



February 1, 2017

Mr. John P. Moriarty
Acting Associate Chief Counsel
Passthroughs & Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Section 41(h), Treatment of Credit for Qualified Small Businesses

Dear Mr. Moriarty:

The American Institute of CPAs (AICPA) is pleased to submit comments with respect to Internal Revenue Code (IRC or “Code”) section 41(h),¹ regarding the expansion of research credit benefits to offset certain payroll tax liabilities of start-up companies engaged in qualified research activities. We also provide comments on the designation of the credit as a “specified credit” that is used to offset the alternative minimum tax (AMT) liability of an eligible small business.

As discussed in our letter, the AICPA recommends that the Internal Revenue Service (IRS) and the United States Department of the Treasury (“Treasury”) issue regulations or other guidance to:

- define “gross receipts” for the purposes of section 41(h);
- clarify the order of the elections that are made under sections 41(h) and 280C(c)(3);
- clarify that a taxpayer is eligible to make the section 41(h) election for its current taxable year (i.e., the “credit year”) even if it has \$5 million or more in gross receipts in one or more of the four taxable years immediately preceding the credit year;
- clarify the application of the general business credit carryforward provisions of section 39(a) to the credit authorized by section 3111(f), and the limitation imposed under section 41(h)(2)(C);
- specify that the section 383 limitation on the section 41 credit does not apply to the credit authorized under section 3111(f);
- identify the mechanics of the section 3111(f) credit and the applicable penalty regimes that apply in the event of a recapture of the payroll tax credit and provide transitional penalty relief;

¹ All references herein to “section” or “§” are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

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- coordinate the election under section 41(h) with Treasury regulations published in May 2016 regarding Certified Professional Employer Organizations;
- clarify the applicable dates for which the section 41 credit is a “specified credit” available to offset certain AMT liabilities; and
- establish automatic consent procedures to revoke the section 41(h) election.

These comments were developed by the AICPA Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

The AICPA is the world’s largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America’s largest businesses.

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact me at (408) 924-3508 or annette.nellen@sjsu.edu; Jennifer Kennedy, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (703) 918-6951, or jennifer.kennedy@pwc.com; or Ogochukwu Eke-Okoro, Lead Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or ogo.eke-okoro@aicpa-cima.com.

Sincerely,



Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: Mr. Christopher Call, Attorney-Advisor, Office of Tax Legislative Counsel,
Department of the Treasury
Mr. Ken Beck, Taxation Specialist, Office of Tax Legislative Counsel, Department of
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Comments on Section 41(h)

**Developed by the AICPA Tax Methods and Periods Technical Resource Panel
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AMERICAN INSTITUTE OF CPAs

Comments on Section 41(h)

Several professional services firms and industry groups have issued comments with respect to newly enacted legislation related to section 41, *Credit for Increasing Research Activities* (“the research credit”). The AICPA offers the following comments to amplify and augment the comments submitted to date with respect to the modifications to the research credit. These comments also are informed by the Form 6765 *Credit for Increasing Research Activities*, Form 8974 *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*, Form 941 *Employer’s Quarterly Federal Tax Return* and Form 3800 *General Business Credit*, that have been released in anticipation of the compliance efforts that will implement the new rules beginning in 2017.

Modifications to the research credit regime include the expansion of research credit benefits to offset certain payroll tax liabilities of start-up companies engaged in qualified research activities and the designation of the credit as a “specified credit” that is used to offset the AMT liability of an eligible small business. These modifications were intended to make the research credit more broadly available to taxpayers who would otherwise have to carry-back or carry-forward their unused credits under section 39(a).

