

Revisiting the Research Credit for Startups

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In this article, the authors examine the history of the research credit and its role in supporting startups, and they share practical considerations for planning and optimizing a claim.

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I. Introduction

Although economists have been concerned about a decline in business dynamism for decades, including small business activity in the United States, there has been recent optimism that this trend may be changing. Entrepreneurship in the United States has surged since the COVID-19 pandemic, and new business applications averaged 430,000 per month in 2024 — a 50 percent increase compared with 2019.¹ While 25.7 percent of innovation-driven growth comes from new entrants,² it comes at a cost, since startups³ generally require a lot of experimentation to

perfect novel business ideas and often end in failure.⁴ To provide the cash flow needed to support experimentation in pursuit of innovation, startups should consider maximizing a valuable tax planning and investment recovery tool — the research credit.⁵

II. Background

As the recent advancement of technology has enabled greater access to information, the pace at which startups are expected to innovate, scale up, and mature has become increasingly quick. Brené Brown, an American research professor and bestselling author, has provided observations on this (and similar) phenomena:

In business today, the journey from innovation to commodity is so swift that successful individuals and organizations must be relentless. They must focus maniacally on invention — while outsourcing or automating much of the execution. This requires those with the ability and fortitude to experiment with novel combinations and to make the many mistakes that inevitably come with an inspiration-centered approach. Fortunately, despite what some might believe, all of us harbor this capacity to invent. Most inventions and breakthroughs come from reassembling existing ideas in new ways.⁶

Even though innovation can be achieved through limited investment, startups will

¹Treasury, "Small Business and Entrepreneurship in the Post-COVID Expansion" (Sept. 3, 2024).

²Ufuk Akcigit and William R. Kerr, "Growth Through Heterogeneous Innovations," 126(4) *J. Pol. Econ.* 1374, 1377 (Aug. 2018).

³Startups are discussed herein using the conventional definition of the term and the definition for purposes of computing the research credit, because these are not mutually exclusive.

⁴Federal Reserve Bank of Richmond, "Why Are Startups Important for the Economy?" Economic Brief No. 23-06 (Feb. 2023).

⁵Petr Marek, "What Small Businesses Need to Know About R&D Tax Credits," *Forbes*, Dec. 29, 2025.

⁶Brown, *Strong Ground: The Lessons of Daring Leadership, the Tenacity of Paradox, and the Wisdom of the Human Spirit*, at 321-322 (2025).

eventually need capital to hire employees, since most projects are too labor-intensive to be handled solely by founders.⁷ Further, while funding may come in several forms, it can still be challenging, particularly during periods of economic uncertainty and downturn. It was this kind of economic environment that prompted the government to create the research credit through the Economic Recovery Tax Act of 1981, as former Sen. Max Baucus explained in 2011:

On the heels of the 1982 recession, a divided Congress passed the first federal research and development tax credit to help stimulate economic growth. The United States became the world's leader in funding research. This ushered in years of innovation and investment in groundbreaking research. Since then, U.S. companies have changed the world with revolutionary inventions.⁸

The introduction of the credit came with questions about its effectiveness at encouraging investment in research and promoting economic growth. A 1984 paper published by the American Enterprise Institute estimated that:

In 1981 firms increased qualified R&D spending by 21.3 percent while decreasing nonqualified R&D spending by 4 percent. The difference is statistically significant, which indicates that some firms made substitutions in response to the credit. Although the numbers are much less dramatic, a similar pattern of responses occurred in 1982, leading [the author] to conjecture that this substitution may be a one-shot phenomenon.⁹

While skeptical of the effect of the research credit based on the limited amount of data available for 1981, Congress still acknowledged the need to encourage taxpayers to undertake and continue research efforts:

Congress concluded that a substantial tax credit for incremental research and experimental expenditures was needed to overcome the reluctance of many ongoing companies to bear the significant costs of staffing and supplies, and certain equipment expenses such as computer charges, which must be incurred to initiate or expand research programs in a trade or business. While such costs have characteristics of investment activity, the relationships between expenditures for research and subsequent earnings often are less directly identifiable, and *many businesses have been reluctant to allocate scarce investment funds for uncertain rewards*. The Congress believed that the provisions of the Act, which are designed to stimulate a higher rate of capital formation and increased productivity, appropriately include incentives for greater private activity in research by operating businesses.¹⁰ [Emphasis added.]

Congress also implemented safeguards to prevent taxpayers from abusing the research credit:

To prevent the utilization of the research tax credit for tax shelter purposes, the credit allowable to individuals may only offset tax attributable to the income from the trade or business with respect to which the research and experimental wage expenditure was incurred.¹¹

The research credit was originally set to expire on December 31, 1985. Congress tried to make it permanent but faced challenges in achieving this result:

The original justification for making the R&E tax credit temporary was to allow Congress to review the performance of the law before making a decision over its permanence, although the actual reason for avoiding this decision appears to be

⁷ Abdo Riani, "The Biggest Challenges Faced by Startups," *Forbes*, Nov. 18, 2021.

⁸ Senate Finance Committee, "Hearing Statement of Senator Max Baucus (D-Mont.) Regarding Tax Reform and Incentives for Innovation" (Sept. 20, 2011).

⁹ AEI, *The R&D Tax Credit: Issues in Tax Policy and Industrial Innovation* 11-12 (1984).

¹⁰ Joint Committee on Taxation, "General Explanation of the Economic Recovery Tax Act of 1981," JCS-71-81, at 120 (Dec. 29, 1981).

