# The OBBBA - Research and Development Expenses

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## Overview

Under the Tax Cuts and Jobs Act of 2017 (TCJA), the research and development (R&D) tax credit and the rule for expensing research and experimental (R&E) expenditures was significantly changed. Effective for tax years beginning after December 31, 2021, the TCJA eliminated the option for businesses to immediately deduct all R&D expenses in the year they were incurred. Instead, it mandated that these costs be capitalized and amortized over a set period. That period was five years for domestic R&D expenses and 15 years for foreign R&D expenses. The amortization period for both domestic and foreign expenses began at the midpoint of the tax year in which the expenditures were paid or incurred.

This change had a major impact on many companies, particularly those that are research-intensive, as it increased their taxable income and, therefore, their tax liability, even if their R&D activities were not yet generating revenue.

However, the One Big Beautiful Bill Act (OBBBA) puts in place a transition rule that reverses the TCJA treatment for eligible taxpayers

## OBBBA Provision

Section 70302 of the OBBBA addresses the R&D tax credit and the expensing of R&E expenditures. Included is a transition rule that allows for a retroactive application of new rules. This is a significant change designed to address the previous requirement from the Tax Cuts and Jobs Act of 2017 (TCJA), which mandated the five-year amortization of R&E expenses starting in 2022.

For domestic R&E expenditures, the OBBBA effectively reverts the rule to pre-2022 law. This means that for qualified expenses, they do not have to be amortized over five years but can be fully deducted in the same year they are incurred. This change applies to taxable years beginning after December 31, 2024. For certain taxpayers, this can be applied retroactively to 2022, 2023, and 2024.

**The "retroactive" election.** The OBBBA permits a specific election for certain taxpayers to apply these new rules retroactively to R&E expenses paid or incurred in tax years beginning after December 31, 2021. This means taxpayers can file amended returns to claim the full deduction for 2022, 2023, and 2024, which could, in a particular situation, result in a significant tax benefit and refund.

The retroactive relief is generally available to "small businesses" that meet a specific test. This test is defined as having average annual gross receipts of $31 million or less for the three taxable years preceding the year in question. The calculation for this threshold is based on the rules in Internal Revenue Code Section 448(c).

**Example**

Green Acres Farm is a family-owned operation specializing in corn and soybean production. To improve crop yield and reduce fertilizer costs, the farm's owner, John, experimented with a new cover crop and no-till planting system from 2022 to 2024. This involved new planting techniques, custom-designed equipment modifications, and extensive testing of soil and nutrient levels. Assume that these activities qualify for the R&D tax credit and that John has kept extensive records to support claiming the credit.

**Financial Data:**

- **Average Gross Receipts (2019-2021):** $25 million
- **Taxable Income (before R&E expenses and credits):**
  - 2022: $2,000,000
  - 2023: $2,100,000
  - 2024: $2,200,000
- **Qualified Research Expenditures (QREs):**
  - 2022: $100,000 (wages for labor, supplies for testing, contractor fees)
  - 2023: $120,000
  - 2024: $130,000
- **Federal R&D Tax Credit Calculation:** Based on the QREs, the farm determines it is eligible for the following credits:
  - 2022: $10,000
  - 2023: $12,000
  - 2024: $13,000

Before the OBBBA, the TCJA required that the QREs be amortized over a five-year period.

**2022 Tax Return:**

- **Initial Taxable Income:** $2,000,000
- **R&E Deduction:** Instead of deducting the full $100,000, the farm could only deduct a portion. The five-year amortization rule means only 10% of the QREs can be deducted in the first year ($100,000 x 10% = $10,000). The remaining $90,000 would be deducted over the next five years.
- **Taxable Income (after R&E deduction):** $2,000,000 - $10,000 = $1,990,000 + $10,000 addition to income from R&D credit amount that must also reduce expenses.
- **Tax Liability:** (Based on standard corporate rates, for simplicity) A 21% tax rate on $2,000,000 would be $420,000.

- **R&D Tax Credit Application:** The farm applies the $10,000 R&D credit to reduce its tax liability.
- **Final Tax Due:** $420,000 - $10,000 = $410,000

This process repeats for 2023 and 2024, with only a small portion of the R&E costs being deducted each year, thereby keeping taxable income artificially high.

**The "New Way" (Filing Amended Returns under the OBBBA)**

Now, with the OBBBA's transition rule, the farm can make an election to retroactively apply the new expensing rules. The farm decides to file amended returns for all three years.

**Amended 2022 Tax Return:**

- **Initial Taxable Income:** $2,000,000
- **R&E Deduction (New Rule):** The farm can now deduct the full $100,000 of QREs in 2022.
- **Taxable Income (after R&E deduction):** $2,000,000 - $100,000 = $1,900,000 + $10,000 addition to income from R&D Credit amount that must also reduce expenses
- **Tax Liability:** A 21% tax rate on $1,910,000 would be $401,100.
- **R&D Tax Credit Application:** The farm applies the $10,000 R&D credit to reduce its tax liability.
  - ***Note:*** *The farm must also reduce its Schedule F deductions by the amount of the credit*
- **Final Tax Due:** $401,100 - $10,000 = $391,000

**Total Savings for 2022:** $410,000 (Old) - $391,100 (New) = $18,900

The farm would see similar, or even greater, savings for 2023 and 2024 because the higher R&E costs for those years would also be fully deductible.

