and amortized.

How does Section 174 interact with other provisions like Section 162 or Section 41?

While Section 174 governs R&E expense treatment, Section 41 pertains to the R&D tax credit, and Section 162 covers general business expenses. Coordination is necessary to avoid overlap or misapplication.

What records are required for section 174 expenses to be substantiated?

Taxpayers must maintain detailed documentation, including:

- Project descriptions
- Labor costs and time allocation
- Costs of materials and supplies
- Contracts with third parties

Are taxpayers required to calculate, amortize, and capitalize Section 174 expenses even if operating in a loss position?

Yes, development expenses must be capitalized and amortized regardless of the company's profit and loss position.

If a taxpayer is not claiming a Section 41 tax credit, do they still need to capitalize Section 174 expenses?

Yes, the requirement to capitalize and amortize development expenses under Section 174 is separate and independent from the decision to claim the R&D tax credit under Section 41. Section 174 expenses cover a wider range of costs than those eligible for the R&D tax credit. For example, indirect costs, certain software development costs, and expenses for unsuccessful projects still require capitalization and amortization under Section 174.

What is the impact of tax planning?

The requirement to capitalize and amortize R&E expenses may result in deferred tax benefits and increased compliance costs. Taxpayers should assess how these changes impact cash flow and financial reporting.

State tax planning is another aspect as some states decouple from the federal Section 174 requirements.

Are there exceptions to the capitalization requirement?

No, as of the 2022 amendment, all development expenditures must be capitalized and amortized, with no election to currently deduct the expenses.



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