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New R&D credit provides startups payroll tax offset

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The Protecting Americans from Tax Hike Act (PATH) of 2015 introduced many changes related to the research and development (R&D) tax program. One such improvement, known as the payroll tax offset, provides qualified small business startups the opportunity to elect to use R&D tax credits to offset payroll taxes, instead of waiting to use the credits to offset income taxes.

The new payroll tax offset, effective as of 2016, allows companies to receive a benefit for research activities regardless of profitability. This provision is particularly valuable for startup companies, such as those operating within local Connecticut tech incubators, which generate R&D expenses but won't have a taxable income or pay federal income taxes.


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For purposes of this credit, a qualified small business startup is defined as a company that has: Gross receipts for five years or less; less than $5 million in gross receipts in 2016 and each subsequent year the credit is elected; and qualifying research activities and expenditures.

The definition for qualifying R&D costs has not changed under these new rules, and the credit is based on a company's eligible R&D expenses. Further, all qualifying activity, wages and consulting fee activity must be performed in the United States.

The credit is based on credit-eligible expenses, but only those incurred beginning in 2016 will be eligible to offset certain employer payroll taxes. The credit must be calculated and reflected on a qualifying company's 2016 federal income tax return, and the portion of the R&D credit that will be applied to offset payroll taxes will need to be identified and elected when that return is filed in 2017.

Companies can take advantage of this payroll offset credit against the employer portion of FICA taxes only; other payroll taxes are excluded. The payroll tax offset will be available on a quarterly basis beginning in the first calendar quarter after a company files its federal income tax return. Taxpayers would need to file their 2016 federal income tax returns by March 30, 2017, in order to apply the payroll tax offset to the second quarter in 2017. An extended business return would result in the refund offset benefits being recognized later.

The initial election is made by using new section D within the R&D Form 6765 and included within the federal income tax filing. When the company files its payroll form 941, there is a new line on that form to include the credit. In addition, the payroll forms must include a new form 8974-Qualifed Small Business Payroll Tax Credit for R&D.

The maximum benefit an eligible company is allowed to claim against payroll taxes each year under the new law is $250,000. Brand new businesses could potentially claim the credit for up to five years, with a maximum of $1.25 million in total credits ($250,000 times five years) claimed on quarterly payroll tax returns.

If the amount of the credit exceeds a company's employer portion of social security tax (OASDI tax) liability in any given quarter, the excess will be carried forward to the next calendar quarter.

Most employers are required to file a quarterly payroll tax return (Form 941). The credit will be applied against the Social Security tax on the quarterly return. Once the credit is applied to payroll tax, it can only be applied to future payroll tax and not income tax.

As with all R&D credit programs, the IRS will continue to require documentation to support all aspects of the credit. Companies should have R&D activities analyzed by their CPAs with expertise in this area, to ensure proper documentation of the qualified expenses and activities. ■

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