R&D TAX CREDIT FAQS - SMALL BUSINESSES - PATH TO PAYROLL TAX CREDIT

April 2017

[redacted] has received a lot of questions related to the federal R&D tax credit and how it can benefit startups and small companies in particular. New legislation has greatly expanded these companies' potential R&D benefit, enabling them to offset, annually, up to $250,000 of their payroll taxes using R&D credits, up to $1,250,000 over a five-year period.

Common questions and answers are outlined below. If you have a question that isn't addressed, please let us know at [redacted].

- What activities qualify?
- What expenses qualify?
- What companies can benefit?
- Does a company have to be a "startup" or "small business" to be eligible for the payroll offset?
- Can companies formed more than five years ago benefit for the payroll offset?
- Are companies that use professional employer organizations (PEOs) eligible for the payroll offset?
- When do I claim the payroll tax offset?
- How do I claim the payroll tax offset?
- What does $5 million in "gross receipts" mean for the payroll offset?
- What if a company can't use the payroll offset this quarter?
- What if a company has a short taxable year in 2016 or another relevant year?
- Examples of the benefit
- What FICA taxes can be offset by the R&D credit?
- What are the risks of claiming the R&D tax credit?
- What documentation is needed to claim R&D tax credits?
- [redacted]

What activities qualify?

In general, activities qualify if they meet each element of a “four-part test” and aren’t excluded.

Four-part Test

1. *Qualified purpose.* The purpose of the activity is to improve the functionality, performance, reliability, or quality of a product, process, software, technique, invention or formula (“component”) that is intended to be used in the taxpayer’s business or held for sale, lease or license.
2. *Technological uncertainty.* The taxpayer encounters uncertainty regarding whether it can or how it should develop the component, or regarding the component’s appropriate design.
3. *Process of experimentation.* To eliminate the uncertainty, the activities include evaluating alternatives through modeling, simulation, systematic trial and error, or other methods.
4. *Technological in nature.* The success or failure of the evaluative process is determined by the principles of engineering, physics, chemistry, biology, computer science, or similar natural or “hard” science, as opposed to principles of, e.g., economics, consumer preferences.

Exclusions

Some activities are excluded because they aren’t likely to incentivize increased R&D in the U.S., e.g., activities:

- Conducted outside the U.S.
- Relying on the social sciences, arts or humanities, as opposed to, e.g., engineering or the physical, biological, or computer sciences.
- To collect routine data or ordinary testing for quality control of existing components.
- Market research; management, consumer preference testing.
- “Funded” by an unrelated third party, i.e., for which the taxpayer doesn’t either retain rights to the results of the activity or necessarily have to pay for the activity because an unrelated third party is contractually obligated to pay for it, even if the activity fails to produce the desired result.
- To develop or improve software originally intended primarily for the taxpayer’s use. Exceptions exist for this exclusion, and taxpayers have claimed and supported on exam hundreds of millions of dollars related to internal-use software development.

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What expenses qualify?

1. *Taxable wages* for employees who perform or directly supervise or support qualified activities.

2. *Cost of supplies* used in qualified activities, including extraordinary utilities, excluding capital items or general administrative supplies.
3. *65%-100% of contract research expenses* for qualified activities, provided the taxpayer retain substantial rights to the activity's results and must pay the contractor whether it succeeds or fails.
4. *Rental or lease costs of computers* used in qualified activities, e.g., payments to cloud service providers (CSPs) for the cost of renting server space to develop or improve a component.

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What companies can benefit?

In general, any company—in any industry and of any size—that invests in activities of the kind outlined above can benefit if it paid, pays or expects to pay:

1. Regular federal income tax;
2. A similar state tax in one of the more than 40 U.S. states that provide for incentives for R&D and R&D-related investments; or
3. Similar taxes in one of the more than 35 non-U.S. countries that, too, provide for such incentives.

Companies can benefit, too, even if they're not paying such taxes now:

1. The federal credit can be *carried back one year and forward 20*. Most states provide similar and sometimes indefinite carryforward periods.
2. Startups and smaller companies may use R&D credits against:
    - Up to $250,000 of their payroll taxes each year, provided they have:
        - Gross receipts less than $5 million in the taxable credit year;
        - No gross receipts for any taxable year preceding the 5-taxable year period ending with the taxable credit year; and
        - R&D credits that they can use in that year; or
    - Alternative Minimum Tax (AMT), provided they:
        - Are privately held;
        - Owe AMT in the current year; and
        - Have $50 million or less in average gross receipts for the preceding three tax years.
3. Many states also allow companies to *sell or transfer* their credits to other taxpayers.
4. Several states' credits are *refundable*, i.e., they are paid to taxpayers even if the taxpayers aren't currently paying taxes.

