The Contemporary Tax Journal

Volume 7
Issue 1 *The Contemporary Tax Journal Volume 7, No. 1 – Winter 2018* Article 6

2-1-2018

R&D Credit Against Payroll Tax Liabilities - The Payroll Tax Credit

Sarah Yaqin Sun
San Jose State University

Follow this and additional works at: http://scholarworks.sjsu.edu/sjsumstjournal

Part of the Taxation Commons, Taxation-Federal Commons, and the Tax Law Commons

Recommended Citation
Sun, Sarah Yaqin (2018) "R&D Credit Against Payroll Tax Liabilities - The Payroll Tax Credit," *The Contemporary Tax Journal*: Vol. 7 : Iss. 1 , Article 6.
Available at: http://scholarworks.sjsu.edu/sjsumstjournal/vol7/iss1/6

This Tax Enlightenment is brought to you for free and open access by the Graduate School of Business at SJSU ScholarWorks. It has been accepted for inclusion in The Contemporary Tax Journal by an authorized editor of SJSU ScholarWorks. For more information, please contact scholarworks@sjsu.edu.

R&D Credit Against Payroll Tax Liabilities - The Payroll Tax Credit

By: Sara Yaqin Sun, *MST student*

An Introduction to the R&D Credit

The Research & Development Tax Credit, or R&D Tax Credit, is a general business tax credit that enables companies to reduce their Federal tax liability based on the amount of eligible R&D costs for the year. The credit was initially introduced in 1981 as an incentive for economic growth and was later codified into Internal Revenue Code Section 41.
[1] The credit was made permanent by the *Protecting Americans from Tax Hikes Act* (the PATH Act) enacted as part of Pub. Law 114-113 in 2015, after going through a number of expirations and extensions over the years.[2]

Analysis of the R&D Credit Against FICA Tax (The Payroll Tax Credit Election)

The PATH Act contains significant changes to the use of R&D tax credit. Before the 2016 tax year businesses could only take the credit to offset their income tax liability. This old law was not fully effective in achieving its original intention to reduce burdens for small, startup businesses. Because most startup businesses accumulate NOLs during their research and development stage, many were not able to utilize the credits for many years, if at all, during the 20-year carryforward period. The new provisions allow *qualified small businesses* (QSBs) to make a Sec. 41(h) election to claim the R&D tax credit as a reduction against the Social Security portion of their FICA payroll tax liability ("payroll tax") under Sec. 3111(f).[3]

The Sec. 41(h) election, also referred to as the payroll tax credit election, allows certain small businesses that are entitled to the R&D credit to elect to use a portion of the credit to offset up to

[1] Legislative History of IRC §41 Credit for increasing research activities. Retrieved from: https://checkpoint.riag.com/app/find?begParm=y&appVer=17.09&dbName=TCODE&linkType=docloc&locId=41&ods=CODEHIST&permaId=idb0b54dd521ac7b7c66694228746e17e&permaType=doc&tagName=HIST&endParm=y
[2] 114th Congress (2015-2016). *Public Law No: 114-113: Protecting Americans from Tax Hike Act of 2015, Div. Q. 129*. Retrieved from: https://www.congress.gov/bill/114th-congress/house-bill/2029/text
[3]U.S. Congress Joint Committee on Taxation (JCT). 2015. *JCX-144-15: Technical Explanation Of The Protecting Americans From Tax Hikes Act Of 2015, House Amendment #2 To The Senate Amendment To H.R. 2029.*Retrieved from: https://www.jct.gov/publications.html?func=fileinfo&id=4861)

$250,000 of payroll taxes in tax years beginning after December 31, 2015. The election particularly helps QSBs in their early years during which they often do not yet generate sufficient taxable income to benefit from an income tax credit.

IRS Payroll Tax Credit Claiming Guidelines (Notice 2017-23)

The IRS released Notice 2017-23 to provide interim guidance with regard to the Sec. 41(h) payroll tax credit election. [4] The following aspects are covered in the guidance: definition of a qualified small business, determination of gross receipts, the aggregation rule, and the time and manner for making the election.

Qualified Small Businesses

A qualified small business (QSB) is a corporation (including S-corporation), partnership, or individual with less than $5 million of gross receipts in a taxable year after December 31, 2015.[5] The business must also not have any gross receipts for any taxable year preceding the five-year period ending with the taxable year.[6]

> Examples: Corporation A generated $3 million of gross receipts in 2016 and did not have any gross receipts prior to 2012. Corporation A is a QSB and is able to claim the credit on its 2016 tax return.

