THE R&D TAX CREDIT FOR START-UP COMPANIES

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Tax advisors must carefully consider the rules when identifying start-ups that qualify and should be taking advantage of the R&D tax credit.

Start-up companies perform quite a bit of research, but to many it may seem as if start-up companies cannot qualify or benefit from the research tax credit (R&D tax credit). This is often not the case. In fact, there are rules that specifically allow many start-up companies to qualify for and benefit from the R&D tax credit. There are other rules that are not exclusively for start-up companies, but they affect start-up companies and their R&D tax credits. This article examines some of these rules, with the aim of helping tax advisors identify start-up companies that might qualify for and be able to benefit from the R&D tax credit.

The R&D tax credit

The R&D tax credit is best described as an employment tax credit. It essentially rewards taxpayers who are scientists, engineers, and others who earn income by performing qualified research in the U.S. It also rewards taxpayers who employ scientists, engineers, and others to perform qualified research in the U.S.

Section 41(d)(1) sets out a four-part test that defines what research activities qualify for the credit. These tests provide a broad definition of qualifying activities. Essentially, they say that activities qualify if they are in the hard sciences and are conducted in a scientific manner. Sections 41(d)(3), and (4) also include laundry lists of purposes and activities that are excluded; this is intended to limit the types of purposes and activities that qualify.

Only expenses associated with qualified research are included. These qualified research expenses (QREs) can include wages, contractor costs, and supply costs.[1] Wage QREs make up the lion's share of QREs for most taxpayers.[2] Only wages for qualified services are counted.[3] Qualified services include services that are used for engaging in qualified research or for directly supporting or supervising qualified research.[4] Payments made to others for research count as contractor QREs; they qualify if the payments would otherwise qualify as wage QREs if they were paid to the taxpayer's own employees rather than contractors.[5] Payments for tangible property to be used in the research can count as supply QREs. The Code also includes various exclusions, which limit the types of QREs that qualify. Most of these limitations are found in Section 174, which is incorporated into the R&D tax credit as one of the four tests taxpayers must satisfy to qualify for the credit.[6]

The QREs that survive this gauntlet of rules are summed up for the current tax year. These

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amounts, along with the taxpayer's average gross receipts for the prior three tax years, are compared to the taxpayer's same expenses and gross receipts for its base period tax years. The increase, i.e., the difference between the two tax year periods, is multiplied by 20% to compute the R&D tax credit.

What is a start-up company?

A start-up company is usually thought of as a company in its first few years of business. This is not necessarily the case for purposes of the R&D tax credit. For the R&D tax credit, the Code describes non-start-up companies or historic companies, and then says that all other taxpayers are start-up companies.[7] A non-start-up or historic company is one that had QREs and gross receipts (1) in a tax year that began on or before 12/31/83 and (2) during three of the four tax years beginning in 1/1/84 and ending 12/31/88.[8] Tax years in which gross receipts are $25,000 or less (not including investment income) are disregarded in determining the first tax year in which the taxpayer has QREs and gross receipts.[9]

Given these rules, a taxpayer can be in business for many years and still be a start-up company for purposes of the R&D tax credit. This article addresses these start-up company rules but focuses on start-up companies that are in their first few years of business, as the term is commonly understood.

General business tax credits limitation rules

The R&D tax credit is one of the general business tax credits set out in Section 38 that are collectively referred to as "general business tax credits." The general business tax credits limitation can prevent some start-up companies from benefiting from the R&D tax credit.

Section 38 limits the amount of general business tax credits a taxpayer can take in any one tax year. For corporations, this rule essentially limits the amount of the tax credit to the amount of the taxpayer's tax liability over $25,000.[10] For individual owners and shareholders of sole proprietorships and flow-through entities, this rule limits the amount of the R&D tax credit to the amount of tax attributable to the portion of taxable income from their interest in the business.[11] This prevents the owners and shareholders from using the R&D tax credit to offset their tax from their non-business income. It also generally prevents taxpayers with less than $25,000 of tax from taking the credit.

Thus, a start-up company and its owners and shareholders may not be able to get an immediate benefit from the R&D tax credit if the business has little or no income or current-year tax liability. The business or its owners and shareholders will have unused R&D tax credit carryforwards that can be taken in the future only if the business is profitable[12]—a time when they may have less of a financial need for an R&D tax credit. This can blunt the utility of the R&D tax credit for some start-up companies.

