

Software R&D Capitalization Made Easier: Our Ultimate Guide

When complex modern software development meets new and not necessarily straightforward financial requirements, it's hard to imagine a happy ending. In fact, shortly after a rule change around deductions for software research and development, a slew of companies are [reporting enormous tax bills and fear for their long-term survival](#), while others are simply struggling to understand what they need to do.

Software research and development capitalization, often shortened to "R&D cap" or "R&D cost capitalization") has been around forever, but changing rules and fast-moving teams make it challenging for engineering managers (and their finance counterparts)

to understand how to assess and track the necessary data in the most efficient way possible. Tax law is *always* complicated and ever-changing. It's safe to say most engineering managers weren't accounting majors, so dealing with this issue costs organizations' time, money, and, no doubt, sanity.

Here's everything you need to know about software research and development capitalization, from its history to the latest legal changes, and how organizations can approach this rather onerous requirement quickly and easily, [using data they already have and Allstacks.](#)

Software R&D Capitalization Fundamentals

What is capitalization?

Capitalization is an accounting process that companies use to classify costs as an investment rather than an expense on financial balance sheets. This allows companies to pay off debt over time in equal installments, also known as amortization. For example, if a business makes a \$10 million investment in a software development tool, that cost could be spread over five years, with 20% of the price added to the balance sheet annually instead of incurring the entire tax burden at once.

In other words, [capitalization](#) is a valuable accounting practice because organizations can amortize the pain of expensive purchases over several years, potentially helping even out their tax burden.

What is software R&D?

From the Internal Revenue Service's point of view, [software research and development](#) means investments in time, headcount, and resources in **future** products, and

very specifically not time, headcount, or resources spent in maintaining, fixing, or updating existing applications.

What is software R&D capitalization?

First, a quick history lesson: In 1954, section 174 of the United States Tax Code was created, which allowed companies to deduct "qualified" costs of research and development in the year the R&D happened. In 2017, the Tax Cuts and Jobs Act enacted by Congress made some significant changes to how organizations can deduct the costs of research and development. Starting with the tax year 2022, no company can deduct the full costs of R&D in the year it happened; instead, they have to amortize those costs over five years (if the R&D occurred in the United States) and 15 years if it took place overseas.

That's all a long way of saying companies across all industries [now have to track R&D work as a percentage of overall work](#) and justify it all to the IRS.

Software Capitalization In Practice



Why is software R&D capitalization important?

Software R&D capitalization matters to all companies, but it will have a different impact depending on the size of the organization. As we noted above, the rule change hits startups hard because, in the past, they were able to deduct the (often high) cost of their development teams in the year the work happened. And, because they're growing companies, potentially a higher percentage of their efforts were focused toward R&D, meaning they likely received healthy annual tax breaks.

At the same time, medium, large, and enterprise companies also benefit from R&D deductions, even if they just partially offset the cost of headcount, because that frees up capital that can be invested in other areas of the business. Also, companies intending to go public will need to track this information as part of the [S-1 SEC process](#).

How can organizations track software R&D capitalization?

Tracking capitalizable software efforts can be a hair-pulling, highly manual, spreadsheet-filling exercise in frustration. First, organizations have to keep track of all work done in a year, then slice it into present and past efforts. It can be tricky to untangle how a single team, or a large group of teams, spends their time, particularly over the course of a month or an entire year. The work has to be understood, justifiable to auditing consultants and the IRS, and quantifiable.

But developing software is more of a complex process than stamping out widgets for a webpage and involves many moving parts, so the concept of "quantifiable" is a common stumbling block for companies trying to track and allocate what developers do all day. Developers don't want to be time-tracked or watched like they work for "big brother" (who does?), so getting their buy-in is yet another hurdle to solve this challenge.

Ideally, organizations can approach this effort through less invasive means that leverage data already being generated in the organization.

What are the benefits of tracking software R&D capitalization?

