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Research Credit Made Permanent and New Potential Abilities to Use Credit to Offset AMT and Payroll Taxes

The section 41 tax credit for increasing research was recently made permanent! Along with the permanent reinstatement of the research credit, certain small businesses can get special tax benefits. This article introduces the permanent extension of the research credit and the ability to offset alternative minimum tax ("AMT") and payroll taxes for eligible businesses.

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Introduction

With the permanent research credit, taxpayers may now engage in research activities with confidence that the credit will be available to offset their costs of engaging in those activities. Furthermore, Congress has now expanded the benefit of the credit by allowing certain small businesses to offset their AMT or payroll tax liabilities with research credits. This benefit may encourage new research spending by start-ups or small businesses that could not otherwise take advantage of the research credit.

Background

On December 18, 2015, the Consolidated Appropriations Act, 2016 (Pub. L. 114-113) ("the 2015 Act") retroactively reinstated research credit for qualified research expenses ("QREs") paid or incurred in 2015, and made the credit permanent, 34 years after its original, temporary enactment. The 2015 Act also provided two tax benefits for eligible small businesses as follows:

- Eligible small businesses with average annual gross receipts of $50 million or less will be allowed to offset their AMT liability with the credits, and

- Certain start-up companies with gross receipts for the year of less than $5 million will be allowed to elect to apply up to $250,000 of their research credit against their payroll tax liability, instead of their income tax liability.[1]

Important issues that might be fleshed out by IRS guidance in possible notices or regulations include how gross receipts will be defined, as further discussed below.

AMT Liability

As a section 38 general business credit, the research credit generally cannot be used to reduce tax liability below the amount of the taxpayer's tentative minimum tax ("TMT") and, generally, also cannot offset the last 25 percent of regular tax liability that exceeds $25,000.[2] This treatment has been a disincentive for any taxpayer with AMT liability. Any unused credits are subject to the general carryover under section 39.[3] However, in the 2015 Act, Congress amended section 38 to allow "eligible small businesses" (as defined under section 38(c)(5)(C)) to ignore their TMT, effective for credits determined for tax years beginning in 2016. For such businesses, in applying the general business credit limitations to these credits, TMT is treated as zero; the limitation based on regular tax liability still applies. Thus, for an eligible small business, the research credit is treated similarly to the energy credit, the rehabilitation credit, the low-income housing credit, the work opportunity credit, and several other so-called specified credits.[4]

An "eligible small business" is a *non-publicly traded corporation,* a partnership, or a sole proprietorship, if the average annual gross receipts for the three-tax-year period preceding the credit year does not exceed $50 million. In determining gross receipts, section 38(c)(5)(C) applies rules

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

[1] The 2015 Act replaced prior section 41(h), which contained the temporary expiration dates, with a new section 41(h) that governs the payroll tax election, and added a new corresponding provision under section 3111(f).

[2] Section 38(c)(1).

[3] Generally carried back one year or if not usable then, carried forward for twenty years.

[4] The TMT benefit for the other specified credits is not, however, limited to eligible small businesses.

similar to the rules under section 448(c)(2) and (3), which provide the following:

- All persons treated as a single employer under section 52(a) and (b) or section 414(m) or (o) are treated as one person.
- If the small business was not in existence for the entire three-year period, then the gross receipts requirement is applied on the basis of the period during which such entity was in existence.
- For a short tax year, 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.
- Gross receipts for any tax year is reduced by returns and allowances made during such year.

Furthermore, for a partnership or S corporation, the gross receipts test must be met both by the entity and by the partner or shareholder for the tax year.

Payroll Tax Credit

Effective for tax years beginning after December 31, 2015, a so-called qualified small business may elect to apply a portion of its research credit—up to $250,000—against its payroll tax liability, instead of its income tax liability. For a qualified small business other than a partnership or S corporation, the amount elected is limited to current year credits that would otherwise be carried forward.

To be eligible, a small business[5] 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 tax year. That is, a taxpayer making this election for 2016 must not have had any gross receipts in a tax year preceding 2012. 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 applies on a controlled group basis.

[5] Unlike the AMT relief, a publicly traded corporation can make the payroll tax 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 2016 and timely files its return in September 2017 would be able to use the credit against payroll tax liability for the fourth quarter of 2017. 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"?

As discussed above, the new Code provisions for the AMT relief and the payroll tax election make eligibility dependent on the taxpayer's gross receipts. While they make clear that certain rules about aggregation and short years apply, however, they do not specifically say what "gross receipts" are, other than that the term excludes returns and allowances.

There is a definition of gross receipts "for purposes of section 41" in section 1.41-3(c), and there is a similar but not identical definition of gross receipts in section 1.448-1T(f)(2)(iv). Because the AMT relief and payroll tax election provisions specifically reference section 448(c)(2) and (3), it might be inferred that the section 1.448-1T(f)(2)(iv) definition should apply, but that is not the only possible reading. Using the section 41 definition would likely produce a smaller gross receipts amount, and make the AMT relief and payroll tax election available to more taxpayers.

The chart below compares the excluded types of income under the two regulations.

Section 1.448-1T(f)(2)(iv) Excludes from gross receipts	Section 1.41-3(c)(2) Excludes from gross receipts
Adjusted basis upon sales of capital assets under section 1221 or sales of property under section 1221(2) (relating to property used in trade or business).	Receipts from the sale or exchange of capital assets under section 1221. Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2).
Repayment of a loan or similar instrument.	Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender).
Amounts received with respect to sales tax or other similar state and local taxes if the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority.	Amounts received with respect to sales tax or other similar state and local taxes if the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority.
	Amounts received by a taxpayer in a tax year that precedes the first tax year that the taxpayer derives more than $ 25,000 in gross receipts other than investment income. Investment income is interest or distributions with respect to stock (other than the stock of a 20-percent-or-greater owned corporation as defined in section 243(c)(2)).

