

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

Number: **AM2017-003**

Release Date: 8/4/2017

CC:TEGE:EOEG:ET2:AGKelley

PRENO-120484-17

UILC: 3111.00-00

date: July 31, 2017

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subject: Timing Issues Related to Payroll Tax Credit for Increasing Research Activities

This memorandum responds to your request for non-taxpayer specific legal advice regarding timing issues related to the payroll tax credit, the credit against employer social security tax for increasing research activities of a qualified small business under section 3111(f) of the Internal Revenue Code. This advice may not be used or cited as precedent.

ISSUES

(1) With respect to a calendar quarter in which the payroll tax credit under section 3111(f) is taken, when should an employer take into account the payroll tax credit for purposes of determining its daily tax liability and its deposit liability? Specifically, on which days on Form 941, Schedule B, Report of Tax Liability for Semiweekly Schedule Depositors, should an employer that is a semi-weekly schedule depositor take into account the payroll tax credit, and for which month or months in the quarter should an employer that is a monthly schedule depositor take into account the payroll tax credit?

(2) If, pursuant to section 4.02 of Notice 2017-23, 2017-16 I.R.B. 1100, a qualified small business that filed a tax return not electing the payroll tax credit files an amended tax return electing the payroll tax credit under section 41(h), for which quarter does the taxpayer claim the payroll tax credit under section 3111(f) on its employment tax return:

(a) the quarter beginning after the date the qualified small business filed the amended return electing the payroll tax credit under section 41(h), (b) the quarter after filing the original tax return not electing the payroll tax credit, or (c) some other quarter?

### CONCLUSIONS

(1) An employer takes into account the payroll tax credit for a quarter against liability for employer social security tax starting with the first payroll payment of the quarter that includes payments of wages subject to social security tax to its employees. The credit may be taken to the extent of employer social security tax on wages associated with the first payroll payment, and then to the extent of employer social security tax associated with succeeding payroll payments in the quarter until the credit is used. In determining the amount to enter on the Record of Federal Tax Liability with respect to a payment of wages subject to social security taxes, the employer should reduce tax liability by the lesser of: (A) the amount of the employer social security tax on the wages or (B) the available payroll tax credit. If any payroll tax credit is remaining at the end of the quarter that has not been used because it exceeds the amount of employer social security tax on wages paid during the quarter, the excess credit may be carried over to the succeeding quarter and treated as a payroll tax credit for that succeeding quarter under section 3111(f)(3).

(2) If a qualified small business that filed a tax return not electing the payroll tax credit files an amended tax return electing the payroll tax credit under section 41(h), pursuant to section 4.02 of Notice 2017-23, the taxpayer claims the payroll tax credit under section 3111(f) on its employment tax return for the quarter beginning after the date the qualified small business filed the amended return and may not claim the payroll tax credit elected on that amended return in an earlier quarter. If any payroll tax credit is not used completely in that quarter because of the limitation in section 3111(f)(2), the excess credit may be carried over to the succeeding quarter and allowed as a payroll tax credit under section 3111(f)(3) for that succeeding quarter.

### LAW AND ANALYSIS

Sections 41(h) and 3111(f) allow a qualified small business to elect to apply a portion of the section 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 (FICA). Sections 41(h) and 3111(f) are effective for taxable years beginning after December 31, 2015.

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

Under section 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 section 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 31.3111-3 provides that the employer tax attaches at the time that the wages are paid by the employer. Section 31.3121(a)-1(a) provides that generally wages are paid by the employer at the time that they are actually or constructively paid.

### **Issue (1)**

Employers generally file either Form 941, Employer's Quarterly Federal Tax Return, or an annual federal employment tax return (such as Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, or Form 944, Employer's Annual Federal Tax Return) to report employer social security tax liability. The employer social security tax is included with employee social security tax on line 5a, Column 2, of Form 941. In Part 2 of Form 941, the employer indicates whether it is a monthly schedule or semiweekly schedule depositor. If the employer is a monthly schedule depositor, it completes boxes in Part 2 of Form 941 showing its total liability for income tax withholding, social security, and Medicare taxes for each of the months of the quarter, and the total for the quarter, which must equal Line 12, Total taxes after adjustments and credits, in Part 1 of the Form 941. If the employer is a semiweekly schedule depositor, it checks a box in Part 2, and must complete Schedule B (Form 941), Report of Tax Liability for Semiweekly Schedule Depositors, and attach it to Form 941. Schedule B is also referred to as Record of Federal Tax Liability (ROFTL) for semi-weekly schedule depositors. The IRS uses this information to determine if the employer made its federal employment tax deposits on time.

