THE EFFECT OF UPCOMING CHANGES TO IRC SECTION 174 ON THE SOFTWARE DEVELOPMENT INDUSTRY

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Research and development (R&D) and innovation have historically driven the US economy's growth and prosperity. Recent legislation, including the Tax Cuts and Jobs Act (TCJA) and the Protecting Americans from Tax Hikes (PATH) Act, has created a favorable environment for small, mid-size, and large companies to benefit from the R&D Tax Credit. Software development is one of the common industries taking advantage of the credit to increase market value and lower their effective tax rates.

There are various classes of qualifying research and experimental (R&E) expenditures and activities that may be considered qualified. R&E are expenditures paid or incurred during the tax year in connection with the taxpayer's trade or business. R&E represents research and development costs in the experimental or laboratory sense (i.e., for activities intended to discover information to eliminate uncertainty concerning the capability, method, or design for developing or improving a product or process).

IRC SECTION 174 OVERVIEW AND UPCOMING CHANGES

IRC Section 174 generally includes all costs incurred in the development or improvement of a product and extends beyond "qualified research expenses" under IRC Section 41. For example, IRC Section 174 costs can include the costs of obtaining a patent.

Current law in effect for R&E paid or incurred in tax years beginning **before January 1, 2022** allows taxpayers to:

- Treat R&E expenditures as deductible expenses under IRC Section 174(a), or
- Elect to capitalize and amortize such expenditures over the period of no less than 60 months, starting with the month the benefit from such expenditures is realized under IRC Section 174(b), or
- Make an alternative election under IRC Section 59(e) to amortize the expenditures over ten years.

When it comes to software development costs, under Rev. Proc. 2000-50, they could be any of the following:

- Expensed
- Capitalized and amortized over a period of not less than 60 months following the date of development completion
- Capitalized and amortized over 36 months following the date the software is placed in service

Significant changes to IRC Section 174 are coming into effect for the tax years beginning **on or after January 1, 2022**. The new rules will require R&E expenditures to be capitalized and amortized beginning at the midpoint of the tax year incurred, over:

- 5 years for expenditures associated with the research conducted in the United States.
- 15 years if research is conducted outside the United States.

Software development costs will be included in the definition of R&E expenditures under IRC Section 174 and Rev. Proc. 2000-50 will only be applicable to software acquisition costs. The new 174 rules state that R&E expenditures include "any amount paid or incurred in connection with the development of any software."

Furthermore, under the new rules going into effect, if a company has abandoned capitalized R&E expenditures, they are longer allowed to write those expenditures off and must continue to amortize those expenditures. This rule is contrary to other provisions in the IRC relating to abandonment costs, such as IRC Section 165.

EFFECT OF IRC SECTION 174 CHANGES ON IRC SECTION 41 RESEARCH CREDIT

The changes to IRC Section 174 will have no direct effect on the R&D credit since the TCJA made amendments to IRC Section 41 to make sure the credit still be available for qualifying IRC Section 174 costs, regardless of capitalization.

The TCJA also made confirming amendments to IRC Section 280C. Currently, under IRC Section 280C, the research credit determined for the tax year reduces IRC Section 174 expenditures unless an election is made to reduce the credit by the maximum applicable corporate tax rate (currently 21%). For tax years beginning **on or after January 1, 2022**, the IRC Section 280C election will be applicable only if the amount of the credit exceeds the amount allowable in the current year as a deduction. Under new capitalization and amortization rules, it will be very rare for the credit to exceed the allowable deduction. Many taxpayers could benefit from not making the IRC Section 280C election.

EFFECT OF IRC SECTION 174 CHANGES ON SOFTWARE DEVELOPMENT INDUSTRY

Due to the lower amortization period (5 vs. 15 years), more software development taxpayers may invest in US-based software development rather than outsourcing development overseas.

It may be beneficial for taxpayers to start tracking IRC Section 174 expenditures:

- Separate in-house domestic and foreign R&E costs.
- Identify software development expenditures, even if not currently treated as IRC Section 174 costs.
- Track location of the contract research and supplies used and consumed in the research.
- Revise contract terms to require contractors to identify the location where research is performed.
- Evaluate whether any of the assets currently developed in-house could be acquired.
- Bring more activities onshore.

We are encouraging taxpayers to get ahead of the game and start re-evaluating IRC Section 174 expenditures now, for immediate and long-term tax planning. ■