A. Summary of the PATH Act Enhancements to the Research Credit

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015² (“the PATH Act”). This legislation, among other things, permanently extended the research credit determined under section 41. Also, for tax years beginning after December 31, 2015, the PATH Act added new section 41(h), which provides that a qualified small business may elect to apply up to \$250,000 of its federal research credit against the employer’s Old Age Survivor and Disability Insurance (OASDI) contribution as part of the subsequent taxable year’s Federal Insurance Contribution Act (FICA) payroll tax obligations (“the payroll tax credit”).³ The election is made annually for up to five taxable years.⁴ The payroll tax credit is applied against the employer’s FICA payroll tax obligations on a quarterly basis, beginning with the first full quarter after an income tax return is filed with a valid payroll tax credit election.⁵ The credit is not taken into account for purposes of determining any amount allowable as a payroll tax deduction (that is, the taxpayer claims the pre-credit payroll tax amount as a deduction).⁶

Section 41(h) defines a “qualified small business” as a corporation or partnership with gross receipts of less than \$5 million (“the gross receipts test”) during the credit year, that has no history of gross receipts prior to the 5-taxable-year period ending with the credit year (“the 5-

² P.L. 114-113.

³ Sections 41(h)(1) and 3111(f). See section 41(h)(4)(B)(i) for the maximum annual designation.

⁴ Section 41(h)(4)(B)(ii).

⁵ Section 3111(f)(1).

⁶ Section 3111(f)(4). See also General Explanation of Tax Legislation Enacted in 2015, Joint Committee on Taxation, footnote 414.

year history test”).⁷ Persons other than a corporation or partnership are a qualified small business if they meet the gross receipts test and the 5-year history test with respect to the aggregate gross receipts received by such person in carrying on all trades or businesses.⁸ When determining the gross receipts of any taxpayer, all members of a controlled group (as defined for other research credit purposes) are treated as a single taxpayer.⁹

Section 41(h)(3)(A) provides that “gross receipts” are determined “under the rules of section 448(c)(3), without regard to subparagraph (A) thereof.”¹⁰ This reference to section 448(c)(3) requires that:

1. gross receipts be annualized in the event of a short taxable year;¹¹
2. gross receipts be reduced by returns and allowances;¹² and
3. any reference to an “entity” includes all predecessor entities.¹³

Separately, the PATH Act also amended section 38(c)(4) to include the research credit among the list of “specified credits” that certain taxpayers may use to offset their AMT liability if it is determined that a balance is otherwise payable under section 55 (“the AMT credit”).¹⁴ To qualify for the AMT credit, a taxpayer must satisfy the definition of an “eligible small business” in section 38(c)(5), meaning a non-public corporation, partnership, or sole proprietorship with average annual gross receipts not exceeding \$50 million for the prior three taxable years.¹⁵ The definition of an eligible small business in section 38(c)(5) also refers to section 448(c), including the rules for annualization of gross receipts amounts for short taxable years, the reduction for returns and allowances, and the predecessor-entity concept.

B. Definition of Gross Receipts in Section 41(h)

Recommendation

The AICPA recommends disregarding interest income and distributions for purposes of section 41(h) with respect to stock of a 20 percent owned corporation, whenever they are received by a taxpayer in a year preceding its first taxable year in which it has operational receipts in excess of \$25,000. Additionally, the AICPA recommends excluding from the definition of gross receipts, Form W-2 wages received by an individual in measuring the individual’s aggregate

⁷ Section 41(h)(3)(A)(i).

⁸ Section 41(h)(3)(A)(ii).

⁹ Section 41(h)(5)(A). Members of a qualifying controlled group may separately decide whether to elect to designate their share of the group’s research credit as a payroll tax credit, but not exceeding an allocable portion of the annual \$250,000 limit that applies to the group as a whole. Section 41(h)(5)(B).

¹⁰ Section 41(h)(3)(A)(i)(I).

¹¹ Section 448(c)(3)(B).

¹² Section 448(c)(3)(C).

¹³ Section 448(c)(3)(D).

¹⁴ Section 38(c)(4)(B)(ii).