On Schedule B, an employer lists its employment tax liability for each day in the quarter on which a liability arises. Generally, the employer's liability includes the total of (1) federal income taxes withheld from employees' pay, (2) employer social security taxes, (3) employee social security taxes, (4) employer Medicare taxes, and (5) employee Medicare taxes.

The Instructions for Schedule B (Form 941) currently provide as follows with respect to the payroll tax credit:

**Adjusting tax liability for the qualified small business payroll tax credit for increasing research activities.** You must account for any qualified small business payroll tax credit for increasing research activities that you reported on Form 941 or Form 941-SS, line 11, when reporting your liabilities on Schedule B.

The total liability for the quarter must equal Form 941 or Form 941-SS, line 12. Failure to account for the amount reported on Form 941 or Form 941-SS, line 11, may cause Form 941 or Form 941-SS, line 12, to be less than the total tax liability reported on Schedule B. Don't reduce tax liability reported on Schedule B below zero.

An employer knows the maximum amount of payroll tax credit potentially available for a quarter at the beginning of the quarter because the income tax return reflecting the payroll tax credit election on Form 6765, Credit for Increasing Research Activities, must have been filed before the quarter begins in which the employer can claim credit. However, the amount of the payroll tax credit that is allowed for the quarter is limited to the employer social security tax on wages paid to the employer's employees during the quarter. Thus, as the employer makes payments of wages from the beginning of the quarter for which the payroll tax credit is taken, the employer can take the payroll tax credit into account for purposes of the Schedule B and for purposes of deposit liability on the Form 941 or other employment tax return, provided the employer later files Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, with the Form 941 or other employment tax return for the quarter.<sup>1</sup>

With respect to the timing of the payroll tax credit for purposes of calculating deposit liabilities, the credit should be taken against deposit liabilities and reflected on Schedule B as the employer incurs liability for employer social security tax on wages paid in the quarter to which it applies, beginning with the first payment of wages in the quarter. It would be counter to the purpose of the payroll tax credit to allow it as a credit only when the employer files its Form 941 for the quarter claiming the credit and not as the employer is paying wages during the quarter subject to employer social security tax.<sup>2</sup> An employer cannot take the payroll tax credit against employee social security tax or income tax withholding. See §3111(f)(1). Note that there should be no negative entries on the Schedule B.

In summary, the employer taking account of the payroll tax credit in a quarter should reduce the first liability on the Schedule B to the extent of employer social security tax

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<sup>1</sup> A payroll tax credit claimed on Form 941 will not be processed and given effect unless the taxpayer files Form 8974 with the Form 941. Form 8974 is essentially a bridge form between Form 6765 and the employment tax return (Form 941, for example). Form 8974 explains how the employer is entitled to the payroll tax credit and the amount of the payroll tax credit that the employer is allowed for the quarter. If the employer does not file Form 8974 with its employment tax return and if it made deposits reflecting the payroll tax credit, it may be subject to a failure-to-deposit penalty (unless it can show reasonable cause).

<sup>2</sup> If, however, the taxpayer files an income tax return properly electing the payroll tax credit on Form 6765 in one quarter, but in the following quarter mistakenly fails to take account of the payroll tax credit in determining its deposits and in filing Form 941, it should file a Form 941-X for that following quarter (with Form 8974) claiming the appropriate credit, provided the Form 941-X is filed within the period of limitations. For example, if, on April 15, 2017, a taxpayer filed an income tax return with Form 6765 properly electing the payroll tax credit, but it failed to take account of the payroll tax credit in determining its deposits for the 2017 third quarter and on the 2017 third quarter Form 941, it should file a Form 941-X (with Form 8974) for the 2017 third quarter claiming the appropriate credit, provided the period of limitations for the 2017 third quarter Form 941 is open.

with respect to the wages for that first liability (provided it does not exceed the amount of payroll tax credit that applies for the quarter). Then the employer should carry any excess payroll tax credit to apply against succeeding liabilities on the Schedule B within the quarter until it is used and if the excess credit is not used in the quarter, carry any excess to the next quarter.

If, in a succeeding quarter, the amount carried over from a quarter in which the payroll tax credit was allowed is not fully used because of the limitation under section 3111(f)(2), any unused amount can be carried forward as a payroll tax credit for the following quarter. For subsequent quarters, if the payroll tax credit cannot be fully used in the quarter because of the limitation to employer social security tax on wages, any unused amount can be carried forward as a payroll tax credit to the following quarter.

The procedure may be expressed in the following steps for the quarter in which the payroll tax credit can be claimed:

**Step 1** – Calculate the employer’s share of social security tax included in the liability to be reported on either the Form 941, line 16 (monthly depositors), or Schedule B (semi-weekly depositors) for the first date wages are paid for the quarter.