¹¹ Senate Finance Committee, "Summary of the Economic Recovery Tax Act of 1981," at 15 (June 25, 1981).

primarily a matter of Congress' budget scoring process — a permanent credit entails scoring a permanent revenue cost, while the cost of a temporary credit needs to be scored only for the period of extension.¹²

To provide adequate time for evaluating and reviewing the research credit, Congress passed the Tax Reform Act of 1986, which included a provision that:

- extended the credit through December 31, 1988;
- modified the computation of the base period qualified research expenditures (QREs); and
- restricted the definition of qualified research by introducing a four-part test and specific exclusions.

In response to a December 1987 request from then-Rep. Brian J. Donnelly, D-Mass., and a mandate in the Technical and Miscellaneous Revenue Act of 1988, which extended the research credit through December 31, 1989, the General Accounting Office (now the Government Accountability Office) released a report on the operation of the research credit, its effectiveness, and suggested alternatives to the credit's structure.¹³ The report said existing congressional and administration proposals would permit startup companies to earn research credits by allowing their research expenditures to qualify for the credit if they intended to use the research results in the active conduct of a future trade or business.

In support of these proposals, the Small Business Administration reported that small firms¹⁴ created more than 20 times more innovations per dollar of credit than larger firms.¹⁵ The GAO concluded that extending the research

credit to startup companies would be reasonable and that:

This finding reflects, at least in part, the fact that small firms have done a large amount of research that has not been rewarded by credits. . . . There is no evidence to suggest that the research spending of start-up companies is any less deserving of the credit than is the spending of established firms.¹⁶

While the design of the research credit evolved during the early years of its existence, its fundamental components remained consistent with its initial design:

Congress always has maintained an incremental tax credit structure because it has sought to encourage firms to increase their R&D spending beyond the level that they would do in the absence of any tax incentive. By setting a base period and rewarding only spending beyond that level, Congress can, in principle, avoid providing a tax subsidy for activity that would have taken place regardless.¹⁷

The Omnibus Budget Reconciliation Act of 1989 provided one of the most significant changes to computing the research credit by redesigning the base amount that taxpayers must exceed to generate a research credit:

Initially, tax credit rules compared current year R&E spending with the level spent in the previous three years. This criterion was widely criticized because the more a firm spent on R&E in any given year, the harder it became to receive the credit in subsequent years. Consequently, in 1989 Congress changed the base comparison from the previous three years to a fixed period of taxable years during 1984-1988 (with an exception for start-up firms). Although this amendment has been considered an improvement by most observers, it is not without drawbacks.¹⁸

¹² Office of Technology Assessment, "The Effectiveness of Research and Experimentation Tax Credits," at 1 (Sept. 1995).

¹³ GAO, "Tax Policy and Administration: The Research Tax Credit Has Stimulated Some Additional Research Spending," GGD-89-114 (Sept. 5, 1989).

¹⁴ We should clarify that there are multiple sources in this article that refer to taxpayers as "firms."

¹⁵ See GAO, *supra* note 13, at 47. In particular, as the GAO report suggested, see the testimony on miscellaneous tax bills of Frank S. Swain, chief counsel for advocacy of the U.S. Small Business Administration, before the Senate Finance Committee's Subcommittee on Taxation and Debt Management (July 12, 1988).

¹⁶ See GAO, *supra* note 13.

¹⁷ See OTA, *supra* note 12, at 9.

¹⁸ *Id.* at 4, n.12.

The selection of a fixed set of years, such as 1984-88, undoubtedly is unfair to some firms and overgenerous to others, depending on the firm's R&D spending trajectory, its revenue growth trends, and its corresponding business cycle. One alternative is to allow firms to select their own base period, as start up firms can do to a certain extent under current provisions. However, arbitrary base periods would be very difficult to administer, and would likely encourage firms to select a particularly advantageous base period, which again would obscure any determination of a typical R&E spending pattern.¹⁹

In addition to establishing the term of the base period, the current law also caps the allowable ratio of R&E spending to gross receipts at 16 percent. . . . Unpublished Internal Revenue Service data indicate that the average base period percentage reported by firms on their 1992 tax returns was only 1.7 percent. The IRS notes that because the fixed base period is relatively far in the past — 1984-88 — the agency often runs into documentation problems when challenging individual firms' base period calculation.²⁰

Taxpayers still face the challenge of substantiating the fixed-base percentage when claiming the research credit using the regular method.²¹ They must perform an annual analysis to determine whether any consistency rule adjustments are necessary for acquisitions, dispositions, and certain costing method changes.²²

The Omnibus Budget Reconciliation Act of 1990²³ extended the research credit and made it available on more favorable terms to startups. This included allowing taxpayers to generate QREs related to potential future lines of business.

Although Congress extended the research credit through the Tax Extension Act of 1991, it faced challenges trying to extend the credit for a longer period. One inhibitor was the congressional budget's "pay as you go" rule, which required an estimate of the revenue cost (over the next 10 fiscal years) of lengthy or permanent extensions and how to offset this effect with tax increases or cuts to nondefense discretionary spending.²⁴

In addition to further extending the research credit, the Omnibus Budget Reconciliation Act of 1993 modified the fixed-base percentage rules for taxpayers that did not have QREs and gross receipts for three of the 1984-1988 tax years.

Over the two decades following 1981, Congress continued to temporarily extend the research credit while redesigning it in significant ways, as shown in Table 1.

Table 1. Research Credit Extensions and Changes

Bill Title	Effective for Tax Years Beginning After	Alternative Incremental Research Credit (AIRC)	Alternative Simplified Credit (ASC)
Small Business Job Protection Act of 1996	June 30, 1996	Created the AIRC method	N/A
Tax Relief and Health Care Act of 2006	December 31, 2006	Increased rates from 1.65%, 2.2%, and 2.75% to 3%, 4%, and 5%, respectively	Established the ASC method
Emergency Economic Stabilization Act of 2008	December 31, 2008	Eliminated the AIRC method	Increased the rate from 12% to 14%
Note: Because Congress eliminated the AIRC method for tax years beginning after December 31, 2008, the AIRC is only included for historical context, and related code sections and regulations will not be examined here.			

