With tax filing deadlines right around the corner, and with tax planning still on everyone’s mind, I thought now would be the perfect time to remind entrepreneurs and executives in the software and tech space of an opportunity that could be the difference in ensuring the future success of their businesses.

As any business owner will tell you, the most important aspect of keeping their company afloat is money—money to hire new employees, money to buy new equipment and money to get those fantastic ideas off the ground. It is also unfortunately what entrepreneurs lack when they first start out, and a key reason why 9 out of every 10 startups fail.

So, how can entrepreneurs (and for that matter, business owners of more established software and tech companies) find that added revenue that is the lifeblood of a successful business?

Well, a good place to start would be the Research and Development (R&D) Tax Credit, an opportunity that has become tailor made for the benefit of software and technology companies. Last December, along with making the credit permanent, Congress made two key modifications to the R&D Tax Credit that have removed many of the barriers that prevented tech companies from taking advantage of it.

But before we get into what’s new, let’s go over why the credit is so relevant to the industry in the first place:

Software and Tech Firms: The Ideal Candidates

First and foremost, the R&D Tax Credit is an activities-based credit, meaning that eligibility hinges on the types of projects and processes that a company completes. The credit was specifically designed to reward technical problem solving based on scientific principles. And, because this version of R&D tends to describe how employees at software and tech companies spend the majority of their day, you can see why the credit fits the industry so well.

Furthermore, those employees happen to be another key component in qualifying for the credit. In addition to being tied to activities, the R&D Tax Credit is also a wage-based credit. This means that the wages of employees working on software and technology development (i.e. each new version of a software product) tie directly to the final amount of tax savings your company receives. This is an important aspect in calculating the credit, as the higher wages of software developers, programmers and other relevant industry employees tend to drive higher credit results.

Why would Congress put a provision in the law to specifically help technology and software companies? Simply put, Congress realized that many of these technical jobs are being outsourced to other countries and they desperately want to keep these technical jobs here in the United States.

As it relates to the software and tech space, the key takeaway here is that the everyday design, implementation and testing that companies and their employees go through to develop a new product before launch are what make software and tech firms great candidates for the R&D Tax Credit.

Qualifying Activities

To break qualification down even further, for a particular project or activity to qualify for this lucrative credit, it must pass the following 4-part test:
1. The project must be related to developing a new product or process or improving upon an existing one (think version 1.0, 2.0, 3.0, etc.).

2. The work must be technical in nature. If you are performing traditional software and tech development activities (such as programming, coding and A/B testing just to name a few), you will likely fulfill this requirement.

3. During the course of the project, you must eliminate "technological uncertainty." In layman’s terms, your work should solve challenges or problems that came up during development, be they related to concept designs or the feasibility of the project itself.

4. The project development must follow a process of experimentation. If you are following some sort of development lifecycle, be it agile, waterfall or something in between, the answer to this question is most likely yes.

To get a better understanding of the kinds of projects that qualify, let’s take a real-world example.

An independent video game developer received over $780,000 in federal and state R&D tax credits for a host of qualifying projects. One of these projects involved the development of a mobile gaming application. Due to the limited data processing capabilities of mobile devices (the “technological uncertainty” in this particular case), the company researched and evaluated a number of different solutions to create a satisfying game play experience.

During the design/concept phase of the project, the company identified a platform for the game that would limit the amount of necessary processing. After encountering further challenges with respect to the ability to animate characters due to limited mobile processing constraints, the company experimented with ways to reduce animation requirements without diminishing the user experience. By identifying the most important animation effects, the video game developer ultimately released a game that satisfied all project requirements.

**Legislative Changes**

Now, to the news that should get software and tech companies very excited – the two key R&D Tax Credit modifications passed near the end of last year.

**The Startup Provision**

In the past, one of the real shortcomings of the R&D Tax Credit was that some of the most innovative and cutting-edge companies around were effectively barred from the credit on the grounds that they were new companies. As most entrepreneurs will attest, startup companies rarely turn a profit during their first few years of existence, meaning that they will thus not pay federal income taxes. Traditionally, the R&D credit was designed to lower income taxes, so if your company wasn’t making a profit, you were effectively barred from the credit.

Due to the recent passing of the startup provision, this changes starting in 2016. Now startups (defined as businesses with gross receipts of less than $5 million a year) can take the credit, capped at $250,000, against their 2017 payroll taxes. For executives of new software and technology firms, I don’t need to tell you how impactful those extra tax dollars can be—they could literally be the difference between another year of life and closing the doors on your company for good.

In addition to the direct startup provision, starting in 2016, small businesses (defined as businesses with less than $50 million in gross receipts) will now permanently be able to claim the credit against their alternative minimum tax (AMT). Without getting too involved in the intricacies of the tax code, the important takeaway here is that the AMT floor was the single greatest barrier preventing perfectly eligible companies from claiming the R&D Tax Credit, and its removal for qualifying businesses will greatly open the door to the number of software and tech companies that can claim the credit.

Combined together, these two changes have the ability to pump billions back into the software and technology sector, spurring growth in both innovative startups and more established companies. For newer firms looking to jump start their business or for those looking to accelerate their growth, it would be a good idea to start exploring the R&D Tax Credit this filing season.

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