**Summary of the Impact:**

By making the election under the OBBBA's transition rule, Green Acres Farm can:

1. **Fully Deduct R&E Expenses:** Instead of a small amortization each year, the farm can take a full deduction in the year the expenses were incurred. This significantly lowers its taxable income for 2022, 2023, and 2024.
2. **Generate a Refund:** The reduction in tax liability will result in a substantial refund for each year, providing a crucial cash infusion back into the business.

**Note:** Green Acre Farms will need to act quickly to take advantage of the new transition rule and file amended returns for all three years by July 4, 2026.

**Observation:** Taxpayers that chose not to seek R&D credits and did not have to amortize qualifying research expenditures for tax years 2022, 2023 and 2024 now may revisit those years to determine if seeking R&D credits for those years is worthy of filing amended returns for those years.

**Promoters**

It is anticipated that there will be a strong push by promoters to encourage businesses, including farm taxpayers, to take advantage of this change. The deadline for making this election is a critical component of the legislation. The election must be made within one year of the bill's enactment, which sets the deadline at July 4, 2026. This tight deadline will likely spur a rush of amended returns.

While the R&D tax credit is a legitimate and valuable incentive for innovation, the IRS is cracking down on abusive practices by some promoters who exploit its complexity for their own financial gain. The IRS has repeatedly issued warnings about aggressive and misleading promotions related to various tax credits, including the R&D credit.

Some promoters use overly broad interpretations of the R&D credit eligibility criteria to persuade ineligible taxpayers they qualify. They might blast ads, promising large refunds without thoroughly understanding a business's operations. This often leads to businesses claiming the credit when they don't legitimately meet the requirements. Promoters may also encourage businesses to claim the R&D credit for routine activities that don't actually meet the IRS's "four-part test" for qualified research (contained in I.R.C. §41). Examples include routine dental cleanings, fittings, or general business process improvements that lack the necessary "technical uncertainty" and "process of experimentation."

Another problem is that some promoters might inflate the amount of qualified research expenses (QREs) to maximize the credit and often charge a high percentage of the calculated benefit as their fee. This creates a strong incentive for them to overstate the credits, even if it puts the taxpayer at risk.

The R&D tax credit has stringent documentation requirements. Promoters may encourage claims without ensuring the taxpayer has the necessary records to support their R&D activities, such as detailed descriptions of research goals, outcomes, and expense tracking by business component. This significantly increases audit risk.

The IRS is well aware of these issues and has increased its scrutiny of R&D tax credit claims. The IRS has updated the required reporting requirements and is actively auditing claims and pursuing cases against fraudulent promoters.

**Note:** The R&D tax credit has appeared on the IRS's "Dirty Dozen" list of tax scams, which highlights abusive tax promotions to warn taxpayers. Taxpayers should be highly skeptical of promoters promising large, easy R&D tax credits without a thorough review of their specific activities. In all situations, maintaining meticulous records of all R&D activities, including research goals, experiments, outcomes, and expenses is critical.

The problems with R&D tax credit promoters extend to targeting farmers and ranchers. Agricultural businesses are often particularly susceptible to these aggressive promotions for several reasons. Many farmers and ranchers are genuinely unaware that their day-to-day activities, which often involve innovation, experimentation, and problem-solving, could qualify for the R&D tax credit. Promoters capitalize on this knowledge gap.

Farmers and ranchers often experiment with new crop varieties, irrigation techniques, livestock management methods, pest control, soil blends, and efficiency improvements. These activities can genuinely qualify if they meet the IRS's criteria. However, the I.R.C. §41 R&D tax credit rules are complex. This complexity makes it difficult for businesses, especially those without in-house tax expertise, to determine eligibility and calculate the credit correctly. Promoters often exploit this complexity by offering simplified (and often misleading) interpretations.

**Note:** Similar to other industries, farmers and ranchers are enticed by the promise of significant tax refunds or reductions. Promoters often highlight the potential for large benefits, sometimes downplaying the stringent requirements and the need for robust documentation.

Promoters will often present examples of agricultural activities that *might* qualify, such as:

- Developing new irrigation systems
- Experimenting with new fertilizers or soil blends
- Testing new livestock feeding techniques
- Implementing new methods to protect crops from pests or disease
- Developing new crop strains or animal breeds
- Improving harvesting or planting techniques
- Optimizing waste management or energy efficiency on the farm

While these activities *can* qualify, the key is whether they meet the "four-part test" (technological in nature, resolving technical uncertainty, process of experimentation, and new or improved business component) and if proper documentation exists. Promoters often gloss over these crucial details.

Promoters might tell a farmer they approach that they qualify, without understanding the nuances of their specific operations. A farm taxpayer should be wary of a promoter that doesn't ask for detailed information about the farmer's specific experimental activities, technical uncertainties faced, or the process of experimentation. What is required to claim the credit is detailed, contemporaneous documentation, such as:

- Records of experimental plots or herds.
- Data on different inputs (fertilizers, feeds, pesticides) and their effects.
- Notes on challenges encountered and solutions attempted.
- Records of employee time spent on research activities.
- Receipts for supplies directly used in experimentation.

**Note:** Claims for common farming practices that don't involve a true process of experimentation (e.g., simply adopting a new, widely available technology without further development or modification) are a major red flag.

## Conclusion

The OBBBA's change in the tax treatment of the R&D tax credit and R&E expenditures to pre-TCJA rules is a welcome change to many businesses, including farm and ranch businesses. However, those that can take advantage of the transition rule will need to be diligent in filing amended returns by the July 4, 2026, deadline.


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