While it might be painful to gather the required data for successful capitalization, tracking capitalizable R&D work has several benefits:

- **Potential tax deductions:** Organizations tend to claim 15-30% of their R&D expenses, which means more available money to put into other key investments.
- **Visibility into the true cost of software development:** Most companies don't know what they're really spending on software development, and that's a problem, particularly for teams that want to justify increased investments. Tracking software R&D capitalization investments will lead to a great understanding of what goes into software development across the organization.
- **Predictability:** Teams that don't track what they're doing certainly can't predict how things are going to turn out, so by implementing the necessary monitoring to monitor exactly what's happening organizations can suddenly gain confidence in predicting outcomes.
- **Efficiency:** A systematic approach, such as a well-established time-tracking policy or a solution like [Allstacks](#) that leverages automation, to track software R&D capitalization is going to mean engineering managers, CTOs, VPs, and the finance team will be able to focus on their day jobs – not endlessly crunch spreadsheets to find the necessary data.
- **Compliance:** Keeping the auditors happy and minimizing any risk of legal ramifications from the IRS are worthwhile goals indeed.

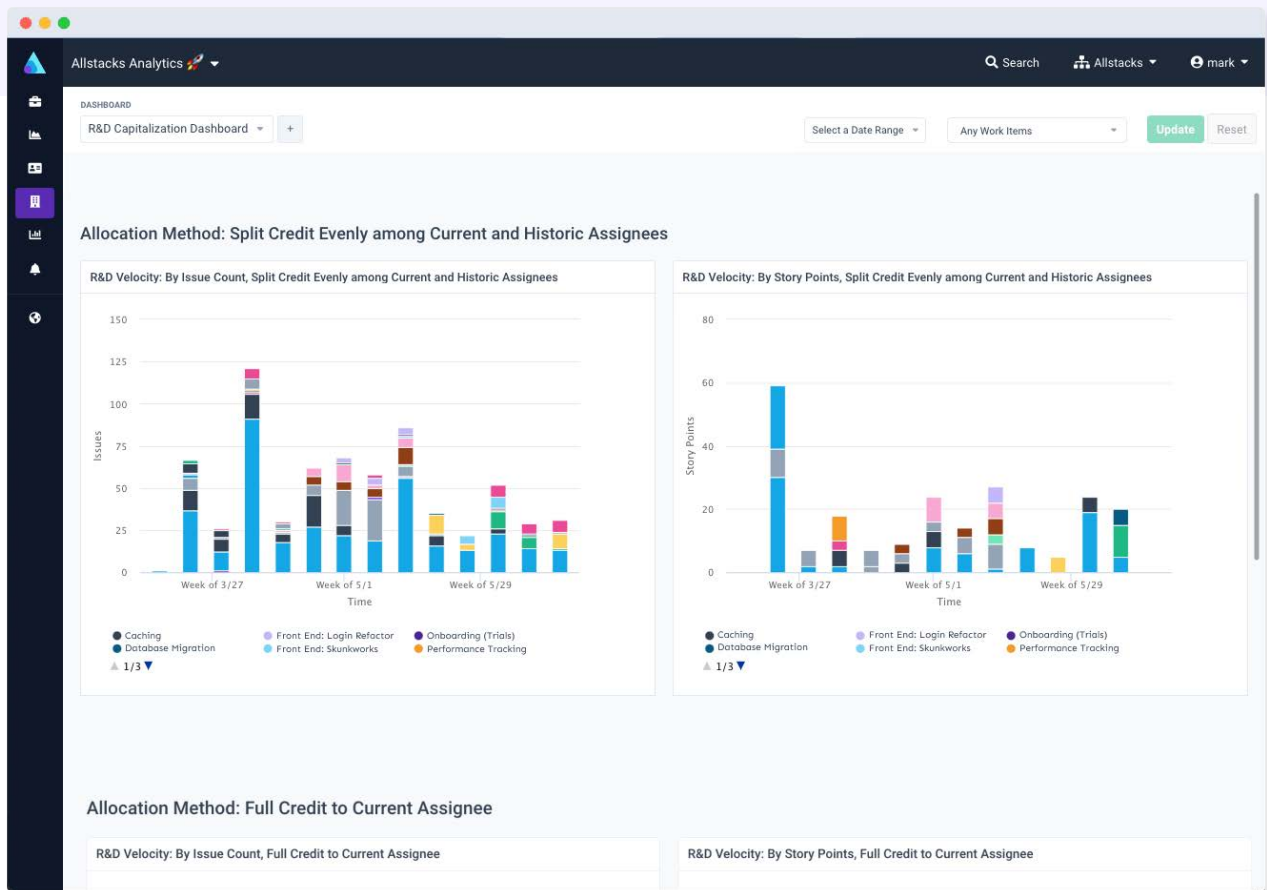
What are the challenges of systematic software R&D capitalization tracking?

