

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Controls for the Qualified Small Business Payroll Tax Credit Were Updated, but Ineligible Taxpayers Continue to Receive the Credit

April 15, 2026

Report Number: 2026-408-012

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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HIGHLIGHTS: Controls for the Qualified Small Business Payroll Tax Credit Were Updated, but Ineligible Taxpayers Continue to Receive the Credit

Final Audit Report issued on April 15, 2026

Report Number 2026-408-012

Why TIGTA Did This Audit

The Protecting Americans from Tax Hikes Act allowed a qualified small business to use up to \$250,000 of the Research Credit as a payroll tax credit to offset the employer's portion of Social Security tax (hereafter called the Payroll Tax Credit). Subsequently, the Inflation Reduction Act of 2022 increased the amount of the Qualified Small Business Payroll Tax Credit from \$250,000 to \$500,000. In addition, a qualified small business may apply up to \$250,000 of any excess credit against the Medicare tax on wages paid starting with Tax Year 2023. For example, if an employer's Payroll Tax Credit exceeds the Social Security tax, the employer can apply the excess against Medicare tax up to \$250,000.

In December 2018, we reported that the IRS did not have processes to identify small businesses that were not eligible for the Payroll Tax Credit. This audit is a follow-up to that review to determine if the IRS's controls ensured that taxpayers who claimed the Qualified Small Business Payroll Tax Credit were eligible and claimed the correct amount.

Impact on Tax Administration

While most businesses that claim the Payroll Tax Credit are eligible, incorrect claims can have far-reaching effects. For example, the payroll taxes that businesses are required to pay help fund programs such as Social Security and Medicare. As a result, erroneous credits reduce the funding paid to these programs.

What TIGTA Found

As of June 2025, the IRS received approximately:

- 11,400 Forms 941, *Employer's QUARTERLY Federal Tax Return*, with \$382 million in Qualified Small Business Payroll Tax Credit for Tax Year 2023.
- 12,600 Forms 941 with \$381 million in Qualified Small Business Payroll Tax Credit for Tax Year 2024.

Qualified small businesses can carry unused credits forward to subsequent quarters indefinitely, until the credit is fully claimed.

Generally, taxpayers use Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*, to claim the Payroll Tax Credit. The IRS uses business rules to check the accuracy of fields and calculations on electronically filed Forms 8974 before tax returns are accepted for processing. The IRS implemented actions to address previous concerns we reported about three Form 8974 business rules. Additionally, the IRS took action to address business rule errors brought to their attention by taxpayers that prevented them from reporting the maximum allowed credit.

However, the IRS still does not have processes to address ineligible taxpayers who claim the Qualified Small Business Payroll Tax Credit. Qualified small businesses must make an election on Section D of Form 6765, *Credit for Increasing Research Activities*, to use the Research Credit to offset payroll taxes. Analysis of business tax returns electronically filed as of December 2024 found that 40 businesses with a Form 6765 election for Tax Year 2023 did not meet the gross receipts eligibility requirement. The IRS erroneously allowed these businesses to claim \$3.1 million in Research Credits to offset Tax Years 2023 and 2024 payroll taxes.

We previously recommended that the IRS implement procedures to identify ineligible businesses that erroneously claim the Payroll Tax Credit. Small Business/Self-Employed Division management agreed with our recommendation [REDACTED]

What TIGTA Recommended

We recommended that the IRS review the 40 ineligible businesses that we identified and recover any erroneously claimed Qualified Small Business Payroll Tax Credit.

The IRS agreed and will review these cases and determine what action is appropriate.



**TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION**

**U.S. DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20024**

April 15, 2026

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

FROM: Diana M. Tengesdal
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Controls for the Qualified Small Business Payroll Tax Credit Were Updated, but Ineligible Taxpayers Continue to Receive the Credit (Audit No.: 2024408029)

This report presents the results of our review to determine whether controls ensure that taxpayers who claim the Research Credit against their payroll taxes are eligible to claim the credit and that they claim the correct amount. This review was part of our Fiscal Year 2025 Annual Audit Plan and addresses the major management and performance challenge of *Implementing Tax Law Changes*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Deann L. Baiza, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Background

Internal Revenue Code Section 41, *Credit for Increasing Research Activities*, was enacted in 1981 to stimulate research and development in the United States by helping businesses offset some of the costs associated with increasing their qualified research activities (the credit is hereafter referred to as the Research Credit).¹ The Protecting Americans from Tax Hikes Act allowed a qualified small business to use up to \$250,000 of the Research Credit as a payroll tax credit to offset the employer's portion of Social Security tax.² Hereafter, this payroll offset is referred to as the Qualified Small Business Payroll Tax Credit or the Payroll Tax Credit.

