

Tax in tech: Adapt to Section 174

Transcript

CHRISTOPHER SUMMER: Hello, my name is Chris Summer. I'm a partner at Grant Thornton and I lead our technology industry initiative for the tax function. I'm joined today by Kevin Benton, a managing director in our Washington National Tax Office. Today, we're going to talk about research and experimentation expenses. For many tech companies, this is a very large, if not the largest, expense item they encounter during the year. Kevin, the R&D deduction is obviously an important deduction for tech companies. The section really came to life in 2023. What are some of the impacts that companies might not have considered before, related to this section.

KEVIN BENTON: One impact that comes to mind is the coordination between the research credit and the treatment of those costs under 174. So, TCJ now requires taxpayers to qualify costs for the research credit and treat those costs as Section 174 specified research or experimental expenditures. Prior to TCJ, to qualify cost for the research credit only required to be eligible for section 174 treatment. However, they might have been deducted as ordinary and necessary expenses under section 162. So, there's now this requirement to coordinate between those two sections. And, while capitalization for Section 174 is a temporary item, the research credit's a permanent item, a dollar-for-dollar reduction of a taxpayer's liability. So, it's important that for cost to be qualified for 41, they're also treated as 174. And one other consideration on that point for startups, particularly in the technology industry who are in NOL's; they can monetize their research credit up to \$500,000 a year against their payroll tax offset for tax years beginning 2022 and forward. So, this is a unique opportunity for start-ups to help monetize their tax credit and help with cash flow. Another consideration relates to the recent IRS guidance in the form of notice 2024-12, which provided clarifications and modifications to a previous notice around Section 174 expenses. So, taxpayers may not have relied on the previous notice because it required an all-or-nothing approach. So, if the taxpayer was relying on that previous notice, notice 2023-63, they were bound to it in its entirety. Now that there was the recent notice 2024-12 issued, it provides an option for taxpayers to rely on portions of the interim guidance. So that's another consideration that taxpayers might not have made last year. And now with the subsequent guidance, it would be beneficial to look at that and is anticipated that Treasury is going to be issuing regulations later this year on 174 and aligned with these notices.

CHRISTOPHER SUMMER: So, I know there's a lot going on, and obviously this is a big item for technology companies as they continue to invest in development of their technology. What are some things companies need to start doing now to prepare?

KEVIN BENTON: Taxpayers should continue to focus on how they track their research or experimental expenditures, particularly in light of the House bill that was passed in January, where it would provide taxpayers with temporary alternative rules related to section 174 and create a new section, section 174 cap A. Now, in the bill's current version, it would allow for retroactive deduction of domestic research, but retain the 15 year mandatory capitalization of research performed outside of the US. So, specifically identifying and tracking those costs that are incident to the research, particularly those that are viewed as more indirect in nature such as overhead — it's really important for taxpayers to continue evaluating and tracking those costs, given the different treatment that may be available if this bill is passed and signed into law.

CHRISTOPHER SUMMER: And so how can this affect an emerging tech company's larger business strategy or third party relationships?

KEVIN BENTON: I have a few considerations here, one being which activities are being performed internally by the taxpayer versus externally, so by a third-party vendor. One change from TCJA was specifically including software development as Section 174. So, as many people know, section 174 now specifically includes any amount paid or incurred in connection with the development of any software shall be treated as a research or experimental expenditure. The proposed section 174A language includes the same definition and does not provide any definitions as far as the terms that are used to define software development in the context of Section 174, but we look to notice 2024-12 and it does provide taxpayers with some further guidance around Section 174. For example, the notice mentions that SR&E expenses generally do not include costs for quality control testing, post-production maintenance, data conversion, training and software installation. So, if a taxpayer is looking at their product development lifecycle, the process that they use from inception of an idea for a product to production and maintenance at the end, one consideration is identifying whether work should be performed internally or externally. And taxpayers may look at who is performing which activities. Because that could mean the difference of being able to deduct 100% of those costs in the year that they're paid or incurred versus having to recover them over a 15-year period. Another consideration is for any research that falls outside of the mandatory capitalization of software development costs taxpayers should consider the terms of agreements with third-party vendors. So, for example, which party retains rights to the research and can use it in their trade or business? Which party is at economic risk for the development? For example, is the agreement focused on effort to develop and enhance something under time-and-materials agreement or arrangement? Or is the agreement focus on

providing a solution that is plug-and-play, if you will, and more of a fixed fee arrangement. This can help determine if the taxpayer has section 174 capitalization or not, but there are of course business considerations that must be made. So, tax is only one of many considerations here. Another consideration with third parties relates to where the work is being performed. If the tax extenders bill is signed into law, allowing for taxpayers to retroactively deduct domestic research, but capitalize foreign research, there's that difference to keep in mind, but there are also state tax considerations. So, while some states conform with the Internal Revenue Code as of a fixed date or on a rolling basis, other states have adopted their own rules for tax provisions such as Section 174. So, taxpayers must consider where the research activities are taking place and how the related cost should be treated both for federal and state income tax purposes. And to clarify one item, even if a state has rolling conformity to the Internal Revenue Code, there still may be exceptions for specific tax provisions, such as section 174.

CHRISTOPHER SUMMER: Thank you so much, Kevin, for that overview of research and experimentation deductions and expenses for companies. Certainly ever-changing, really anxious to see where this goes for companies — I know a lot of my clients are looking forward to seeing what changes as the extenders package works through and as we go forward for the next couple of years. Thank you for joining us today. We appreciate your insight.

KEVIN BENTON: Thank you.