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The Inflation Reduction Act Doubles R&D Tax Credit

Certain small businesses have qualified to take a tax credit for research and development costs since 2015. However, the Inflation Reduction Act (IRA) changed the credit, making it even more valuable for small businesses.

Background on the R&D Tax Credit

The Protecting Americans from Tax Hikes (PATH) was enacted in 2015. It added a payroll tax credit for certain qualified small businesses. The credit was based on a portion of their research and development (R&D) costs. The credit directly reduced Social Security obligations, which meant that even companies with no income tax could monetize the credit right away.

The PATH Act made a previously temporary R&D credit a permanent part of the tax code. It also allowed certain startups and small businesses to take the R&D tax credit for up to five years. In addition, business owners could use the credit to offset Alternative Minimum Tax (AMT) as well. Before the PATH Act, companies could only use the credit to offset regular tax liabilities instead of the AMT.

Doubling the R&D Tax Credit through the IRA

Employers under the PATH Act could offset their Social Security payroll tax obligations (of 6.2% of pay) up to \$250,000. However, the IRA doubles this limitation, allowing businesses to offset up to \$500,000 of their payroll obligations. Under the IRA, it can soon be used to offset the 1.45% employer contribution for Medicare payroll tax as well.

The Social Security and Medicare offsets are particularly beneficial to startups and small businesses. These companies might not have much in the way of income tax obligations as they get started, but as long as they have employees, they will have Social Security and Medicare obligations.

The new offset starts after December 31, 2022, which means it will go into effect for the 2023 tax year.

Eligibility Requirements for the R&D Tax Credit

The R&D tax credit is sometimes overlooked, but it can be very valuable, especially for startups. It is available to “qualified small businesses.” The Internal Revenue Code specifically defines this term. Qualified small businesses (QSB) must meet the following requirements.

1. Is no more than five years past the period for which it had no gross receipts (less than five years old, in most cases); and
2. Gross receipts for the year in which the credit is elected of no more than \$5 million.

The business must also be conducting “qualifying research activities.” The IRS also defines this term in the code. Essentially, the activities must include:

- **A business component.** There must be some business reason for the research and development expense. It should improve the functionality, performance, quality, etc., of a product or service; it cannot be research for the sake of research.
- **Elimination of uncertainty.** The business must also be able to show that the activities were intended to eliminate technical uncertainty about methods, design or capability of a product or service.
- **Process of experimentation.** The credit will only be provided to businesses that have gone through an experimentation process. That is, the business must have considered alternatives and tested those alternatives in a systematic way. Examples might include simulations, trial and error testing and modeling.
- **Technological in nature.** The research must relate to “hard science,” such as biology, engineering, computer sciences, physics or chemistry. While “soft sciences” certainly have value in business (i.e., sociology and psychology), they do not qualify for the R&D tax credit.

The R&D credit offset can be applied to both Social Security and Medicare obligations, but it is limited to \$250,000 for Medicare and \$250,000 for Social Security. The offset is not refunded if there is no liability, and it cannot be used as a credit against any other type of employment tax.

Showing Eligibility for the R&D Tax Credit

Some companies struggle to prove that they can take the R&D tax credit. The qualifications are extensive and somewhat complicated, and they require comprehensive documentation. However, when the credit is potentially worth hundreds of thousands of dollars, it may be worth the effort. Talk to an experienced tax professional to learn more about how your business can take advantage of the R&D tax credit.

Contact [Frankel Zacharia](#) today if you have any questions or would like additional information. Please contact us at 402-496-9100 or www.fzacpa.com.