

Small Business Notes

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No Exception for Small Research and Experimental Expenditures Under New Internal Revenue Code Section 174 Changes

For tax years beginning in 2022 the Tax Cuts and Jobs Act of 2017 made a major change to the treatment of research and experimentation expenditures under IRC Section 174. Formerly, a business could expense those expenditures in the year they were sustained and deduct them in their income tax filing for that year.

Under the change to Section 174, such expenditures can no longer be expensed and deducted in the year they were sustained but, instead, must be amortized over a period of 5 years (15 years for foreign expenditures). For the first year of the amortization the expenditures are considered to be placed in service at the midpoint of the business tax year thus making any amortized deductible the first year only half of what it will be in later years.

The new Section 174 specifically identified software development costs—for software for both internal use and external use – as research and experimentation expenditures subject to the new amortization requirement.

There is no exception to the requirement based on the size of the taxpayer or the size of the research and experimentation expenditures.

The research credit under Section 144 remains in place and may offer some offset to the costs of the new liability. But potentially affected taxpayers should look at Section 144 costs which are more narrow than those covered under Section 174.

Briefly Noted: Eighth Circuit Court of Appeals Addresses Franchise Fee Issue

On April 24, 2023 the U.S. Eighth Circuit Court of Appeals released its decision in a case on appeal from the U.S. District Court for Minnesota, *Louis DiGidio Services, Inc. v. Industrial Combustion, LLC*. This case involved a sixty year distributor relationship between the parties that was sometimes written and sometimes oral but always involved DiGidio purchasing parts from Industrial Combustion for parts to service industrial equipment manufactured by Industrial Combustion.

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When the relationship was terminated by Industrial Combustion, DiGidio argued that the monies paid to Industrial Combustion over the years under their various agreements constituted a franchise fee thereby giving DiGidio a franchise that could not be cancelled “except for cause” under the terms of the Minnesota Franchise Act.

The Court in its decision noted that “the purchase of goods or agreement to purchase goods at a bona fide whole sale price” is not the payment of a franchise fee. Likewise the Court quoted the finding of the district court that inducements Industrial Combustion offered (a “price match” program to match the prices of other original equipment manufacturers) “were not a requirement to do business with Industrial Combustion and thus cannot constitute a franchise fee.”

NOTE: In recent years the economics of contracts literature has stressed the reality of “incomplete contracts” that cannot take into consideration every possible event or contingency between the parties. In some industries, especially in Silicon Valley, this was addressed with a move to “relational contracts” with more emphasis on the trust and joint intentions of the parties rather than on the explicitly documented terms of an agreement. While these have had some uptake in private firms, the duty of care owed to shareholders has limited their use in public companies.

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