¹⁵ Section 38(c)(5)(C). Pass-through credits determined with respect to partnerships or S corporations are not treated as “eligible small business” credits unless the \$50 million gross receipts test is satisfied at both the entity level and the partner/shareholder level. Section 38(c)(5)(D). Aggregation rules that treat members of a controlled group as a single taxpayer also apply under section 38(c)(5).

gross receipts from all trades or businesses to determine whether the individual meets the definition of a qualified small business under section 41(h)(3).

Analysis

Various commentators have requested guidance regarding the definition of gross receipts for the purposes of new section 41(h). The definition of gross receipts contained in section 41(h) is similar to the definition of gross receipts in section 41(c)(7), which provides that “gross receipts for any taxable year shall be reduced by returns and allowance made during the taxable year.”

Treasury regulations have been issued under both sections 448 and 41 to elaborate on the definition of gross receipts.¹⁶ Both sets of regulations reflect the shared statutory language that describes gross receipts as generally including all receipts, less returns and allowances. Each set of regulations then enumerates a list of exceptions to this general rule. The specific differences between the section 448 and section 41 regulations are adequately described in comments submitted by other organizations with respect to section 41(h).¹⁷

The AICPA’s comments reinforce the views of other practitioners who have requested a definition of gross receipts that includes the *de minimis* rule in Treas. Reg. § 1.41-3(c)(2)(vi), which excludes from the definition of gross receipts “[a]mounts received by a taxpayer in a taxable year that precedes the first taxable year in which the taxpayer derives more than \$25,000 in gross receipts other than investment income.”¹⁸ For purposes of this exclusion, investment income is defined as interest or distributions with respect to stock of a 20 percent owned corporation as defined in section 243(c)(2) (“dividends”).¹⁹

Inclusion of the *de minimis* rule will benefit small businesses formed six or more years earlier than the taxable year for which a research credit is determined. The *de minimis* rule may extend eligibility of a qualified small business for the payroll tax credit, because the business might otherwise fail the five-year history test due to its receipt of passive investment income in its early start-up years. Once a taxpayer receives more than \$25,000 in operational gross receipts, the exclusion of interest and dividends no longer applies, so that interest, dividends, rents, royalties and other income are generally included in gross receipts.

Applying an exclusion of interest and dividend income for section 41(h) purposes will ensure that qualified small businesses are not penalized merely because they earned certain investment returns on their working capital before it was required for current research or other business-development activities.

As discussed above, the statute references the definition of gross receipts in section 448(c)(3) (without regard to subparagraph (A) describing rules for entities not in existence for a 3-year period). Treasury regulations under section 448 define gross receipts as “total sales (net of

¹⁶ See generally Treas. Reg. § 1.448-1T(f)(2)(iv)(A) and Treas. Reg. § 1.41-3(c)(2).

¹⁷ See Priority Guidance Plan comments submitted by KPMG LLP on May 11, 2016; alliantgroup comments submitted on May 24, 2016, and the Biotechnology Innovation Organization comments submitted June 1, 2016.

¹⁸ Treas. Reg. § 1.41-3(c)(2)(vi).

¹⁹ *Id.*

returns and allowances) and all amounts received for services.”²⁰ Wages paid to an employee are amounts received for services. If an individual is a sole proprietor, or holds an equity interest in a partnership or an S corporation that is treated as a single taxpayer with the individual under the controlled group rules of section 41(f)(1), any wages also received by such individual are included in the gross receipts analysis. The inclusion of wages in gross receipts is likely to disqualify most individuals from becoming a qualified small business, because most individuals are likely to have greater than a 5-year history of earning wages. The AICPA believes that the inclusion of Form W-2 wages in the definition of gross receipts is inconsistent with the congressional intent that the new payroll tax credit should broadly benefit individuals starting new research ventures.

