

Interim Guidance and Request for Comments; Election by Qualified Small Business to Claim Payroll Tax Credit for Increasing Research Activities

Notice 2017-23

SECTION 1. PURPOSE

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are developing guidance to implement the payroll tax credit election available to certain small businesses under § 41(h) of the Internal Revenue Code (Code) to claim the payroll tax credit under § 3111(f) of the Code. Sections 41(h) and 3111(f) allow a qualified small business to elect to apply a portion of the § 41(a) research credit for the taxable year against the employer portion of the old-age, survivors, and disability insurance tax (social security tax) under the Federal Insurance Contributions Act. Sections 41(h) and 3111(f) are effective for taxable years beginning after December 31, 2015. For purposes of this notice, the term “research credit” refers to the credit under § 41(a) against income tax liability, the term “payroll tax credit” refers to the credit under § 3111(f)(1) against liability for the employer portion of social security tax, and the term “payroll tax credit election” refers to the election available under § 41(h) to claim the payroll tax credit.

This notice provides interim guidance for making the payroll tax credit election. Specifically, this notice provides interim guidance regarding the term “qualified small business,” including the applicable guidance for determining gross receipts for purposes of § 41(h). This notice also provides interim guidance relating to the time and manner of making the payroll tax credit election and claiming the credit. Finally, the Treasury Department and the IRS request comments on the interim guidance described in this notice and other issues affecting payroll tax credit elections that may require additional guidance.

SECTION 2. BACKGROUND

Sections 41(h) and 3111(f) were enacted by section 121(c) of the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, 129 Stat. 2242. Section 41(h)(1) provides that at the election of a qualified small business for any taxable year, § 3111(f) shall apply to the payroll tax credit portion of the research credit for the taxable year and such portion shall not be treated (other than for purposes of § 280C) as a research credit.

Section 41(h)(2) provides that the payroll tax credit portion of the research credit with respect to any qualified small business for any taxable year is the least of (A) the amount specified in the payroll tax credit election, (B) the research credit for the taxable year (determined before the application of § 41(h)), or (C) in the case of a qualified small business other than a partnership or S corporation, the amount of the business credit carryforward under § 39 carried from the taxable year (determined before the application of § 41(h) to the taxable year).

Under § 41(h)(3)(A)(i), a “qualified small business” means, with respect to any

taxable year, a corporation or partnership if (I) the gross receipts (as determined under the rules of § 448(c)(3), without regard to subparagraph (A) thereof) of such entity for the taxable year are less than \$5,000,000, and (II) such entity did not have gross receipts (as so determined) for any taxable year preceding the 5-taxable-year period ending with such taxable year. In addition, under § 41(h)(3)(A)(ii), a “qualified small business” includes any person (other than a corporation or partnership) who meets the requirements of § 41(h)(3)(A)(i)(I) and (II), determined by substituting “person” for “entity” each place it appears, and by taking into account only the aggregate gross receipts received by such person in carrying on all the trades or businesses of such person. Under § 41(h)(3)(B), a “qualified small business” shall not include an organization that is exempt from income taxation under § 501.

Section 41(h)(4)(A)(i) provides that any payroll tax credit election shall specify the amount of the research credit to which the election applies. Section 41(h)(4)(A)(ii) provides that any payroll tax credit election shall be made on or before the due date (including extensions) of (I) in the case of a qualified small business that is a partnership, the return required to be filed under § 6031 (for example, the Form 1065 or successor form), (II) in the case of a qualified small business that is an S corporation, the return required to be filed under § 6037 (for example, the Form 1120-S or successor form), and (III) in the case of any other qualified small business, the return of tax for the taxable year. Section 41(h)(4)(A)(iii) provides that, once made by a taxpayer, a payroll tax credit election may be revoked only with the consent of the Secretary.

Under § 41(h)(4)(B)(i), the amount specified in any payroll tax credit election shall not exceed \$250,000. Section 41(h)(4)(B)(ii) provides that a person may not make a

payroll tax credit election if such person (or any other person treated as a single taxpayer with such person under § 41(h)(5)(A)) has made a payroll tax credit election for 5 or more preceding taxable years.

Section 41(h)(4)(C) provides that, in the case of a qualified small business that is a partnership or S corporation, the payroll tax credit election shall be made at the entity level.

