

OCTOBER 3, 2022

## Inflation Reduction Act expands valuable R&D payroll tax credit

When President Biden signed the Inflation Reduction Act (IRA) into law in August, most of the headlines covered the law's climate change and health care provisions. But the law also enhances an often overlooked federal tax break for qualifying small businesses.

The IRA more than doubles the amount a qualified business can potentially claim as a research and development (R&D) tax credit to offset its payroll tax for tax years starting after 2022 — to a maximum of \$2.5 million over five years. The credit allows a qualified business to leverage the substantial R&D tax benefit even if it has little to no income tax liability, potentially freeing up significant cash flow.



### Background on the pre-IRA credit

The Protecting Americans from Tax Hikes (PATH) Act created a permanent incentive for eligible start-up companies to pursue R&D activities within the United States. The Section 41 tax credit for qualifying in-house and contract research activities already existed, but early-stage companies that hadn't yet incurred income tax liability couldn't take advantage of it.

The PATH Act revised the Sec. 41 credit to allow taxpayers to elect to apply up to \$250,000 of the credit against their share of the Social Security, or FICA, tax for their employees, rather than against income tax. The revision became effective for tax years that began after Dec. 31, 2015.

The payroll tax election is available to taxpayers with 1) gross receipts of less than \$5 million for the tax year, and 2) no gross receipts for any tax year more than five years prior to the end of the current tax year. The latter requirement essentially limits the payroll tax credit to start-up companies. If the taxpayer had a tax year of less than 12 months, the gross receipts must be annualized for a full year.

Be aware that not all research is eligible. To qualify for the credit, the research must be:

- Performed to eliminate technical uncertainty about the development or improvement of a product or process, including computer software, techniques, formulas and inventions,
- Undertaken to discover information that's technological in nature (meaning based on physical, biological, engineering or computer science principles),
- Intended for use in developing a new or improved business product or process, and
- Elements of a process of experimentation relating to a new or improved function, performance, reliability or quality.

Qualifying research expenses include wages for employees involved with the research, supplies to conduct it and amounts paid for the use of computers. They also include 65% of the amounts paid or incurred for contractors.

The credit equals the smallest amount of 1) the current year Sec. 41 credit, 2) an elected amount not exceeding \$250,000, or 3) the general business credit carryforward for the tax year (before application of the payroll tax credit for the year). Note that the general business credit carryforward limit doesn't apply to S corporations or partnerships.

### The IRA expansion

Under the PATH Act, a qualified small business could elect to apply its R&D credit against only the 6.2% Social Security tax. Beginning with the 2023 tax year, eligible businesses will be allowed to apply an additional \$250,000 against their 1.45% Medicare tax liability.

While the total maximum credit is now \$500,000, that amount is bifurcated. You can apply no more than \$250,000 against each prong of payroll tax liability — FICA and Medicare, respectively.

As under the PATH Act, you can claim the credit for no more than five years. Existing aggregation rules, which treat related entities as a single taxpayer for purposes of determining gross receipts, also continue to apply. Any credit is allocated among the entities, but each entity must make the election separately.

### Claiming the credit

You can make a payroll tax credit election by completing the appropriate portion of Form 6765, "Credit for Increasing Research Activities," and submit it with your income tax return. To then claim the credit, complete Form 8974, "Qualified Small Business Payroll Tax Credit for Increasing Research Activities" and attach it to your employment tax return.

You can apply the credit to offset payroll tax no earlier than the first quarter after you file the return reporting the election. The credit can't exceed the amount of tax imposed for any calendar quarter. Unused amounts can be carried forward.

What if you were eligible for the R&D credit previously but didn't claim it because you were unaware of it or for another reason? The IRS recently tightened the requirements to claim a refund of the R&D credit.

To be considered sufficient, a refund claim must:

- Identify all the business products and processes to which the Sec. 41 research credit claim relates for the relevant year.
- For each business product and process, identify all research activities performed, all individuals who performed each research activity and all of the information each individual sought to discover.
- Provide the total qualified employee wage expenses, total qualified supply expenses and total qualified contract research expenses for the claim year. (This may be done using Form 6765.)

These so called "items of information" must be submitted when the refund claim is filed, along with a declaration signed under penalty of perjury verifying their accuracy. If your refund claim is deemed deficient, you'll receive a letter providing 45 days to cure the deficiency.

## More to come

The IRS is expected to issue guidance on the expanded small business R&D tax credit, as well as revised tax forms for 2023. [Contact us](#) if you think you may qualify, now or in the past.

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