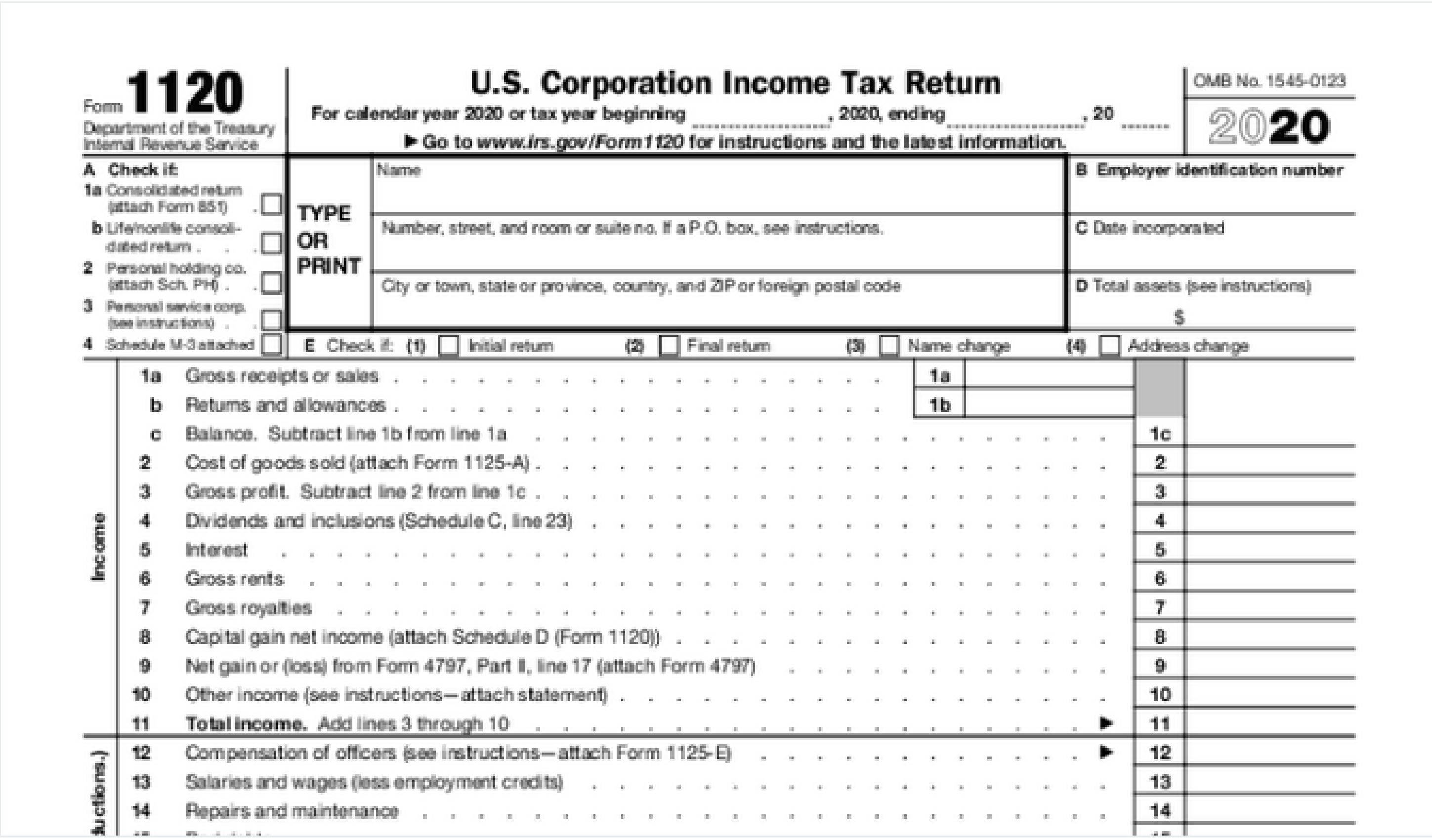
and development expenses ... pushing many money losing startups into owing taxes.

Vanessa Kruze • Nov. 18, 2022



Form **1120**
Department of the Treasury
Internal Revenue Service

U.S. Corporation Income Tax Return
For calendar year 2020 or tax year beginning ...., 2020, ending ...., 20 ......
► Go to *www.irs.gov/Form1120* for instructions and the latest information.