**Step 2** – Compare that amount of employer social security tax on the wages paid for the first pay date to the amount of the payroll tax credit available for the quarter.

- If the credit is greater than or equal to the total amount of the employer’s share of the social security tax on wages paid for that pay date, the employer’s share of the social security tax is not reflected on Form 941, line 16, or Schedule B (as applicable) related to that first pay date liability and is not required to be deposited.
- If the available credit is less than the employer’s share of the social security tax for that period, the employer’s share of the social security tax is reduced by the amount of the credit and the balance of the employer’s share of social security tax must be included on Form 941, line 16 or Schedule B (as applicable) and in the deposit related to that pay date.
- Note that the amounts of income tax withholding, Medicare tax, and employee social security tax on the wages required to be reported on Form 941, line 16 or Schedule B (as applicable), for that pay date (and other pay dates) are unaffected by the payroll tax credit.

**Step 3** – Timely deposit the amount of the reported liability for (a) the amount of employer social security tax that cannot be offset by the payroll tax credit, (b) the amount of employee social security tax, (c) the amount of employer Medicare tax, (d) the amount of employee Medicare tax, and (e) the amount of income tax withholding.

**Step 4** -- If the employer's share of social security tax for the first pay date is less than the amount of the payroll tax credit allowed to be deducted for the quarter (or year if filing an annual employment tax return), the remaining payroll tax credit can be carried forward to offset the employer share of social security tax in subsequent pay dates in the return period applying these 4 steps until it is used up. If the remaining payroll tax credit cannot be used in the quarter (or the remainder of the year in the case of annual employment tax return filers), the remaining payroll tax credit can be carried forward to the next period to be used to offset employer social security tax liability with respect to wages paid to employees of the employer. A Form 8974 will also be required for each quarter (or year, if filing an annual employment tax return) for which the payroll tax credit offsets the employer social security tax liability on the employment tax return.

### **Issue (2)**

Under section 41(h)(4) and Section 4.02 of Notice 2017-23, a qualified small business makes a payroll tax credit election by completing the appropriate portion of Form 6765, 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. For this purpose, 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 (for example, Form 1120 or successor form).

Section 4.02 of Notice 2017-23 provides that 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 the 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.

Nothing in Notice 2017-23 changes the rule in section 3111(f)(1) that the amount elected under section 41(h) shall be allowed as a payroll tax credit "for the first calendar quarter which begins after the date on which the taxpayer files the return specified in section 41(h)(4)(A)(ii)" making the election. Therefore, if the payroll tax credit is elected on an amended return, the payroll tax credit elected is allowed against employer social security tax for the quarter that begins after the amended return is filed. The payroll tax credit cannot be applied to an earlier quarter.

**Examples.** Example 1 relates to Issue (1) and Examples 2 and 3 relate to Issue (2). The following examples assume that the amount elected as a payroll tax credit by the taxpayer meets the requirements for electing a payroll tax credit under section 41(h), unless specifically provided otherwise:

**Example 1**

**Facts:** On April 6, 2017, Employer X, a semi-weekly schedule depositor, filed an income tax return electing a payroll tax credit under section 41(h) of \$5,000. Employer X claims the payroll tax credit under section 3111(f) for the third quarter of 2017, the first quarter that begins after the return electing the payroll tax credit was filed. During 2017, Employer X pays \$10,000 of wages subject to social security tax each week to its employees, pays the wages on Friday of each week, and pays no other wages during the week. For purposes of this example the total income tax withholding with respect to the total wages paid each wage payment date is assumed to be \$1,000, and it is assumed that no employee is subject to the Additional Medicare tax and that no employee receives remuneration in excess of the social security tax wage base. The employer social security tax (6.2%) on each payment of wages is \$620 (6.2% X 10,000), the employee social security tax on the wages is \$620, and there are 13 payroll dates during the quarter. The employer would also incur liability for employer Medicare tax (1.45%) on each payment of wages, or \$145 (1.45% X 10,000) and employee Medicare tax of \$145 would be withheld, for a total of \$290 Medicare tax liability on each payment date.

**Analysis:** In determining its social security tax liability for purposes of Schedule B with respect to the first wage payment date in the 2017 third quarter, Employer X would add the employer social security tax of \$620 and the employee social security tax of \$620, but then reduce that amount by \$620 of the payroll tax credit to determine a social security tax liability of \$620, which would be added to income tax withholding of \$1,000 and the employer and employee shares of Medicare tax (\$290) to determine the amount to enter on Schedule B for that payment date. The second wage payment date through the eighth wage payment date would contain similar calculations of the liability for social security tax for purposes of Schedule B. Thus, \$620 multiplied by 8, or \$4960 of the \$5,000 elected credit will have been used by the eighth payroll date. With respect to the ninth payroll date, the employer will have \$40 remaining payroll tax credit that it can use. Therefore, the liability for employer social security tax for that payment will be \$620-40 or \$580. With respect to the remaining pay dates for the quarter, the amount to be entered on the Schedule B will include liability for the employer social security tax of \$620 because the payroll tax credit will have been fully used up before the payments are made, or a total of \$1240 social security tax.

