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, mainly as a requirement for costs to be capitalized in adherence with technical accounting standards under US Generally Accepted Accounting Principles (US GAAP). However, now more than ever, changing tax rules and fast-moving teams make it

challenging for engineering leaders (and their finance counterparts) to understand how to assess and track the necessary data in the most efficient way possible. Adherence to US GAAP for financial statement purposes and tax law is **always** complicated and ever-changing. It's safe to say most engineering managers weren't accounting or taxation majors, so ensuring compliance 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.

One quick caveat: always consult finance professionals, independent auditors, tax lawyers, and the IRS as needed. We're not in the business of giving financial or legal advice and we do not have the necessary and legally required certifications to do so! Finally, it is important to note that compliance and tax laws are ever-changing, thus further requiring the reliance on outside certified professionals.

Software R&D Capitalization Fundamentals

What is capitalization?

Capitalization is an accounting process that companies use to classify costs as an asset on the balance sheet rather than an expense recorded on the income statement. This is beneficial because it allows companies to better align the expenses of acquiring the asset to the income generated from the asset.

These assets are amortized **over their useful lives**, also known as expensing the assets in increments over time until it goes down to zero. 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 income sheet annually instead of incurring the entire expense burden being recorded to the income statement at once.

> In other words, capitalization is a accounting practice mandated by US GAAP or the new tax codes where organizations must amortize the pain of expensive purchases over its intended useful life.

What is software R&D?

From the Internal Revenue Service (IRS)'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. From US GAAP's point of view in the Accounting Standards Codification (ASC) 350, costs to develop or obtain software for internal use must be evaluated for capitalization.

What is software R&D capitalization for US GAAP accounting and tax purposes?

To understand the landscape, start with the US GAAP's Statement of Position (SOP) 98-1 issued by the Financial Accounting Standards Board in 1998. SOP 98-1 requires companies to record and present their financial statements under US GAAP, thus capitalizing internal-use software and amortizing the asset over their intended useful life. SOP 98-1 has now been codified to ASC 350. Now, a quick history lesson on the tax code governed by the IRS: 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 the costs were incurred; instead, they have to amortize those costs over five years (if the R&D was in the United States) and 15 years if it took place overseas. It is important to note that compliance and the Internal Revenue Code are constantly evolving and changing. It is important to stay up to date with all areas that are applicable with the help of certified industry subject matter expert professionals. For example, the updated Section 174 is currently being evaluated by the U.S. Government.

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 in order to comply with section 174 of the Internal Revenue Code.

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 and the stage of the organization. As we noted above, the tax 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. Also as noted above, US-based companies do not have a choice of R&D capitalization under US GAAP. However, depending on a company's stage (such as well before an IPO) it might decide to delay capitalizing for financial statement purposes for as long as possible or until forced by their independent auditors.

At the same time, from a pure tax perspective, 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 for both use cases as part of the process which includes filing a Registration Statement Form S-1 with the Securities & Exchange Commission (SEC).

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 and in some cases on a monthly and/or quarterly basis, 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, quarter, or an entire year. The work has to be understood, justifiable to independent auditors, third-party tax advisors, consultants, and sometimes the IRS, and in a quantifiable and defendable way.

But developing software is more of a complex process than stamping out widgets in a factory 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, **leveraging data already being generated in the organization while at the same time meeting all aforementioned compliance needs.**

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/accounting team will be able to focus on their day jobs—not endlessly crunch spreadsheets to find the necessary data.

- **Compliance:** Keeping the independent auditors happy and minimizing any risk of legal ramifications from the IRS are worthwhile goals indeed.

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

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, are 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 existing systems of record like Jira or Azure DevOps.

- **Finding accurate and defensible data:** Rapidly iterating DevOps teams operating in an Agile software development life cycle (SDLC) 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 energy into creating a reliable and repeatable system in order to track the data. For many companies, that's going to mean starting with Jira or an equivalent product, like Azure DevOps.