In the wake of the 2008 financial crisis and slow recovery during the Great Recession, there

¹⁹ *Id.*

²⁰ *Id.* at 10-11.

²¹ Section 41(c)(1)-(3) and (5)-(6).

²² Section 41(c)(5).

²³ This act included language that established the "pay as you go" process for discretionary spending and taxes.

²⁴ Jane G. Gravelle and Mark P. Keightley, "The Federal Research and Development (R&D) Tax Credit," Congressional Research Service Report 48848, at 20-21 (Feb. 6, 2026).

was concern about the number of U.S.-based startups and investment in research. In 2014 economists observed a steep decline in entrepreneurship and job creation in the life sciences industry, which is a major contributor to innovation in the United States.²⁵ Even more concerning was the broader trend emerging in the U.S. economy:

Alarmingly, recent research has also demonstrated that rates of entrepreneurship in America have fallen near a 40-year low, and that this decline is occurring in all 50 states, in all but a handful of 360 metro areas examined, and across a broad range of industry sectors, including high-technology.²⁶

Despite the value that the research credit created for the U.S. economy, it came with certain limitations. In particular, while the credit provided a benefit for established taxpayers that generated federal income tax liability, startups often did not enjoy the same immediate benefit:

Many taxpayers do not have current-year tax liability for which to take advantage of the credit immediately. In recent years, roughly half of the current-year credit for both corporate and individual taxpayers is not used in the current taxable year.²⁷

In addition to that drawback, members of Congress expressed frustration and concerns about the research credit not being permanent:

Year after year Congress scrambles at the last minute to retroactively extend tax provisions that families and businesses depend on each year. . . . This is not an effective way to implement tax policy and underscores the need to fix our broken tax system. . . . The R&D tax credit plays an important role in promoting greater investment in new technologies across many industries. . . . The permanency of

the R&D tax credit is critical in preserving our long-term global competitiveness.²⁸

Before the Protecting Americans From Tax Hikes (PATH) Act of 2015 became law on December 18, 2015, Congress temporarily extended the research credit 16 times — despite earlier efforts to make it permanent. The PATH Act:

- established the research credit as a permanent provision in the code;
- permitted qualified small businesses (QSBs)²⁹ to use the research credit to offset the employer portion of the Social Security payroll tax liability or the federal alternative minimum tax liability; and
- allowed taxpayers to make an alternative simplified credit (ASC) election on an amended return if they had not claimed the research credit for that year and the general three-year statute of limitations had not closed.

Taxpayers and other stakeholders hailed the passage of the PATH Act as a significant win for startups. Dean Zerbe, former senior counsel to the Senate Finance Committee, said:

Many of these provisions, especially those related to the R&D Tax Credit, will greatly aid small and medium businesses. . . .

Over the years, one of the oddities of the R&D Tax Credit has been that many of our nation's most innovative companies cannot benefit from the credit since they are just opening up their doors. . . . The new start-up provision finally addresses that issue.³⁰

Guidance regarding the definition of a QSB and the rules for making a payroll tax offset election was issued in Notice 2017-23, 2017-16 IRB 1100, which included procedural clarifications for

²⁵ James Pethokoukis, "Another Worrisome Sign That the Beating Heart of the US Economy Is Failing," AEI (June 11, 2014).

²⁶ Ian Hathaway and Robert E. Litan, "Declining Business Dynamism in the United States: A Look at States and Metros," The Brookings Institution (May 5, 2014).

²⁷ See Treasury Office of Tax Analysis, "Research and Experimentation (R&E) Credit," at 3 (Oct. 12, 2016).

²⁸ Rep. Brett Guthrie, R-Ky., release on voting to permanently extend key tax provisions and avoid government shutdown (Dec. 18, 2015).

²⁹ A QSB is a corporation or partnership with less than \$5 million in annual gross receipts, as defined by section 448(c)(3), that did not have gross receipts in any tax year preceding the fifth tax year (credit year). See section 41(h)(3).

³⁰ Alliantgroup release on Congress reaching a deal on tax extenders and making the R&D tax credit permanent (Dec. 17, 2015).

how to claim the research credit on an employment tax return.

The Inflation Reduction Act of 2022 enhanced the ability of taxpayers to benefit from the payroll tax offset. For tax years beginning after December 31, 2022, the IRS increased the maximum amount of research credit that could offset payroll tax liabilities from \$250,000 to \$500,000.

While the PATH Act allowed QSBs to offset against the 6.2 percent employer portion of the Social Security payroll tax, the IRS allowed taxpayers to use up to \$250,000 per credit year against the 1.45 percent employer portion of the Medicare payroll tax liability.³¹ The payroll tax credit is first used to reduce the employer share of Social Security tax up to \$250,000 per quarter, and any remaining amount reduces the employer share of Medicare tax for the quarter. Any unused credit carries forward into the subsequent quarter.³²

III. The Code and Regulations

Taxpayers, especially startups, face the challenge of analyzing and applying the research credit rules to their particular facts or risk not being able to successfully substantiate their research credit claims. This challenge is best summarized by a recent Congressional Research Service report:

It is generally recognized that complying with the regulations is difficult . . . especially [for] smaller firms, and that the regulations are costly for the IRS to administer. One study³³ found that the compliance costs of the credit reduce its utilization.³⁴

Further analysis demonstrates how the administration of the research credit can be a mitigating factor for startups claiming it:

The risk of IRS scrutiny not only discourages firms from claiming R&D tax

credits but also suppresses R&D investment more broadly — highlighting a potential social cost of tax enforcement. This is not to suggest that the IRS should scale back its oversight of the R&D credit, as doing so could lead to greater misuse of the credit. Instead, both survey responses [from 116 corporate executives] and archival data point to *the critical role of internal information quality* in successfully claiming R&D tax credits.³⁵ [Emphasis added.]

