

# Amortization of Research expenses

## How does it increase your tax costs in the US?

### 1. Background

- For any start-up or newly established entity, incurring Research and Development expenditure can be highly relevant and plays a crucial role in several ways as it enables them to innovate, differentiate themselves, gain a competitive advantage, fuel growth, adapt to market changes, attract talent and investment and ensure long-term success and sustainability.
- Prior to January 2022, taxpayers of the US could either deduct these expenses or capitalize & amortize research and experimental expenditure over five years.
- However, the Tax Cuts and Jobs Act ('TCJA') brought about certain changes to the provisions of Section 174 of the Internal Revenue Code ('the tax Code'), removing the option to expense specified research and experimental ('SRE') expenditures. Instead, taxpayers are mandated to **capitalize and amortize these expenses over 5 years for domestic research and 15 years for foreign research**<sup>1</sup>. It is pertinent to note that the TCJA brings even software development costs under the ambit of SRE expenditures.
- Further to the above, the Internal Revenue Service ('IRS') had issued interim guidance for public comments in Notice No. 2023-63 ('the notice'), to throw light on the treatment of SRE under Section 174 of the Tax Code. Further, the notice specifies that until these regulations get published in the federal register, the guidance provided in the current notice shall be followed by the taxpayers.
- The notice discusses several key technical aspects of the capitalization and amortization requirements of Section 174, which has been listed below:
  - Applicability and scope of Section 174.
  - Identification and allocation of SRE expenditures.
  - What constitutes a Software development cost.
  - Treatment of research performed under a contract.
  - Application to Percentage of completion method for long-term contracts.
  - Disposition, retirement or abandonment of property etc.
- It is to be noted that these amendments shall apply to SRE expenditures incurred in taxable years **beginning after December 31, 2021.**

### 2. Applicability and scope of Section 174

- Section 174 of the tax code applies to any taxpayer that incurs qualifying SRE expenditures with respect to any taxable year after December 2021 in connection with the taxpayer's trade or business, regardless of their industry or business size. This provision impacts every type of entity i.e., C-Corporations, S-corporations, small businesses and startups, Sole proprietorships, partnerships, and limited liability companies ('LLCs') etc.

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<sup>1</sup> The term foreign research means any research conducted outside the US, the Commonwealth of Puerto Rico, or any U.S territory or other possession of the United States.

- SRE expenditures are attributed to the place (US/ foreign) where the SRE activities are conducted. "SRE Activities" is defined as software development activities<sup>2</sup> and research and experimental activities in the experimental or laboratory sense intended to discover information that would eliminate the uncertainty concerning the development or improvement or appropriate design of a product or a component or subcomponent of a product.

### 3. Identification and allocation of SRE expenditures

- The notice provides a non-exhaustive list of examples of the type of cost that are treated as SRE expenditures and the costs that are not treated as SRE expenditures.
- The type of costs that are **considered as SRE expenditures** or incurred in connection with "software development activities" include but are not limited to:
  - a) Labour cost, including stock compensation, overtime, sick leave pay, payroll taxes and payments incidental to a supplemental unemployment benefit plan.
  - b) Materials and supplies cost, including tools and equipment that are not depreciable and which are used in the performance of SRE activities.
  - c) Cost recovery allowances such as depreciation, amortization, or depletion allowances with respect to the property used in performance of SRE activities.
  - d) Patent cost including the attorney's fees expended in making the patent application.
  - e) Certain operation and management cost such as rent, utilities, insurance, taxes and similar overheads with respect to equipments used in performance of SRE activities.
  - f) Travel Cost incurred for the performance of SRE activities.
- The following costs are **not required to be treated as SRE expenditures**, regardless of whether they are incurred in connection with the SRE activities defined above or in connection with software development activities:
  - a) Costs paid or incurred by general and administrative ('G&A') services departments that indirectly support or benefit SRE activities.
  - b) Interest on debt to finance SRE activities.
  - c) Costs paid or incurred for computer software developed by a taxpayer for use in its trade or business.
  - d) Costs incurred to input content into a website.
  - e) Amounts representing amortization of research and experimental expenditures paid or incurred in taxable years beginning before January 2022.
  - f) Costs associated with research conducted after the beginning of commercial production.
  - g) Quality control testing of materials/ products.
  - h) Advertising or promotions.
  - i) Acquisition of another's patent, model, production or process.
  - j) Consumer surveys.
- The allocation of the above costs would depend on the cause-and-effect relationship between the costs and the SRE activities or another relationship that reasonably relate the costs to the benefits provided to the SRE activities. For example, if the total labour cost incurred by the entity is \$200,000 and 30% of the labour time goes on research activities, and balance goes on other than research activities, then out of the total cost of \$200,000 only \$60,000 ( $\$200,000 * 30\%$ ) shall be treated as SRE expenditure and balance shall not be treated as SRE expenditure for the purpose of Section 174. However, the allocation method used for one type of cost cannot be replicated to another type of cost, and each cost shall have their own apportionment formula. However, the said allocation method shall be consistently applied.

