

## SBTC April 13 Discussion on Sec. 174 & Sec. 162

**Note: No one at SBTC or on the call today is a tax accountant or tax lawyer, and this should not be construed as legal advice. We are providing this information so you can discuss it with your tax accountants and/or tax attorneys.**

While many high-tech small companies have filed extensions in hopes that Congress will fix the Sec. 174 problem before they must file their 2022 returns, that may not happen.

The issue of 174 R&D expensing is a new and critical issue. For many firms, this provision might make them go bankrupt, or stop doing SBIR work. The requirement of incurring income in year one and having to spread the expenses is particularly challenging for very small businesses. For large firms this is an accounting problem, but for many SBIR firms it is a life-or-death problem.

For today's discussion we want to provide you with information about a possible work-around to the 174 problem. Most accountants say that you must take a 174 and expense your R&D over 5 years because of tradition of looking at the latest change in the law as controlling. We are going to be discussing this today. Below we are providing some information to help you in your decision.

### **The Supreme Court in Snow v. Commissioner of Internal Revenue**

*Held:* It was error to disallow the deduction, which was "in connection with" petitioner's trade or business, and the disallowance was contrary to the broad legislative objective of the Congress when it enacted § 174 to provide an economic incentive, especially for small and growing businesses, to engage in the search for new products and new inventions. Pp. 416 U. S. 502-504.

the section in question (old § 23(a)) "involves holding one's self out to others as engaged in the selling of goods or services." The words "trade or business" appear, however, in about 60 different sections of the 1954 Act. [Footnote 4] Those other sections are not helpful here, because Congress wrote into § 174(a)(1) "in connection with," and § 162(a) is more narrowly written than is § 174, allowing "a deduction" of "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business."

### **The IRS Taxpayer Advocate said**

[https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC19\\_Volume1\\_MLI\\_01\\_TradeorBusinessExpenses.pdf](https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2020/08/ARC19_Volume1_MLI_01_TradeorBusinessExpenses.pdf)

PRESENT LAW Internal Revenue Code (IRC) § 162(a) permits a taxpayer to deduct ordinary and necessary trade or business expenses paid or incurred during the taxable year. 3 These expenses include: ■ A reasonable allowance for salaries or other compensation for personal services actually rendered; ■ Travel expenses while away from home in the pursuit of a trade or business; and ■ Rentals or other payments for use of property in a trade or business. 4 In addition to the general allowable

expenses described above, IRC § 162 addresses deductible and nondeductible expenses incurred in carrying on a trade or business, and provides special rules for health insurance costs of self-employed individuals. 5 The interaction of IRC § 162 with other Code sections that explicitly limit or disallow deductions can be complex. For example, the year in which the deduction for trade or business expenses can be taken and its amount depend on when the cost was paid or incurred, the useful life of an asset on the date of 1 See National Taxpayer Advocate 1998-2018 Annual Reports to Congress. 2 See Taxpayer Bill of Rights (TBOR), [www.TaxpayerAdvocate.irs.gov/taxpayer-rights](http://www.TaxpayerAdvocate.irs.gov/taxpayer-rights). The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3). 3 The taxable year in which a business expense may be deducted depends on whether the taxpayer uses the cash or accrual method of accounting. IRC § 446. 4 IRC § 162(a)(1), (2), and (3). 5 See, e.g., IRC § 162(c), (f), and (l). For example, nondeductible trade or business expenses include illegal bribes, kickbacks, fines, and penalties. Trade or Business Expenses Under IRC § 162 and Related Sections Taxpayer Advocate Service — 2019 Annual Report to Congress 129 Most Litigated Issues Most Serious Problems Appendices Research Studies Case Advocacy acquisition, and when it was sold or when the business operation is terminated. 6 Rules regarding the practical application of IRC § 162 have evolved largely from case law and administrative guidance over the years. When a taxpayer seeks judicial review of the IRS's determination of a tax liability relating to the deductibility of a particular expense, the courts must often address a series of questions, including, but not limited to, the ones discussed below

**CONCLUSION** The existence and amount of allowable business expenses are highly fact-specific and are often open to interpretation. IRC § 162 deductions are based upon a complex interaction of multiple statutes and regulations, as well as case law. This circumstance perpetuates substantial controversy between the IRS and taxpayers regarding the scope and extent of properly claimed business deductions. As a result, courts rendered decisions in 82 cases involving IRC § 162 related issues between June 1, 2018, and May 31, 2019.