QREs must be paid or incurred by the taxpayer during the tax year in carrying on any trade or business. This includes in-house research expenses, such as wages and supplies, as well as contract research expenses.³⁶ But the regulations provide a clarification for new businesses:

Expenses paid or incurred prior to commencing a new business (as distinguished from expanding an existing business) may be paid or incurred in connection with a trade or business but are not paid or incurred in carrying on a trade or business. Thus, research expenses paid or incurred by a taxpayer in developing a product the sale of which would constitute a new trade or business for the taxpayer are not paid or incurred in carrying on a trade or business.³⁷

However, the trade or business requirement is disregarded for in-house research expenses of certain startups provided that, at the time the expenses are paid or incurred, the principal purpose of the taxpayer in making the expenditures was to use the results of the research in the active conduct of a future trade or business either of the taxpayer or of one or more other persons that are treated as a single taxpayer for purposes of computing the research credit.³⁸

Finally, for purposes of computing the research credit, taxpayers that are members of a

³¹ Pinky Shodhan et al., “The Research Credit: Payroll Tax Offset,” *J. Acct.* (Jan. 1, 2023).

³² See IRS, “Research Credit Against Payroll Tax for Small Businesses” (last updated Oct. 4, 2025).

³³ Mary Cowx, “Tax Enforcement and R&D Credits,” 80(1) *J. Acct. & Econ.* No. 101784 (Aug. 2025).

³⁴ See Gravelle and Keightley, *supra* note 24, at 17.

³⁵ Nathan Goldman, “Simplifying Tax Compliance Criteria May Increase Corporate Innovation,” *Forbes*, Apr. 22, 2025.

³⁶ Section 41(b)(1).

³⁷ Reg. section 1.41-2(a)(2).

³⁸ Section 41(b)(4).

controlled group of corporations³⁹ or a group under common control⁴⁰ are treated as though they are one taxpayer. Taxpayers that do not file a consolidated return must identify the designated member of the group (that is, the member allocated the greatest amount of the group credit based on the proportionate share of QREs).⁴¹ While an election by the designated member to adopt or revoke a credit computation method (that is, regular or ASC) is binding to the controlled group,⁴² the section 280C election can only be made at the filing entity level.

A. Regular Method

When claiming the research credit using the regular method, taxpayers must first determine whether they are a startup company, since this will dictate how they compute the base amount. The base amount is the product of the fixed-base percentage, not to exceed 16 percent, and the average annual gross receipts of the taxpayer for the four tax years preceding the credit year.⁴³ The two approaches for computing the fixed-base percentage are:

- **General:** The fixed-base percentage is the percentage that the aggregate QREs of the taxpayer — for tax years beginning after December 31, 1983, and before January 1, 1989 — make up of the aggregate gross receipts of the taxpayer for those tax years.⁴⁴
- **Startup:** The fixed-base percentage will be an exclusion to the general rule above, if:
 - the first tax year in which a taxpayer had both gross receipts and QREs begins after December 31, 1983; or
 - there are fewer than three tax years beginning after December 31, 1983, and before January 1, 1989, in which the taxpayer had both gross receipts and QREs.⁴⁵

Table 2 summarizes the steps for startup companies to compute the fixed-base percentage.⁴⁶

Table 2. Computing Fixed-Base Percentage

Tax Year	Fixed-Base Percentage Computation
1	3% statutory rate
2	3% statutory rate
3	3% statutory rate
4	3% statutory rate
5	3% statutory rate
6	$(\text{QRE}_{\text{S4-5}} / \text{GR}_{\text{S4-5}}) \times 1/6$
7	$(\text{QRE}_{\text{S5-6}} / \text{GR}_{\text{S5-6}}) \times 1/3$
8	$(\text{QRE}_{\text{S5-7}} / \text{GR}_{\text{S5-7}}) \times 1/2$
9	$(\text{QRE}_{\text{S5-8}} / \text{GR}_{\text{S5-8}}) \times 2/3$
10	$(\text{QRE}_{\text{S5-9}} / \text{GR}_{\text{S5-9}}) \times 5/6$
11 and later	QREs (selected from five of TY5-TY10)/GR (the same five tax years)

Note: QRE_{x-y} and GR_{x-y} denote the aggregate QREs and aggregate gross receipts, respectively, for the indicated range beginning with the first tax year after December 31, 1993, for which the taxpayer has QREs (that is, tax year 1).

When applying the fixed-base percentage against the average annual gross receipts to compute the base amount, taxpayers must consider that:

- if they had no prior tax years before the credit year, then the average annual gross receipts are zero; or
- if they had at least one prior tax year, but fewer than four, then the average annual gross receipts are computed using only the tax years in which the taxpayer existed.⁴⁷

The term gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (for example, revenues derived from the sale of inventory before reduction for cost of goods

³⁹ Section 41(f)(1)(A).

⁴⁰ Section 41(f)(1)(B).

⁴¹ Reg. section 1.41-6(c).

⁴² Reg. section 1.41-9(b)(4).

⁴³ Section 41(c)(1).

⁴⁴ Section 41(c)(3)(A).

