



# R&D TAX CREDITS

THE ULTIMATE  
BEGINNER'S GUIDE EBOOK

No matter what business you're in, everyone wishes they had more money, and ways to save money. But it's shocking to find out just how many small businesses and startups don't know what programs and credits are out there to help them do so.

If you're a startup, burn rate, runway, growth rate, buying a new ping pong table, and hiring those high-priced engineers who want to leave the enterprise world are all factors within managing upward mobility in an era where getting investment money is critical for success.

But thinking about taxes and tax incentives is a dark-horse way to keep the lights on and keep people innovating. It's estimated that more than **80% of startups and small and midsize businesses** are unaware they're eligible for government-sponsored tax credits.

## **We've got a secret for you:**

**There are business credits and tax incentives that could change how your startup or small business operates for decades to come. All you have to do is know how to access this information and unlock the potential for your company by doing the work you're already doing.**

# THE RESEARCH AND DEVELOPMENT TAX CREDIT

One of the most innovative ways to reduce tax liability is the Research and Development (R&D) tax credit. Companies from all over the business spectrum can qualify for this government-sponsored tax benefit.

The generalization of "research and development" is pretty broad. The Government's definition reads, "[26 U.S.C. § 41](#), may be claimed by tax paying businesses that develop, design, or improve products, processes, formulas, or software."

As you probably know, research and development takes a ton of time and resources. Think about it - do you think anything Steve Jobs or Google created happened overnight? Innovations like iPhones or Google Maps took years to develop before becoming household names. And one of the ways a lot of companies in the know fund their ventures into the unknown is by leveraging the R&D Tax Credit.

The U.S. Government loves when world-changing innovations come from our country, it makes our annual G.D.P. go up, and allows our country to keep its standing as a top performer in business.



# A QUICK HISTORY ON THE R&D TAX CREDIT



Back in the stone age, or as we call it, 1981, the credit was created to reward American businesses that invest in innovation.

Since then, there have been multiple evolutions due to regulation changes, new laws, old rules, and expansion of what kinds of businesses can benefit from the credit.

In 2003, something called the Discovery Rule was removed, and a new set of parameters was introduced, which changed the game by stating that research activities (aka the technology you're creating) didn't have to be "new to the world" but instead just "new to the taxpayer."

And in 2015, The [Protecting Americans from Tax Hikes \(PATH\) Act](#) made the R&D tax credit permanent. Soon after, Congress modified the credit to help small and midsize businesses by allowing them to utilize the R&D credit as a payroll tax offset (more on this later).

Now, the R&D credit is the most valuable tax incentives available to American businesses and can be levied at both the state and federal level in most cases. Over thirty states offer some form of credit that encourages innovation within their zip codes.

# DOES MY BUSINESS QUALIFY FOR THE R&D TAX CREDIT?



The million-dollar question (and for some businesses, that's a literal number of savings).

One of the biggest misnomers about the R&D tax credit is that eligibility extends beyond companies that employ folks in white lab coats.

The good thing is, the R&D tax credit is set up so that businesses of all sizes can take advantage. It doesn't matter if you're a high-powered research lab or an early stage startup working on your first product release. The program is applicable across the board. But many business owners don't realize this credit is at their fingertips!

Activities like changing manufacturing and production methods count just as software development or improving quality control on existing products or services.

Here's a quick way to consider whether your company can qualify for the R&D tax credit.

- ☒ Do you design or develop new products, processes, or tools?
- ☒ Do you make existing products better?
- ☒ Do you make software or make it better by creating add-ons?

Think of different industries at this point. Nothing is one-size-fits-all. Startups do amazing things, and sometimes, they may not think what they do falls within the parameters of the R&D tax credit.