C. Grant Funding and Gross Receipts

Recommendation

The AICPA recommends that the IRS and Treasury issue regulations excluding grant funding from the definition of gross receipts for purposes of section 41(h). The rule could provide that if research activities do not meet the definition of “qualified research” because the research is regarded as “funded” under section 41(d)(4)(H), then any grants or similar payments received by the taxpayer from governmental or nonprofit entities to subsidize the research is excluded from the definition of gross receipts for purposes of the \$5 million gross receipts test.

Analysis

The inclusion of grant funding in the definition of gross receipts is inconsistent with the congressional intent that the new payroll tax credit should broadly benefit start-up research ventures. The regulations issued under sections 448 and 41 include grant funding in their broad definitions of gross receipts. Congress intended that the new payroll tax credit should benefit start-up companies,²¹ many of which receive grant funding from federal and state agencies, and a variety of private foundations and other nonprofit organizations. A company can receive substantial grant funding in any one year. When considered with other sources of gross receipts, grants may cause otherwise eligible qualified small businesses to fail the \$5 million gross receipts test. As such, the IRS and Treasury should issue regulations excluding grant funding from the definition of gross receipts for purposes of section 41(h).

D. Ordering Rules Regarding the Reduced Credit Election and the Section 41(h) Designation

Recommendation

The AICPA recommends that the IRS and Treasury provide ordering rules clarifying that the election to designate up to \$250,000 of the current year research credit as an offset to subsequent payroll tax liabilities is made prior to the reduced credit election authorized by section 280C(c)(3), and that the reduced credit election only applies to the balance of any research credit that remains after the section 41(h) election.

²⁰ Treas. Reg. § 1.448-1T(f)(2)(iv)(A).

²¹ P.L. 114-113.

Analysis

Under the regular credit and alternative simplified credit rules for calculating the federal research credit, taxpayers have the option of making a reduced credit election under section 280C(c)(3) in lieu of adding their research credit back to taxable income in the form of a reduced section 174 deduction. The reduced credit is equal to 65 percent of the full credit. Mathematically, claiming the reduced credit results in the same federal tax liability as claiming the full credit with a reduced section 174 deduction.

The new section 41(h) allows taxpayers to designate up to \$250,000 of their current research credit as an offset to the employer's OASDI contributions in the subsequent tax year. A question arises with respect to the ordering of the section 41(h) designation and the section 280C(c)(3) reduced credit election. If the reduced credit election is made before the section 41(h) election, taxpayers are denied the full value of the payroll tax credit if the full credit exceeds the maximum designation amount (\$250,000) but the reduced credit does not (e.g. if 65 percent of the full credit reduces the amount available for the designation to an amount less than \$250,000). If the section 280C(c)(3) election is made after the section 41(h) designation, the reduced credit election is applied to the balance of the research credit that exceeds the designated amount (e.g. the amount of credit that exceeds \$250,000) or the value of the payroll tax credit will be similarly diminished.

The 2016 Form 6765, released January 10, 2017, includes a new "Section D" that allows taxpayers to make the payroll tax credit election, and designate the amount of credit that is applied to subsequent year payroll tax obligations. The mechanics of Form 6765 provide that the amount designated under section 41(h) is determined by reference to the available regular research credit or the alternative simplified credit, respectively reported on lines 17 and 34 of the form. Both lines contain a check box to make the reduced credit election. It is not clear from the 2016 Form 6765 or the accompanying instructions whether the section 41(h) designation is made prior to making the reduced credit election, or if making the section 280C(c)(3) election requires taxpayers to accept a lower cap on the amount that is designated for use against subsequent payroll taxes. Taxpayers are best served if allowed to make the section 41(h) election based on the amount of the full credit, and then make a reduced credit election on the balance of any remaining research credit.

E. Interrupted Eligibility for the Payroll Tax Credit

Recommendation

The AICPA recommends that the IRS and Treasury provide an illustration in the regulations indicating that gross receipts of \$5 million or more during any year within the 5-taxable-year period, ending with the credit year, would prevent the taxpayer from being considered a "qualified small business" for such a year. However, the IRS and Treasury should also clarify that this interrupted eligibility will not prevent the taxpayer from being considered a "qualified small business" for a subsequent tax year, within the 5-taxable-year period, with less than \$5 million in gross receipts.