⁴⁵ Section 41(c)(3)(B)(i).

⁴⁶ Section 41(c)(3)(B)(ii).

⁴⁷ Reg. section 1.41-3(a).

sold).⁴⁸ However, certain amounts are excluded from gross receipts,⁴⁹ such as:

- returns or allowances;
- receipts from the sale or exchange of capital assets; and
- amounts received by a taxpayer in a tax year that precedes the first tax year in which they derive more than \$25,000 in gross receipts other than investment income.

Further, in the case of a foreign corporation, gross receipts include only gross receipts that are effectively connected with the conduct of a trade or business in the United States, the Commonwealth of Puerto Rico, or other possessions of the United States.⁵⁰

While the base amount is prorated if the credit year is a short tax year, no adjustments will be made to account for a short tax year when computing the taxpayer's fixed-base percentage.⁵¹ Taxpayers must understand that in applying the consistency rule, QREs and gross receipts used to compute the fixed-base percentage and the base amount must be determined on a basis consistent with the definition of QREs and gross receipts for the credit year.⁵² Therefore, the onus is on the taxpayer to apply this rule with each subsequent research credit claim computed using the regular method.

B. ASC Method

For taxpayers computing the research credit using the ASC method that have no QREs in any of the three tax years preceding the credit year, the research credit is equal to 6 percent of the credit year QREs⁵³ rather than 14 percent of the credit year QREs above the base amount.⁵⁴ Similar to the regular method, taxpayers must determine QREs for the three tax years preceding the credit year on

a basis consistent with the definition of QREs for the credit year.⁵⁵ If the taxpayer has not previously claimed a research tax credit on its original return or an amended return for that tax year, and the statute of limitations has not closed,⁵⁶ it may make an ASC election on an amended return.⁵⁷

C. Payroll Tax Offset

For QSBs that intend to use the research credit against payroll tax liabilities, an election must be made on an originally filed return (including extensions) specifying the amount of the credit that will be used in this manner.⁵⁸ An important consideration is that, when evaluating the gross receipts rule in determining whether the definition of a QSB is met, the rule is also applied to an individual, but only considering the aggregate gross receipts received by that individual in carrying on all their trades or businesses.⁵⁹ While certain gross receipts are excluded from the computation of the research credit, these exceptions are not applicable to taxpayers claiming the payroll tax offset.

IV. Case Law

To clarify ambiguity in the code and regulations, including the subjective nature of the research credit rules, taxpayers should evaluate the practical application of their technical positions and the related IRS and judicial risk tolerance. This can be particularly important for startups because recent research suggests that greater IRS scrutiny is associated with smaller research credits on average.⁶⁰ Therefore, regardless of the taxpayer's size or amount of the research credits in question, taxpayers should focus on the evolving reasoning of the courts and recognize how these concepts could apply to startups.

⁴⁸ Reg. section 1.41-3(c)(1).

⁴⁹ Reg. section 1.41-3(c)(2).

⁵⁰ Section 41(c)(6) and reg. section 1.41-3(c)(3).

⁵¹ Section 41(c)(5)(B) and reg. section 1.41-3(b).

⁵² Section 41(c)(5)(A) and reg. section 1.41-3(d)(1).

⁵³ Section 41(c)(4)(B).

⁵⁴ Section 41(c)(4)(A).

⁵⁵ Reg. section 1.41-9(c)(2). While the regulations reference the applicability of the consistency rule under section 41(c)(6), the reference should be to section 41(c)(5).

⁵⁶ Section 6501(a).

⁵⁷ Reg. section 1.41-9(b)(2).

⁵⁸ Section 41(h)(4).

⁵⁹ Section 41(h)(3).

⁶⁰ Cowx, *supra* note 33.

A. *Research Inc.*

In *Research Inc.*,⁶¹ the taxpayer designed, manufactured, and sold control instrumentation and heating devices, operating through both a standard product line and customer-specific special systems projects that often required the design and construction of prototype systems to meet customer specifications. The company historically claimed the research credit only for QREs associated with its standard product line but later amended its 1985 tax return to claim additional QREs attributable to unique systems projects.

The government argued that by expanding the method for determining credit-year QREs, the taxpayer needed to recompute the base period QREs using that same method. The court disallowed the credit, not because the unique systems activities were inherently nonqualifying, but because the taxpayer could not reconstruct or substantiate the 1982-1984 base amounts attributable to the activities. With documentation destroyed or otherwise unavailable, the court ruled that there was no reliable evidentiary basis to quantify the incremental benefit.

From a startup perspective, *Research Inc.* illustrates the application of the consistency requirement. When a taxpayer initially limits its research credit claim to a narrower set of projects or expenditures before expanding the scope, it must reevaluate the base period QRE and the supporting documentation. In particular, the base period QREs must be determined on the same basis as the credit-year QRE, as if the taxpayer treated the expanded categories similarly during the base period. Taxpayers claiming the research credit using the regular method may have more inherent risk compared with the ASC method when evaluating consistency rule adjustments.

The ruling in *Research Inc.* also illustrates the importance of establishing and documenting research credit methods that can carry forward in subsequent tax years. To the extent that a startup goes through significant changes in its business, such as scaling up research and development activities, it is critical that taxpayers properly

analyze and retain documentation demonstrating the qualified activities they performed.

B. *Quebe*

*Quebe*⁶² involved an S corporation that owned and operated three separate electrical contractor companies: Chapel Electric (acquired in 2022), Romanoff Electric (acquired in 2002), and CRT Technologies (formed in 2003). The S corporation filed amended tax returns to claim research credits for the 2009 and 2010 tax years, which the sole owner, Dennis Quebe, received and claimed on his individual tax return.