SECTION THREE

Our Solution
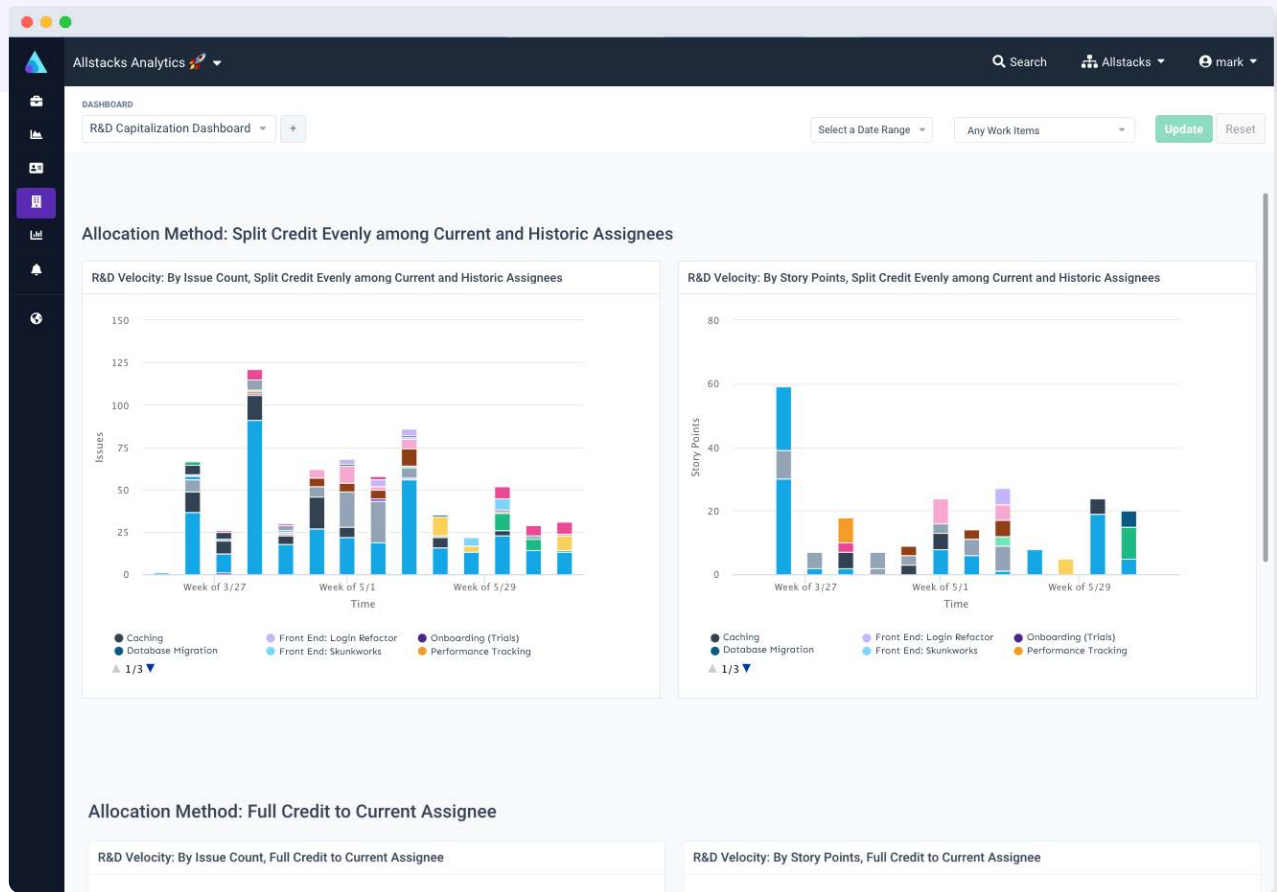
[Allstacks](#) can help with software R&D capitalization

Here's everything you need to know. ↓

Here is an example of how an organization leveraging Jira can generate automated and defensible capitalization reports.