The Inflation Reduction Act of 2022 increased the amount of the Payroll Tax Credit from \$250,000 to \$500,000.³ In addition, a qualified small business may also apply up to \$250,000 of any excess credit against the Medicare tax on wages paid starting with Tax Year (TY) 2023. For example, if an employer's Payroll Tax Credit exceeds the Social Security tax, the employer can apply the excess against Medicare tax up to \$250,000.

A qualified small business is a corporation (including an S corporation), partnership, or any other taxpayer that: 1) filed an income tax return claiming gross receipts of less than \$5 million for the tax year that they elect to use the credit, and 2) had no gross receipts for any tax year before the five-year period ending with the tax year that the election was made. Below is a hypothetical example of the gross receipts eligibility requirement for a qualified small business:

Corporation A had gross receipts as follows – \$1 million in TY 2019, \$7 million in TY 2020, \$4 million in TY 2021, \$3 million in TY 2022, and \$4 million in TY 2023. Corporation A had no gross receipts for tax years before TY 2019.

Corporation A is a qualified small business for TY 2023 because it has less than \$5 million in gross receipts in that year and had no gross receipts before TY 2019 (*i.e.*, before the five-year period ending with TY 2023).

Claiming the Qualified Small Business Payroll Tax Credit

Qualified small businesses must make an election on Section D of Form 6765, *Credit for Increasing Research Activities*, to use the Research Credit to offset payroll taxes. Each election must specify the amount of the Payroll Tax Credit covered by the election. The form must be attached to the taxpayer's timely filed annual income tax return, including extensions. Once filed, the taxpayer can begin offsetting payroll taxes through the Payroll Tax Credit on the next quarter's employment tax return.

Generally, taxpayers use Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities*, to claim the Payroll Tax Credit. The Form 8974 must be attached to an

¹ Qualified research must include discovering information that is technological in nature, and its application must be intended for use in developing a new or improved business component of the taxpayer. In addition, substantially all of the activities of the research must be elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

² Pub. L. No. 114-113, 129 Stat. 2242 (2015). The offset became effective in Tax Year 2016. See Appendix IV for a glossary of terms.

³ Pub. L. No. 117-169, 136 Stat. 1818.

**Controls for the Qualified Small Business Payroll Tax Credit Were Updated,
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employment tax return (e.g., Form 941, *Employer's QUARTERLY Federal Tax Return*). As of June 2025, the IRS received 11,416 Forms 941 with \$382 million in Payroll Tax Credit for TY 2023, and 12,612 Forms 941 with \$381 million in Payroll Tax Credit for TY 2024. Figure 1 shows the volume of Forms 941 for TYs 2023 and 2024 by quarter and the amount of the Payroll Tax Credit claimed.

**Figure 1: Payroll Tax Credits Claimed
on Form 941 for Tax Years 2023 and 2024**

Form 941	Tax Year 2023		Tax Year 2024	
	Tax Returns	Credit Claimed	Tax Returns	Credit Claimed
Quarter 1	3,214	\$166.7M	3,559	\$157.9M
Quarter 2	2,565	\$71.1M	2,977	\$88.2M
Quarter 3	2,562	\$64.4M	2,919	\$68.5M
Quarter 4	3,075	\$80.0M	3,157	\$66.2M
Total	11,416	\$382.0M	12,612	\$380.8M

Source: Analysis of Forms 941 from the Business Return Transaction File for Processing Years 2023 through 2025 as of June 17, 2025. Numbers may not add up due to rounding. M = millions.

Qualified small businesses can carry unused credits forward to subsequent quarters indefinitely, until the credit is fully claimed. For example, a taxpayer whose Payroll Tax Credit is \$200,000 more than the payroll taxes on their first quarter Form 941 can use the \$200,000 to offset payroll taxes in subsequent quarters. Form 8974 lists the remaining Payroll Tax Credit based on each election from a timely filed annual income tax return.

Validating Qualified Small Business Payroll Tax Credit claims

The IRS validates some of the information used to calculate the Payroll Tax Credit claimed on Form 8974 during tax return processing. This includes:

- Screening electronic tax returns for errors before processing. The IRS uses business rules to check the accuracy of fields and calculations on electronically filed (e-filed) Forms 8974 before tax returns are accepted for processing. Tax returns that are rejected by the business rules are sent back to the taxpayer for correction and resubmission. Business rules are used to validate information on e-filed tax returns for acceptance into tax return processing. This helps ensure that accurate information is being submitted to the IRS.
- Screening tax returns for errors during processing. The Error Resolution System validates the computation of the Payroll Tax Credit on both e-filed and paper-filed tax returns. Tax returns with discrepancies receive an error code and are sent to the Error Resolution function for manual review and correction by a tax examiner. [REDACTED] the IRS will correspond with the taxpayer to resolve the error. [REDACTED] it will be processed as filed.