Consider some of these industries or areas of innovation that are likely performing activities that qualify:

- |                                                             |                                                          |
|-------------------------------------------------------------|----------------------------------------------------------|
| <input checked="" type="checkbox"/> Aerospace               | <input checked="" type="checkbox"/> Virtual reality      |
| <input checked="" type="checkbox"/> Oil and gas             | <input checked="" type="checkbox"/> Textiles and Apparel |
| <input checked="" type="checkbox"/> Big Data                | <input checked="" type="checkbox"/> Agriculture          |
| <input checked="" type="checkbox"/> Food and beverage       | <input checked="" type="checkbox"/> Software (SaaS)      |
| <input checked="" type="checkbox"/> Machine learning        | <input checked="" type="checkbox"/> Manufacturing        |
| <input checked="" type="checkbox"/> Artificial intelligence | <input checked="" type="checkbox"/> Pharmaceutical       |
| <input checked="" type="checkbox"/> Consumer packaged goods | <input checked="" type="checkbox"/> Digital Health       |
| <input checked="" type="checkbox"/> Cryptocurrency          | <input checked="" type="checkbox"/> Cleantech            |

# HOW DOES THE GOVERNMENT DEFINE A RESEARCH EXPENSE



The IRS also has something called the four-part test that allows companies to see if they qualify. The four parts are:

## **1 Do you have a new or improved business component?**

Can you demonstrate a new or improved aspect of your company's product/process/software and how the activities result in a new or improved level of function, performance, reliability, quality, and/or significant cost reduction?

## **2 How were you able to eliminate uncertainty during development?**

How was uncertainty or risk measured at the outset of the project? Qualified Research Activities (QRAs) which determine eligibility must intend to eliminate uncertainties concerning the capability, durability, or ultimate design during the development or improvement of a product, process, technique, invention, formulation, or software.

## **3 What was your process of experimentation?**

Experimentation occurs when the means of achieving the desired objective is not readily discernible at the outset. The process of experimentation (POE) is identifying and evaluating alternatives, performing trial and error experiments, and testing results. The IRS also considers "process of experimentation" when a candidate creates prototypes, models and simulations. Any failed projects that are technological in nature, are also considered part of the QRAs.

## **4 Is the new or improved component technical in nature?**

Explain how the component is based upon the principles of engineering, physical or biological sciences, or computer science.

In other words, can you say yes to the following:

*Do I make something?*

If you're developing or improving upon technology or products, odds are you probably are entitled to some money back from the IRS!

*Does my product change over time?*

Businesses rarely make their products the exact same way year after year. So, if your company invests resources to make its own products, software, or processes cleaner, greener, quicker, or cheaper, you most likely qualify for the credit!





# APPLYING FOR THE R&D TAX CREDIT



Okay, so up to this point we've gone over the history of the R&D credit and how to know if you qualify. Now, let's dive into the process for claiming this credit!

Businesses claim the R&D Credit by filing [IRS Form 6765, Credit for Increasing Research Activities](#). As part of this process, they need to identify their qualifying expenses and provide adequate documentation that shows how they meet the requirements.

In a sense, you're going to need a paper trail. Suppose you're planning on claiming the credit for both current and prior tax years. The more information you can provide that shows practical usage for both past and present claims, the more proof you have that you meet the qualifications.

Some things to keep in mind:

- ✓ The documentation should be from the time the R&D was done
- ✓ It should prove that the work occurred in the fiscal year you are claiming
- ✓ It should highlight the technical challenges to substantiate the R&D that was done and who was involved

Some examples of what you can provide are:

- |                       |                                  |
|-----------------------|----------------------------------|
| ✓ Project notes       | ✓ Whiteboard or product roadmaps |
| ✓ Project lists       | ✓ Timesheets for technical staff |
| ✓ Technical documents | ✓ Invoices/receipts              |
| ✓ Emails              | ✓ Development/engineering notes  |

Anything not listed but you think shows an investment toward R&D, it can't hurt to include. This documentation, coupled with credible employee testimony, is a good bedrock for proving that you qualify for this incentive and will be great to have if the IRS should ever decide to audit your R&D claim.

# HOW IS IT CALCULATED?

Estimating your R&D tax credit is not always straightforward and can get a little technical (which is why we recommend having a professional do it).



There are two methods to choose from—the Regular Research Credit or the Alternative Simplified Credit method.

Form 6765 outlines a series of steps to calculate your tax credits using either method. You can work out your credits using both and then apply the one that gives you a better result.

The **Regular Research Credit** is 20 percent of all qualifying expenditures for the current year that exceed a given base amount. This base amount may involve complex and detailed calculations, depending on whether you're a start-up or well-established business.

The **Alternative Simplified Credit** is typically 14 percent of the difference between the amount of qualifying expenditures for the current year, and 50 percent of the average qualifying expenditure for the preceding three years.

