KPMG

What's News in Tax

Analysis that matters from Washington National Tax

January 7, 2026

Treatment of Domestic R&E Expenditures under the One Big Beautiful Bill Act—State Tax and Important Federal Considerations

by Justin Hill, Carol Conjura, Deanna Luciani, and Andrew Grace, KPMG[*]

The One Big Beautiful Bill Act restored immediate expensing of domestic research and experimental expenditures under new section 174A. In response, a number of states issued guidance on the treatment of these expenditures. This article explains why taxpayers need to understand the impacts from a state tax perspective to comply with the changes.

Introduction

The One Big Beautiful Bill Act (OBBBA)[1] restores immediate expensing of domestic research & experimental (R&E) expenditures under new section 174A[2] for federal income tax purposes for tax years beginning after December 31, 2024. The OBBBA also reinstates additional accounting method options that were available prior to the Tax Cuts and Jobs Act (TCJA).[3] Taxpayers must not only consider the appropriate treatment for federal income tax purposes but also consider the impact from a state income tax perspective. In response to the OBBBA, a number of states have reacted and issued guidance on the treatment of R&E expenditures for tax years beginning in 2025.

It is critical that taxpayers consider the impacts and considerations for state income tax purposes when preparing federal and state tax returns for tax year 2025 and beyond.

---

[*] Justin Hill is a partner in the Washington National Tax (WNT) state and local tax (SALT) income & incentives group of KPMG LLP, Carol Conjura is a partner in the WNT methods group, Deanna Luciani is a senior manager in the WNT methods group, and Andrew Grace is a managing director in the WNT SALT income & incentives group.

[1] *See* Pub. L. No. 119-21.

[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[3] *See* Pub. L. No. 115–97.

Navigating the New Tax Landscape: State Tax Treatment of R&E Expenditures After Federal Changes

A major shift in federal tax law has created a complex landscape for businesses that incur domestic R&E expenditures. OBBBA has permanently reinstated the ability for businesses to immediately expense these domestic costs for federal tax purposes, a significant change from the recent requirement to amortize them over five years. Expenses incurred outside the United States remain subject to capitalization with a 15-year amortization period. Notwithstanding the shift back to domestic expensing, the impact of this federal change on state tax obligations is far from uniform, creating complexity and an inconsistent set of rules that companies must navigate carefully.

Federal Tax Changes and Continued Importance Notwithstanding the Return to Immediate Expensing

Prior to 2022, businesses could immediately deduct their R&E expenditures. The TCJA of 2017 changed this, mandating that for tax years beginning after December 31, 2021, all R&E costs, including software development, be capitalized and amortized—over five years for domestic expenses and 15 years for foreign expenses.

The recently enacted OBBBA reverses this for domestic expenditures, allowing immediate expensing for tax years beginning after December 31, 2024. However, the 15-year amortization period for foreign R&E remains in effect.

The OBBBA also reinstates some version of the options available prior to the TCJA. Notably, domestic R&E costs incurred in tax years beginning after 2024 may be immediately deducted or, at the taxpayer's election, capitalized and amortized either:

- Over a period of at least 60 months under new section 174A(c), or
- Over ten years under section 59(e).

This flexibility allows research-intensive businesses to optimize their overall tax positions from a federal income tax perspective. For example, many taxpayers are considering one of the capitalization options for domestic R&E for federal tax purposes in order to mitigate exposure to the base erosion anti-abuse tax (BEAT) and/or the corporate alternative minimum tax (CAMT), as well as section 163(j) limitations. Taxpayers that choose to capitalize R&E will need to carefully analyze the treatment of expenses, develop methods for allocating direct and indirect costs to section 174 expenses, and document whether expenses satisfy the definition of R&E under section 174. The research credit under section 41 applies to a subset of expenses meeting the definition of R&E under section 174. Similarly, meeting the definition of R&E under section 174 will become a more critical step in properly capturing the full benefit of a taxpayer's foreign derived deduction eligible income (FDDEI) beginning in 2026, when R&E expenses are no longer allocable to FDDEI.

The OBBBA also provides several options for transitioning to the new rules for domestic R&E costs, including elective retroactive application of section 174A for eligible small businesses and accelerated recovery of previously capitalized costs (beginning in 2025) for all taxpayers.

