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Startups, Other R&D-Heavy Companies May Face Significantly Higher Tax Costs in 2022

May 1, 2023

The Tax Cuts and Jobs Act was enacted more than five years ago, but certain changes under the legislation are only now coming into focus as taxpayers prepare their 2022 tax returns. In particular, there are significant changes as to the deductibility of certain research and experimentation expenses, as well as the ability to utilize net operating loss (NOL) carryforwards. These changes may result in greater tax liabilities for companies and may also affect certain qualified small business stock eligibility requirements. **As discussed below**, many expected new legislation would repeal or delay this capitalization requirement, but no such legislation has yet been passed.

Treatment of research and experimentation expenses

Under Internal Revenue Code (IRC) Section 174, certain research and experimentation expenses, specifically including expenses incurred in connection with the development of software (R&E expenses), were fully deductible in tax years beginning prior to January 1, 2022. However, for tax years beginning after December 31, 2021, these R&E expenses are required to be capitalized and amortized over five years (or, in the case of R&E expenses incurred outside of the US, 15 years).

Under current rules, amortization of capitalized R&E expenses begins with the midpoint of the taxable year in which such expenses are paid or incurred. Below is an illustration of how this works.

- Assume a taxpayer incurs $5 million of domestic R&E expenses in 2022. The taxpayer is only permitted to deduct $500,000 of those expenditures in 2022, $1 million in each of 2023, 2024, 2025 and 2026, and the remaining $500,000 in 2027.

Under prior law, taxpayers often did not need to distinguish R&E expenses from other more general expense deductions, but it is now important to do so because of the capitalization requirement. The statute does not clearly define what constitutes R&E expenses, but existing regulations provide that R&E expenses are “expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense,” and would include “all such costs incident to the development or improvement of a product,” such as compensation expenses for service providers conducting research and experimentation, as well as costs paid or incurred by the taxpayer for research or experimentation carried out on the taxpayer’s behalf by another person or organization.

This change will impact companies in research-dependent industries, such as life sciences and software development, and is expected to increase the taxable income (or decrease the taxable loss) of companies that incur such R&E expenses. The requirement to capitalize R&E expenses will be particularly relevant to companies that receive large lump sum payments under licensing and collaboration agreements or certain types of funding arrangements.

Further, the treatment of R&E expenses under IRC Section 174 could impact the application of other tax provisions – including the research credit under IRC Section 41, the deduction for foreign-derived intangible income under IRC Section 250, global intangible low-taxed income (GILTI) and the foreign tax credit rules.

In addition, for companies whose stock is intended to constitute qualified small business stock (QSBS) under IRC Section 1202, the capitalization of R&E expenses may impact the $50 million “aggregate gross asset” value threshold, which generally is based on the issuer’s tax basis in its assets. The IRC Section 1202 “aggregate gross asset” value of a company increases by the amount of cash received in a financing, but the increase could be quickly reduced under prior law if the financing proceeds were applied toward deductible expenses. The requirement to capitalize R&E expenses prolongs the time period over which the expenses funded with such financing proceeds may be deducted, keeping the “aggregate gross assets” higher during that period. The change in law may, therefore, prevent stock issued in subsequent financings from qualifying as QSBS.

Treatment of NOL carryforwards generated after 2017

For taxable years beginning after December 31, 2020, corporate taxpayers may offset only 80% of net taxable income for the year, with NOL carryforwards generated in taxable years beginning after 2017. This is a change from the prior law, which potentially allowed up to 100% of such income to be offset with available NOL carryforwards.

This limitation on corporations’ ability to use certain NOL carryforwards, when combined with the requirement to capitalize R&E expenses, may cause corporations that historically operated at a loss to become cash taxpayers even if they have NOLs (including NOL carryforwards) that exceed taxable income in an applicable tax year.

Below are two basic examples of how the rules discussed above might impact two different companies with similar income/expense/NOLs in each of 2017, 2021 and 2022 (i.e., before and after the rules discussed above were operative).

Example 1 – Smaller corporation ▪ $6 million of revenue, $5 million of R&E expenses and $1 million of available NOL carryforwards ▪ Taxable income example (2017 versus 2021 versus 2022)			
Tax year	2017	2021	2022
Income	$6,000,000	$6,000,000	$6,000,000
R&E expense Deductible R&E expense Capitalized R&E expense	$(5,000,000) $(5,000,000) $-	$(5,000,000) $(5,000,000) $-	$(5,000,000) $(500,000) $(4,500,000)
Net taxable income before use of NOL carryforwards	$1,000,000	$1,000,000	$5,500,000
Available NOL carryforwards (generated pre-2017)	$(1,000,000)	$-	$-
Available NOL carryforwards (generated post-2017)	N/A	$(1,000,000)	$(1,000,000)
Net taxable income after use of NOL carryforwards	$-	$200,000	$4,500,000
US federal income tax cost*	$-	$(42,000)	$(945,000)

* US federal corporate income tax rate for post-2017 tax years = 21%

Example 2 – Larger corporation

- $80 million of revenue, $75 million of R&E expenses and $150 million of available NOL carryforwards
- Taxable income example (2017 versus 2021 versus 2022)

Tax year	2017	2021	2022
Income	$80,000,000	$80,000,000	$80,000,000
R&E expense Deductible R&E expense Capitalized R&E expense	$(75,000,000) $(75,000,000) $-	$(75,000,000) $(75,000,000) $-	$(75,000,000) $(7,500,000) $(67,500,000)
Net taxable income before use of NOL carryforwards	$5,000,000	$5,000,000	$72,500,000
Available NOL carryforwards (generated pre-2017)	$(150,000,000)	$ -	$ -
Available NOL carryforwards (generated post-2017)	N/A	$ (150,000,000)	$ (150,000,000)
Net taxable income after use of NOL carryforwards	$-	$1,000,000	$14,500,000
US federal income tax cost*	$-	$(210,000)	$(3,045,000)

* US federal corporate income tax rate for post-2017 tax years = 21%

Possible congressional action

As companies grapple with potentially significant higher tax costs associated with the rules discussed above, a bipartisan group of US senators – led by Sen. Maggie Hassan, a Democrat from New Hampshire, and Sen. Todd Young, a Republican from Indiana – introduced a bill last month that would, among other things, amend IRC Section 174. Called the **American Innovation and Jobs Act**, **the bill** would repeal the Tax Cuts and Jobs Act capitalization rule and double the tax credit for certain research and development expenditures. The American Innovation and Jobs Act has significant industry backing (e.g., the **National Association of Manufacturers** and the **Technology Councils of North America** support its passage), but it remains unclear whether the proposed legislation will ultimately gain any traction in Congress.

If you have questions about how these changes may impact your company, we strongly advise you to contact a member of the Cooley tax team, your accountant or other tax adviser.

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