Like *Research Inc.*, the dispute in this case did not hinge on whether the activities were qualified for the research credit; rather, the court examined the mechanics of the research credit computation and whether the taxpayer was eligible to compute its base amount using the startup rules under the regular method. For purposes of computing the research credit, the controlled group was treated as a single taxpayer, so the credit computation and base period mechanics were evaluated on a combined basis rather than entity-by-entity. Thus, when a taxpayer acquires a major portion of a trade or business, tax attributes such as QREs and gross receipts transfer to the acquiring taxpayer and must be considered when computing the research credit.

Although the taxpayer claimed the research credits using the startup rules, the government provided evidence that the taxpayer (through Chapel Electric) performed qualified research in the early 1980s and therefore would not be eligible to use the startup rules. A representative from the professional services firm that performed the research credit study on behalf of the taxpayer provided deposition testimony, but the court determined that the testimony was inadmissible hearsay because the representative did not have personal knowledge of the taxpayer, much less an understanding of the qualified research performed at Chapel Electric during the 1980s. The court granted summary judgment for the government and disallowed the research credit claims for the 2009 and 2010 tax years.

⁶¹ *Research Inc. v. United States*, No. 3-94-385 (D. Minn. 1995).

⁶² *United States v. Quebe*, No. 3:15-cv-00294 (S.D. Ohio 2019).

Quebe demonstrates how taxpayers bear the burden of proof to substantiate research credit claims, which includes retaining sufficient records related to credit year and base period activities of the taxpayer and acquired entities.

C. *George*

In *George*,⁶³ an S corporation served as the live-production arm of a broader, vertically integrated poultry enterprise. During the 2012-2014 tax years, the taxpayer oversaw front-end commercial broiler production while tracking large volumes of operational and cost data at the flock or customer contract level. This involved a multistep process that included egg incubation and hatchery operations through feed mills, grow-out on farms operated by independent growers under contract, flock health monitoring, and live hauls to the processing plant.

The taxpayer computed its research credits using the ASC method and filed amended returns to claim them, which flowed through to the shareholders. While the Tax Court determined that some of the projects were qualified based on contemporaneous documentation and credible testimony provided by the taxpayer, it rejected the base period QREs that the taxpayer retroactively estimated using a ratio of QREs to expenditures from the credit years. Further, the court determined that the general recollections and vague references in board minute notations did not provide sufficient evidence to substantiate the base period QREs or allow the court to estimate the QREs using the *Cohan*⁶⁴ rule.

While it appeared that the taxpayer likely performed qualified research during the base period, the Tax Court allowed the taxpayer to claim research credits under the ASC method as though there were no QREs during the 2009-2011 tax years. It could thus be interpreted that the Tax Court treated the startup rules for the ASC method⁶⁵ as a safe harbor by applying the reduced rate of 6 percent to the 2012-2014 QREs instead of disallowing the research credit. Although this resolution does not align with the intent of

Congress to provide the tax credit for incremental research activities and is a departure from the district court's decision in *Research Inc.*, it provided the taxpayer with a favorable result.

George emphasizes the importance of providing sufficient documentation to substantiate estimated QREs. This is particularly important for taxpayers in their initial years of research, which, in general, can be more challenging to determine and substantiate with each subsequent tax year that passes.

D. *Suder*

*Suder*⁶⁶ involved an S corporation that developed telephone systems for small and midsize businesses. The taxpayer claimed research credits of about \$500,000 per year for the 2004-2007 tax years, which passed through to two partners — Eric Suder, its founder⁶⁷ and CEO (owning 90 percent of the shares), and Douglas Boyd, its president and COO (owning 10 percent of the shares). The Tax Court noted the volume of information provided during the three-week special session in Dallas, which included 3,500 pages of testimony and more than 170,000 pages of exhibits.

Suder was deeply involved in product development, focusing on generating ideas for new products and ways to improve existing products. With 13 patent applications to his name, he was known to coworkers as the chief idea guy and the product visionary. Suder spent little time during the day on the general administrative tasks of running the business, which fell to Boyd, and focused on ideation and personally testing new and improved products.

The taxpayer determined that 75 percent of Suder's time was spent on performing qualified services, with the other 25 percent spent on running the business. These percentages were determined by Harvey Wende, who was the company's senior vice president of product operations from 2004 to 2006 and the senior vice president of product development during 2007.

⁶³ *George v. Commissioner*, T.C. Memo. 2026-10.

⁶⁴ *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

⁶⁵ Section 41(c)(4)(B)(ii).

⁶⁶ *Suder v. Commissioner*, T.C. Memo. 2014-201.

⁶⁷ Like the archetypical startup, Suder founded the business in his garage before hiring additional employees and moving into an office building a year or so later.

While the Tax Court determined through expert witness testimony that Suder's wages were excessive and reduced the amount of his wage QREs, the decision provides a clear example of how a founder and CEO can perform qualified services. However, taxpayers must be able to demonstrate the nexus of an individual to the qualified research activities and expenditures, particularly with contemporaneous documentation and reliable testimony, or risk having the related QREs disallowed.

V. Considerations

Method and election planning for research credit claims is a valuable tool for taxpayers, particularly for startups, based on the magnitude of the benefit to the business. As demonstrated by the case law above, taxpayers should also continuously evaluate how they are using contemporaneous documentation to support the underlying tax positions for their research credit claims. Finally, taxpayers may want to consider advocating for enhancements to the research credit either independently or through professional organizations.

