



FREQUENTLY ASKED QUESTIONS ABOUT CHANGES TO R&D EXPENSE TAX DEDUCTIONS

Congressional legislation will unexpectedly surprise many unprofitable startups with a tax bill. The team at Kruze has put together a plan to guide our clients to the lowest possible tax bill. Details are below.

1. What has changed?

While there is no impact to accrual-based financial accounting, the rules around how R&D expenses can be deducted tax purposes have become less favorable. Before this rule change, companies could fully deduct R&D expenses on the tax return in the year they were incurred - so if a revenue generating startup was spending a lot on R&D, they could probably expect no income tax due.

Section 174 rules have changed for tax year 2022, and taxpayers may no longer currently deduct 100% of R&D expenses on their tax return. Instead, taxpayers must amortize specified R&D expenses ratably over five years (or 15 years for foreign R&D expenses).

Sec. 174 R&D expenses are research or experimental expenditures which are paid or incurred in connection with the taxpayer's business in developing a new or improved product or process, and include software development expenses.

2. Does this impact my GAAP financials?

There is no impact to your accrual-based financials - this only impacts the timing of income tax return deductions.

3. Are all companies subject to Sec. 174 requirements? Do I absolutely have to file a Sec. 174 adjustment?

Pretty much any startup conducting R&D will be impacted. In particular, taxpayers with R&D expenses that would qualify for the R&D tax credit under Sec. 41 of the tax code are subject to the new Sec. 174 capitalization and amortization requirements. The adjustment is required in order to be in tax compliance.



4. What is the additional fee for preparation of the Sec. 174 adjustment?

Kruze is charging a nominal \$200 fee for the 2022 tax return calculation of the adjustment for federal/state tax returns, tracking the amortization schedule over time, and filing all the necessary disclosures on the tax return. While this will be an annual fee, if Congress acts to repeal this requirement, it would one a one-time fee for 2022 tax return preparation.

5. Why wasn't this requirement and fee mentioned before?

A number of legislative attempts were made to repeal or delay Section 174, and both Kruze Consulting and the larger business community expected changes would be made before the end of 2022 due to the obvious chilling effect this would have on domestic R&D and how it runs completely counter to the increase in the R&D tax credit recently passed. Bipartisan legislation that would repeal the Sec. 174 capitalization requirement was introduced in the House and Senate in 2021, but failed to pass. Other attempts were made in 2022 to delay the Section 174 requirement, including in the year-end spending bill, but also failed to pass. The tax preparation community was caught by surprise by Congress' fault to act to repeal this legislation, and its impact is being felt by companies both large and small.

6. When will I be charged?

The \$200 fee will be billed after the final tax return deadline, in mid-to-late October 2023.

Thank you!

Kruze Consulting is a leading provider of accounting, finance, HR, and tax consulting to venture capital-funded startups. Kruze's clients have raised over \$12 billion dollars in financing, and the Kruze team takes pride in setting up systems and producing data that prepare startups to successfully navigate venture capital due diligence.