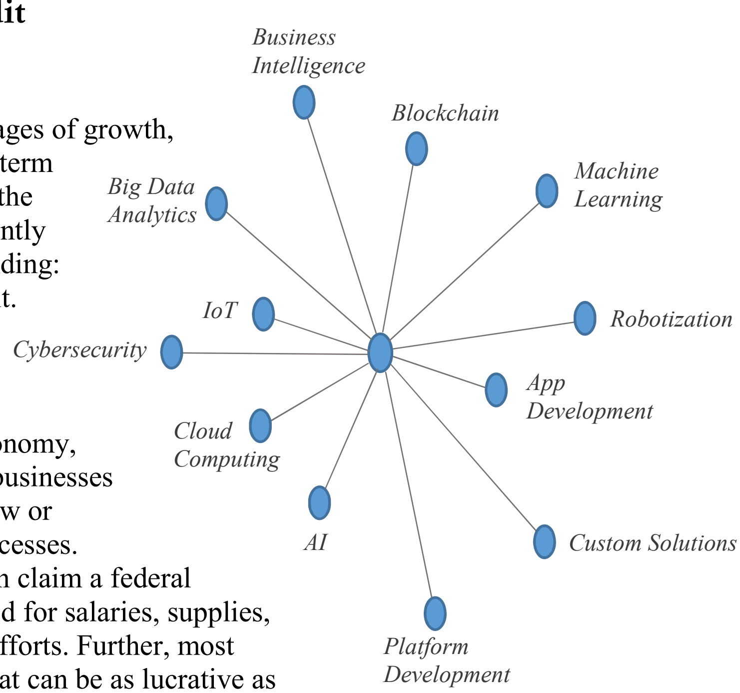
# Startup or Small Business Strapped For Cash? Why the R&D Tax Credit Should Be On Your Radar




For startups or small businesses in the early stages of growth, success hinges on the ability to generate short-term cash flow and operating capital. In navigating the myriad of financing options, businesses frequently overlook a potential non-dilutive source of funding: the research and development (R&D) tax credit.

### What is the R&D Credit?

Originally enacted by Congress in 1981 as a mechanism to stimulate growth in the U.S. economy, the R&D credit is a tax incentive available to businesses of any size and in any industry that develop new or improved products (including software) or processes. Businesses that engage in eligible activities can claim a federal R&D credit of up to 10 percent of amounts paid for salaries, supplies, and contract research related to development efforts. Further, most states also offer corresponding R&D credits that can be as lucrative as the federal credit. The federal and state R&D credits may be used to offset income tax liability on a dollar-for-dollar basis.

### What is "R&D?"

The definition of "R&D" for tax credit purposes is quite broad and–despite common misconceptions–encompasses much more than activities aimed at obtaining new scientific knowledge or creating new technology.

To qualify for the R&D credit, activities must meet each of the following requirements:

- **Technological in nature**–activities must be based on hard sciences such as engineering or computer science
- **Permitted purpose**–activities must be intended to develop a new or improved product or process
- **Technical uncertainty**–activities must be aimed at eliminating uncertainty with respect to the development of a product or process
- **Process of experimentation**–activities must involve an iterative or systematic approach of evaluating different alternatives to eliminate uncertainty

## 3 Reasons Why Startups Should Be Excited About the R&D Credit

### 1 No Tax Liability = No Problem

As a result of a law change in 2015, certain startups and small businesses that generate federal R&D credits but do not have income tax liability can elect to offset the R&D credit against payroll taxes (up to $250,000 per year). Eligible businesses must have gross receipts of less than $5 million in the current tax year and no gross receipts in any tax year preceding the five-year period ending with the current tax year.

Why is this law change important? Prior to the law change, startups claiming the R&D credit, but not in an income tax paying position, received no immediate benefit from the R&D credit because the credit is nonrefundable (i.e. can only be used to reduce income tax liability). The payroll tax credit creates an effective mechanism for startups to monetize and reap the benefits of R&D credits.

The payroll credit election must be made on a timely filed income tax return. Qualified businesses can start utilizing the elected amount of payroll tax credit in the first calendar quarter after the filing of the federal income tax return. Excess credits can be carried forward to subsequent payroll tax reporting periods until fully used.

### 2 FinTech and HealthTech and GovTech…Oh My!

The startup industry is replete with businesses developing transformative and disruptive technologies, from the development of next-generation blockchain and cybersecurity solutions to the use of AI and machine learning for the diagnosis and treatment of diseases. Technology startups operating in this space undoubtedly engage in activities that qualify for the R&D credit.

> *"Disruptors don't have to discover something new; they just have to discover a practical use for new discoveries."*
> —Jay Samit

However, it's not the level of technological advancement or innovation that determines eligibility for the R&D credit, but rather the technical nature of the underlying activities. Accordingly, businesses operating in traditionally "non-tech" industries that leverage existing technology to streamline business processes (e.g. supply chain management); interact with customers; develop or upgrade products; manage, analyze, and protect data; and so on, are also able to take advantage of the R&D credit.

What it boils down to is this: startup businesses employing (or contracting) engineers, software developers, scientists, programmers, architects, or other technical specialists to design, develop, test, and implement solutions–whether revolutionary or incremental–stand to benefit from the R&D credit.

### 3 Recurring, Predictable Cash Flow? #Neat

As a permanent feature of the tax code, the R&D credit can be claimed by businesses on an annual and ongoing basis. The best part? A business does not need to incur year-over-year increases in R&D spend to generate a federal R&D credit. The mechanics of the R&D calculation enable startup businesses to yield significant R&D credit savings in ramp-up periods, yet still benefit from the credit in periods with flat, or even decreasing, headcount.

The predictability of the R&D credit provides an efficient tax and cash flow planning tool for startup businesses, and should factor into capital stack considerations. Further, businesses that have missed out on R&D credits in prior tax years have the ability to file retroactive R&D credit claims.

### Ready to Take Advantage of the R&D Credit?

If you would like to learn more about how the R&D credit may apply to your business, please contact a Howard & Howard professional. Howard & Howard has an experienced team of engineers, CPAs, tax attorneys, and consultants with deep knowledge in R&D tax incentives.