However, this inclusive definition has greatly limited the eligibility for businesses that have existed for more than five years. For instance, if Corporation A in the example above sold just one unit of a product for a profit, or had small amounts of investment income prior to 2012, either activity would disqualify Corporation A from being a QSB for the 2016 tax year. Furthermore, tax-exempt organizations cannot be considered QSBs.[7]

[4] Internal Revenue Service (2017*). Notice 2017-23: Interim Guidance and Request for Comments; Election by Qualified Small Business to Claim Payroll Tax Credit for Increasing Research Activities.* Retrieved from: https://www.irs.gov/pub/irs-drop/n-17-23.pdf. [Hereinafter: IRS Notice 2017-23].
[5] IRC §41(h)(3)(A)(i)(I)
[6] IRC §41(h)(3)(A)(i)(II)
[7] IRC §41(h)(3)(B)

The Gross Receipts Definition

Gross receipts, for purposes of the payroll tax election, are defined under section 448(c)(3). Basically, gross receipts include total sales net of returns and allowances and income received for services, passive income (such as investment or interest income), as well as proceeds from selling properties that are used in the trade or business.

The Aggregation Rule

For purposes of the gross receipts measurement, all members of a controlled group, including both domestic and foreign related parties, are treated as a single taxpayer. Therefore, gross receipts of all members of a controlled group must be aggregated when determining whether the gross receipts requirement is met.[8]

Example: Corp X has 100% ownership of domestic subsidiary Corp Y and foreign subsidiary Corp Z. In taxable year 2016, Corps X, Y, and Z generated $2.5 million, $1.5 million, and $2 million of gross receipts respectively. Corp X, Corp Y, and Corp Z are not qualified small businesses for the payroll tax election purpose for taxable year 2016 because the aggregate gross receipts of the three (as a controlled group) exceed $5 million.

Time and Manner of Election

A QSB can claim the payroll tax credit by making an election in section D of Form 6765 and reporting the credit amount on a timely filed federal tax return with a Form 6765 attached to it.[9] The payroll tax offset is available on a quarterly basis after the QSB makes the election, starting in the first quarter of 2017. The credit is reported and claimed on the QSB's quarterly Federal payroll tax return (Form 941).[10]

[8] IRC §41(h)(5)
[9] Internal Revenue Service (2017*). Form 6765, Credit for Increasing Research Activities.* Retrieved from: https://www.irs.gov/forms-pubs/about-form-6765-credit-for-increasing-research-activities. [Hereinafter: Form 6765].
[10] *See* IRS Notice 2017-23, Pg.12-13. *Supra note 6.*

Published by SJSU ScholarWorks, 2018

Example: Corp A filed its 2016 federal tax return Form 1120 on March 30, 2017 and attached a Form 6765 to the return to reflect the payroll tax credit election. It is eligible to claim the payroll tax credit on its quarterly payroll tax return (Form 941) for the second quarter, in July 2017.

If a QSB filed its original tax return reporting a R&D credit without electing the payroll tax credit for taxable year 2016, the IRS allows the filing of an amended return by the end of 2017 to elect the payroll tax credit.[11]

Credit Limitations and the Carryback/Carryforward Period

A QSB may claim the payroll tax credit for maximum five taxable years with the limitation of $250,000 each year, depending on the amount of its useable R&D credits and payroll tax liability.[12] Any amount not utilized in a taxable year follows the standard R&D credit carryback period (per the general business credit rules) of one year and carryforward period of 20 years.

Special Rules for Controlled Groups

Each member of a controlled group may separately elect to use the R&D credit against payroll tax at the entity level. The $250,000 amount is allocated to each member on a proportionate basis, and if a member does not make the election, its portion cannot be allocated to the other group members that made the election.[13]

Payroll Tax Credit Reporting Requirements

1) *Form 6765: Credit for Increasing Research Activities.*

   As mentioned previously, this form is used to make the payroll tax credit election, and it must be filed and attached to the timely-filed business income tax return (including extensions).[14] If

[11] IRC §41(h)(6)(C)
[12] IRC §41(h)(4)(b)
[13] Treas. Reg. § 1.41-6
[14] *See* IRS Form 6765. *Supra Note 12.*

an election is made for an amended return filed for 2016 tax year, a QSB must indicate on the top of Form 6765 or attach a statement to Form 6765 showing that the form is "FILED PURSUANT TO NOTICE 2017-23."[15]

2) *Form 8974: Qualified Small Business Payroll Tax Credit for Increasing Research Activities.*[16] The form is used to determine the amount of the payroll tax credit a QSB can claim on its Form 941, Employer's Quarterly Federal Tax Return. The quarter on the form must be the same as shown on the Form 941 to which it is attached.

Conclusion

It is extremely exciting news to the Bay Area's tech startups that the R&D credit was made permanent. Small businesses should take advantage in utilizing the credit against not only their income tax but also their AMT and payroll tax liabilities. However, even though startups might be able to use their accumulated R&D credits to offset up to $250,000 of their payroll taxes, very small amounts in gross receipts in prior tax years could potentially prohibit their eligibility. Taxpayers should pay close attention to the requirements of QSBs, especially the investment activities that may ultimately create passive income. In short, the payroll tax credit election is a great add-on to the R&D credit to help small businesses reduce their tax burdens, which also creates tax planning opportunities.

[15] *See* IRS Notice 2017-23, Pg. 9-10. *Supra note 6.*
[16] Internal Revenue Service (2017*). Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities.* Retrieved from: https://www.irs.gov/forms-pubs/about-form-8974