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Recognizing this issue, Congress amended the Code in 2008 to allow certain small businesses to accelerate unused R&D tax credits that are carried forward from pre-2006 tax years.[13] This change made pre-2006 R&D tax credits refundable. To qualify for the refundable tax credit, a start-up company would have to have placed certain depreciable equipment or property in a service that qualified for bonus depreciation, and booked its pre-2006 R&D tax credits by filing tax returns within the period for doing so.[14]This benefit was recently extended for equipment or property placed in service through 1/1/13.[15] This change can help some start-up companies free up unused R&D tax credit carryforwards. It also serves as a reminder to all taxpayers and their tax advisors to book R&D tax credits even if it does not appear that the taxpayer will be able to obtain an immediate benefit from them.

[1] Sections 41(b) and (d)(1). Computer rental costs can also qualify; however, they represent a very small portion of QREs taken by taxpayers.

[2] SOI Tax Stats—Corporation Research Credit, Figure C. Corporations Claiming a Credit for Increasing Research Activities, www.irs.gov/taxstats/article/0,,id=164402,00.html.

[3] Section 41(b)(2)(B).

[4] *Id*.

[5] See, e.g., FSA 2184, Vaughn # 2184, 9/17/97.

[6] Section 41(d)(1)(A).

[7] Section 41(c).

[8] Section 41(c)(3).

[9] Reg. 1.41-3(c)(2)(vi).

[10] Section 38(c).

[11] Section 41(g).

[12] Tax credit amounts that are not used in the current tax year are carried back one year, carried forward 20 years, and used on a first-in-first-out basis. Section 39(a) (1).

[13] Sections 168(k)(4).

[14] Sections 168(k)(4), 168(k)(4)(E)(iii). See also Rev. Proc. 2009-16, 2009-6 IRB 449

[15] Section 168(k)(2).

Fixed-base percentage rules

The fixed-base percentage rules can also present a number of difficulties for start-up companies. The fixed-base percentage is part of the computation that is used to measure the taxpayer's increase in spending. For older or historic companies, the fixed-base percentage is simply the product of the average of the taxpayer's gross receipts for the prior four tax years and the average of its QREs for the same years.[16] For start-up companies, the Code provides a set of mechanical rules for computing the fixed-base percentage.[17] These rules set the fixed-base percentage at 3% for the first five years and then a percentage of the gross receipts and QREs for later tax years.[18] The five-year period starts in the first year the taxpayer has both QREs and gross receipts, as previously described.

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As a practical matter, the taxpayer's R&D tax credit is typically larger to the extent that its fixed-base percentage is smaller. Even small changes to the fixed-base percentage can cause large changes in the amount of the R&D tax credit. The computation can produce counter-intuitive results; however, generally, a maximum fixed-base percentage of 16% will usually result in the taxpayer not being able to take a R&D tax credit, a fixed-base percentage of 1% or less will usually result in the taxpayer being able to take a R&D tax credit, and a 3% fixed-base can go either way. Thus, the statutory 3% fixed-base percentage can help some start-up companies qualify for the R&D tax credit.

However, many start-up companies find that they are not able to benefit from this somewhat low statutory fixed-base percentage. This is often due to the base amount limitation.[19] The base amount limitation limits the amount of the taxpayer's current tax year QREs that are counted, to the lesser of (1) the taxpayer's total QREs for the current year minus its base amount, or (2) one-half of the taxpayer's total QREs for the current year.[20] The first option is the normal method of computing the tax credit. The second option is the limitation. The research tax credit will almost always be larger under the first option rather than the second option.

Because the low statutory fixed-base percentage for start-up companies is only factored into option one and not option two, the base amount limitation usually forces start-up companies to compute their tax credits using the less advantageous second option. This negates the benefit of the statutory fixed-base percentage for many start-up companies, it can significantly reduce the amount of credit available to start-up companies, and it can even prevent start-up companies from being able to take a tax credit.

Contract expense rules

The contract expense rules can also pose problems for start-up companies. The Code includes a limitation that limits QREs for amounts paid to contractors to 65% of the amounts spent.[21] It does not contain a similar limitation for wage or supply QREs. This preference encourages taxpayers to use their in-house staff to perform research activities. This, of course, assumes the taxpayer has a choice between using its in-house staff or an outside researcher.