A. Performing Method and Election Planning

The research credit is a general business credit,⁶⁸ which, for any tax year, will not exceed the excess of the taxpayer's net income over the greater of the tentative minimum tax or 25 percent of the taxpayer's net regular tax liability exceeding \$25,000.⁶⁹ Taxpayers with net operating losses should model the research credit to determine the optimal tax strategy. Also, taxpayers filing amended tax returns to claim a research credit that generates a refund will need to include additional information with the return.⁷⁰

A critical step in evaluating the research credit is determining whether the regular or ASC method is most advantageous for the taxpayer. While taxpayers should evaluate both methods for each tax year to determine their potential

benefits, they must also weigh the potential risks associated with each method. Based on its design, outside the first five tax years with QRE, the regular method carries more inherent risk because it requires more detail when computing and substantiating the base amount.

Once a taxpayer elects to use the regular method or ASC method for computing a research credit, the election carries forward to the next tax year until revoked by the taxpayer on a timely filed return. By default, taxpayers must use the regular method for computing the research credit until one of the following takes place on an originally filed return: (1) the taxpayer makes a protective ASC method election, or (2) the taxpayer claims the credit using the ASC method. Taxpayers that have not previously claimed the research credit can make the ASC method election on an amended return, provided that the three-year statute of limitations has not ended.

Historically, taxpayers have been required to "tax effect" their research credit by either adding back the amount of the gross research credit or making a section 280C election on the originally filed return and claiming the reduced credit. However, the Tax Cuts and Jobs Act only required taxpayers to tax effect the excess research credit above the section 174 amortization deduction for the 2022-2024 tax years. Taxpayers may have planning opportunities involving research credit claims and other elements because they must annually make the section 280C election on an originally filed return.

For example, QSBs electing to apply the research credit against their payroll tax liability, which can only be done on an originally filed return, may want to consider claiming the gross credit if the relevant maximum cap (that is, either \$250,000 or \$500,000, depending on the applicable tax year) is not met. While taxpayers must add back the gross research credit for federal income tax purposes, the larger credit will generate greater cash flow. Other service providers have emphasized the value and flexibility that startups have when using the research credit to offset payroll taxes:

It can be applied to taxes for all employees, not just technical staff. . . . Unused credits carry forward as you scale your team. . . . This isn't a benefit that kicks in when you

⁶⁸ Section 38(b)(4).

⁶⁹ Section 38(c)(1).

⁷⁰ See IRS, "Required Information for a Valid Research Credit Claim for Refund" (last updated Sept. 26, 2025). See also FAA 20214101F.

turn a profit. Your savings will start before then, when cash flow matters most. . . . It brings money in and extends the runway [founders are] working so hard to protect.⁷¹

Startups with a recent change in ownership structure should consider the following, or similar, questions when planning their research credit claim:

- Does the taxpayer still meet the definition of a startup?⁷²
- Is the taxpayer a QSB for purposes of making the payroll tax offset election?⁷³
- Does the computation of the research credit information include more than one tax accounting period?⁷⁴
- Was the research credit computed correctly and allocated to members of the controlled group or group under common control?⁷⁵

B. Using Contemporaneous Documentation

In the absence of project-tracking or similar systems that track details aligning with the provisions in section 41, taxpayers commonly apply the *Cohan* rule to estimate QRE. From an administrative perspective:

IRS recognizes that under the *Cohan* rule the courts may estimate the allowable amount of credit, but only if two conditions are met: (1) the taxpayer has demonstrated that it has engaged in qualified research but does not have sufficient records to document the amount of QREs and (2) there is sufficient credible evidence to provide a basis for making an estimate. . . . *The key issue is not the contemporaneity of the evidence, but its quality* (e.g., time survey estimates made by employees who actually performed or supervised the research, rather than estimates made by someone in the firm's

tax department who had no first-hand knowledge of the research).⁷⁶ [Emphasis added.]

An argument can be made that documents generated during research are less likely to contain inaccuracies and are potentially of higher quality. However, it is also important how the taxpayer uses the documentation to demonstrate sufficient credible evidence.

Startup taxpayers should consider the following questions to better evaluate how documentation can substantiate their research credit claims:

- What contemporaneous documentation exists that supports the QREs and, in the case of taxpayers using the regular method, gross receipts?
- How are the activities performed by founders, executives, and individuals above first-level managers documented contemporaneously with the research?
- What documents provide a roadmap to the research? This could include artifacts such as project charters, product development life cycle summaries, department overviews, and other documents that address the often iterative research activities.

C. Advocating for Research Credit Enhancements

Since the inception of the research credit, which a divided Congress approved, it has received significant support from both sides of the aisle. Members in the House and the Senate have recently introduced bills that would enhance the research credit, particularly for startups:

- **Fostering Innovation and Research to Strengthen Tomorrow Act.**⁷⁷ This bill would double the rate of the tax credit for increasing research expenses and the alternative simplified research tax credit. It would also increase the credit rate for taxpayers with no research expenses during a specified three-year period, and the

⁷¹ Andrew Brewster, "Extend Your Startup Runway With a Tax Credit That Nobody Talks About," Alvarez & Marsal (Feb. 26, 2026).

⁷² Section 41(c)(3)(B).

⁷³ Section 41(h).

⁷⁴ Reg. section 1.41-6(g).

⁷⁵ Section 41(f)(1)(A)-(B).

⁷⁶ GAO, "The Research Tax Credit's Design and Administration Can Be Improved," GAO-10-136, at 90 (Nov. 2009).

⁷⁷ H.R. 5056 was sponsored by Rep. Claudia Tenney, R-N.Y., and introduced on July 27, 2023.

amount of the credit that certain small businesses may apply against payroll tax liabilities.

