Surety Bond Quarterly
https://www.suretybondquarterly.org/2023/03/10/changes-to-research-and-development-expense-rules-impact-contractors/

Changes to Research and Development Expense Rules Impact Contractors

By Barry A. Fischman and William R. Kuhlman of Marcum LLP

Spring 2023

Investing in research and development can save contractors time and money. However, a change in tax law may present a surprise tax bill for contractors when filing their taxes in 2022.

Background

The Research and Development (R&D) tax credit was created in 1981 to encourage businesses to invest in the development of new or improved business components in order to promote economic growth in the United States. Contractors have significantly benefited from this tax incentive in the 40-plus years since. Moreover, many states have R&D type credits that follow federal qualification guidelines.

The federal credit provides a significant benefit by reducing a contractor's tax liability by up to 10% of qualifying expenses (eligible wages, contractor costs, and supplies). This benefit is a potential one-for-one reduction in tax liability for the current and past three years. The R&D credit has provided long-term tax liability relief with increased cash flow and capital within the construction industry.

The Tax Cuts and Jobs Act (TCJA) of 2017 made the R&D credit even more lucrative by providing contractors potentially larger credits for tax years ending after December 31, 2017. However, the TCJA also contained a punitive provision with a deferred effective date that eliminates the current deduction for research and experimentation costs (R&E costs), as defined under Internal Revenue Code (IRC) § 174, for tax years beginning in 2022.

Update

Effective for years commencing after December 31, 2021, contractors will be required to capitalize section 174 costs and amortize them over a five-year period (15 years for research and experimentation conducted outside of the United States). This new rule also impacts the write-off of capitalized R&D costs on the disposition or abandonment of R&D activities in the future.

Contractors investing in research and development maybe be significantly impacted by these new requirements. Furthermore, these new requirements apply whether or not a credit for R&D is claimed under IRC § 41.

There was a provision in the Build Back Better Act (BBBA) that would have deferred the effective date of this rule until after 2025. This was consistent with the Green Book discussion of the Biden tax proposals, which were intended to encourage US research and experimentation activities. However, the BBBA legislation has stalled in Congress, so the TCJA rule remains in effect.

The new provision may impact current period tax provisions and estimated tax payments. This may require a review and discussion with key personnel so that R&D costs can be identified as well as segregated in the contractor's accounting records. Additionally, the provision will impose an obligation on the tax return preparer to consider R&D costs when preparing construction company tax returns for 2022 and later (see "Considerations" below).

Historical Context

Under longstanding tax law, IRC § 174 provided taxpayers options as to the treatment of research and development expenses. These could be expensed in the current tax year under IRC § 174(a); treated as deferred expenses capitalized and amortized over a period of not less than 60 months, beginning with the month that the taxpayer first realized a benefit from these costs under IRC § 174(b); or capitalized and amortized over a 10-year period under IRC § 59(e). (Most contractors utilize the current expense methodology for optimal tax planning purposes.)

When research and experimentation costs are capitalized, costs can be deducted in the year that the research is disposed of, sold, or abandoned.

A special rule applied to software development. Under Revenue Procedure 2000-50, the IRS stated that it would allow either current expensing under IRC § 174(a) or amortization under IRC § 174(b) if the taxpayer had consistently applied these methods. This revenue procedure also provided an alternative method of amortizing software development costs over 36-months beginning in the month the software is placed in service.

Current Rules

Under the TCJA provisions, for tax years beginning after December 31, 2021, the current expensing method under old IRC § 174(a) is no longer available. Contractor R&D costs must be capitalized and amortized over 60 months, beginning with the midpoint of the tax year in which the costs are incurred. If the research is foreign, the amortization period is extended to 180 months (15 years). Note that the ability to begin amortization at the midpoint of the year of occurrence produces a better result than that generated under old IRC § 174(b), where the amortization (of no less than 60 months or a longer period elected by the taxpayer) began on the first month during which the taxpayer received a benefit.