Analysis

The \$5 million gross receipts test applies to each taxable year for which the research credit is determined and the section 41(h) election is potentially made (subject to the limitation that the election is not made for more than five taxable years). The statutory rules do not address the situation where a taxpayer exceeds (i.e., fails) the \$5 million gross receipts test in one or more years but satisfies the test in a subsequent year, within the 5-taxable-year period. For example, a start-up venture, still within the 5-taxable-year period, may have less than \$5 million in gross receipts in the current year, but may have sold patented technology or entered into a licensing agreement the previous year with respect to its technology still under development, resulting in receipt of \$5 million or more in the immediately preceding year.

An appropriate reading of section 41(h)(3)(A) is that the taxpayer in this case is a “qualified small business” for the current year even though the tax payer was not considered a “qualified small business” in the preceding year. The IRS and Treasury should provide clarification supporting this interpretation of section 41(h)(3)(A).

F. Effect of the Section 41(h) Election on Section 383

Recommendation

The AICPA suggests that the IRS and Treasury clarify in the regulations that section 383 does not apply to the credits authorized by section 3111(f). We also recommend allowing the acquiring taxpayer of a corporation that previously elected to apply a portion of its research credit against subsequent OASDI contributions to utilize the payroll tax credits against its OASDI contributions in post-acquisition years. This rule should apply regardless of whether the acquiring taxpayer itself is a qualified small business at the time that it acquired the target company or at the time the target company originally made the section 41(h) election.

Analysis

The goal of many start-up companies is to become a potential target for acquisition by a larger organization. Many start-up companies operate at a loss which prevents them from utilizing general business credits, including the research credit. Unused general business credits are carried forward to subsequent tax years under section 39(a). Section 383 limits the amount of excess credits that the buyer of a loss company can utilize in the post-acquisition tax years. The section 383 excess credit limitation applies to “any unused general business credit of the corporation under section 39.”²²

The general business credits under section 39 are enumerated in section 38. The list of general business credits includes the research credit determined under section 41(a).²³ The election to designate a portion of the section 41(a) credit as an offset to the subsequent year’s OASDI contribution is made under section 41(h), but the credit against the payroll tax is authorized by section 3111(f). The credit under section 3111(f) is not listed in section 38 as a general

²² Section 383(a)(2)(A).

²³ Section 38(b)(4).

business credit. Section 3111(f) provides its own carryover rules for unused credits.²⁴ If the payroll tax credit is not a general business credit listed in section 38 and not an excess credit that is carried forward under section 39, then the payroll tax credit is not subject to the section 383 limitations.

G. Recapture and Transitional Penalty Relief

Recommendation

The AICPA recommends that the IRS and Treasury confirm that the payroll tax credit is implemented through a pro-rata reduction of the taxpayer's remaining payroll tax deposits beginning for the first full quarter after an income tax return is filed with the section 41(h) election. The AICPA also recommends that the IRS and Treasury provide guidance as to which penalties are imposed as a result of a failure to deposit or recapture event. Further, we recommend that any tax assessed as part of a recapture event is treated as an assessment of income tax for which no penalties are assessed that impose personal liability on the persons responsible for the payments.