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Does a company have to be a “startup” or “small business” to be eligible for the payroll offset?

No. It just has to have:

1. Gross receipts less than $5 million in the taxable credit year;
2. No gross receipts for any taxable year preceding the 5-taxable year period ending with the taxable credit year; and
3. R&D credits it can use in that year.

So even companies that have been around for more than five years and have spent billions of dollars to try to develop or improve a component could be eligible; e.g., a significant percentage of life science companies with $0 gross receipts for long periods of time before their drug receives U.S. Food and Drug Administration approval.

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Can companies formed more than five years ago benefit for the payroll offset?

Yes. For the 2016 payroll offset, a company isn’t eligible if it generated gross receipts prior to 2012, because then it would have gross receipts in a taxable year preceding the 5-taxable year period ending with the taxable credit year, 2016. But a company formed prior to 2012 that didn’t receive gross receipts could qualify.

Although the law is intended to benefit small businesses, large businesses could also potentially benefit. For example, a significant percentage of life science companies have $0 gross receipts for long periods of time before their drug receives US Food and Drug Administration approval.

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Are companies that use professional employer organizations (PEOs) eligible for the payroll offset?

Yes.

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When do I claim the payroll tax offset?

The payroll tax offset is available on a quarterly basis beginning in the first calendar quarter that begins after a taxpayer files their federal income tax return.

For example, companies need to file their 2016 federal income tax returns by March 30, 2017, to apply the payroll tax offset to the second quarter. As a result, the earliest taxpayers are likely to see a benefit is July 2017, when they file their quarterly payroll tax returns for the second quarter (Form 941).

If you extend your return, you'll be able to take advantage of the offset in the quarter after you file your federal return: **file the return by June 30, 2017; take offset on the October 31, 2017 Form 941 filing; file return by September 30, 2017; and take offset on January 31 Form 941 filing.**

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How do I claim the payroll offset?

1. Identify and gather support for the credit to which you're legally entitled.
2. Report the credit on a timely-filed 2016 federal tax return and elect the payroll offset.If you filed a 2016 return reporting the R&D credit but not electing the payroll tax credit, you may make the election on an amended return filed on or before December 31, 2017. To qualify for this extension, your business must either (a) indicate on the top of your Form 6765 showing the payroll tax credit election that the form is "FILED PURSUANT TO NOTICE 2017-23" or (b) attach a statement to your Form 6765 showing the payroll tax credit election that the form is filed pursuant to Notice 2017-23.
3. Claim no more than $250,000 of the credit on your quarterly Form 941.

If you didn't claim the credit in 2016, you can still take advantage of the payroll offset for tax years 2017, 2018, 2019 and 2020. If you couldn't have used the credit in 2016, you may identify it and carry it back to 2015. If it could not have been used in 2015, you may carry it forward to 2017 or a future year in which you could use it, up to 20 years from the year in which the credit was generated.

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What does $5 million in "gross receipts" mean for the payroll offset?

There are three things to consider regarding gross receipts.

1. Businesses related or under common control must aggregate their gross receipts.
2. Gross receipts for any taxable year of less than 12 months must be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.
3. What should be included as “gross receipts”?
    - Current guidance from the IRS defines gross receipts for purposes of this provision as total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. As currently defined, a company that reported interest only on its tax return prior to 2012 would be precluded from taking the payroll tax offset.
    - The IRS has received several comment letters regarding this definition, which precludes several businesses from qualifying, even though the payroll offset was enacted primarily to benefit such companies. We are waiting on additional guidance from the IRS to see if this definition will be modified.

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What if a company can’t use the payroll offset this quarter?

If a company can’t use the credit to offset its payroll taxes this quarter, it may carry the credit forward to subsequent quarters in which it can use it, provided the $250,000 annual cap isn’t exceeded. Amounts over $250,000 can be carried forward for 20 years to offset future regular tax liability on the company’s tax return.

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What if a company has a short taxable year in 2016 or other relevant year?

