



Better tax break when applying the research credit against payroll taxes

The credit for increasing research activities, often referred to as the research and development (R&D) credit, is a valuable tax break available to certain eligible small businesses. Claiming the credit involves complex calculations, which we'll take care of for you.

But in addition to the credit itself, be aware that there are two additional features that are especially favorable to small businesses:

- Eligible small businesses (\$50 million or less in gross receipts for the three prior tax years) may claim the credit against alternative minimum tax (AMT) liability.
- The credit can be used by certain smaller startup businesses against their Social Security payroll and Medicare tax liability.

Let's take a look at the second feature. The Inflation Reduction Act (IRA) has doubled the amount of the payroll tax credit election for qualified businesses and made a change to the eligible types of payroll taxes it can be applied to, making it better than it was before the law changes kicked in.

Election basics

Subject to limits, your business can elect to apply all or some of any research tax credit that you earn against your payroll taxes instead of your income tax. This payroll tax election may influence you to undertake or increase your research activities. On the other hand, if you're engaged in — or are planning to undertake — research activities without regard to tax consequences, you could receive some tax relief.

Many new businesses, even if they have some cash flow, or even net positive cash flow and/or a book profit, pay no income taxes and won't for some time. Thus, there's no amount against which business credits, including the research credit, can be applied. On the other hand, any wage-paying business, even a new one, has payroll tax liabilities. Therefore, the payroll tax election is an opportunity to get immediate use out of the research credits that you earn. Because every dollar of credit-eligible expenditure can result in as much as a 10-cent tax credit, that's a big help in the start-up phase of a business — the time when help is most needed.

Eligible businesses

To qualify for the election a taxpayer must:

- Have gross receipts for the election year of less than \$5 million, and
- Be no more than five years past the period for which it had no receipts (the start-up period).

In making these determinations, the only gross receipts that an individual taxpayer considers are from the individual's businesses. An individual's salary, investment income or other income aren't taken into account. Also, note that an entity or individual can't make the election for more than six years in a row.

Limits on the election

The research credit for which the taxpayer makes the payroll tax election can be applied against the employer portion of Social Security and Medicare. It can't be used to lower the FICA taxes that an employer withholds and remits to the government on behalf of employees. Before a provision in the IRA became effective for 2023 and later years, taxpayers were only allowed to use the payroll tax offset against Social Security, not Medicare.

The amount of research credit for which the election can be made can't annually exceed \$500,000. Prior to the IRA, the maximum credit amount allowed to offset payroll tax before 2023 was only \$250,000. Note, too, that an individual or C corporation can make the election only for those research credits which, in the absence of an election, would have to be carried forward. In other words, a

C corporation can't make the election for the research credit to reduce current or past income tax liabilities.

These are just the basics of the payroll tax election. Keep in mind that identifying and substantiating expenses eligible for the research credit itself is a complex task. Contact us about whether you can benefit from the payroll tax election and the research tax credit.

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