Analysis

Section 3111(f) provides that a qualified small business which has made the election under section 41(h) shall be allowed a credit against the tax imposed by section 3111(a) for the first calendar quarter which begins after the date on which the taxpayer files its prior year income tax return.²⁵ The tax imposed by section 3111(a) is the OASDI component of the FICA payroll tax. Taxpayers with less than \$50,000 in historical FICA payroll tax liabilities must make monthly deposits towards current quarterly FICA payroll tax liabilities.²⁶ Taxpayers with \$50,000 or greater historical FICA payroll tax liabilities must make semi-weekly deposits towards current quarterly FICA payroll tax liabilities.²⁷ A credit generally operates as a reduction of a payment obligation. If the benefit authorized by section 3111(f) is a credit against the OASDI tax imposed by section 3111(a), the benefit should be a pro-rata reduction in the monthly or semi-weekly deposits a qualified small business would otherwise make beginning in the first quarter after the date on which it files its prior year income tax return. If the IRS implements the mechanics of the payroll tax credit through other means, taxpayers who file a 2016 income tax return in the first quarter of 2017 and reduce their FICA payroll tax deposits in subsequent quarters of 2017 are subject to failure to deposit penalties under section 6656.

Section 41(h)(6) directs the Secretary of the Treasury ("the Secretary") to prescribe regulations related to the recapture of the payroll tax credit portion of the research credit if a subsequent adjustment is made to a taxpayer's tax return that affects the taxpayer's eligibility for the payroll tax credit.²⁸ The recapture of the payroll tax credit could result in a number of penalties that are imposed on the taxpayer. The penalties include failure to pay penalties under section

²⁴ Section 3111(f)(3).

²⁵ Section 3111(f)(1).

²⁶ Treas. Reg. § 31.6302-1(b)(2).

²⁷ Treas. Reg. § 31.6302-1(b)(3).

²⁸ Section 41(h)(6)(C).

6651, failure to deposit penalties under section 6656, and/or the trust fund recovery penalties under section 6672. The magnitude of penalties that are imposed range from 0.5 percent of the amount of tax due for each month that the payment is outstanding,²⁹ to a 100 percent penalty and personal liability for the amounts due.³⁰ It is unclear which penalties are applicable to the recapture of the payroll tax credit. In light of the uncertainty regarding the applicable penalty regimes, it is also appropriate for the IRS to provide transitional penalty relief for the first two years that taxpayers attempt to comply with the new rules.

H. Coordination of Regulations Implementing Section 41(h) with the Proposed Regulations for Certified Professional Employment Organizations

Recommendations

The AICPA recommends establishing an appropriate test to determine which party is entitled to claim the payroll tax credit which looks beyond the legal structure of the arrangement to the actual employer-employee relationship and considers the economics of the arrangement between the customer and the professional employer organization (PEO). This test will ensure that the party that bears the unreimbursed expense associated with payroll and employment taxes is the party that benefits from the payroll tax credit.

Analysis

A PEO acts as the direct employer of its customers' employees for the purpose of outsourcing and streamlining the customers' human resources, benefits, and payroll functions. The PEO is generally treated as the employer of its customers' employees for tax purposes. Proposed regulations published in the federal register on May 6, 2016, established the role of a Certified Professional Employer Organization (CPEO).³¹ The preamble to the proposed regulations describes a PEO as a "co-employer" of its customers' employees and notes that the PEO is responsible for paying the workers and the related federal employment taxes. The designation of a CPEO is a voluntary designation that a PEO may obtain from the IRS to minimize disputes and clarify the obligations of the PEO and its customers with respect to the withholding and deposit of federal employment taxes.

The proposed regulations apply to "covered employees," which are defined as employees who are subject to a CPEO contract.³² The regulations further define "work site employees" as employees performing services at a physical location where at least 85 percent of the individuals performing services are subject to one or more CPEO contracts.³³ Proposed Treas.

²⁹ Section 6651(a)(2) imposes a penalty at the rate of 0.5 percent of the amount of tax due for each month that the liability is outstanding, with a maximum penalty amount of 25 percent of the original tax due.

³⁰ Section 6672 imposes personal liability and a penalty equal to the total amount of tax due (a 100 percent penalty) for the failure of a responsible person to collect and remit employment taxes collected on behalf of another party. The penalty may not relate to an employer's payment obligation of its own OASDI contribution, but could arise in the context of a certified professional employer organization ("CPEO") or a non-certified PEO that refrains from making payroll tax deposits in reliance on the customer's payroll tax credit. Subsequent adjustments that extinguish the payroll tax credit could result in section 6672 penalties for the CPEO or PEO.