The percentage of developer time that is capitalizable is pure gold, but it is also a very difficult number to come by.

The biggest challenges companies are likely to face include:

- **Achieving developer buy-in:** Time-tracking, or other “oversight” efforts in order to dissect what developers are working on in any given moment or sprint, is likely to be a non-starter in nearly every organization, so it will be important to find a way to leverage data already tracked in systems like Jira.
- **Finding accurate and defensible data:** Rapidly iterating DevOps teams are often doing many things at the same time, so it’s critical to have a widely agreed upon understanding of and visibility into what constitutes capitalizable vs. non-capitalizable work.
- **Avoiding the time suck:** Organizations wanting to avoid manual time tracking are going to need to be willing to invest some time in creating a reliable and repeatable system in order to track the data. For many companies, that’s going to mean starting with Jira.

Our Solution



Allstacks can help with software R&D capitalization

Here's everything you need to know. ↓



R&D Velocity: Capitalizable

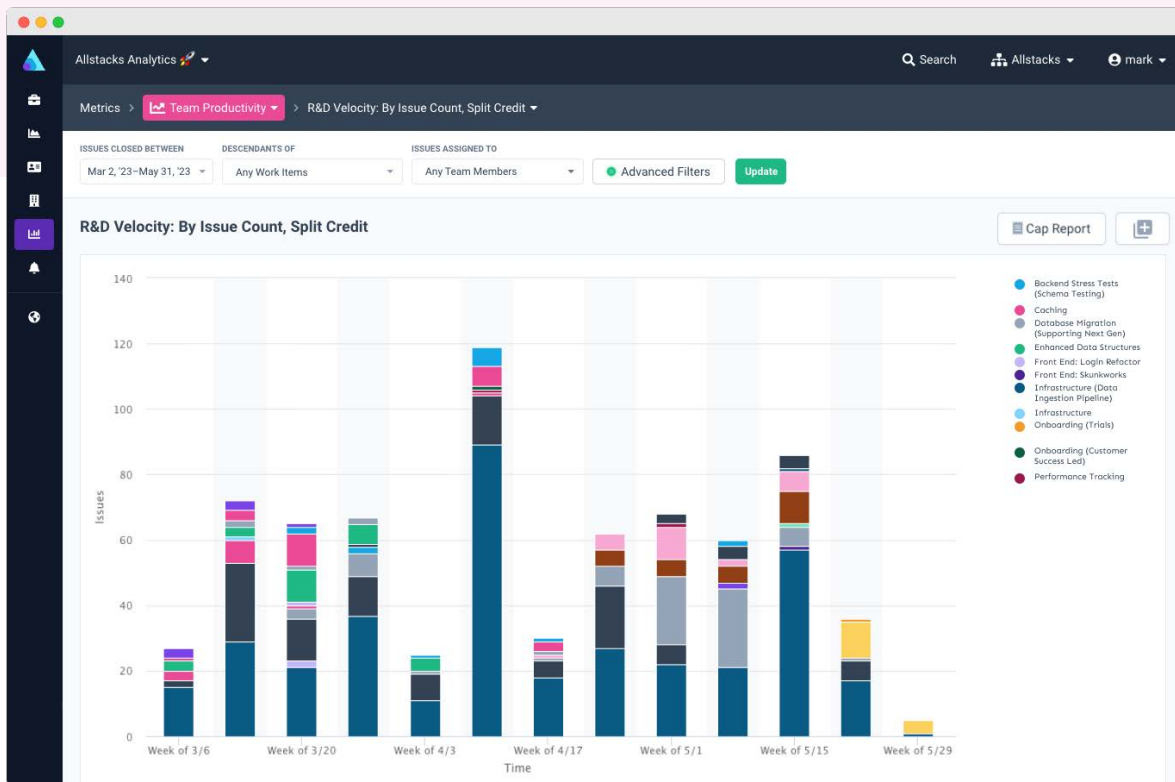
24 ▲

Story Points Completed

Up 12.7%

1

Start with Jira, and make sure it's connected to Allstacks and correctly configured. Track development work in Jira, and, specifically, create a custom field to track all R&D efforts.



Building the R&D Velocity metric by Issue count with split credit

2

Understand the scope of your R&D effort. The engineering manager can select the "R&D Metric View" with split credit among assignees so it's possible to track partial work. Enable Story Points to account for tickets of different sizes. Remember to include the time period to be measured, the R&D identifier, the Jira issue that gets the identifier (the Parent to be measured), and credit out attribution. Don't forget to filter out anything not necessary to measure such as "Won't Do" work.

3

Allstacks generates the R&D report.

