



# TaxNewsFlash

United States



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## Reminder of opportunity; payroll offsets using R&D tax credits (COVID-19)

Small businesses may be looking for ways to better manage their cash flow and total tax liabilities—in particular given the challenges that U.S. businesses are facing with regard to the coronavirus (COVID-19) pandemic.

A section 41(h) election may provide opportunities for eligible small businesses. Under section 41(h), a qualified small business (QSB) can elect to convert up to \$250,000 per year, for up to five years, into payroll offset credits.

### **Payroll offset rules, research tax credits**

The consolidated Appropriations Act, 2016 (the *Protecting Americans from Tax Hikes Act of 2015* or “PATH Act”), retroactively extended the section 41 research tax credit for all of 2015 and made it permanent. The PATH Act also created a new section 41(h) election so that a QSB can elect to apply up to \$250,000 of credit against their payroll tax liability instead of their income tax liability.

To be eligible, a small business<sup>1</sup> must have gross receipts for the tax year of less than \$5 million, and no gross receipts for any tax years preceding the five-tax-year period ending with the credit determination tax year. That is, a taxpayer making this election for 2019 must not have had any gross receipts in a tax year preceding 2015.

A small business that is not a corporation or partnership (such as a sole proprietor) must take into account the aggregate gross receipts the taxpayer receives in carrying on all its trades or businesses. For corporations and partnerships, the gross receipts and the credit limitation apply on a controlled group basis. For a QSB other than a partnership or S corporation, the amount elected is limited to current year credits that would otherwise be carried forward.

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<sup>1</sup> Unlike a PATH Act benefit for eligible small businesses to use R&D credits to offset alternative minimum taxes, a publicly traded corporation can make the payroll election.

Gross receipts for purposes of the payroll tax credit are determined under the rules of section 448(c)(3)(B), (C), and (D). This is similar to the rules for determining gross receipts for purposes of AMT liability. Hence, for short tax years, gross receipts are 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. Furthermore, gross receipts for any tax year are reduced by returns and allowances made during such year.

A taxpayer may make the election by specifying the amount on or before the due date (including extensions) of the tax return for the tax year the credits are generated; the election may be revoked only with the consent of the Secretary of the Treasury. The credit can be claimed in no more than five tax years. In the case of a partnership or S corporation, this election is made at the entity level.

The elected amount is allowed as a credit against the qualified small business's FICA (section 3111(a)) tax liability on wages paid for the first calendar quarter beginning after the date on which the qualified small business files its income tax or information return for the tax year. That is, the elected credit amount is used to reduce the taxpayer's payroll tax following the time the return is filed.

A taxpayer that makes the election for the 2019 tax return and timely files its return (with extension) on April 30, 2020, would be able to use the credit against payroll tax liability for the third quarter of 2020. Any credit that exceeds the payroll liability for that first calendar quarter following the filing of the return is carried over to the succeeding calendar quarter.

Because of the timely filed return requirement, a taxpayer will need to determine and report a research credit on the timely filed return to use the payroll tax election. A taxpayer with no current income tax liability (e.g., because of net operating losses) cannot wait to determine the credit for the year that it will end up using as a carryover, if it wants to make the payroll tax election.

### **What are "gross receipts" for QSB Purposes?**

There is a definition of gross receipts "for purposes of section 41" in Reg. section 1.41-3(c), and there is a similar but not identical definition of gross receipts in Reg. section 1.448-1T(f)(2)(iv).

However, Section 3.04 of IRS Notice 2017-23 provides:

*The term "gross receipts" in section 3 of this notice means gross receipts as determined under §448(c)(3) (without regard to §448(c)(3)(A)) and §1.448-1T(f)(2)(iii) and (iv) of the Income Tax Regulations. The definition of gross receipts under §41(c)(7) and §1.41-3(c) does not apply for purposes of §41(h).*

As a result, gross receipts for purposes of QSB eligibility includes interest and dividends and there is no de minimis rule like that in Reg. section 1.41-3(c).

### **KPMG observation**

The rules are particularly attractive for qualified small businesses that invest in new or improved products or processes, but were unable to obtain a tax benefit under the former R&D tax credit rules.

The R&D tax credit provides cash savings and a more immediate return on investment. Certain filing requirements, however, must be met prior to receiving a cash benefit. Also, analyzing qualified research activity and gathering documentation are necessary to support a calculated R&D tax credit.

The R&D tax credit applies to many businesses, but the tax rules can be complex and the burden of proof is on the taxpayer to show how the work performed and costs incurred qualify.

For more information about R&D credits, the payroll offset for QSBs, or any R&D issue, contact a tax professional with KPMG's Research Credit Services practice:

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