



# A Guide to the R&D Tax Credit for Small Businesses

**Have you ever been stumped by the tax code? You're not alone! In this guide, indinero decodes the R&D tax credit for startup founders and small business owners to identify, qualify, calculate, and document your innovation credit.**



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# A Brief History of the R&D Tax Credit

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Many founders and owners of small businesses don't even think about the R&D tax credit for one good reason: it favored profitable companies. Here's a little historical context.

The Research and Experimentation Tax Credit (aka the innovation credit or R&D tax credit) was established in 1981 by I.R.C. § 41 to incentivize profitable U.S. businesses engaged in technological advances. Since then, the R&D tax credit has become more attractive if you know how to calculate, substantiate, and use it.



**Understanding the R&D Tax Credit can save your company 10% of the expenses on experimental research and development activities to benefit your business in the credit year and years to come.**

The R&D tax credit used to be renewed by Congress every few years. In 2015, the Protecting Americans from Tax Hikes Act (PATH Act) made the credit permanent, opened it to qualified small businesses, and permitted the tax credit to offset a C corporation's alternative minimum tax (AMT).

In 2017, the Tax Cuts and Jobs Act (TCJA) did not directly change the R&D tax credit. However, it lowered the corporate tax rate to 21% and effectively eliminated the AMT for C corporations, making the R&D credit more valuable. Additionally, the TCJA retained the payroll credit offset for qualified small businesses.

While economists debate the economic effect of the R&D tax credit program on the U.S. economy, public accounting firm [Ernst & Young](#) found 17,700 corporations claimed \$6.6 billion in [R&D Tax Credits](#) on their 2005 tax returns. Of those entities, 71.2% had a Standard Industrial Classification in some type of Manufacturing, and the remaining 28.8% included Services, Information, and Agriculture. The R&D tax credit is for those who invest in their hunches.

Understanding the R&D tax credit can save your company 10% of the expenses on experimental research and development activities, benefit your business in the credit year, and years to come.

# Four Reasons You Could Benefit from the R&D Tax Credit

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**Small businesses incurring significant expenses on qualified research can see enormous benefits from claiming this credit.**

**1**

Because the R&D tax credit is not a deduction but rather **a dollar-for-dollar credit against taxes owed**, there is a high potential to dramatically lower your effective tax rate for when you start making a [profit](#).

**2**

The tax credit **can carry forward 20 years**, so you have plenty of time to develop your product as you bring it to market.

**3**

The R&D tax credit program was **made permanent in December 2015** with the passage of the PATH Act and is a reliable strategy for your company's cash flow and taxes in the future.

**4**

The TCJA reduced the corporate tax rate from 35% to 21%, so it indirectly increased the value of the R&D tax credit; as there is a trade-off between expensing for research and development and the R&D tax credit.

In addition to taking the credit, you may also be able to deduct qualifying R&D expenses in the year incurred.

Timely filing of IRS [Form 6765](#) with your tax return will ensure that you can make use of the credit as soon as possible.

# The ‘Four-Part Test’ for the R&D Credit

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**Qualified Research Activities (QRA) can be those performed by you or someone else on your behalf. However, for the research expenses to count toward your tax credit, they must meet all four elements.**

## Specificity

**The research and development have to relate to a specific product or business component that you provide, rather than “general” research applicable to multiple areas of your business.**

For example, you can claim a credit for salaries paid to researchers investigating how to make a smaller and more efficient microchip for a smartphone (or a new process for making a microchip). You couldn't claim the salaries of marketing assistants who surveyed potential buyers for such a new smartphone.

## Experimental

**The research process must identify the uncertainty and establish and evaluate alternative resolutions. So, it doesn't count as experimental if you “know the answer to the problem” ahead of time.**

For example, an ice cream company that experiments with flavor combinations for summertime — while delicious — can't be claimed in the R&D tax credit.

## Discovery

**You're trying to eliminate the uncertainty associated with the development or improvement of your business's product.**

In other words, you need to claim that you're making real scientific advances in your field of business by doing this research.

## Technological

**Your experimentation must rely on principles of science or engineering.**

For example, you use hard science (i.e., architecture, biology, or computer science) rather than social science surveys or psychological experiments.

# What Kind of Research Doesn't Qualify?

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**Before you get excited about passing the Four-Part Test for your expenses to count toward your R&D credit calculation, a little more research is required.**

**The research credit generally doesn't apply to the following activities:**

- Research conducted **after commercial production** of the product begins
- Research adapting an existing product to **one particular customer's needs**
- **Duplication** of existing business components
- Reverse engineering
- Surveys, studies, activity relating to management function/ technique, market research, routine data collection, or routine testing/quality control
- Research relating to computer software that will **only be used internally\*** at your company
- Research conducted **outside the U.S.** and its territories
- Research in the social sciences, arts, or humanities
- Research funded by another person or entity (i.e., government, grant, or contract)



**Keep these in mind, but be sure to seek advice on any **gray areas** you come across before you file!**

*\*There are exceptions for using computer software in R&D meant to improve products, processes, and production for internal use if the activity passes a 7-part test.*

# Qualified Research Expenses You Can Claim

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**Wouldn't you agree that the tax code is not as easy to memorize as the Morse code? --- (That's "Yes" in Morse code).**

**We've broken down the basic categories of qualified research expenses (QRE) for you.**

## Wages

Wages paid to or incurred by W2 employees. This expense may or may not include payments made related to the exercise of [stock options](#).

