

Changes to the deductibility of research and development expenses may significantly impact companies' tax liabilities for tax year 2022.

What is changing related to research and development costs?

For tax years beginning after December 31, 2021 (i.e. for the 2022 tax year) taxpayers are required to capitalize and amortize all research and development (R&D) costs over a 5 year period (15 years for foreign based research), using a mid-year convention, pursuant to Internal Revenue Code Section 174. This change in the treatment of the deductibility of these costs was originally enacted as part of the Tax Cuts and Jobs Act (TCJA) of 2017, but did not come into effect until this year. Depending on business operations, the requirement to capitalize research and development costs could significantly impact a taxpayer's 2022 tax liability.

Prior to the enactment of the TCJA, R&D costs were typically fully deductible in the same manner that expenses incurred in the ordinary course of business were deductible. Given this, taxpayers have generally not had to quantify and track their R&D costs in previous years.

Below is a simplified example to illustrate the potential impact to companies' tax liabilities under the new law in 2022 in comparison to the old law in 2021:

	2021	2022	Difference
Taxable Income before R&D Expenses	\$1,000,000	\$1,000,000	\$ --
R&D Expense Deduction	\$(100,000)	\$(10,000)	\$90,000
Taxable Income	\$900,000	\$990,000	\$90,000
Corporate Federal Tax Rate	21%	21%	21%
Federal Tax Liability	\$189,000	\$207,900	\$18,900

Does this apply to me?

It may. The definition of R&D under Section 174 is broad, but generally means any amount paid or incurred to discover information related to the development or improvement of a product, process, computer software, technique, formula, or invention. In addition, the definition of R&D also includes any amount paid or incurred in connection with the development of any software. If you are incurring expenses related to these types of activities, regardless of whether you are claiming an R&D credit, these costs may now need to be capitalized beginning in 2022, whereas previously they were likely fully deductible.

What is next?

It has been widely anticipated since its enactment that this law would be repealed or further deferred, and would never actually come into effect. Many commentators, business groups, lobbyists, and politicians have expressed concern that the new law disincentivizes US companies to perform research activities and thus puts them at a disadvantage in the global economy. As a result, there has generally been bi-partisan support to repeal or defer this law; however, as it stands today Democrats have continued to hold firm that they will not give in on R&D expense capitalization unless Republicans allow for the expanded Child Tax Credit to continue. There continues to be speculation that Congress could still change this law in 2023, with it possibly being made retroactive back to the beginning of 2022, but entering the 2022 filing season the requirement to capitalize these expenses is in effect.

What do I do now?

If you believe you are conducting R&D activities that may be subject to these new rules and have questions, let us know as you may need to develop a plan to identify, quantify, and track your R&D expenses. It is expected that the IRS may issue guidance on how to interpret and apply this new law in the Spring or Summer of 2023. To allow time for this guidance to be issued it is recommended that you extend your tax return. Given this new requirement may significantly increase taxpayers' tax liabilities for 2022, the new law will still need to be considered when filing extensions and making payments by the March 15 and April 18 deadlines.

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