

Section 174

A comprehensive guide for R&D expenses



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Applies to Tax years after Dec 31, 2021
Audience Startup Founders & CFOs
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SECTION 01

Why Section 174 Matters Now

What changed?

For almost 70 years, you could deduct R&D the year you spent it. The 2017 Tax Cuts and Jobs Act ended that: starting with tax years after December 31, 2021, every "specified research or experimental" (SRE) expenditure had to be capitalized and amortized instead. Then Congress changed its mind. The **One Big Beautiful Bill Act, signed July 4, 2025**, brought back **immediate expensing for domestic R&D** through new §174A, effective for tax years beginning **after December 31, 2024**. Foreign R&D didn't get the reprieve; it's still on the 15-year schedule under §174.

Critical for cross-border startups



If you're a US C-Corp running engineering teams in India or the UK, here's a tax nuance you need to know about. When the US parent company pays or reimburses those overseas subsidiary costs, they're classified as "foreign SRE." The catch? You have to stretch that deduction out over a painful 15 years.

Meanwhile, if you hired that exact same engineer right here in the US, you could deduct their entire cost immediately. The tax gap between hiring locally versus building a team abroad has honestly never been wider. This is a clear push by the US government to prioritize and boost US-based R&D investment over international spending.

DOMESTIC RESEARCH

Deduct in full

From 2025 on, research done in the US is expensed the year you incur it (§174A). Costs from 2022–2024 stay on the old 5-year schedule unless you elect to capitalize them differently.

FOREIGN RESEARCH

15 years

Research performed outside the United States. Only ~3.33% is deductible in Year 1 under the mid-year convention. Unchanged by the 2025 law.

Scope

The scope of Section 174 is deliberately broad. It captures any amount paid or incurred "in connection with" research or experimentation, including software development costs (per Rev. Proc. 2000-50, now folded into Section 174). For a typical technology startup, this means the majority of engineering, product, and design costs are affected.



The Mid-Year Convention Explained

Section 174 requires the "mid-year convention," meaning amortization begins at the midpoint of the year the expenditure is incurred, regardless of when during the year the spending occurs.

YEAR	DOMESTIC DEDUCTION (5 YR)	CUMULATIVE	FOREIGN DEDUCTION (15 YR)	CUMULATIVE
Year 1	10.0%	10.0%	3.33%	3.33%
Year 2	20.0%	30.0%	6.67%	10.0%
Year 3	20.0%	50.0%	6.67%	16.67%

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YEAR	DOMESTIC DEDUCTION (5 YR)	CUMULATIVE	FOREIGN DEDUCTION (15 YR)	CUMULATIVE
Year 4	20.0%	70.0%	6.67%	23.33%
Year 5	20.0%	90.0%	6.67%	30.0%
Year 6	10.0%	100%	6.67%	36.67%
Years 7-15	-	-	6.67% per year	96.67%
Year 16	-	-	3.33%	100%

SECTION 02

Includable vs. Excludable Expenditures

The following master reference tables categorize the most common cost line items a startup will encounter. Use these as a checklist during tax preparation.



Navigate to

Table 2A **Includable** Expenditures (Must be capitalized under §174)

Table 2B **Excludable** Expenditures (Not subject to §174 capitalization)

TABLE 2A

Includable Expenditures

Must be capitalized under §174

The domestic column below applies to 2022–2024 costs (and to anyone who elects to capitalize domestic R&D under §174A). From 2025, domestic R&D is generally deducted in full in Year 1. The foreign schedule hasn't changed.

COST CATEGORY	DETAILS & NOTES	DOMESTIC OR FOREIGN
Engineer / Developer Salaries	Wages, bonuses, and payroll taxes for employees directly performing or supervising R&D. Allocate by time spent on qualifying activities.	Based on where the work is performed
Stock-Based Compensation	Section 83(h) deduction amount for options exercised or RSUs vested, to the extent attributable to R&D employees. Per Notice 2023-63.	Based on where the employee works

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COST CATEGORY	DETAILS & NOTES	DOMESTIC OR FOREIGN
Product Managers & Designers	Compensation for PMs and UX/UI designers whose work is directly connected to the development of the product. Must allocate if they split time.	Based on where the work is performed
QA / Testing (Development Phase)	Testing during the development cycle — integration testing, UAT, performance testing on pre-release software.	Based on where the work is performed
Contract Research / Outsourced Dev	Payments to third-party contractors, dev shops, or consultants performing R&D on your behalf. Full amount paid is §174.	Where the contractor performs the work
Software Development Costs	All costs to plan, design, code, test, and deploy software — internal use, SaaS, or embedded. Explicitly included by statute.	Based on where performed
Cloud / Hosting (Dev & Test)	AWS, GCP, Azure costs for development environments, CI/CD pipelines, testing infrastructure. Must allocate dev vs. production.	Generally domestic (US-based servers), but analyze
Depreciation on R&D Equipment	Depreciation allocable to R&D use on lab equipment, servers, testing devices. The asset purchase itself is not §174.	Where the asset is located/used
Materials & Supplies (R&D)	Lab chemicals, prototype components, test hardware. Reduce by salvage value if the output is sold.	Where consumed

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