On August 28, the IRS released Revenue Procedure 2025-28, providing the procedures for making elections and/or accounting method changes to:

- Comply with the OBBBA's amendments to section 174 and new section 174A,
- Accelerate the recovery of unamortized domestic R&E costs capitalized under section 174, as in effect under the TCJA (TCJA section 174), and
- In the case of eligible small business taxpayers, retroactively apply section 174A to domestic R&E costs incurred in tax years beginning after 2021.

State Conformity: A Mixed Bag for Taxpayers

The crucial question for businesses is how individual states will treat these changes. State conformity to the Internal Revenue Code broadly falls into two categories: rolling conformity states and static (fixed-date) conformity states. Within these categories, however, the treatment of section 174 and new section 174A costs can differ, as all states have the ability (and do) decouple from specific provisions of the Internal Revenue Code.

For instance, Alaska conforms to the Internal Revenue Code on a rolling basis, has not specifically decoupled from section 174 in prior years, and does not specifically decouple from sections 174 or 174A currently. Therefore, it is likely that, to the extent that the filing group in Alaska matches the federal consolidated filing group, no modification to the federal section 174/174A deduction—including elections related to capitalized but not amortized R&E expenditures—would be required for Alaska corporate income tax purposes.

In contrast, Alabama, another state that generally conforms to the Internal Revenue Code on a rolling basis, decoupled from the TCJA version of section 174 in prior years. Therefore, while Alabama currently conforms to section 174A (which could change if the state legislature enacts legislation to decouple from the new federal section 174A), modification to the federal section 174/174A deduction may be required to account for the inconsistent conformity to the federal R&E expenditure provisions.

In a state like California, which is a fixed-date conformity state, modification to the federal section 174/174A deduction will be required because California did not adopt the TCJA version of section 174 in prior years and does not adopt sections 174 or 174A under its current incorporation of the Internal Revenue Code.

In other fixed-date conformity states that have not updated their conformity statutes to generally adopt the provisions of OBBBA (e.g., Georgia, Hawaii), modification to the federal section 174/174A deduction will be required, but the modification will not be consistent across this group of states. For instance, Georgia specifically decoupled from the TCJA version of section 174. Therefore, to the extent that Georgia and Hawaii adopt section 174A in a future legislative session, the modification to the federal section 174/174A deduction for Georgia corporate income tax purposes will differ from the modification required for Hawaii corporate income tax purposes because Hawaii did adopt the TCJA version of section 174 for all years that the TCJA version of section 174 was effective.

Falling somewhere between Georgia and Hawaii is Kentucky, which is also a fixed-date conformity state. Like Hawaii and Georgia, Kentucky has not yet updated its conformity statute to adopt the provisions of OBBBA. However, to add further complexity, Kentucky only began to apply the provision of the TCJA version of section 174 for tax years 2023 and forward. Thus, while Kentucky, Georgia, and Hawaii could broadly be grouped together as fixed-date conformity states that have not yet adopted the provisions of OBBBA, how these states adopted old versions of section 174 materially changes the section 174/174A modification required for state corporate income tax purposes.

The state tax treatment of section 174A can also affect other items on the state income tax return, such as the state section 163(j) limitation amount or the state-specific FDDEI deduction. Taxpayers that may have no federal section 250 deduction due to the taxable income limit may have an allowable state FDDEI deduction. As such, it is critical for taxpayers to model state-specific results in connection with an overall section 174A conformity analysis. It is also imperative for taxpayers to analyze state section 174A conformity on a recurring basis as part of the state income tax provision review, state income tax estimated payment computation, and state income tax return preparation. To highlight the dynamic conformity landscape, in the months since the OBBBA was enacted, at least six jurisdictions have modified their conformity to new section 174A (Washington D.C., Maine, Maryland, Michigan, Pennsylvania, and Rhode Island).

Observations

The varied approaches by states create several challenges and considerations for taxpayers:

- **Administrative Complexity:** The lack of uniformity means companies will need to track R&E expenditures and their tax treatment on a state-by-state basis, adding a significant administrative burden.
- **State-Specific Guidance:** It is crucial to monitor guidance from individual state tax authorities, as many are still in the process of clarifying their positions.
- **Potential for Constitutional Challenges:** The preferential treatment of domestic R&E expenditures at the federal level could be challenged at the state level under the Commerce Clause of the U.S. Constitution, which prohibits states from discriminating against foreign commerce.

In conclusion, while there is some clarity on a federal level with respect to the immediate expensing of domestic R&E expenditures, the state tax implications add complexity and are evolving. Taxpayers must pay close attention to the specific laws and regulations in each state where they operate to achieve compliance and attempt to optimize their tax positions.