taxnotes
DOC 2023-21168

Research Expense Amortization Complications Abound

Posted on Jul. 24, 2023

By Nathan J. Richman

Taxpayers hit by the new requirement to amortize their research expenses may see a benefit in other tax provisions, but modeling is key, according to tax professionals.

The pain from changes to section 174 — requiring research costs to be amortized rather than immediately deducted — won't be spread out and will fall most heavily on the first year of implementation, Shelby Ford of Crowe LLP noted in a July 18 webcast sponsored by her firm.

Many have wrung their hands over the need for additional substantive and procedural guidance to implement the change to section 174 under the Tax Cuts and Jobs Act. So far, there's only been one batch of procedural guidance (Rev. Proc. 2023-11, 2023-3 IRB 417) describing how taxpayers can make the required tax accounting method changes under the provision, which took effect for tax years beginning after December 31, 2021.

Ford also noted that she wasn't the first to point out that new section 174's cost in terms of increased taxable income comes with some potential upsides in increased allowances under other provisions — like the TCJA's revamped interest limitation in section 163(j) — that also depend on income.

Under the TCJA, section 174 requires taxpayers to amortize research expenses over five years for domestic activities, and over 15 years for foreign activities. Both periods are further extended by the half-year convention — allowing only half of a year's amortization in the year the taxpayer spends the money — so it's really six and 16 years, respectively, to fully recover research spending.

While there are still many issues on which taxpayers need guidance, Ford noted that a lot of the costs of section 174 could wash out over the years as taxpayers finish their batches of amortization.

Theoretically, after those six- and 16-year periods elapse, a taxpayer has gotten the full benefit otherwise spread out by section 174, Ford said. Still, that means a taxpayer spending, for example, $5 million on domestic research and $15 million on foreign research in 2022 would have to wait until 2037 to recover what would have been fully taken care of in 2021 for spending that year under prior law, she noted.

A.J. Schiavone of Crowe said that while there's been a lot of congressional attention on reversing or delaying the TCJA's changes to section 174, he doesn't expect any relief to apply to the 2022 tax year. The changes will eventually be reversed because they are bad policy, he added.

Digging Deeper

Ford later told *Tax Notes* that many taxpayers and tax professionals didn't even model the effects of the TCJA's section 174 changes in the law's immediate wake because they assumed Congress would

(C) Tax Analysts 2023. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

never let the pay-for take effect. “Even a year ago, many taxpayers were looking at estimates, but it really was year 1, and it never actually followed the full cycle,” she said.

In 2023 taxpayer modeling efforts have grown substantially, including plotting out effects over time, Ford said.

Ellen McElroy of Eversheds Sutherland (US) LLP said that while she agrees that the TCJA’s change to section 174 is primarily “a timing detriment that will diminish after several years, what I fear is that because of amortization, rather than an immediate deduction, companies will begin to think of research as less valuable.” More research is done in countries with more favorable tax benefits, so it seems counterproductive to impose amortization when the United States wants to encourage research investment, she said.

Ford noted that, beyond the large amount of pain from section 174 falling on the first year, small taxpayers and companies with cash tied up elsewhere because they hadn’t modeled the effects will feel the most pronounced impact of the change.

Taxpayers continuing to conduct research will have to deal with the cycle restarting, according to Ford. It gets more and more complicated when taxpayers contemplate research spending growing over time or particular projects with substantial spending outside the norm, she said.

Jordan Bacon of Crowe said that while the delayed cost recovery of section 174 might be primarily a timing difference, there’s a possibility that the increased income will trip a threshold in something like the global intangible low-taxed income provisions that will trigger a different tax treatment and thus a permanent difference.

But Wait, There’s More

McElroy noted that while many taxpayers are displeased with the increased cash tax payments, IRS auditors seem to be paying increased attention to research credit claims. It would be better for the agency to issue substantive research amortization guidance than for it to rely on similar audit activity and the resulting litigation to provide taxpayers with answers, she said.

Ford noted that until recently she had heard little discussion of the potential for a financial accounting deferred tax asset for taxpayers facing section 174’s bite, likely because most observers expected Congress not to allow it to take effect as it has. Because most modeling didn’t go through the full life cycle of section 174 costs until recently, those efforts hadn’t paid much attention to the financial accounting benefit, she said.

Andrew Eisinger of Crowe said research amortization came with lots of additional tax consequences not previously considered because tax professionals didn’t expect it to take effect. The section 163(j) interaction is especially interesting because, at the same time research amortization took effect, the interest limitation became stricter with the end of a depreciation addback, he said.

(C) Tax Analysts 2023. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Many of the efforts to reverse or delay section 174 amortization have included delaying or reversing the end of the section 163(j) depreciation addback, which increases the cap on deductible interest.

The two proposals are substantially intertwined, because if only the depreciation addback is reversed, the section 174 amortization will no longer reduce the cap on interest expense deductions, Eisinger said.

Bacon noted that the foreign-derived intangible income provision could also dull some of the pain from section 174's increased income. The benefit of FDII rises with income, so it rises at the same time taxpayers face more taxable income because of slower section 174 cost recovery, he said.

McElroy noted that many professionals reacting to the TCJA predicted counterintuitive results. Section 174 amortization reducing taxpayers' effective tax rates by increasing other deductions or other limitations seems to fit into that category, she said.

The layers of section 174's impact show themselves more every day, according to Ford. "It's like peeling an onion, and it looks different the next day than it did today," she said.

Those perplexing consequences make the application of section 174's change to amortization complicated and further underscore taxpayers' need for additional guidance, Ford said.

(C) Tax Analysts 2023. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.