- Research and Development Tax Credit Expansion Act of 2023.⁷⁸ This bill would modify the refundable research tax credit for new and small businesses to (1) provide for an inflation adjustment to the limit on credit refundability, (2) allow refundable amounts to cover all payroll taxes paid by those businesses, and (3) extend eligibility for the credit to small businesses with less than \$10 million (today, less than \$5 million) in gross receipts. The bill would also increase the rate of the alternative simplified tax credit for those businesses.
- American Innovation and Jobs Act.⁷⁹ This bill would increase the refundable cap from \$500,000 to \$750,000 over a 10-year period, expand eligibility for the credit to qualified small businesses with gross receipts below \$15 million, and extend the refundable credit period from five to eight years. The bill would also increase the credit rate for qualified small businesses using the ASC method from 14 percent to 20 percent, and the credit rate for those businesses with no QREs in each of the three prior tax years from 6 percent to 10 percent.
- Research and Development Tax Credit Expansion Act of 2025.⁸⁰ This bill included the same provisions as the Research and Development Tax Credit Expansion Act of 2023, mentioned above, and it would also increase the credit rate for qualified small businesses with no QREs in any of the three prior tax years from 6 percent to 20 percent.

From a global perspective, while approximately 55 percent of total support for business R&D in the OECD is through tax incentives,⁸¹ the United States has lagged behind other countries in recent years:

As recently as the mid-1990s, the United States maintained the most generous R&D tax incentive in the world. As scholarly studies have shown, that helped America stay ahead of its competitors by boosting R&D investment, innovation, jobs, and GDP growth. . . . Fast forward to today, and it's a very different picture. . . . Among the 30 OECD nations with more than 4 million people, plus the BRICs (Brazil, Russia, India and China), America's R&D tax credit support ranks just 24th in its generosity.⁸²

The CRS, which provides Congress with comprehensive and reliable legislative research and analysis, recently provided recommendations for enhancing the research credit:

The credit could be more generally available by (1) eliminating the general business credit limit, (2) expanding eligibility for the payroll tax offset to larger and older firms, or (3) making the credit fully refundable (i.e., allowing firms to receive a refund if their R&D credits exceeded their tax liabilities). These options are not mutually exclusive and could be enacted with other reforms aimed at simplifying or expanding the credit.⁸³

Other policy options include simplifying the credit by substituting a flat credit of approximately 8.2 percent for the current incremental credit, which would achieve the same incentive effect.⁸⁴ However, economists have indicated that increasing the credit rate is necessary to equate social and private returns. This ranges from a 14 percent flat rate, which could generate a 2:1 return, to a 26.6 percent flat rate, which could generate a 20:1 return.⁸⁵

Taxpayers and other stakeholders should continue providing Congress, Treasury, and

⁷⁸ H.R. 6685 was sponsored by Rep. Joe Neguse, D-Colo., and introduced on Dec. 7, 2023.

⁷⁹ S. 1639 was sponsored by Senate Finance Committee member Todd Young, R-Ind., and introduced on May 7, 2025.

⁸⁰ H.R. 4933 was sponsored by Neguse and introduced on Aug. 8, 2025.

⁸¹ OECD, "R&D Tax Incentives Continue to Outpace Other Forms of Government Support for R&D in Most Countries" (Apr. 22, 2025).

⁸² Robert D. Atkinson, "The Case for Improving America's Research and Experimentation Tax Credit," Information Technology & Innovation Foundation (May 28, 2021).

⁸³ See Gravelle and Keightley, *supra* note 24, at 16.

⁸⁴ *Id.* at summary.

⁸⁵ *Id.* at 11.

professional organizations⁸⁶ with feedback to better support startups and keep the United States competitive in the global economy through enhancing the research credit.

VI. Conclusion

Startups should stay up to date with developments involving the research credit and explore opportunities to claim additional qualified activities and expenditures. While access to information, technology solutions, and experienced research credit specialists is greater than ever before, professionals still view this as an underclaimed benefit.

It's estimated that more than 80 percent of start-ups and small and midsize businesses are either completely unaware they're eligible for government-sponsored tax credits or don't have an easy way to get them. But the fact is these credits can save

your company thousands of dollars every year.⁸⁷

While the research credit can provide cash-tax savings and improve valuation and investor narratives, it does not come without challenges. Taxpayers must evaluate the best approach for evaluating, documenting, and defending research credits that align with their particular facts and risk profile.⁸⁸ ■

⁸⁷ Ari Palmer, "R&D Tax Credits: America's Best Incentive Program for SMBs and Startups," Bloomberg Daily Tax Report, Apr. 30, 2021. While we are respectfully cautious of this estimate, we believe that it conveys the general message that the research credit is underclaimed by startups, including small and midsize taxpayers.

⁸⁸ The foregoing information is general in nature and is based on authorities that are subject to change. It is not, and should not be construed as, accounting, legal, tax, or professional advice provided by Grant Thornton Advisors LLC. This material may not be applicable to, or suitable for, the reader's specific circumstances or needs and may require consideration of tax and nontax factors not described herein. Contact your tax professional before taking any action based upon this information. Changes in tax laws or other factors could affect, on a prospective or retroactive basis, the information contained herein; Grant Thornton Advisors LLC assumes no obligation to inform the reader of any such changes. This article represents the authors' views only and does not necessarily represent the views or professional advice of Grant Thornton Advisors LLC. Grant Thornton Advisors LLC and its subsidiary entities are not licensed CPA firms.

⁸⁶ National Association of Manufacturers comment letter in response to IRS request for comment on Form 6765 related to the credit for increasing research activities (Mar. 17, 2026). This is a recent example of a comment letter that aggregated and anonymized member feedback and was submitted by a professional organization to the government.