Also, sections 41(f)(7) and 1.41-3(c)(3) specifically provide that, for purposes of section 41, a foreign corporation counts gross receipts only if they are effectively connected with the conduct of a trade or business in the United States, Puerto Rico, or a U.S. possession.

The differences between the two definitions could be significant. Note, above, that section 1.41-3(c)(2) totally excludes receipts from the sale or exchange of capital assets under section 1221 (and certain other transactions), whether or not those receipts would be entitled to capital gain or loss treatment. Section 1.448-1T(f)(2)(iv) provides that, in determining gross receipts, only the adjusted basis of such assets is excluded, but net gain would still be counted.

The complete exclusion under section 1.41-3(c)(2) of all gross receipts prior to the year the taxpayer derives more than $25,000 of noninvestment income would potentially have a significant effect on claiming the payroll tax credit, as a taxpayer's ability to make the election can't extend past the fifth year in which it had gross receipts.

Alternative Incremental Research Credit ("AIRC")

The 2015 Act replaced the old section 41(h) in its entirety, and in doing so, repealed section 41(h)(2). For tax years beginning before 2009, section 41(c)(4) allowed taxpayers to elect to compute their credit using the so-called Alternative Incremental Research Credit ("AIRC").[6] The AIRC was terminated by providing, in section 41(h)(2), that no election was allowed for tax years beginning after December 31, 2008. As the AIRC election continues to be in section 41(c)(4), but without its termination provided in the old section 41(h), the 2015 Act begs the question, "is the AIRC election back?" This question was answered recently in a letter dated January 27, 2016, from the Chairmen and Ranking Minority Members of the House Ways and Means Committee and Senate Finance Committee to Treasury and the IRS. The letter notes that the 2015 Act "could be read as having reinstated the alternative incremental research credit" and concludes that "Congress did not intend to reinstate the previously terminated alternative incremental research credit." The letter provides that technical corrections legislation will be introduced "to strike section 41(c)(4) and the last sentence of section 41(c)(5), effective as if included in the PATH Act. Until such technical correction is enacted, we strongly

[6] The AIRC allowed a taxpayer to compute a credit without determining a fixed-base percentage based on prior years' research spending intensity.

encourage you to be mindful of the fact that there was no Congressional intent to reinstate the alternative incremental research credit."

Treasury and the IRS Guidance

Treasury and the IRS have issued multiple regulations during the past few years that have clarified and provided much needed guidance in the research credit area. With the new payroll tax election in subsection 41(h), Congress has yet again directed Treasury and the IRS to provide guidance to implement the new law. The specific issues Treasury and the IRS need to consider per section 41(h)(6) are briefly described below.

Prevent the avoidance of the purposes of the limitations and aggregation rules on the payroll tax election through the use of successor companies or other means

A single taxpayer rule under section 41(f), which treats a group of controlled corporations and other businesses (controlled group) as a single taxpayer, applies for purposes of the payroll tax credit. Section 41(h) further provides that the election to offset its payroll tax can be made separately by each member of the controlled group, without binding the other members; however, the $250,000 limitation amount is allocated among all persons in the group in a manner similar to section 41(f)(1).

In 2015, Treasury and the IRS issued temporary regulations (T.D. 9717) relating to the allocation of credits among a group of controlled corporations and businesses. It seems likely that Treasury and the IRS will follow the same principle of aggregation and allocation as provided in T.D. 9717 (i.e., generally in proportion to the QREs the members generate for the tax year). However, the elective nature of the payroll tax credit adds an extra wrinkle to the aggregation rule. Assuming the limitation amount is allocated to each member based on each member's share of the QREs, question arises as to what happens if a member does not make the election. Could the allocated amount be transferred to other members of the controlled group?

Minimize compliance and recordkeeping burdens

Lack of documentary substantiation has frequently been a reason for research credit disallowance by the IRS, and producing documentation necessary to pass the IRS audit continues to be an enormous burden on taxpayers. This burden can only be exacerbated by the addition of the new law. When Treasury and the IRS attempted to impose specific and

contemporaneous recordkeeping requirement in prior regulations, the proposed change was met with much criticism. Taxpayers pointed out that significant variations in documentation practices among taxpayers and industries may make any specific documentation requirement unworkable in some cases. It will be interesting to see how Treasury and the IRS will address Congress's mandate to minimize such compliance and recordkeeping burdens. This might be another opportunity for taxpayers to submit any suggestions or recommendations to Treasury and the IRS as they again consider how to minimize such burdens.

Recapture the benefit of credits determined under section 3111(f) when there is a subsequent adjustment to the payroll tax credit portion of the research credit, including requiring amended income tax returns when there is such an adjustment

Other than the statutorily provided issues, below are some additional items that beg further clarification.

- As discussed above, what definition of gross receipts—and exclusions—should be applied in determining whether an entity is an eligible small business or a qualified small business?
- How many calendar quarters may taxpayers carry over the excess research credit to offset the payroll tax: the statute says excess credits from the first quarter may be carried to the succeeding quarter; may excess carried over credits from the succeeding quarter be carried over further?
- Under what circumstances may a taxpayer revoke its election? While section 41(h) provides that the consent of the Secretary of the Treasury is required for a revocation, will this be automatically granted or will the taxpayer be required to establish rare and unusual circumstances?

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