You have the option of taking a reduced credit irrespective of the method you choose. This lowers your R&D tax credits but saves you from having to make an unfavorable adjustment to your taxable income. It may also simplify the preparation of state tax returns as well.

# WHAT EXPENSES CAN MY BUSINESS CLAIM?



There are four buckets of expenses you can pull from when calculating your R&D credit savings. These include:

1

W-2 Wages for any employee involved in R&D activities based in the U.S. – including supervision, support, or doing the actual work

2

Contractors who are U.S.-based, which are performing the company's technical work. NOTE: This provision doesn't include overseas workers, and these credits are only applicable for workers within the country.

3

Materials used for prototyping and development throughout the process of working on your product or service

4

For SaaS companies - cloud costs for your pre-production and staging environment (think Google cloud, AWS, Heroku, etc.)

# WHAT'S THE STARTUP PROVISION?



A secret weapon for startups.

Suppose you're a startup or small business. In that case, you qualify for up to \$1.25 million (or \$250,000 each year for up to five years) of the federal R&D tax credit, which will offset the [Federal Insurance Contributions Act \(FICA\)](#) portion of your payroll taxes.

**To be eligible, you need to prove two things:**

- ✓ You have less than \$5 million in gross receipts
- ✓ No more than five years of gross receipts

When this provision was introduced, it changed the game for startups. Now, companies who may be pre-revenue can more immediately benefit from the R&D credit.

**One caveat:** If you're electing for the payroll offset, the R&D credits can only be taken on your timely filed return. As such, you want to include it within your regular or extension filed tax return.

# WHAT CAN I EXPECT BACK?



As a general rule of thumb, you can earn up to 10% back of what you've spent on product development.

Say for example, your company paid \$500,000 in W-2 salaries to software engineers in 2021. Through the R&D study process, you can expect up to \$50,000 in relief against your federal tax liabilities. If you spent \$1,000,000 in W-2 salaries, you can expect up to \$100,000 back, and so on.

Sometimes, however, this can vary based on the type of research activity and whether you do the work in house, or contract it out, as 1099 contractors hold a little less weight in the calculation than that of a wage earner.

Let's say you do qualify as a startup. Using the same example above, your \$500k in W-2 salaries would mean you owe \$31,000 in FICA (payroll) taxes annually. That \$50k credit can wipe out that liability completely in 2022!

Plus, any unused credits carry up to 20 years, which companies in the know use to factor in how they plan for the long term!

# WHAT ABOUT GETTING AUDITED?

The IRS won't audit you just because you took the Research and Development Tax Credit, but there are still random audits of all tax returns.

Keep in mind that the R&D Tax Credit is not a loophole, and the rules for what you can and can't claim are clear in most cases.

As long as you work with an R&D tax specialist to determine your eligible expenses and properly document them, you have nothing to worry about!



# WRAPPING UP



**Let's recap some of the things we've covered in this ebook:**

- ☒ If your company is developing new products or technologies here in the US, chances are you're a good fit for the R&D credit.
- ☒ Because these savings are a windfall of money for businesses, the R&D credit can help fund innovations, hire new workers, and help your company do its best work.
- ☒ You don't have to be profitable to benefit from the R&D credit.
- ☒ The more information you can provide that shows practical usage for both past and present claims, the more proof you have that you meet the qualifications of the R&D credit.



Don't miss the opportunity to transform your business, whether big or small. This credit can be a lifesaver if you're creating new things or improving upon old processes.

And if you've never claimed the R&D credit, you can retroactively claim the credits (on an amended return) from the last three years!

What's crazy is most startups don't know they're eligible to get these credits – and it doesn't matter if you're in the market making money or still in the lab fine-tuning. The Government has built-in programs to see businesses around the country innovate to keep our business sector competitive for decades to come.

Calculating the R&D credit can get a bit technical. As such it's wise to work with a team of knowledgeable professionals (like us) to navigate these waters. The tax credit has expanded over the years, but there are also other possible red tape scenarios.

If you're interested in learning more about the R&D Tax Credit, TaxTaker is ready to help. We've got years of experience in this field and help you assess if you're eligible to access these funds, which could make a difference in not only what you're developing, but also your bottom line.

Full stop.

**WANT TO SPEAK WITH AN EXPERT ABOUT THIS?**

**BOOK A CALL WITH A  
TAXTAKER TEAM MEMBER .**

**[BOOK HERE](#)**