1 Start with Jira or Azure DevOps (ADO), and make sure it's connected to Allstacks and correctly configured. Track development work in Jira or ADO, and, specifically, create a custom field to track all R&D efforts.
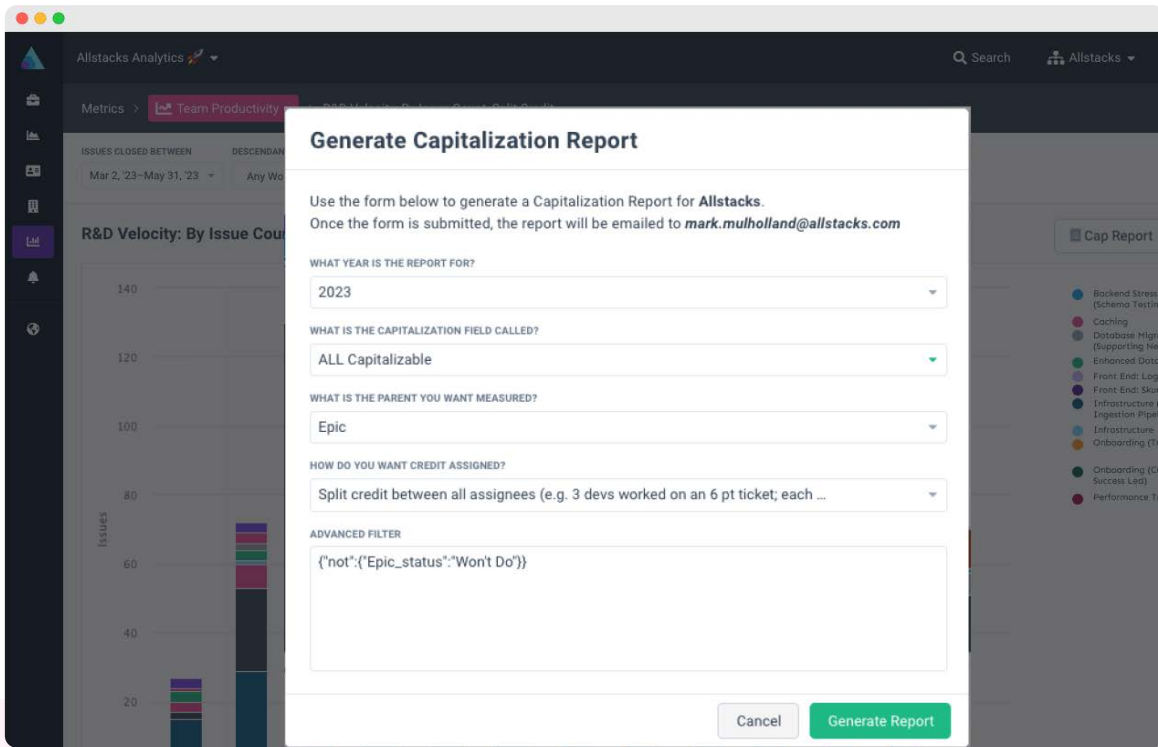
R&D Velocity: Capitalizable