Section 41(h)(5)(A) provides that, except as provided in § 41(h)(5)(B), all persons or entities treated as a single taxpayer under § 41(f)(1) shall be treated as a single taxpayer for purposes of § 41(h). Section 41(h)(5)(B)(i) provides that, for purposes of §§ 41(h) and 3111(f), each of the persons treated collectively as a single taxpayer under § 41(h)(5)(A) may separately make the payroll tax credit election for any taxable year. Section 41(h)(5)(B)(ii) provides that, for purposes of §§ 41(h) and 3111(f), the \$250,000 amount under § 41(h)(4)(B)(i) shall be allocated among all persons treated collectively as a single taxpayer under § 41(h)(5)(A) in the same manner as under § 41(f)(1)(A)(ii) or (B)(ii), whichever is applicable.

Section 41(h)(6) instructs the Secretary to prescribe regulations as may be necessary to carry out the purposes of § 41(h), including (A) regulations to prevent the avoidance of the purposes of the limitations and aggregation rules through the use of successor companies or other means, (B) regulations to minimize compliance and recordkeeping burdens under § 41(h), and (C) regulations for recapturing the benefit of payroll tax credits in cases where there is a subsequent adjustment to the payroll tax credit portion of the research credit, including requiring amended income tax returns in the cases where there is such an adjustment.

Section 3111(f)(1) provides that, in the case of a taxpayer who has made a payroll tax credit election for a taxable year, there shall be allowed a payroll tax credit for the first calendar quarter which begins after the date on which the taxpayer files the return specified in § 41(h)(4)(A)(ii) in an amount equal to the payroll tax credit portion of the research credit determined under § 41(h)(2).

Under § 3111(f)(2), the payroll tax credit shall not exceed the employer portion of social security tax imposed for any calendar quarter on the wages paid with respect to the employment of all individuals in the employ of the employer.

Section 3111(f)(3) provides that if the amount of the payroll tax credit exceeds the limitation of § 3111(f)(2) for any calendar quarter, such excess is carried to the succeeding calendar quarter and allowed as a payroll tax credit for such quarter.

Section 3111(f)(4) provides that the payroll tax credit shall not be taken into account for purposes of determining the amount of any deduction allowed under chapter 1 of subtitle A of the Code for the employer portion of social security taxes.

The Treasury Department and the IRS recognize that businesses need immediate guidance to determine their eligibility for the payroll tax credit election with respect to taxable years beginning in 2016, and the procedures for making the election and claiming the credit. In response to Notice 2016-26, 2016-14 I.R.B. 533, which requests recommendations for the 2016-2017 Priority Guidance Plan, several commenters requested guidance under §§ 41(h) and 3111(f). In particular, commenters requested guidance regarding the term “gross receipts” for purposes of determining whether a business is a “qualified small business” under § 41(h)(3). In addition, commenters requested guidance regarding controlled groups of corporations and

groups of trades or businesses under common control (collectively referred to as controlled groups) in the context of § 41(h). Because immediate guidance is necessary, this notice prescribes interim guidance in sections 3 and 4 regarding the definition of “qualified small business” and the time and manner of making the payroll tax credit election. Further, because the Treasury Department and the IRS are developing guidance under § 41(h), the Treasury Department and the IRS request comments in section 6 of this notice on the interim guidance provided in this notice and other issues under § 41(h) that may require additional guidance.

SECTION 3. INTERIM GUIDANCE FOR DEFINING QUALIFIED SMALL BUSINESS

.01 Corporations and partnerships.

A corporation (including an S corporation) or partnership is a qualified small business with respect to any taxable year if the corporation or partnership:

(1) Has gross receipts, as defined in section 3.04 of this notice, of less than \$5,000,000 for the taxable year, and

(2) Did not have gross receipts, as defined in section 3.04 of this notice, for any taxable year before the 5-taxable-year period ending with the taxable year.

.02 Other businesses.

Any person (other than an entity described in section 3.01 of this notice) is a qualified small business if the person meets the requirements of section 3.01(1) and (2) of this notice taking into account the person’s aggregate gross receipts, as defined in section 3.04 of this notice, received in carrying on all the person’s trades or businesses.

.03 Tax exempt organizations.

Organizations exempt from income tax under § 501 are not qualified small

businesses even if they satisfy the requirements of sections 3.01 or 3.02 of this notice.

.04 Determination of gross receipts.

The term “gross receipts” in section 3 of this notice means gross receipts as determined under § 448(c)(3) (without regard to § 448(c)(3)(A)) and § 1.448-1T(f)(2)(iii) and (iv) of the Income Tax Regulations. The definition of gross receipts under § 41(c)(7) and § 1.41-3(c) does not apply for purposes of § 41(h).

.05 Aggregation rule.