**Section 41(b)(2)(B) identifies three types of qualified services:**

- Engaging in qualified research
- Directly supervising qualified research
- Directly supporting qualified research.

## Contract Research

A portion — 65% — of the total contract fee is a QRE if you are entitled to the results, financially obligated regardless of the success of the research, and you signed the contract before the investigation began.

## Supplies

Supplies (non-depreciable, tangible property) that you acquire to perform qualified services. For example, raw materials used in a prototype would qualify, but the facility, the machinery, or the electric bill that kept the lights on and equipment going would not be QREs. Another example, the percentage of your web service subscription used toward R&D could qualify if you can document it.

**The following are NOT QRE supplies:**

- Travel, meals, or entertainment
- Telecommunications expenses of researchers
- Relocation or rental/lease expenses
- Professional dues or royalty/license expenses

# How to Calculate Your Credit

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**The R&D tax credit is referred to as a single credit, but it breaks down into four parts.**

**Regular Research Credit (RRC)**

20% of current year QRE over a base amount

**OR**

**Start-up Credit**

Using a fixed base percentage calculator for companies incorporated after December 31, 1983, or had fewer than three years with QRE and revenue between January 1, 1984, and December 31, 1988

**OR**

**Alternative Simplified Credit (ASC)**

Equals 14% of the QREs for the taxable year that exceeds 50% of the average QREs for the three taxable years preceding the credit year

**Plus either or both of:**

**Basic Research Credit  
Credit for Energy Research**

## Things to keep in mind when calculating the credit

In any given year, you can claim either the regular or alternative simplified credit along with both of the others.

The RRC and the ASC are ultimately two different calculation methods for the same credit. Both are structured to be worth a portion of QREs beyond a base amount. The method for calculating your base amount varies depending on whether you are a startup or an established entity with historic gross receipts.

The credit's structure aims to incentivize additional research beyond what companies would typically conduct, rather than subsidizing already-planned research activities.

**The ASC is usually more generous than the regular credit, particularly if an entity has:**

- A base amount that is large under the regular research credit.
- Incomplete records of determining its base amount.
- Gross receipts that have grown significantly in recent years.
- A complicated history (e.g., one that includes mergers and acquisitions).

# Documentation is a Decoder

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**The IRS wants your R&D activities clearly and reasonably documented. No secret codes, please!**

**Here are the types of documentation that you should use to support your tax credit claim:**

- 1. Materials explaining research activities**, including brochures, pamphlets, press releases, and similar documents
- 2. Submissions to management**, the board of directors, review committees, or other similar groups regarding research projects, activities, expenditures, and the R&D credit
- 3. Documents prepared by an internal audit team**, including quarterly and annual reports that refer in any manner to experimental activities
- 4. Minutes, notes, or other similar recordings from the budget**, board of directors, managerial, or other similar meetings concerning QRE activities
- 5. Project authorizations**, budgets, or work orders that initiates a research project, as well as the internal authorization policies for approving a research project
- 6. Project summaries**, progress reports, and project meeting minutes
- 7. Field and lab verification data**/summary data
- 8. Research credit studies** conducted by outside consultants
- 9. Papers, treatises, or other published documents** regarding the taxpayer's research
- 10. Complete copies of contracts** (including all modifications), letter agreements, memoranda of understanding, or similar documents for analysis performed by, or on behalf of, a third party



**Timekeeping or time-tracking software is not necessary to compliance but helpful!**



# Maximize Your R&D Tax Credit with Indinero

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**The R&D tax credit can provide up to 10% of your annual R&D expenses as a credit. The credit carries forward for 20 years and offers cash as early as the first quarter after filing.**

Indinero offers the R&D Tax Credit Study to clients seeking to maximize their credit benefit and minimize the risk of evaluation or the claim being partially or fully disallowed.

**Depending on the size of your project and your business, the project can take three to six weeks to complete and will cost between 12–14% of your total credit.**

## Our Four-Step R&D Tax Credit Study Process:

1

### Consultation

Our R&D Audit expert will explain what is involved in the study and ask questions about your business model to understand the project scope.

2

### Engagement

You will receive an engagement letter from indinero outlining the project with a timeline.

3

### Data Collection

We interview your research lead for a high-level project understanding. We gather supporting data, including employee list, W2s and 1099s, supply costs with account numbers, general ledger, and previously IRS-substantiated R&D spreadsheet.

4

### IRS Narrative

Our expert creates a comprehensive IRS narrative summarizing your claim. We provide a spreadsheet detailing: regular research credit calculations (startup or standard) and alternative simplified credit (if applicable).



## About indinero

No matter the size of your business or the scope of your goals, indinero has the tools and expertise you need to eliminate financial errors, streamline operations, and grow.



# Talk to an Expert

For more information about the R&D tax credit, see our [blog](#).

To get started on your R&D tax credit before your income tax return is due, schedule a consultation below.

**Schedule consultation**



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