³¹ REG-127561-15.

³² Treas. Reg. § 301.7705-1(b)(5).

³³ Prop. Reg. § 31.3511-1(a)(2).

Reg. § 31.3511-1(e) provides that work site employees of the CPEO are treated as employees of the customer for the purpose of certain specified credits, including the research credit under section 41.³⁴

The proposed regulations under section 3511 do not address the question of which party is entitled to the payroll tax credit if the PEO does not voluntarily seek the designation of a CPEO. The proposed regulations are also silent with respect to covered employees who are not work site employees. A CPEO's status as the employer of its customers' employees is a legal structure that enables efficiencies across multiple companies by consolidating the human resources, benefits, payroll, and employment tax functions. The reality behind that structure is that a PEO's customer retains all rights to hire and terminate employees, set compensation, and provide direction and control over the employee's actions performed in the course of his or her employment. Start-up companies frequently outsource their human resources, payroll and employment tax functions to PEO service providers. Start-up companies are also likely to use remote work sites (work from home), incubator and/or shared workspace environments.

It is not clear how the payroll tax credit is coordinated with the proposed CPEO regulations. Consistent with the congressional intent of the PATH Act legislation, the payroll tax credit should not be denied to otherwise qualified small businesses that use the services of a non-certified PEO, or who do not aggregate their workforce in a location that qualifies them as "work site employees."

I. Designation of the Section 41 Credit as a Specified Credit

Recommendation

The AICPA recommends that the IRS and Treasury provide guidance as to whether a taxpayer may carry back a research credit determined for a tax year beginning in 2016 (consistent with the carryback rules under section 39(a)(1)) to offset its AMT liability for a tax year beginning in 2015.

Analysis

The PATH Act revised the list of "specified credits" in section 38(c)(4)(B) to add the research credit to the list of credits used to offset the AMT, provided the research credit was determined with respect to an "eligible small business." Previously, when other specified credits were added to section 38(c)(4)(B), Congress made clear in the statute or legislative history the earliest taxable year for which a taxpayer may apply the credit as an offset to AMT. In this regard, the PATH Act provides that the research credit determined by an eligible small business is a specified credit for tax years beginning after December 31, 2015. However, the PATH Act does not specify the earliest taxable year for which a taxpayer may apply the research credit as an offset to AMT. The instructions for Form 3800 are also silent on this issue which is causing confusion for taxpayers. Guidance from the IRS and Treasury will alleviate the confusion.

³⁴ Prop. Reg. § 31.3511-1(e)(2)(i).

J. Clarification of Carryforward Rules for Payroll Tax Credits

Recommendation

The AICPA recommends that the IRS and Treasury clarify that the limitation imposed on the payroll tax credit by section 41(h)(2)(C) is the balance of any prior year research credits that is carried forward to a taxable year in which the taxpayer is eligible to make the section 41(h) election. The AICPA also recommends that the IRS and Treasury confirm that the credit carryover period provided in section 3111(f)(3) is unlimited.

Analysis

Section 41(h)(2) limits the portion of the research credit that is designated as an offset to subsequent OASDI contributions to the least of three amounts defined in subsections (A) through (C). Section 41(h)(2)(A) defines the amount (\$250,000) authorized by the enacting legislation. Section 41(h)(2)(B) defines the current year credit determined under section 41(a) before the designation of a portion of the credit as an offset to subsequent OASDI contributions.

Section 41(h)(2)(C) definition provides that—

“in the case of a qualified small business other than a partnership or S corporation, the amount of the business credit carryforward under section 39 carried from the taxable year (determined before application of this subsection to the taxable year).”