For purposes of the gross receipts rules in sections 3.01 and 3.02 of this notice, all members of a controlled group, as defined in § 1.41-6(a)(3)(ii), for a taxable year are treated as a single taxpayer. Thus, the aggregate gross receipts of all members of a controlled group for a taxable year must be taken into account in determining whether the requirements of section 3.01(1) and (2) of this notice are satisfied.

.06 Examples.

The following examples illustrate the application of section 3 of this notice:

(1) Corp A, a calendar year corporation, is not a tax-exempt organization under § 501 or a member of a controlled group in taxable year 2016. Corp A has gross receipts, as determined under section 3.04 of this notice, of \$1 million, \$7 million, \$4 million, \$3 million, and \$4 million for taxable years 2012, 2013, 2014, 2015, and 2016, respectively. Corp A did not have gross receipts, as determined under section 3.04 of this notice, for any taxable year prior to 2012. Corp A is a qualified small business for taxable year 2016 because it has less than \$5,000,000 in gross receipts for taxable year 2016 and did not have gross receipts before taxable year 2012 (before the 5-taxable-year period ending with 2016). Corp A’s gross receipts in taxable years 2012-

2015 are not relevant in determining whether Corp A is a qualified small business in taxable year 2016. Because Corp A had gross receipts in taxable year 2012, Corp A is not a qualified small business in taxable year 2017, regardless of its gross receipts in 2017.

(2) Corp A, Corp B, and Corp C are calendar year taxpayers that are not tax-exempt organizations under § 501 and are members of a controlled group for taxable year 2016 (Corp ABC controlled group). Corp A has gross receipts, as determined under section 3.04 of this notice, of \$1 million, \$7 million, \$4 million, \$3 million, and \$4 million for taxable years 2012, 2013, 2014, 2015, and 2016, respectively. Corp B has gross receipts, as determined under section 3.04 of this notice, of \$500,000, \$1 million, \$2 million, \$1 million, and \$1 million for taxable years 2012, 2013, 2014, 2015, and 2016, respectively. Neither Corp A nor Corp B had gross receipts, as determined under section 3.04 of this notice, for any taxable year prior to 2012. Corp C has gross receipts, as determined under section 3.04 of this notice, of \$1 million, \$3 million, \$4 million, \$3 million, \$1 million, and \$500,000 for taxable years 2011, 2012, 2013, 2014, 2015, and 2016, respectively. Corp A, Corp B, and Corp C are not qualified small businesses for taxable year 2016 because the aggregate gross receipts of Corp ABC controlled group for taxable year 2016 are not less than \$5 million (\$4 million (Corp A) + \$1 million (Corp B) + \$500,000 (Corp C)). In addition, neither Corp A, Corp B, nor Corp C is a qualified small business in taxable year 2016 because Corp C had gross receipts in taxable year 2011 (before the 5-taxable-year period ending with 2016).

SECTION 4. INTERIM GUIDANCE FOR ELECTING THE PAYROLL TAX CREDIT

.01 In general.

A qualified small business, as defined in section 3 of this notice, may make a payroll tax credit election in an amount limited as specified in section 4.03 or 4.05(2) of this notice for any taxable year beginning after December 31, 2015. If a qualified small business makes a payroll tax credit election, the amount elected is not treated as a research credit, except for purposes of § 280C.

.02 Time and manner of election.

A qualified small business makes a payroll tax credit election by completing the appropriate portion of Form 6765, Credit for Increasing Research Activities, or successor form, relating to the payroll tax credit election, and attaching the completed form to the qualified small business's timely filed (including extensions) return for the taxable year to which the election applies. The term "return" means the return required to be filed under § 6031 in the case of a partnership (for example, the Form 1065 or successor form), the return required to be filed under § 6037 in the case of an S corporation (for example, the Form 1120-S or successor form), and the return with respect to income tax for the taxable year in the case of any other qualified small business.

If a qualified small business timely files its return for a taxable year beginning after December 31, 2015, but fails to make the payroll tax credit election, it may make the election on an amended return filed on or before December 31, 2017. To qualify for this extension, the business must either: 1) indicate on the top of its Form 6765 reflecting the payroll tax credit election that the form is "FILED PURSUANT TO NOTICE

2017-23,” or 2) attach a statement to its Form 6765 reflecting the payroll tax credit election that the form is filed pursuant to Notice 2017-23.

.03 Amount of election.

The amount of any payroll tax credit election may not exceed the least of:

- (1) The qualified small business’s research credit for the taxable year (determined before the application of § 41(h)),
- (2) \$250,000, or
- (3) In the case of a qualified small business other than a partnership or S corporation, the amount of the qualified small business’s business credit carryforward under § 39 carried from the taxable year (determined before the application of § 41(h)).