Start-up companies may not always have this choice. Many start-ups use independent contractors or temporary workers provided by staffing companies in lieu of employees. Start-up companies do this with the intent of hiring the contractors as employees once they are able to pay the workers a regular salary. Because the payments to these workers are contract QREs subject to the 65% limitation rather than wage

[16] Section 41(c)(3)(A).

[17] Section 41(c)(3)(B)(ii).

[18] *Id*.

[19] The base amount is the product of the fixed-base percentage and the average of the taxpayer's gross receipts for the prior four tax years. Section 41(c).

[20] *Id*.

[21] Section 41(b)(3)(A).

[22] Section 41(b)(1).

[23] Green, 83 TC 667 (1984), Snow, 416 U.S. 500, 33 AFTR 2d 74-1251 (1974). These cases overturned prior cases that said that taxpayers had to be engaged in a trade or business at the time the expenses were incurred in order for the expenses to be deductible under Section 174. These court cases address the distinction between the language used in Sections 162 and 174. The R&D tax credit statute uses the term "in carrying on any trade or business" as does Section 162, rather than the "in connection with" language of Section 174. The 162 language is not as broad as that in 174. Thus, this rule comes from the case law for Sections 162 and 174, rather than the law for the R&D tax credit itself.

[24] *Id*.

[25] Section 183.

[26] Section 41(b)(4).

[27] Section 41(b)(3)(B).

[28] Sun Microsystems, TCM 1995-69, *acq. in result*, 1998-1 CB 5. See also Apple Computer, Inc., 98 TC 232 (1992), *acq. in result* 1992-2 CB 1 (Income generated by an employee on the exercise of non-statutory stock options that did not have a reasonably ascertainable value at the time of grant were wages for purposes of the R&D tax credit, even though some of the qualified services are performed at times other than the periods in which the options are exercised).

[29] *Id*.

QREs that are not subject to the limitation, the rule can limit the amount of R&D tax credits available to start-up companies.

The Code also includes a trade or business limitation for contract expenses, which can limit the benefit start-up companies may realize from the R&D tax credit. This limitation says that only expenses paid or incurred in carrying on a trade or business of the taxpayer count as QREs.[22] This requires the taxpayer to currently have a trade or business.[23] Incurring expenses when one intends to enter into a trade or business in the future will not do.[24] Also, the trade or business must not merely be a hobby or not-for-profit activity.[25]

For the R&D tax credit, these general rules give way to a special rule that says that for all but contract QREs, the taxpayer only needs to pay or incur the expense at a time when it *intends* to enter into a trade or business in the future.[26] This rule helps start-up companies take the tax credit for wage and supply QREs, but it does not help them take contract QREs, such as payments made to independent contractors and temporary workers provided by employment staffing services. Given that many start-up companies rely heavily on contractors and temporary workers, this trade or business limitation can limit the amount of the R&D tax credit available to start-up companies.

Stock option QRE rules

Stock options can also be problematic for start-up companies. The general rule is that an expense is counted as a wage or contract QRE in the year in which the research activity is performed.[27] This rule is different for stock options.[28] Stock options are generally counted as wage or contract QREs in the year in which they are exercised, yet the qualification of the activity is measured in the year in which the options were awarded.[29] Many start-up companies that do not have immediate access to capital instead use stock options to compensate workers and to attract and retain skilled workers. In doing so, they defer counting the options as QREs for their R&D tax credits until the workers exercise the options. In some cases, this can be years or decades in the future. Otherwise, the options are never exercised, which happens if the company eventually ends up failing. Given that many start-up companies pay employees and contractors with stock options in lieu of actual wages, this delayed inclusion of stock options as QREs can significantly limit the benefit start-up companies realize from the R&D tax credit.

Business aggregation rules

The business aggregation rules can also present a number of challenges for start-up companies. For purposes of the R&D tax credit, "trades or businesses under common control" are aggregated and treated as one taxpayer.[30] This can include sole proprietorships, partnerships, trusts, estates, or corporations.[31] Whether trades or businesses are under common control is spelled out in Reg. 1.52-1(b)-(g).[32] This regulation includes rules for parent-subsidiary, brother-sister, and combined groups under common control. The Code and regulations include similar rules for corporations.[33]

