

# BIG CREDIT for Small Business

BY LISA DEROSE, CPA, CCIFP, CGMA

THE RESEARCH AND DEVELOPMENT Tax Credit (R&D) is an opportunity for startup and small businesses to achieve a dollar-for-dollar credit and is more accessible than people realize.

The original R&D Tax Credit was signed in 1981 by President Ronald Reagan as a temporary credit to spur innovation in American companies within the United States. However, the credit needed to be renewed by Congress each year, which made its future uncertain. Forward the clock to December 2015 when President Barack Obama signed the “Protecting Americans from Tax Hikes Act” (PATH). Along with many other provisions, the PATH Act made the Research and Development Tax Credit permanent beginning on January 1, 2016.

Before the PATH Act, tax law carried forward unused R&D tax credit. However, as many startups and small businesses operate at a loss in their first years, they had no income tax liability to offset. Many companies found themselves in a challenging position as they needed to invest in R&D to grow, but they received no benefit regardless of their outlay. Together with making the R&D Tax Credit permanent, the PATH Act included offsets to the alternative minimum tax and payroll tax for eligible businesses. Knowing how to take advantage of the credit could save small and startup businesses a total of \$1.25 million at an amount of \$250,000 a year for up to five years.

## How does the PATH Act help small businesses?

The PATH Act allows qualified small businesses to elect to claim all (or a portion of) the R&D Tax Credit against the employer portion of social security taxes due. This payroll tax offset allows companies to receive a benefit from research (with qualified expenses) even if they're not yet profitable.

In order to earn the credit for 2019, a company would need to appropriately compute the credit and reflect it on their 2019 federal tax return filed in 2020. The offset is then available every quarter, beginning in the first calendar quarter after filing their federal tax return. The next step is to complete and file Form 8974, “Qualified Small Business Payroll Tax Credit for Increasing Research Activities,” along with their quarterly payroll tax return.

## How can the payroll tax credit be used?

The Payroll Tax Credit can also be used to offset the employer portion of social security taxes for all employees. To claim the credit, the taxpayer makes an election in section D of Form 6765, “Credit for Increasing Research Activities.” The election is made on or before the due date

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of the income tax return. The purpose of Form 6765 is that it permits the taxpayer to elect the amount they wish to designate as the payroll tax credit. Any amount not included would be eligible for the standard R&D credit carryback of one year and carryforward of 20 years.

Alternatively, the taxpayer can elect an amount greater than their payroll tax liability in the current quarter and carryforward the remaining credit to subsequent quarterly payroll tax returns. It is important to note that the payroll tax credit applies only to R&D costs incurred after the PATH Act was signed.

## What defines a qualifying business?

The PATH Act intended to create more cost-saving opportunities for American businesses to spur growth and ingenuity.

In order to qualify for the payroll tax credit, a business must have:

- Gross receipts for five years or less. In determining eligibility for the payroll tax credit, the taxpayer must not have had any gross receipts for five years ending with the current year.
- Less than \$5 million in gross receipts the year the credit is elected.
- A payroll tax liability. The payroll tax offset is applied to the social security portion of payroll taxes, which would be 6.2% on up to \$137,700 of each employee's salary in 2020.
- Adequate documentation of R&D activities, such as wages, time spent toward an R&D project, supplies, contract research, rental or lease costs that relate to a new product or process.

## What actions qualify for the R&D Tax Credit?

Many businesses think that they're not eligible for the credit because they do not have a scientist on staff, or R&D is not the nature of their business. This is not the case. The outcome of a research and development process does not need to lead to a new discovery. If a company can answer “yes” to the following criteria, then exploring the credit is worth the effort.

- **Technical uncertainty:** The activity performed is to eliminate technical uncertainty about the development or improvement of a product or process, which can include any number of applications, techniques, formulas, and inventions.
- **Process of experimentation:** The activity includes some process of experimentations undertaken to eliminate or resolve a problem.
- **Technical in nature:** The experimentation needs to rely on hard sciences such as engineering, physics, chemistry, biology, or computer science.
- **Qualifies purpose:** The purpose of the activity is to create a new or improved product or process.

The PATH Act, and the associated payroll tax credit, is an excellent cost savings opportunity. Startups to established businesses would benefit from consulting a tax professional to learn how they can take advantage and lower their tax obligation. ■



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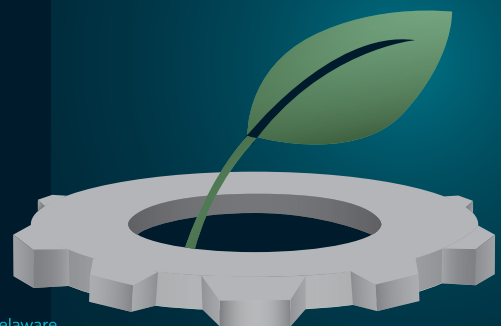


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