Tax Impact

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How to claim research payroll tax credits

If your business dedicates resources to creating or improving products, processes or software, it may be eligible for substantial federal tax credits for "increasing research activities." There's just one catch: To enjoy the benefits, you must have sufficient federal tax liability against which to offset the credit. Historically, that meant *income* tax liability, but qualifying small businesses may now elect to apply some or all of their research credit against up to $250,000 in *payroll* taxes.

Recent history

The Protecting Americans from Tax Hikes (PATH) Act of 2015 not only made the research credit permanent but created the payroll tax election for the research credit (often referred to as the "research and development," "R&D" or "research and experimentation" credit). IRS Notice 2017-23 provides interim guidance on claiming research credits against payroll taxes.

In addition to clarifying the eligibility requirements and outlining the procedures for making the election, the IRS allows companies that failed to make the payroll tax credit election on their 2016 return to take advantage of the credit by filing an amended return on or before December 31, 2017. (See "Not too late for 2016" on page 3.)

Is your business eligible?

Research payroll tax credits are intended to provide relief to smaller businesses, particularly start-ups, which often invest heavily in research and development but have little or no income tax liability. Although unused credits may be carried forward up to 20 years, payroll tax credits allow these businesses to enjoy the benefits of research credits when they need them most, rather than wait until they begin to generate taxable income.

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The PATH Act makes payroll tax credits available to "qualified small businesses," defined as those with 1) less than $5 million in gross receipts in the current taxable year, and 2) no gross receipts for any taxable year preceding the five-taxable-year period ending with the current taxable year. (For example, a business making the payroll tax credit election for 2017 must not have had any gross receipts before 2013.)

Notice 2017-23 clarifies that, for purposes of determining whether a corporation (including an S corporation) or partnership (including a limited liability

Not too late for 2016

If your business didn't make a payroll tax credit election on its 2016 return, it's not too late. But you need to act quickly. IRS Notice 2017-23 offers relief to qualified small businesses that filed their 2016 returns on time but didn't make the election, provided they make the election on an amended return filed on or before December 31, 2017. (Because December 31 falls on a weekend and January 1 is a federal holiday, an amended return filed on January 2, 2018, will be considered timely.)

To qualify for the extension, your business must include Form 6765, "Credit for Increasing Research Activities," with its amended return and either 1) indicate at the top of the form that it is "FILED PURSUANT TO NOTICE 2017-23," or 2) attach a statement to Form 6765 that the form is filed according to Notice 2017-23.

company taxed as a partnership) is a qualified small business, gross receipts include:

- Total sales, net of returns and allowances,
- All amounts received for services, and
- Income from investments and other incidental or outside sources.

For businesses other than corporations and partnerships, gross receipts include all of a person's aggregate gross receipts from all trades or businesses.

The IRS doesn't, as many had hoped, establish a "de minimis" test for gross receipts. So, unless the IRS provides additional guidance, a business with minimal gross receipts prior to the five-year period — even a small amount of bank interest — is ineligible.

The IRS also requires members of a controlled group, or a group of businesses under common control, to aggregate their gross receipts for purposes of the $5 million threshold.

How to claim payroll tax credits

To take advantage of payroll tax credits, you must make the election by filing Form 6765, "Credit for Increasing Research Activities," with your timely filed business income tax return. You may elect to apply some or all of your research credit against the employer portion of Social Security taxes.

After you make the election, you may use your research credit to offset payroll taxes on a quarterly basis, starting with the first calendar quarter that begins after you file your federal income tax return. To claim the credit, you must file Form 8974, "Qualified Small Business Payroll Tax Credit for Increasing Research Activities," with your Form 941, "Employer's Quarterly Federal Tax Return," for that quarter.

The maximum payroll tax credit is $250,000 per year (with special rules for allocating that amount among members of a controlled group). In addition, you may not make a payroll tax credit election in more than five tax years. To the extent that your credit exceeds your Social Security tax liability in a given calendar quarter, you may carry the excess forward and use it as a credit against Social Security tax in the succeeding calendar quarter (subject to the annual five-tax-year limits).

