

¶525 Research and Experimental Expenditures

NEW LAW EXPLAINED

Five-year amortization of research expenditures.—In tax years beginning after December 31, 2021, amounts paid or incurred for most research expenditures are amortized ratably over 5 years (Code Sec. 174, as amended by Tax Cuts and Jobs Act). The amortization period begins at the mid-point of the tax year in which the expenditures are paid or incurred (Code Sec. 174(a)(2), as amended by the 2017 Tax Cuts Act).

COMMENT

The prior rule which allowed taxpayers to currently deduct research and experimental expenditures is eliminated. Furthermore, taxpayers may no longer elect an amortization period 60 months or greater beginning when benefits are first realized. The rule in Code Sec. 59(e) which allows a taxpayer to elect 10-year amortization of research and experimental expenditures beginning in the year the expenditures are paid or incurred remains available. However, the specific reference to Code Sec. 59(e) in Code Sec. 174(f) has been removed as part of the rewriting of the entire Code Sec. 174.

PLANNING NOTE

Taxpayers with significant losses have often elected 10-year amortization to reduce amounts that could be subject to expiration under the 20-year net operating loss carryforward limitation even if they had no alternative minimum tax liability. Under the new law, NOLs may now be carried forward indefinitely. Consequently, taxpayers are less likely to elect 10-year amortization.

Five-year amortization applies to “specified research or experimental expenditures.” This term is simply defined as research or experimental expenditures paid or incurred by the tax payer during a tax year in connection with the taxpayer’s trade or business (Code Sec. 174(b), as amended by the 2017 Tax Cuts Act. Certain exclusions described below are provided.

COMMENT

Research and experimental expenditures are defined in Reg. §1.174-2.

Software development expenditures. Any amount paid or incurred in connection with the development of any software is treated as a research or experimental expenditure for purposes of this amortization provision (Code Sec. 174(c)(3), as added by the 2017 Tax Cuts Act).

COMMENT

Under current law, the IRS allows a taxpayer to treat all software development expenses as currently deductible even if such expenses do not otherwise meet the requirements of Code Sec. 174 (Rev. Proc. 2000-50). Under the new law, no portion of software development costs are currently deductible and all such expenses must be amortized as research expenditures over 5 years.

Exclusion for acquisition costs of land and other property. As under prior law, expenditures for acquiring land, acquiring or improving depreciable property, or acquiring property subject to a depletion allowance are not treated as research expenditures even if used in connection with research and experimentation and depreciation and depletion allowances on such property are considered research expenditures (Code Sec. 174(c)(1), as amended by the 2017 Tax Cuts Act).

Exclusion for exploration expenditures. The new law also retains the prior rule that amounts paid or incurred for the purpose of determining the existence, location, extent, or quality of an ore, mineral, or oil and gas deposit are not research expenditures (Code Sec. 174(c)(2), as amended the 2017 Tax Cuts Act).

15-year amortization period for foreign research. A 15-year amortization period now applies to research or experimental expenditures which are attributable to foreign research (Code Sec. 174(a)(2)(B), as amended by the 2017 Tax Cuts Act). Foreign research is defined by reference to Code Sec. 41(d)(4)(F) to mean any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

COMMENT

Prior law contained no restrictions on the deduction of research or experimental expenditures attributable to foreign research.

Amortization continues after a disposition. A taxpayer must continue to amortize its research or experimental expenditures even if the property with respect to which the expenditures were paid or incurred is disposed, retired, or abandoned during the amortization period. No deduction of the unamortized portion of the expenditures is allowed (Code Sec. 174(d), as amended by the 2017 Tax Cuts Act).

Change in accounting - provision applied on cut-off basis. Although the switch to a 5-year amortization period and other changes in this provision are considered a change in accounting method it will not be necessary to file an accounting method change and no Code Sec. 481(a) adjustment is required or allowed. The provision will only apply on a cut-off basis to research or experimental expenditures paid or incurred in tax years beginning after December 31, 2021. The change is treated as initiated by the taxpayer and as made with the consent with the IRS (Act Sec. 13206(b) of the 2017 Tax Cuts Act).

Coordination with research credit. The amount capitalized and otherwise eligible for amortization over 5-years under this provision is reduced by the excess (if any) of the research credit allowed for the tax year and the amount allowable as a deduction for the tax year as qualified research expenses or basic research expenses (Code Sec. 280C(d)(1), as amended by the 2017 Tax Cuts Act)).

COMMENT

Under current law, the deduction otherwise allowed for the portion of qualified research expenses (as defined in Code Sec. 41(b)) or basic research expenses (as defined in Code Sec. 41(e)(2)) is reduced by the amount of the research credit (Code Sec. 280C(d)(1), prior to amendment by the 2017 Tax Cuts Act). The same rule applies under the new provision except that only the amount otherwise allowed as an amortization deduction during the tax year that the credit is claimed reduces the research credit.

Definition of qualified research expenses. In a conforming amendment, the definition of qualified research for purposes of the research credit (Code Sec. 41) is adjusted to mean research with respect to which expenditures are treated as “specified research or experimental expenditures under section 174.” In other words, qualified research relates to research costs which must be amortized over five-years under section 174 (Code Sec. 41(d)(1)(A), as amended by the 2017 Tax Cuts Act. Under current law, qualified research is defined by reference to expenditures which may be currently deducted under Code Sec. 174. No change is made to the additional requirements imposed by Code Sec. 41 for qualified research, such the requirement that the research be undertaken for the purpose of discovering information which technological in nature and intended to be useful in the development of a new or improved business component of the taxpayer (Code Sec. 41(d)(1)(B)).

Effective date. The amendments made by this section apply to amounts paid or incurred in tax years beginning after December 31, 2025 (Act Sec. 13206(e) of the Tax Cuts and Jobs Act).