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<sup>2</sup> Refer para 4 for more detail on what constitutes a Software development activity.

#### 4. What is Software development cost?

- As discussed above, the software development cost is treated as a SRE expenditure and would be required to be amortized over a period of 5 or 15 years depending on whether the said expenditure is incurred in US/ outside US.
- The notice provides an inclusive list of activities that are considered as software development for the purpose of Section 174, which is provided below:
  - Planning the development of computer software including identification and documentation of the software requirements.
  - Designing software, including upgrades and enhancements.
  - Building a model of the computer software.
  - Writing source code and converting it into machine-readable format.
  - Testing the computer software and making necessary modifications to address the defects identified during testing till the time the software is ready for sale or licensing to others.
- Further, the notice also provides the activities that are not treated as Software development for the purpose of Section 174, as follows:
  - A. Computer software developed by taxpayer for use in its trade or business:
    - Training employees and other stake holders who will use the computer software;
    - Maintenance activities that do not give rise to upgrades and enhancements
    - Data conversion activities
    - Installing the computer software.
  - B. Computer software developed by taxpayer for sale or licensing to others:
    - Activities that occur after such software is ready for sale or licensing to others, such as marketing and promotional activities, maintenance activities that do not give rise to upgrades and enhancements, distribution activities and customer support activities.
- Computer software for the purpose of Section 174 has been defined as “*any computer program or routine (that is, any sequence of code) that is designed to cause a computer to perform a desired function or set of functions and the documentation required to describe and maintain that program or routine. The code may be store on a computing device, affixed to a tangible medium or accessed remotely via private computer network or the internet, for example via **cloud computing**”.* The said definition is wide enough to cover every type of computer software including the ones stored on cloud.
- Further, the notice provides certain examples which are included in the “computer software” definition which are system software, programming software, embedded software, operating systems, executive systems, software monitors, compilers and translators, assembly routines and utility programs.

#### 5. Illustrative examples

- **Example 1: Domestic research**
  - Company XYZ, a pharmaceutical company, is developing a new drug. In the year 2022, the Company has incurred USD 1 million in SRE expenses related to clinical trials, lab testing, and research etc.
  - While these expense were fully deductible earlier, with the amended Section 174, the company must capitalize these expenses and amortize them **over 5 years** (beginning from 2022).

- So, in 2022, they can only deduct USD 200,000 (\$1 million / 5 years) as an expense. The remaining USD 800,000 is spread over the next four years.

- **Example 2: Foreign research**

- Company ABC is a multinational tech company with research facilities in multiple countries. In 2023, they spent \$3 million on SRE outside US for a groundbreaking software product.
- Under the prior regulations, the company could deduct the entire USD 2 million in the year 2023. However, with the amended Section 174, they must capitalize foreign research expenses and amortize them over **15 years** (beginning in 2023).
- So, in 2023, they can only deduct \$200,000 (\$3 million / 15 years) as an expense. The remaining amount is to be spread over the next 14 years.

- **Example 3: Domestic research – special case**

- Company LMN, a fully US based manufacturing entity incurred \$ 7 million in the year 2022 for manufacturing a product X and a new variant of product Y.
- Out of the \$ 7 million, \$1 million of expenses towards product Y qualifies under section 174 for SRE expenses and hence the same must be amortized over the period of **5 years**.
- During the year 2024, the research proved to be a failure and the product Y was completely discarded.
- Irrespective of the above, the research amount of USD 1 million will continue to be amortized over a period of 5 years. Hence, USD 200 thousand (USD 1 million/5 years) will continue to be amortized for over the period of 5 years irrespective of whether the product is in existence or not.

## 6. Our comments

- This amendment shall significantly impact Start-ups & SaaS companies which are incurring significant SRE expenditure and also earning reasonable revenue. This would result in incurrance of significant cost in the initial year(s) but availability of deduction over 5- or 15-year period resulting in tax outflow at the company level. Companies which are bootstrapped or having limited cash flow would have to factor additional cash outflow on account of the tax impact.
- The company would need to maintain a robust accounting system which clearly bifurcates the SRE costs incurred within US and outside US as both have differing amortization period for Section 174 purposes.
- It is important to note that SRE expenditure incurred on a contract basis (i.e., availed from a contractor, customized as per the needs of the company) also gets covered in the amended Section 174 and hence, even those expenses need to be amortized as per the amended regulations. The US entities which are outsourcing software development works to foreign countries (say India, Philippines, etc) on contract basis will only be eligible to claim deduction over 15-year period.
- Traditionally foreign-founded startups incorporated in Delaware to attract investments will now face challenges due to Section 174 changes. To avoid US amortization requirements, companies may consider moving their intellectual property (IP) and R&D capabilities to an alternative jurisdiction, enabling them to claim the full expenditure without the 5-year/ 15-year amortization burden.

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