.04 Limitation on number of taxable years.

A person may not make a payroll tax credit election for a taxable year if the person (or any other member of the person’s controlled group as defined under § 1.41-6(a)(3)(ii)) has made an election for 5 or more preceding taxable years.

.05 Special rules for controlled groups.

(1) In general.

In the case of a controlled group, as defined under § 1.41-6(a)(3)(ii), each member of the controlled group separately makes the payroll tax credit election in the time and manner described in section 4.02 of this notice.

(2) Amount of election.

Each member of a controlled group can separately elect the least of:

- (a) The electing member’s allocable share of the group’s research credit, as determined under § 1.41-6T(c),

(b) The electing member's allocable share of the \$250,000 amount, as determined under section 4.05(3) of this notice, or

(c) In the case of an electing member other than a partnership or S corporation, the amount of the electing member's business credit carryforward under § 39 carried from the taxable year (determined before the application of § 41(h)).

(3) \$250,000 amount.

The \$250,000 amount is allocated for purposes of section 4.05(2)(b) of this notice to each member of a controlled group in the same manner as the group's research credit is allocated under § 1.41-6T(c), regardless of whether all members of the controlled group make the payroll tax credit election. Thus, the \$250,000 amount is allocated to each member of a controlled group on a proportionate basis to its share of the aggregate of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums (collectively referred to as QREs) taken into account for the taxable year by such controlled group for purposes of the research credit.

(4) Example.

The following example illustrates the application of section 4.05 of this notice:

A, B, and C, all calendar year partnerships, are the only members of a controlled group (ABC controlled group) and are qualified small businesses under section 3 of this notice. A and B, but not C, make a payroll tax credit election for taxable year 2016 by completing the portion of their Forms 6765 relating to the payroll tax credit election and attaching the completed Forms 6765 to their timely filed (including extensions) Forms 1065, U.S. Return of Partnership Income, for taxable year 2016. ABC controlled group

calculated its total research credit for taxable year 2016 to be \$300,000. Under § 1.41-6T(c), A is allocated \$60,000, B is allocated \$90,000, and C is allocated \$150,000 of the group's research credit on a proportionate basis to each member's proportionate share of the controlled group's aggregate QREs. In the same manner as under § 1.41-6T(c), A is allocated \$50,000, B is allocated \$75,000, and C is allocated \$125,000 of the \$250,000 amount for purposes of section 4.05(2)(b) of this notice. For taxable year 2016, the maximum amount that A can elect as a payroll tax credit is \$50,000 (the lesser of A's allocable share of the group's research credit and A's allocable share of the \$250,000 amount). The maximum amount that B can elect as a payroll tax credit is \$75,000 (the lesser of B's allocable share of the group's research credit and B's allocable share of the \$250,000 amount). C did not make a payroll tax credit election. If A makes the payroll tax credit election in the amount of \$50,000, A still has a research credit available for income tax purposes in the amount of \$10,000. If B makes the payroll tax credit election in the amount of \$75,000, B still has a research credit available for income tax purposes in the amount of \$15,000. Because C did not make the payroll tax credit election, C still has a research credit available for income tax purposes in the amount of \$150,000.

.06 Claiming the credit on the employment tax return.

A qualified small business that elects to claim the payroll tax credit and files quarterly employment tax returns, claims the payroll tax credit on its employment tax return for the first quarter that begins after it files the return reflecting the election as specified in section 4.02 of this notice. For example, if a qualified small business files an income tax return on April 10, 2017, with a Form 6765 attached reflecting the payroll

tax credit election, the qualified small business would claim the payroll tax credit on its Form 941, Employer's Quarterly Federal Tax Return, for the third quarter of 2017. A qualified small business that files annual employment tax returns claims the payroll tax credit on its annual employment tax return that includes the first quarter beginning after the date on which the business files the return reflecting the election as specified in section 4.02 of this notice. A qualified small business claiming the payroll tax credit on its employment tax return must complete Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, or successor form, and attach the completed form to that employment tax return. Under various employment tax procedural rules, the Employer Identification Number (EIN) of the taxpayer filing the employment tax return may differ from the EIN of the taxpayer that filed the return with an attached Form 6765 reflecting the election as specified in section 4.02 of this notice. On Form 8974, the taxpayer filing the employment tax return claiming the credit provides the EIN used on the Form 6765 reflecting the election.