OMB No. 1545-0123
2020

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

TYPE OR PRINT
Name
Number, street, and room or suite no. If a P.O. box, see instructions.
City or town, state or province, country, and ZIP or foreign postal code

B Employer identification number
C Date incorporated
D Total assets (see instructions) $

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales	1a
	b	Returns and allowances	1b
	c	Balance. Subtract line 1b from line 1a	1c
	2	Cost of goods sold (attach Form 1125-A)	2
	3	Gross profit. Subtract line 2 from line 1c	3
	4	Dividends and inclusions (Schedule C, line 23)	4
	5	Interest	5
	6	Gross rents	6
	7	Gross royalties	7
	8	Capital gain net income (attach Schedule D (Form 1120))	8
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)	9
	10	Other income (see instructions—attach statement)	10
	11	**Total income.** Add lines 3 through 10 ►	11
Deductions	12	Compensation of officers (see instructions—attach Form 1125-E) ►	12
	13	Salaries and wages (less employment credits)	13
	14	Repairs and maintenance	14

A large number of unprofitable startups are going to have a surprise tax bill on April 18. A little discussed provision in the Tax Cuts and Jobs Act (TCJA) changes how tax law treats research and development expenses, dramatically reducing how cash expenses are accounted for – pushing many money losing startups into owing taxes. Ernst and Young estimates that this will reduce U.S.-based spending on R&D by $4.1 billion in the first few years.

Many VC backed startups will owe taxes – even

The TCJA forces companies to capitalize their R&D expenses, recognizing them over a 5-year schedule. The way the calculation will work is even more punitive in the first year, when only one-tenth of the first year's R&D will be counted. It's even worse for a company that does some innovation outside of the U.S., as the amount that can be recognized is even lower. Since many VC-backed startups invest heavily in R&D, many startups that are generating revenue will be caught in a situation where their cash expenses are meaningfully higher than their tax expenses.

Let's take a look at how this might impact a hypothetical startup aggressively investing in R&D. Imagine a startup generating $2 million in revenue, spending $500k on non-R&D expenses, and another $5 million on R&D expenses. This company is losing $3.5 million a year – a healthy burn rate for a VC backed company. Ordinarily they would not owe any taxes, since they have negative net income.

Of course, the TCJA changes that. In 2022, this hypothetical company would only be able to deduct one tenth of their $5 million in R&D expenses – that's only $500,000. That means that, for tax purposes, they will generate $1 million in pre-tax profit, and will end up owing over $200,000 in federal taxes. That's enough for them to hire one additional software engineer! Assuming the company's financials are stable the subsequent year (not a good assumption for a VC-backed startup, but good enough for this exercise), the startup deducts one fifth of their R&D expenses, $1 million, leaving them with $500,000 in taxable income and just over a $100,000 tax bill.

The most exposed category of startups to this change are largely software businesses ranging in size from 10 to 1,000 employees. With the recent slowdown in venture funding and the looming recessionary environment, these surprise tax bills could not be coming at a worse time. These types of startups tend to lead on many of the tech innovations in development right now, providing a disproportionate amount of the competitive advantage to the U.S. There are thousands of revenue-generating startups heavily investing in R&D in the U.S. who will now have to consider how

research. But the TCJA clearly moves against this incentive – Ernst and Young estimates that the TCJA will reduce employment in the US in R&D by over 23,000 per year.

Moreover, according to the Information Technology and Innovation Foundation (ITIF), the U.S. is now one of only a few countries that doesn't allow immediate expensing for R&D costs. As of 2020, the ITIF noted that tax support for research and development in the U.S. ranked 24th out of a comparison group of 34 countries in the Organization for Economic Cooperation and Development (OECD), along with China, Russia, India, and Brazil. The ITIF notes that this new R&D amortization rule (assuming that states follow the federal government's lead) will bring the US ranking down to 32 out of 34 countries.

There are currently Senate and House bills with significant bipartisan support that would eliminate the R&D amortization requirement. If Congress really wants to promote innovative research, canceling the R&D capitalization rule is a good first step.

====

Vanessa Kruze, CPA, is the founder and CEO Kruze Consulting, providing startup CFO consulting, including accounting, tax and HR services, to startups in San Francisco, Los Angeles, and New York City. Prior to establishing her firm in 2012, Vanessa began her career with Deloitte Tax and is a University of San Francisco alum.

Accounting • Income Tax • Taxes

(NASBA) as a sponsor of continuing professional education on the National Registry of CPE