



Help when needed: Apply the research credit against payroll taxes

Here's an interesting option if your small company or start-up business is planning to claim the research tax credit. Subject to limits, you can elect to apply all or some of any research tax credits that you earn against your payroll taxes instead of your income tax. This payroll tax election may influence some businesses to undertake or increase their research activities. On the other hand, if you're engaged in or are planning to engage in research activities without regard to tax consequences, be aware that some tax relief could be in your future.

Here are some answers to questions about the option.

Why is the election important?

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. Therefore, there's no amount against which business credits, including the research credit, can be applied. On the other hand, a wage-paying business, even a new one, has payroll tax liabilities. The payroll tax election is thus an opportunity to get immediate use out of the research credits that a business earns. 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.

Which businesses are eligible?

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 takes into account are from his or her businesses. An individual's salary, investment income or other income aren't taken into account. Also, note that neither an entity nor an individual can make the election for more than six years in a row.

Are there limits on the election?

Research credits for which a taxpayer makes the payroll tax election can be applied only against the employer's old-age, survivors and disability liability — the OASDI or Social Security portion of FICA taxes. So the election can't be used to lower 1) the employer's liability for the Medicare portion of FICA taxes or 2) any FICA taxes that the employer withholds and remits to the government on behalf of employees.

The amount of research credit for which the election can be made can't annually exceed \$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 research credits that the taxpayer can use to reduce current or past income tax liabilities.

The above Q&As just cover the basics about the payroll tax election. And, as you may have already experienced, identifying and substantiating expenses eligible for the research credit itself is a complex area. Contact us for more information about the payroll tax election and the research credit.