These rules can produce some surprising results. For example, consider the case of a married couple living in a community property state. One spouse owns an existing car dealership; the other spouse forms a start-up company. Each spouse owns a 50% community property interest in each business. As a result, the two businesses are considered brother-sister trades or businesses under common control.[34] The start-up company would have to include the car dealership in computing its own R&D tax credit even though the companies do not file a combined tax return. If the car dealership does not have any QREs (such as wages paid to develop internal use computer software, etc.), the start-up company cannot allocate the R&D tax credit to the car dealership (nor can the credit be used on the owners' individual income tax returns to offset income from the car dealership).[35]

The start-up company would have to include the car dealership's gross receipts in computing its R&D tax credit. Depending on the amount of the gross receipts, this could result in the start-up company qualifying for the R&D tax credit when it would not otherwise qualify, it could increase the amount of the start-up company's R&D tax credit, or it could reduce or eliminate the start-up company's R&D tax credit. Also, it could even prevent the start-up

[30] Section 41(f)(1)(B), Reg. 1.41-6(a)(3)(ii).

[31] Reg. 1.41-6(a)(2).

[32] Reg. 1.41-6(a)(3)(ii).

[33] Sections 41(f)(5), 1563(a); Reg. 1.41-6(a). The Code says that 50% control is sufficient to trigger the aggregation rules for controlled groups of corporations.

[34] Reg. 1.52-1(d).

[35] Sections 41(f), (g).

company from qualifying as a start-up company for purposes of the R&D tax credit.

ASC base period limitation rules

The alternative simplified credit (ASC) provides a simplified method for computing the R&D tax credit.[36] It compares the taxpayer's QREs for its current tax year to its QREs for its prior three tax years.[37] Thus, the prior three years are the base period tax years—not the historic or start-up company base period tax years described above.

As with the regular method for computing the tax credit, the Code includes a base period limitation for the ASC.[38] It says that if the taxpayer does not have QREs for any one of the prior three tax years, its ASC is computed as 6% of its current tax year QREs.[39] This limits the amount of ASC available to start-up companies that have not been in existence for more than three tax years, given that the base amount limitation for the regular computation uses a 10% amount.[40]

Recordkeeping rules

The recordkeeping rules can also present challenges for start-up companies. While there are no specific recordkeeping requirements for the R&D tax credit, the general rule in Section 6001 applies.[41] It says that taxpayers are to keep records to substantiate their tax positions. The IRS has taken this to mean that taxpayers must create and keep contemporaneous documentation for individual research activities, business components, and QREs on a project-by-project basis.[42]

Start-up companies generally do not have the same need as older (usually larger) companies to create and maintain detailed business records. They usually do not have multiple layers of management. They do not need to create records to report to upper management. They do not need to record breakthroughs in their research efforts to show the CEO that their employees are doing satisfactory work. Their CEO will be aware of the breakthrough, and may have been the driving force behind the breakthrough. Start-up companies generally do not need to track employee activities in hourly increments to show the payroll department that people showed up to work and in fact worked. If individuals do not show up or work, everyone else in the business is readily aware of it. They will usually see it (or the absence of it) with their own eyes.

Yet the IRS expects to see detailed records when it examines R&D tax credits. The IRS's policy of not accepting anything other than project-based accounting records as evidence (such as demonstrations of new innovative products or processes and oral testimony) prevents many start-up companies from being able to benefit from the R&D tax credit and being denied credits that are examined on audit.[43] Start-up companies that do not have adequate records may have to defer taking the R&D tax credit and, even then, take an ASC in lieu of a regular research tax credit.

Conclusion

The R&D tax credit is a one-size-fits-all tax credit intended to reward all taxpayers who engage in qualified activities and who incur qualified expenses. There are several rules that affect start-up companies. These rules present opportunities for start-up companies. They can also prevent start-up companies from being able to benefit from the tax credit. Tax advisors must carefully consider these rules when identifying taxpayers who qualify and should be taking advantage of the R&D tax credit. ■

36 Section 41(c)(5).

37 *Id*.

38 Section 41(c)(5)(B).

39 *Id*.

40 The base amount limitation for the regular method of computing the credit uses 50% of the taxpayer's QREs, and then it multiplies that by 20%. This 50% multiplied by 20% is 10%.

41 Reg. 1.41-4(d).

42 See Mitchell, "The R&D Tax Credit: Accounting for Nexus," 12 J. Tax Prac. & Proc. 2 (April/May 2011) for an overview of the recordkeeping rules.

43 See Mitchell, "Section 41 Research and Experimentation Tax Credit Audit Considerations," 37 Colorado Law. 3 (March 2008) for an overview of the IRS audit process for R&D tax credits.