Overview of Changes to Federal R&D Tax Credits/ Deductions and Impact on Architecture Firms

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Background: In 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), sweeping tax legislation that, among other things, reduced corporate tax rates and the top rates paid by individual filers. One of several provisions in the legislation meant to pay for those rate cuts was a change to how businesses may deduct research and development (R&D) related costs, which prior to January 1, 2022, could be expensed in the year in which they were incurred. Now, five years after the bill's passage, costs related to R&D are no longer available for immediate deduction and must be amortized over 5 or 15 years for domestic or international expenses respectively. ***It is important to note that the changes to Section 174 requiring amortization of R&D costs apply whether or not the filer also claims an R&D tax credit.*** These changes will in all likelihood negatively impact architecture firms who have been taking advantage of a substantial up-front deduction for R&D costs, but now must spread the deduction over 5 years for domestic costs and 15 years for international costs.

Impact on R&D Tax Credit: While the TCJA retained the tax credit allowed under Section 41(d)(1) of the IRC, the bill narrowed the definition of qualified research for purposes of the credit to align with the definition of in Section 174 for purposes of expensing. In other words, now, to claim the R&D tax credit, the expenses for which you are claiming and calculating the credit ***must*** also have been included as specified R&D expenditures and amortized under Section 174. The TCJA also added an amendment to prohibit taxpayers from receiving a double benefit from the Section 174 R&D deductions and the R&D tax credit under Section 41. Going forward, if the amount of a taxpayer's R&D tax credit under Section 41 exceeds the amount of deductible R&D expenditures, the amount of the capitalized expenditures must be reduced by the difference.

It is also important to remember that the R&D expenses required to be amortized under the changes to Section 174 are broader in scope than those allowable in calculating the R&D credit and some Section 174 expenses will not be eligible in calculating the credit. Complicating matters is the fact that the IRS continues to challenge (in audits) the eligibility of some smaller service firms. These firms include architecture and engineering firms, for the R&D tax credit based on their interpretation that the firms are not producing a "tangible product" or engaged in "experimentation" under the four-part eligibility test for what research activities qualify for the credit. Firms are urged to consult with a CPA on both the new amortization rules under Section 174 and the narrower definition of qualified expenses for purposes of the R&D credit under Section 41.

Use of New 179D Deduction Limits to Offset Reduced R&D Deductions: Changes included in the Inflation Reduction Act (IRA) of 2022 expanded the deduction available to architecture, engineering, and construction firms for energy-efficient commercial buildings to include non-profit, tribal, state, and local government buildings and increased the deduction from $1.88/sq foot for 2022 to as much as $5/sq. ft for buildings placed in service starting in 2023. This increased deduction could be utilized to offset or mitigate some of the increased tax liability firms will experience with the new R&D amortization requirements discussed above. Again, firms should consult with a CPA on this before filing.

Potential Congressional Action on R&D Amortization Changes: A provision in the stalled Build Back Better Act from last year would have delayed the changes until 2025. Legislation has recently been filed in the new 118th Congress to delay the changes and has garnered bipartisan support. AIA and other stakeholders are advocating strongly for the repeal or delay of the new requirements. However, given the uncertain political environment, it would not be prudent for filers to count on a retroactive change to the new TCJA provisions that will cover the 2022 tax year --and firms should therefore plan accordingly and consult with a CPA on how the changes will impact their 2022 tax returns.