Stay tuned

The payroll tax credit is a valuable tax break for businesses that wouldn't otherwise benefit currently from the research credit. The IRS may provide additional guidance that affects your eligibility for the credit, so be sure to monitor future guidance on the subject. ■

Restricted stock: Should you pay tax now or later?

For growing companies, equity-based compensation is a powerful tool for attracting and retaining executives and other key employees. If you receive an award of restricted stock or purchase shares subject to vesting, consider making an election under Internal Revenue Code Section 83(b) to accelerate taxable income associated with the stock.

2 ways Sec. 83(b) reduces taxes

Accelerating income may seem counter-intuitive, but if the stock's growth prospects are strong and the risk of forfeiture is low, a Sec. 83(b) election can generate significant tax savings. Ordinarily, restricted stock isn't subject to tax until it vests. At that time, however, you're subject to tax at ordinary-income rates on the stock's vesting-date value (less the purchase price you paid, if any). This can result in a substantial tax bill if the stock has appreciated significantly in value.

A Sec. 83(b) election can reduce your taxes in two ways:

1. If the stock's value increases, the election minimizes ordinary-income taxes by allowing you to pay the tax on the grant or purchase date value rather than on the vesting date value. If you purchase the stock at its fair market value, you'll recognize *zero* income on the purchase date.

2. It accelerates the start of the one-year long-term capital gains holding period to the grant or purchase date rather than the vesting date. Remember, long-term capital gains rates are lower than ordinary-income rates.

Bear in mind that you can't take too long to decide whether to make the election: You have only 30 days from the award or purchase date.

A Sec. 83(b) election in action

Let's say Heather's employer grants her 10,000 shares of restricted stock with a fair market value of $1 per share. When the stock vests one year later, its value has grown to $10 per share. Heather sells the stock a year after the vesting date for $25 per share. Assume that Heather is in the 35% tax bracket and that her long-term capital gains tax rate is 15%. (To keep things simple, we'll ignore state and payroll taxes.)

If Heather doesn't make a Sec. 83(b) election, no tax will be due when the stock is granted. When the stock vests, however, Heather will recognize $100,000 in ordinary income (10,000 × $10), resulting in a $35,000 tax bill. When Heather sells the stock a year later, she'll recognize a long-term capital gain on the stock's additional appreciation of $15 per share, resulting in a $22,500 tax bill (10,000 × $15 × 15%). Heather's total tax liability is $57,500.

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Now, let's assume that Heather files a timely Sec. 83(b) election when the stock is granted. She'll pay tax on $10,000 in ordinary income as of the grant date ($3,500), but when she sells the stock two years later, all of its appreciation in value ($24 per share) will be treated as a long-term capital gain, resulting in a $36,000 tax bill (10,000 × $24 × 15%). Her total tax liability is $39,500. By making the election, Heather enjoys $18,000 in tax savings.

Consider the risks

Be aware that a Sec. 83(b) election isn't risk-free. If you forfeit the stock (because, for example, you leave the company before it vests) or the stock declines in value, you'll have paid tax on income you didn't receive. You also might end up paying more tax than necessary if tax rates go down. Your tax advisor can help you weigh the pros and cons. ■

To file or not to file

What you need to know about filing gift and estate tax returns

Have you made substantial gifts of wealth to family members this year? Or are you the executor of the estate of a loved one who died recently? If so, you need to know whether you must file a gift or estate tax return. Let's take a closer look at the rules.

Filing a gift tax return

Generally, a federal gift tax return (Form 709) is required if you make gifts to or for someone during the year (with certain exceptions, such as gifts to U.S. citizen spouses) that exceed the annual gift tax exclusion ($14,000 for 2017); there's a separate exclusion for gifts to a noncitizen spouse ($149,000 for 2017).

Also, if you make gifts of *future* interests, even if they're less than the annual exclusion amount, a

gift tax return is required. Finally, if you split gifts with your spouse, regardless of amount, you must file a gift tax return.

The return is due by April 15 of the year after you make the gift, but the deadline may be extended

to October 15. (Dates may be slightly later if the 15th falls on a weekend or holiday.) Being required to file a form doesn't necessarily mean you owe gift tax. You'll owe tax only if you've already exhausted your lifetime gift and estate tax exemption ($5.49 million for 2017).