Thus, looking at the entries to be made on Schedule B beginning with the wages paid on Friday, July 7, 2017, the employer would enter for month 1, box 7 the amount of \$1910 [consisting of employee social security tax of \$620, Medicare tax of \$290, and income tax withholding of \$1000]. The amount of \$1910 would also be entered in each of the next 7 pay dates (i.e., month 1 boxes 14, 21, 28 and month 2 boxes 4, 11, 18, and 25). Then in month 3, box 1, the amount of \$2490 [consisting of employee social security tax of \$620, employer social security tax of \$580, Medicare taxes of \$290, and income tax withholding of \$1000]. In month 3, the amount of \$2530 [\$620 employee social security tax, \$620 employer social security tax, Medicare taxes of \$290, and

\$1000 income tax withholding] will be entered in each of boxes 8, 15, 22, and 29. The employer should make deposits on the dates that are appropriate for the liabilities reflected in the Schedule B.

### **Example 2**

**Facts:** Employer M, a calendar year corporation, timely filed an income tax return for taxable year 2016 on March 15, 2017, and did not make an election on Form 6765 to take the payroll tax credit under section 41(h). Pursuant to section 4.02 of Notice 2017-23, 2017-16 I.R.B. 1100, M filed an amended income tax return on July 15, 2017, amending its income tax return for taxable year 2016 by electing the payroll tax credit on Form 6765.

**Analysis:** Under section 3111(f)(1) of the Code, the payroll tax credit can be claimed against employer social security tax with respect to wages paid to M's employees for the fourth quarter of 2017, the first calendar quarter which begins after the date on which M filed its amended return reflecting the payroll tax credit election on Form 6765. The payroll tax credit elected on the amended return filed on July 15, 2017, may not be taken as a credit against employer social security tax for any earlier quarter and must be taken as a payroll tax credit for the 2017 fourth quarter to the extent allowed. If the amount of the payroll tax credit exceeds the employer social security tax on wages paid to M's employees in the 2017 fourth quarter, then the excess is carried forward to the first quarter of 2018 as a payroll tax credit for the 2018 quarter.

### **Example 3**

**Facts:** Employer N, a fiscal year corporation with a taxable year ending April 30, filed its income tax return for the taxable year beginning May 1, 2016, and ending April 30, 2017, on July 15, 2017. Employer N did not make an election under section 41(h) to take the payroll tax credit on Form 6765 filed with that return. Employer N had gross receipts of \$3,000,000 for its fiscal year ending April 30, 2017, and also met the other requirements to be a qualified small business (see section 41(h)(3)). Employer N had gross receipts of \$10,000,000 for its fiscal year ending April 30, 2018, and thus did not meet the requirements to be a qualified small business for its fiscal year ending April 30, 2018 (See section 41(h)(3)(i)). Pursuant to section 4.02 of Notice 2017-23, N filed an amended income tax return on January 2, 2018, for the taxable year ending April 30, 2017, and the amended return included an election to take the payroll tax credit on Form 6765.

**Analysis:** N's amended return filed on January 2, 2018, meets the requirement that it must be filed on or before December 31, 2017, under section 4.02 of Notice 2017-23 because December 31, 2017, is a Sunday, and January 1, 2018, is a legal holiday. See §7503, which provides that when the last day prescribed under authority of the internal revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next



succeeding day which is not a Saturday, Sunday, or legal holiday. Under section 3111(f)(1) of the Code, the payroll tax credit is allowed as a credit against employer social security tax for the second quarter of 2018, the first calendar quarter which begins after the date on which the taxpayer filed its amended return reflecting the payroll tax credit election on Form 6765. (Note the fact that the amended return meets the December 31, 2017, timeliness requirement does not change the filing date for other purposes (January 2, 2018), such as the period of limitations on assessment or, in this case, the payroll tax credit under section 3111(f)(1).) The payroll tax credit may not be taken as a credit against employer social security tax for any earlier quarter and must be taken as a payroll tax credit for the 2018 second quarter to the extent allowed. If the amount of the payroll tax credit elected exceeds the employer social security tax on wages paid in the 2018 second quarter, then the excess is carried forward to the third quarter of 2018 as a payroll tax credit for the 2018 third quarter.

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Please call (202) 317-4774 if you have any further questions.