For businesses with a short taxable year in 2016—e.g., businesses that started up in 2016—gross receipts must be annualized. This is true for all short taxable years that affect the determination of whether a company is eligible for the payroll offset. For more on the definition of “gross receipts,” please see this section.

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Examples of the benefit

Example 1. A company incurs $300,000 in eligible costs in an attempt to develop its flagship software product. The company was founded in 2012 and has generated no gross receipts to date. Eligible expenses generate a credit of approximately $30,000. Because the company meets the criteria, it can use $30,000 of credits to offset its FICA payroll tax on its quarterly Form 941 filings.

Example 2. A company incurs $2,500,000 in eligible costs related to developing a new medical device. The company was founded in 2008 and has generated no gross receipts, not even interest income, prior to 2014. For 2016 they generated $4,000,000 in gross receipts. Eligible expenses generate a credit of approximately $250,000. Because the company meets the criteria, it can use $250,000 in credits to offset its FICA payroll tax on its quarterly Form 941 filings.

Example 3. A company incurs $6,000,000 in eligible costs related to developing and improving its new line of consumer products. The company was founded in 2013 and has generated $500,000 in gross receipts each year to date. Eligible expenses generate a credit of approximately $600,000. Because the company meets the criteria, it can use $250,000 of these credits to offset FICA payroll tax on its quarterly Form 941 filings. The remaining $350,000 in credits will carryforward for 20 years to offset future regular tax liability on the company's tax return.

In each example, should the companies continue to meet the payroll offset criteria in future tax years, they can use up to $250,000 in credits each year for the next 5 years to offset their FICA payroll taxes, for **a potential of $1,250,000 in cash savings**.

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What FICA taxes can be offset by the R&D credit?

Up to $250,000 of the employer's Social Security portion (OASDI) of payroll taxes can be offset by R&D credits.

Companies are required to pay Social Security tax of 6.2 percent on up to $118,500 of each employee's salary in 2016. A company that employs 50 employees with an average salary of $95,000 per person would pay approximately $294,500 in Social Security payroll taxes in 2016. As such, a company would need to have more than $4 million in annual payroll subject to Social Security tax and $2.5 million in eligible R&D costs to offset the maximum $250,000 in payroll taxes each year under the new law.

Most employers are required to deposit their payroll taxes to the federal government on a monthly or semiweekly basis and file a quarterly payroll tax return (Form 941). The credit is applied against the Social Security tax on the quarterly return, or against amounts when the tax is deposited monthly or semiweekly.

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What are the risks of claiming the R&D credit?

1. *IRS exam.* Like any other tax position, it is possible that the IRS will examine an R&D credit position. *Original* tax returns that include R&D credit positions have not been more likely to be examined than those not that do not include R&D credit positions. Amended tax returns claiming R&D credits that are used in the years under examination have been more likely to be examined. If examined, R&D credits may be allowed or disallowed, in whole or in part. If credits are allowed, the IRS may consider the taxpayer's other tax positions to identify additional tax liability, but only to the extent of offsetting the credit. This has been uncommon.
2. *Disallowed credits.* It is possible the IRS would examine and disallow some or all the R&D credits. Credits that have been appropriately identified and supported are generally allowed. Credits that aren't often aren't.
3. *IRS penalty and interest.* If the IRS disallows a credit it may assess a penalty if it finds that the credit was either claimed through negligence or the disregard of rules or regulations, or results in a substantial understatement of income tax. Generally, this penalty equals 20 percent of the credit disallowed, i.e., of the tax the IRS believes was underpaid. The IRS may also assess interest due on that 20 percent from the date that the tax should have been paid, but this has not been our experience.

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What documentation is needed to claim R&D credits?

A taxpayer claiming an R&D credit must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit.

[redacted] can help determine whether and to what extent your records meet the standards IRS examiners typically apply and, if not, what other evidence you may be able to adduce to support your credits.

Although IRS agents are not required to follow them, the standards outlined in IRS audit techniques guides provide some signposts:

- *Audit Techniques Guide: Credit for Increasing Research Activities*;
- *Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities § 41*;
- *Audit Guidelines on the Application of the Process of Experimentation for All Software*;
- *Pharmaceutical Industry Research Credit Audit Guidelines*; and
- *Aerospace Industry Research Credit Audit Technique Guide*.

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