In some cases, it's a good idea to file a gift tax return even if you're not required to do so. For example, let's suppose Linda gives $10,000 worth of closely held stock to each of 10 family members, for a total of $100,000. Each gift is within the annual exclusion amount, so she doesn't file a gift tax return. However, 10 years later, the IRS determines that the value of each gift was actually $20,000 and assesses penalties for failure to file a gift tax return (plus taxes, penalties and interest if the lifetime exemption is exhausted).

Had Linda filed a properly completed gift tax return at the time she made the gifts, it would have triggered the three-year limitations period for auditing her return. Without a return, there's no time limit on how long the IRS can wait to challenge the valuation of her gifts.

Filing an estate tax return

If required, a federal estate tax return (Form 706) is due nine months after the date of death. Executors can seek an extension of the filing deadline, an extension of the time to pay, or both, by filing Form 4768. Keep in mind that the form provides for an *automatic* six-month extension of the filing deadline, but that extending the time to pay (up to one year at a time) is at the IRS's discretion. Executors can file additional requests to extend the filing deadline "for cause" or to obtain additional one-year extensions of time to pay.

Generally, Form 706 is required only if the deceased's gross estate plus adjusted taxable gifts exceed the exemption. But a return is required even if there's no estate tax liability after taking all applicable deductions and credits.

Even if an estate tax return isn't required, executors may need to file one to preserve a surviving spouse's portability election. Portability allows a surviving spouse to take advantage of a deceased spouse's unused estate tax exemption amount, but it's not automatic. To take advantage of portability, the deceased's executor must make an election on a timely filed estate tax return that computes the unused exemption amount.

In some cases, it's a good idea to file a gift tax return even if you're not required to do so.

Preparing an estate tax return can be a time consuming, costly undertaking, so executors should analyze the relative costs and benefits of a portability election. Generally, filing an estate tax return is advisable only if there's a reasonable probability that the surviving spouse will exhaust his or her own exemption amount.

Seek professional help

Estate tax rules and regulations can be complicated. If you need help determining whether a gift or estate tax return needs to be filed, contact your tax advisor. ■

Year-end planning for mutual funds

If you've sold mutual fund shares at a gain during the year, there are some year-end moves you can make to soften the tax blow. One strategy is to "harvest" capital losses (by selling investments that have declined in value) and using those losses to offset the gain. You can even buy back the investments after deducting the loss, so long as you wait at least 31 days.

Another strategy is to ensure that mutual fund shares with the highest cost basis are sold first, minimizing your gains. To do this, use the "specific identification" method for calculating basis and inform your broker which shares you wish to sell. Absent such instructions, the first-in, first-out method will be applied by default, which may increase your capital gains. ■

Tax-free capital gains?

For taxpayers in the middle and upper ordinary-income tax brackets, long-term capital gains are taxed at rates ranging from 15% to 23.8% (including the 3.8% tax on net investment income). Taxpayers in the 10% and 15% ordinary-income brackets, however, enjoy a 0% tax rate on long-term capital gains. One way to take advantage of tax-free capital gains is to transfer stock or other investments to family members in the two lowest tax brackets — for instance, single filers with taxable income of $37,950 or less in 2017 ($75,900 for married couples filing jointly).

A few caveats:

- Consider potential gift tax consequences before transferring assets.
- Watch out for the "kiddie tax." Generally, if you transfer capital assets to a dependent child under the age of 19 (24 for a full-time student), any unearned income (including capital gains) in excess of $2,100 will be taxed at the *parents'* rate.
- The 0% rate applies only to the extent that capital gains increase the recipient's taxable income to the top of the 15% bracket. Additional long-term capital gains are taxed at 15% until the highest bracket is reached; then they're taxed at 20%. ■

Beware deduction limits

A basic precept of year-end tax planning is to defer income to next year and accelerate deductions into the current year. But as you consider your options, keep in mind that deduction limitations for high-income taxpayers may reduce the effectiveness of this strategy.

The limits apply to deductions for taxes paid, interest paid, charitable gifts, job expenses and certain miscellaneous deductions. They don't apply to medical expenses, investment interest expense, or casualty, theft and gambling losses. ■