Generate Capitalization Report

Use the form below to generate a Capitalization Report for Allstacks. Once the form is submitted, the report will be emailed to mark.mulholland@allstacks.com

WHAT YEAR IS THE REPORT FOR?
2023

WHAT IS THE CAPITALIZATION FIELD CALLED?
ALL Capitalizable

WHAT IS THE PARENT YOU WANT MEASURED?
Epic

HOW DO YOU WANT CREDIT ASSIGNED?
Split credit between all assignees (e.g. 3 devs worked on an 6 pt ticket; each ...)

ADVANCED FILTER
(!not:('Epic_status':'Won't Do'))

Cancel Generate Report

Generating the capitalization report from the R&D metric

Employee	Base Salary	Burden Rate	Overhead Rate	Compensation Total	Capitalization Rate	Capitalizable Compensation
Baily Osorio	\$125,000	10%	30%	\$137,500	0%	\$0
Charlotte Nary	\$135,000	10%	30%	\$148,500	42%	\$62,370
Christopher Tough	\$133,000	10%	30%	\$146,300	18%	\$25,603
Donnell Vaughton	\$96,000	5%	30%	\$100,800	0%	\$0
Farlee Batt	\$139,000	10%	30%	\$152,900	22%	\$34,250
Geordie Charlewood	\$130,000	10%	30%	\$143,000	0%	\$0
Karney Sweeten	\$145,000	10%	30%	\$159,500	7%	\$11,165
Kelci MacKinnon	\$95,000	5%	30%	\$99,750	19%	\$18,853
Merrie Piddocke	\$152,000	15%	30%	\$174,800	70%	\$122,360
Molises Paske	\$127,000	10%	30%	\$139,700	0%	\$0

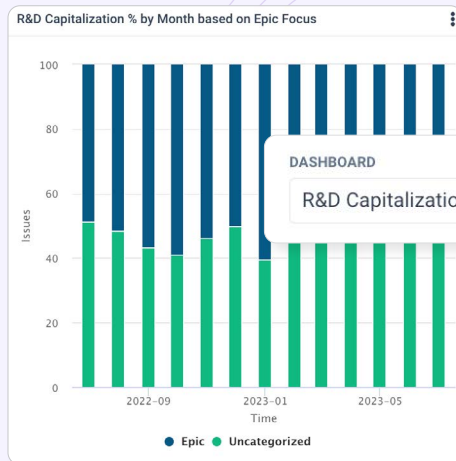


Voilà! Receive the R&D report

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The report comes to the engineering manager in two files, making it simple to pair the R&D data with accounting information like salaries or budgets. Here's how it works:

- One of these two files contains metadata and the other is the actual R&D accounting report.
- The engineering manager uses the cap reporting macro to merge files.
- Optionally, salary information can then be added.



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Pin the metrics to the dashboard so it's easy to refer back to them.

And literally that's it... no spreadsheets, late nights, or frustration allowed.

Ready to get started? ↓

Book a demo today or
try Allstacks for free.