One year after enactment of the law one news source said that 162 is an alternative to 174.

<https://taxnews.ey.com/news/2018-0373-implications-of-certain-tax-reform-provisions-on-research-incentives>

### **Looking forward: Section 174 amortization**

Taxpayers should start considering how best to classify their research and development related costs once the Section 174 amortization provision applies (amounts paid or incurred in tax years beginning after December 31, 2021).

One option may be to evaluate costs to see if they may be classified as ordinary and necessary business expenses under Section 162, rather than Section 174 costs, possibly because there is no technical uncertainty associated with the activities to which the costs relate. This would allow taxpayers to immediately expense these costs under Section 162, rather than amortize under Section 174. In evaluating which costs may be treated as Section 162 expenses, taxpayers will have to segregate software development costs because those costs will be deemed Section 174 expenditures. Furthermore, such software development costs would have to be further segregated between development costs incurred in the US and those incurred outside of the US for purposes of determining the applicable amortization period.

Reclassifying expenses as deductible under Section 162, rather than research or experimental expenditures under Section 174, is not a change in method of accounting. Rather, it is a factual determination based on whether there is uncertainty about the research activity such that the expenses would or would not qualify under Section 174. Companies with a large amount of foreign research expenditures should pay particular attention to how such costs are characterized. Furthermore, taxpayers should consider how characterizing costs as Section 162 costs could affect their BEAT liability from two perspectives: the benefit of a higher research credit and the benefit of a greater amount capitalized as cost of goods sold....

**The 2017 amendments to 174 is below. Nowhere in this provision (Sec. 13206 of the 2017 TCJA) is Sec. 162 amended or mentioned.**

<https://www.govinfo.gov/content/pkg/PLAW-115publ97/uslm/PLAW-115publ97.xml>

SEC. 13206. AMORTIZATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES.

(a) In General.—Section 174 is amended to read as follows:

*“SEC. 174. AMORTIZATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES.*

*“(a) In General.—In the case of a taxpayer’s specified research or experimental expenditures for any taxable year—*

*“(1) except as provided in paragraph (2), no deduction shall be allowed for such expenditures, and*

*“(2) the taxpayer shall—*

*“(A) charge such expenditures to capital account, and*

*“(B) be allowed an amortization deduction of such expenditures ratably over the 5-year period (15-year period in the case of any specified research or experimental expenditures which are attributable to foreign research (within the meaning of section 41(d)(4)(F))) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.*

*“(b) Specified Research or Experimental Expenditures.—For purposes of this section, the term ‘specified research or experimental expenditures’ means, with respect to any taxable year, research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer’s trade or business.*

*“(c) Special Rules.—*

*“(1) Land and other property.—This section shall not apply to any expenditure for the acquisition or improvement of land, or for the acquisition or improvement of property to be used in connection with the research or experimentation and of a character which is subject to the allowance under section 167 (relating to allowance for depreciation, etc.) or section 611 (relating to allowance for depletion); but for purposes of this section allowances under section 167, and allowances under section 611, shall be considered as expenditures.*

*“(2) Exploration expenditures.—This section shall not apply to any expenditure paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).*

*“(3) Software development.—For purposes of this section, any amount paid or incurred in connection with the development of any software shall be treated as a research or experimental expenditure.*

*“(d) Treatment Upon Disposition, Retirement, or Abandonment.—If any property with respect to which specified research or experimental expenditures are paid or incurred is disposed, retired, or abandoned during the period during which such expenditures are allowed as an amortization deduction under this section, no deduction shall be allowed with respect to such expenditures on account of such disposition, retirement, or abandonment and such amortization deduction shall continue with respect to such expenditures.”*

**The question for you and your tax advisor or lawyer to consider is *does the new 2017 amendment above change 162 or 174 as found by the Supreme Court?***

**Some of you have been taking 162 deductions all along. With 162 you do not get R&D tax credits. Many of you have been taking 174 to get tax credits. Should you change to 162 to deduct most of your R&D expenses in the year they occurred is a question for you and your tax advisors and tax attorney.**