The phrase “the business credit carryforward under section 39 carried from the taxable year” in section 41(h)(2)(C) is unclear. The first two potential limitations are the amount authorized by statute (\$250,000) or the amount of current year research credit (if the amount is less than \$250,000). If a taxpayer generates a research credit after December 31, 2015, and if that credit is carried forward to a year in which the taxpayer is eligible to make the section 41(h) election, but does not otherwise generate a current year research credit, section 41(h)(2)(C) is construed as a provision that authorizes an election to designate a portion of any general business credit carryforward as an offset to subsequent FICA liabilities. If this is the meaning of section 41(h)(2)(C), then the third limit imposed by the statute is the balance of any business credit carryforward under section 39 *from a prior taxable year*, up to the \$250,000 limit authorized by statute.

The AICPA believes that the correct interpretation of section 41(h)(2)(C) is a limitation equal to the balance of any prior year research credit generated after December 31, 2015, that carries forward to a taxable year in which the taxpayer is eligible to make the section 41(h) election. It is unclear how the least of three limits imposed by section 41(h)(2) is applied. If a taxpayer has zero current year credit and a carryforward credit less than \$250,000, the least of the statutory limit, the current year credit and the carryforward credit is zero. If the intent is to limit the payroll tax credit to \$250,000, or the balance of *either* the current year credit (if under \$250,000), *or* the balance of an eligible carryforward balance (if under \$250,000), then additional guidance is necessary. To avoid potential confusion, the AICPA recommends that the IRS and Treasury issue guidance clarifying the correct interpretation and application of section 41(h)(2).

Additionally, the AICPA recommends that the IRS and Treasury provide guidance confirming that the credit carryover provided for under section 3111(f)(3) is not subject to any limitation. The payroll tax credit authorized by section 3111(f) is not included in the general business credits listed in section 38(b), to which the one-year carryback and twenty-year carryforward limitations of section 39(a) apply. Instead, section 3111(f) contains its own carryforward language, providing in subsection (f)(3) that unused credits against OASDI contributions “shall be carried to the succeeding calendar quarter and allowed as a credit...” The separate carryforward provision of section 3111(f)(3) contains no limitation on the number of periods in which unused credits are carried forward. Thus, under section 3111(f)(3) unused payroll tax credits are carried forward indefinitely, until the credits are depleted through offsets to OASDI contributions.

K. Automatic Consent Procedures and Effect of Revocation

Recommendation

The AICPA suggests that the IRS and Treasury provide an automatic procedure under which a taxpayer is deemed to have the Secretary’s consent to revoke the section 41(h) election by following the prescribed procedure.

The AICPA also recommends that if an election is revoked, or rescinded by way of IRS exam adjustments that render the taxpayer ineligible for the election, the designated payroll tax portion should return to the balance of the research credit that is applied to offset the taxpayer’s income tax liability for the credit year or otherwise be carried back or carried forward pursuant to section 39(a).

Analysis

The new section 41(h)(4)(A)(iii) provides that the election under section 41(h) is revoked only with the consent of the Secretary. The section 41(h) election is made on the return for the credit year and establishes a balance of research credits that is applied against the OASDI contribution of the taxpayer in the subsequent tax year. There are circumstances under which it is desirable to revoke the election, including for example, the outsourcing of employees to a non-certified PEO, or the acquisition of a target that made the section 41(h) election.

Any guidance regarding the time and manner for revoking the section 41(h) election should also describe the effect of revocation on the payroll tax portion that a taxpayer designated for use against OASDI contributions.

L. Conclusion

The expansion of the research credit regime, as part of the PATH Act for start-up companies with payroll tax liabilities, as well as AMT taxpayers, is an important opportunity for many small businesses performing qualified research to realize a financial benefit from claiming the research credit for the first time. The recommendations provided herein will help clarify the operation of the new rules and are consistent with the intent of Congress that the research credit provide a current economic benefit to a broad class of start-up ventures and small businesses.