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Tax Notes

Starting in 2022 R&D Expenses Must Be Amortized Over 5 Years

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On a going forward basis, Research and Experimentation (R&D as it is commonly called) expenditures must be amortized over 5 years. Unless new federal tax legislation, such as the stalled Build Back Better bill, reverses or changes the law, amortization of R&D expenses is here to stay.

Backdrop

Until now, most taxpayers elected under IRC Section 174 to deduct R&D expenditures in the year incurred. However, there were two other options of 1) deferring and amortizing; or 2) indefinitely capitalizing that expenditure, but these two choices saw limited application.

The ability to immediately expense all R&D expenditures benefited taxpayers with reduced federal income (directly for corporations and Schedule C filers and indirectly for partners/members/shareholders of pass-through entities).

TCJA Effect on R&D Deduction

Regarding the TCJA's impact, it now specifically requires R&D expenses paid or incurred in a year to be capitalized and amortized ratably over a 5-year period on a mid-year convention. The current year deduction is now effectively stretched over 6 years. Foreign research expenditures are amortized over 15 years.

For an expenditure amortized over 5 years (6, with mid-year convention), an R&D expenditure paid in 2022 of $10,000 generates a $1,000 deduction whereas, if the expenditure had been paid in 2021, it would have been fully deductible. The mid-year convention allows 10% (or ½ of 1 year) of amortization in the year of the expenditure, 20% for the next 4 years and 10% in the final year of amortization. Assuming a 21% federal tax rate, the current year tax benefit is reduced from $2,100 ($10,000 times the 21% federal rate) to only $210 ($10,000 with a half year of amortization equaling $1,000 times the 21% federal rate). Also, if the R&D project is abandoned, disposed of, etc., amortization continues, and there is no mechanism to write-off the remaining basis.

R&D Tax Credit

Any current year R&D deduction is in addition to an IRC Section 41 R&D tax credit that can be taken. The R&D credit is based on the taxpayer's current year R&D expenditures as well (although under IRC Section 41 the expenses available for the credit are limited in other ways). Until this year, taxpayers could take advantage of a significant current year R&D deduction and credit simultaneously. The R&D credit has not been impacted by the amortization requirement under the TCJA. The legislation's impact is solely on the taxable income calculation. (The R&D credit itself has been impacted this year by new tougher requirements for refund claims.)

Combined R&D Expense Deduction with R&D Credit

For taxpayers, the combined benefit from the R&D expense deduction concurrently with the R&D credit was, and still is, a catalyst for entities of all sizes to invest in R&D. Further, taxpayers of all sizes conducting R&D can mitigate the impact of the new R&D expense amortization. The means to do so is through an R&D credit. The opportunity is particularly beneficial for those who have not previously taken full advantage of the credit.

Contact Us

Determining the credit is complex and the best way to do so while maximizing the credit is through an R&D credit study. The PKF O'Connor Davies credit team has successfully completed hundreds of R&D credit studies. If you have questions regarding the new federal R&D amortization requirement or are interested in an R&D tax credit study, contact any of the following:

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