If the research is abandoned or sold, the remaining unamortized basis must still be amortized over the remaining period. It cannot be applied against sales proceeds or expensed in the year of abandonment or other disposition.

The new rule applies to "specified research or experimental expenditures." Under IRC § 174(c)(3) such expenditures include costs connected to the development of software. This eliminates the current expensing and 36-month options under Revenue Procedure 2000-50.

Considerations for the Contractor

While many businesses, as well as tax professionals, are hopeful that this TCJA change will be repealed, or at least deferred, contractors must deal with the reality that it is current law. This may have a number of impacts:

- **Change of Accounting Method**: Application of section 174 capitalization will be treated as a change of accounting method for the taxpayer. However, it is not clear whether the IRS will require the filing of a Form 3115 Request for Change in Accounting Method, since the change will be applied on a cut-off basis and, thus, there will be no IRC § 481(a) adjustment.
- **Expansive Definition of R&D Expenses Affected:** The definition of research and experimentation expenses under old IRC § 174 is much broader than those used in calculating a research and development credit under IRC § 41. It can include a portion of utilities, property maintenance, depreciation, legal fees (to obtain a patent), fringe benefits, payroll not qualifying for the credit, and the list goes on. Consequently, contractors and professional service providers cannot merely consider costs used for computing the R&D credit as being subject to this rule. Contractors will need to analyze their business operations to determine all affected R&D costs.
- **Need to Separate IRC § 174 Costs from Normal Operating Expenses:** Given the pre-TCJA option of currently expensing research and experimentation costs, contractors have generally not been diligent in separating IRC § 174 research and experimentation costs from normal IRC § 162 business operating costs and expenses. This revised tax law may create a new IRS audit issue on examination, i.e., whether costs that have been deducted as general operating business costs are actually R&D costs that should be capitalized and amortized.
- **Contractors Taking the R&D Credit Should Have Covered IRC § 174 Costs:** For contractors who are claiming (or have claimed) the R&D credit, the expectation is that R&D costs are being incurred; so there should be amortizable costs that are more expansive than those that qualifying for the credit.

- **Contractors Not Taking the R&D Credit May Attempt to Bury Section 174 Costs:** Application of the new amortization rule is not limited to contractors that take the IRC § 41 R&D credit. Those not taking the credit will need to communicate with their various departments to determine if there are R&D expenses that will be subject to the new rule.
- **Difference in Amortization Periods May Incentivize Movement of Foreign Research to the US:** Since foreign research is subject to 15-year amortization versus a 5-year amortization for domestic research, there may be an incentive to move such activities on-shore. This may involve tracking the location of contract research, including the revision of contract terms to identify the location of the research.
- **Potential Impact on Tax Provisions:** Where the new capitalization rule applies for tax, a timing item will generally be created between tax and book, which can affect federal and state deferred taxes. While it is possible that the law could be changed before the end of the year, this can impact tax provisions on interim reports.
- **Potential Impact on Other Tax Computations:** The deferred deduction will impact a number of other tax computations including Net Investment Income Tax, Qualified Business Income Deduction, and Foreign Tax Credits.

Regardless of how the construction industry and Congress feel about the punitive R&D capitalization provision, all contractors should be discussing the new R&D cost capitalization requirements internally, as well as reaching out to their professional service providers. Evaluation should also include the immediate cash flow impact of federal and state taxes related to 2022 and 2023 taxable income.

Barry A. Fischman is a tax partner in Marcum LLP's New Haven, Connecticut, office and is a member of the Firm's National Construction Services group. He has more than 35 years of tax and consulting experience serving closely-held businesses. MARCUM LLP is one of the leading construction accounting firms in the U.S., providing audit, consulting, and taxation services to clients ranging from start-ups to multi-billion-dollar enterprises. Contact him at barry.fischman@marcumllp.com or 203.781.9630.

William Kuhlman is a tax partner in Marcum LLP's Philadelphia office and is the Firm's Research & Development Tax Credit leader. He has spent over 20 years consulting with middle-market U.S. corporations. Contact him at William.kuhlman@marcumllp.com or 215.297.2230.