24 ▲

Story Points Completed

Up 12.7%
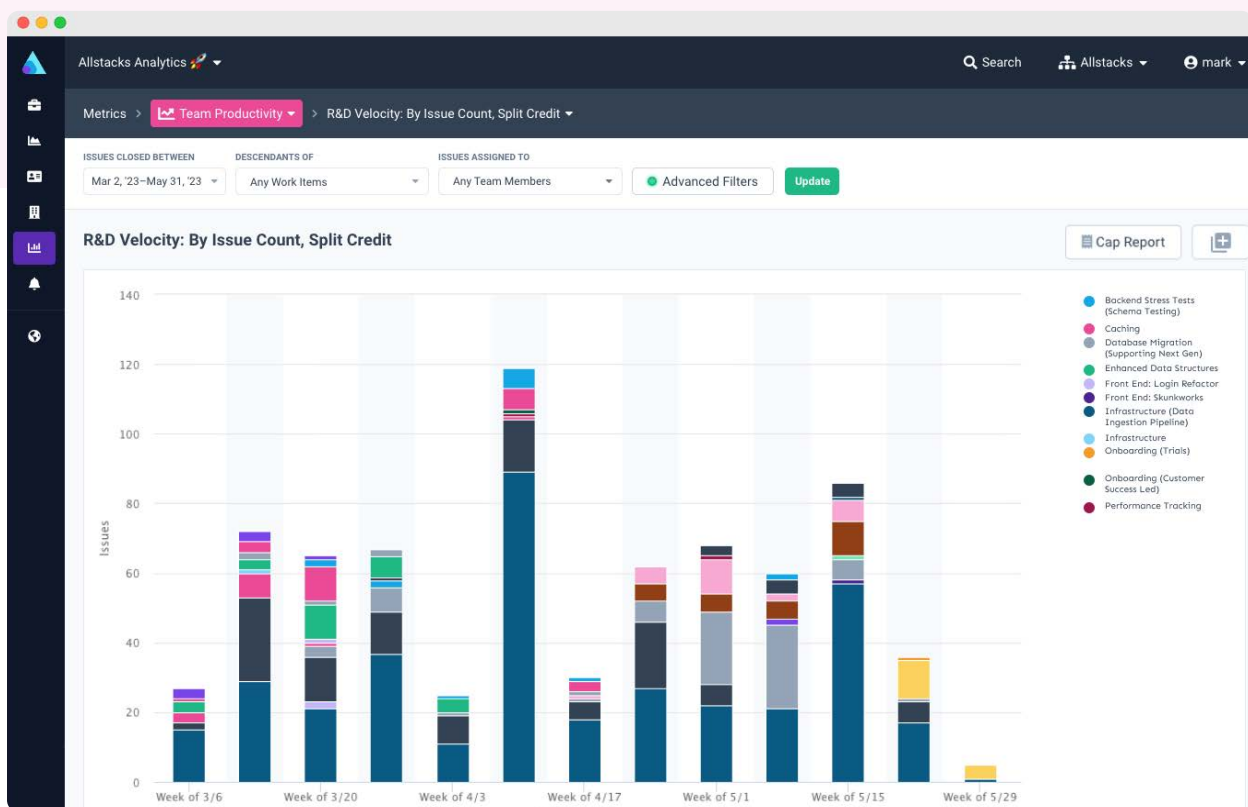
Building the R&D Velocity metric by Issue count with split credit

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

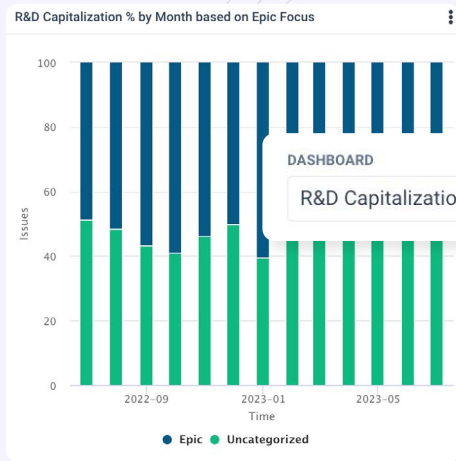| Employee	Base Salary	Burden Rate	Overhead Rate	Compensation Total	Capitalization Rate	Capitalizable Compensation
Baily Osorio	$125,000	10%	30%	$137,500	0%	$0
Charlotte Nary	$135,000	10%	30%	$148,500	42%	$62,370
Christopher Tough	$133,000	10%	30%	$146,300	18%	$25,603
Donnell Vaughton	$96,000	5%	30%	$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
Moises Paske	$127,000	10%	30%	$139,700	0%	$0

Voilà! Receive the R&D report

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

A. One of these two files contains metadata and the other is the actual R&D accounting report.

B. The engineering manager uses the cap reporting macro to merge files.

C. Optionally, salary information can then be added.

R&D Capitalization % by Month based on Epic Focus

DASHBOARD

R&D Capitalization Dashboard   ▾   +

● Epic ● Uncategorized

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

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

Ready to get started? ↓

[Book a demo](#) today or try [Allstacks for free.](#)