The payroll tax credit claimed by an employer on an employment tax return cannot exceed the employer portion of the social security tax for any calendar quarter on wages paid with respect to the employment of all individuals in the employ of the employer. The employer uses Form 8974 to apply this limit to the amount of the payroll tax credit it elected on Form 6765 and to determine the amount of the credit allowed on its employment tax return. If the payroll tax credit elected on Form 6765 exceeds this limitation, then the excess determined on Form 8974 is carried over to the succeeding calendar quarter(s) and allowed as a payroll tax credit for the succeeding quarter(s), subject to the social security tax limitation applicable to the quarter(s).

SECTION 5. EFFECTIVE DATE

This notice applies to payroll tax credit elections made with respect to taxable years beginning after December 31, 2015.

SECTION 6. REQUEST FOR COMMENTS

.01 Comments requested.

The Treasury Department and the IRS request written comments on issues relating to §§ 41(h) and 3111(f) and the interim guidance provided in this notice. In particular, the Treasury Department and the IRS request comments that address the following:

(1) Section 41(h)(6)(A) grants the Secretary authority to provide rules to prevent the avoidance of the purposes of the limitations and aggregation rules under § 41(h) through the use of successor companies or other means. Because there may be scenarios in which a business could make a payroll tax credit election that is inconsistent with the intent of § 41(h) through the use of a successor company or otherwise, the Treasury Department and the IRS are considering whether rules are necessary to treat successor companies as the same person for purposes of § 41(h) and, if so, how the term “successor company” should be defined for purposes of § 41(h). In addition, the Treasury Department and the IRS are exploring whether businesses could otherwise avoid the purposes of the limitations and aggregation rules through means other than successor companies and, if so, whether rules are necessary to prevent such a result. The Treasury Department and the IRS invite comments regarding rules to address successor companies and other means of avoiding the purposes of the rules under § 41(h).

(2) Section 41(h)(6)(C) grants the Secretary authority to provide rules for recapturing the benefit of payroll tax credits in cases where there is a subsequent adjustment to the payroll tax credit portion of the research credit, including requiring amended income tax returns in cases where there is such an adjustment. The Treasury Department and the IRS invite comments on how the IRS should recapture excessive payroll tax credits if there is a subsequent adjustment to the payroll tax credit portion of the research credit. For example, the Treasury Department and the IRS request comments on how the IRS should recapture excessive payroll tax credits if: (A) the payroll tax credit portion of the research credit is reduced because the IRS subsequently adjusts a business's research credit, or, in the case of a business other than a partnership and S corporation, the amount of the business credit carryforward under § 39 carried from the taxable year (determined before the application of § 41(h)); (B) a business makes an invalid election because, for example, the business is not a qualified small business; or (C) an error in determining or claiming the payroll tax credit is made on the employment tax return. The Treasury Department and the IRS also request specific comments on how the IRS should recapture excessive payroll tax credits if the situation is described in either (A), (B), or (C) of the preceding sentence, and either (i) the period of limitations on assessment of tax under § 6501 has expired for the income tax return, but has not expired for the employment tax return, or (ii) the period of limitations on assessment of tax has expired for the employment tax return, but has not expired for the income tax return.

(3) The Treasury Department and the IRS invite comments regarding whether guidance is necessary to address how the § 41(h) election rules apply to members of a

consolidated group.

(4) Section 41(h)(4)(B)(ii) provides that a person may not make a payroll tax credit election if such person (or any other person treated as a single taxpayer under § 41(h)(5)(A) with such person) has made a payroll tax credit election for 5 or more preceding taxable years. The Treasury Department and the IRS invite comments regarding whether controlled group relationships that existed in previous taxable years that do not exist in the current taxable year are relevant for purposes of the 5-year-limitation period under § 41(h)(4)(B)(ii).

.02 Date for comments.

Comments in response to this notice are requested by July 17, 2017.

.03 Address to send comments.

(1) Comments responding to this notice should be sent to:

Internal Revenue Service
CC:PA:LPD:PR (Notice 2017-23)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Please include "Notice 2017-23" on the cover page.

(2) Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to:

Internal Revenue Service
Courier's Desk
1111 Constitution Ave., N.W.
Washington, DC 20224
Attn: CC:PA:LPD:PR
(Notice 2017-23)

(3) Submissions may also be sent electronically to the following e-mail address: Notice.Comments@irscounsel.treas.gov. Please include "Notice 2017-23" in the subject line.

All comments will be available for public inspection and copying.

SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Jennifer A. Records of the Office of Associate Chief Counsel (Passthroughs & Special Industries). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Ms. Records at (202) 317-6853 (not a toll-free call).