

Start-Ups and Small Businesses Shouldn't Overlook These R&D Tax Credits

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The 2015 Protecting Americans from Tax Hikes (“PATH”) Act included various changes to the Research and Development credit (“R&D credit”) that are mostly beneficial for start-ups and small businesses.

Payroll

PATH enables a qualified small business to elect to claim a certain amount of its R&D credit as a payroll tax credit against its employer portion of FICA liability, rather than against its income tax liability.

A qualified small business for this purpose is defined as a corporation, partnership, LLC or individual that, with respect to any taxable year:

- Has gross receipts of less than \$5M.
- Did not have gross receipts for *any* taxable year preceding the 5-tax-year period ending with the tax year.

In other words, in order for a company to qualify to utilize the payroll tax offset in 2017, the company must not have more than \$5M of gross receipts in 2016. It must also not have had *any* gross receipts in tax years prior to 2012. The definition of gross receipts is not clearly defined within the section, but many interpretations point to the following guidance: Gross receipts include all sales (net of returns and allowances), service income, interest, dividends, rents and royalties, and any income from incidental or outside sources.

The amount of the credit is limited to the lesser of \$250,000 per year or the amount of the R&D credit computed on the taxpayer’s income tax return. Any credit that exceeds the amount of the taxpayers FICA tax liability in a given quarter may be carried forward to future quarters.

Process for Claiming the Payroll Tax Offset

- Compute the R&D credit on the 2016 or subsequent income tax return on Form 6765.
- Complete Form 8974, which is a new form, to report the credits elected to offset FICA tax.
- File payroll Form 941 with Form 8974 attached for each quarter that there is an offset.

A taxpayer may only claim the election for 5 years for a maximum credit of \$1.25 million. Any election to apply the R&D credit to offset payroll tax cannot be revoked without the consent of the IRS.

These changes afford small businesses and start-ups an excellent opportunity to realize the tax benefit of their R&D credits, whereas in the past they may have had to wait years to reach profitability or even been precluded from using their credits due to various limitations.

During the current tax filing season, consideration should be given to the preparation of elections, calculation of the R&D credit and timely filing of the returns in order to enable taxpayers to obtain the largest possible benefit from the new PATH Act rules.

AMT

In the past, the R&D credit could not be used to offset Alternative Minimum Tax (“AMT”), with limited exception. The PATH Act provides the ability for certain taxpayers to utilize the credits to offset both regular or AMT for tax credits generated during tax years beginning on or after January 1, 2016. Credits generated in prior years typically will not be eligible to offset AMT, but can continue to be carried forward to offset future regular tax in accordance with previous tax law.

The AMT offset is available only to eligible small businesses. Eligible small businesses are those that are a:

- Corporation, the stock of which is not publicly traded
- Partnership
- Sole proprietorship

In addition, the average annual gross receipts of such corporation, partnership or sole proprietorship for the 3-taxable-year period preceding the taxable year must not exceed \$50 million. For example, if the business wishes to utilize the credit to offset AMT in 2016, its average annual gross receipts for tax years 2013, 2014 and 2015 must not exceed \$50 million. Any partner or S corporation shareholder claiming a pass-through credit must also meet the gross receipts test for its pass-through credit to be eligible to offset AMT.

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