Results of Review

Actions Were Taken to Prevent Payroll Tax Credit Claims From Rejecting Incorrectly, but More Can Be Done to Address Erroneous Claims

The IRS addressed previously reported concerns with three Form 8974 business rules.⁴ These three business rules were rejecting Payroll Tax Credit claims [REDACTED] and burdening taxpayers because they had to identify where on the form the calculation error occurred, correct the error, and resubmit the tax return. We recommended that the IRS [REDACTED] to these business rules and Submission Processing management updated the business rules for TY 2024. During this review, we confirmed these business rules were working as intended.

The IRS also took action to address business rule errors brought to their attention by taxpayers. According to Submission Processing analysts, the IRS began receiving information in May 2024 indicating that the maximum Payroll Tax Credit amount for TY 2023 was incorrectly limited to \$250,000. As previously stated, the Inflation Reduction Act of 2022 increased the maximum Payroll Tax Credit amount to \$500,000. The IRS found that the Form 8974 business rules were not updated to account for the maximum credit amount.

The IRS initiated a programming change to allow credit amounts up to \$500,000 for TY 2024 and subsequent tax years in May 2024. However, TY 2023 was not included in the criteria. As a result, the IRS created a temporary work-around that allows taxpayers to e-file their employment tax return and receive the maximum credit for TY 2023. The IRS published the work-around for TY 2023 tax returns to the *Known Issues and Solutions* section of the Modernized e-File page on IRS.gov.

The number of taxpayers impacted by the programming error was minimal. As of December 2024, we identified nearly 2,000 e-filed tax returns for TY 2023 that reported the election for and claimed the Payroll Tax Credit. Only 4 of the nearly 2,000 taxpayers needed to use the IRS's work-around process because their Payroll Tax Credit amount exceeded \$250,000. The other taxpayers were able to file their tax return normally.

The IRS still does not have processes to address ineligible taxpayers who claim the Qualified Small Business Payroll Tax Credit

As previously mentioned, for a business to be considered a qualified small business and eligible to claim the Payroll Tax Credit, the business has to have gross receipts of less than \$5 million. We reviewed nearly 7,300 TY 2023 e-filed business tax returns with a Form 6765 election as of December 2024 and identified 40 tax returns where the business did not meet the gross receipts eligibility requirement to use the Research Credit to offset payroll taxes. As a result, the IRS erroneously allowed these businesses to claim \$3.1 million as a Payroll Tax Credit. The taxpayers applied \$1.4 million as Payroll Tax Credits to their TY 2023 and 2024 payroll taxes. These

⁴ TIGTA, Report No. 2024-408-004, *Inflation Reduction Act: Assessment of Implementation of Processing Year 2023 Tax Provisions*, p. 5 (October 2023).

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businesses can use the remaining \$1.7 million in unused Payroll Tax Credits to offset payroll taxes in subsequent tax quarters until the credit is used in full.

Additionally, in December 2018, we reported that the IRS did not have processes to identify small businesses that were not eligible for the Payroll Tax Credit. As a result, we recommended that the IRS implement procedures to identify businesses tax returns after they are processed that do not meet eligibility requirements and erroneously claimed the Payroll Tax Credit and potentially recover any erroneous claims.⁵ Small Business/Self-Employed Division management agreed with our recommendation and had their Research Office evaluate the compliance risk of the population. The IRS applied the same eligibility requirements we used and determined that the [REDACTED]

While most businesses that claim the Payroll Tax Credit are eligible, incorrect claims can have far-reaching effects. For example, the payroll taxes that businesses are required to pay help fund the Social Security and Medicare systems and erroneous Payroll Tax Credit claims reduce funding to those systems. As a result, the IRS should take reasonable steps to ensure that only those businesses that meet the Payroll Tax Credit eligibility requirements are allowed to use the credit to offset their payroll taxes.

Recommendation 1: The Commissioner, Small Business/Self-Employed Division should review the 40 businesses identified as ineligible for the Qualified Small Business Payroll Tax Credit and recover any erroneously claimed credit.

Management's Response: IRS management agreed with the recommendation. They will review the 40 cases and determine what action, if any, is appropriate.

⁵ TIGTA, Report No. 2019-40-014, *Processes Are Needed to Identify Small Businesses Erroneously Claiming the Research Tax Credit Payroll Tax Offset*, p. 3 (December 2018).

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine whether controls ensure that taxpayers who claim the Research Credit against their payroll taxes are eligible to claim the credit and that they claim the correct amount. To accomplish our objective, we:

- Evaluated the IRS's actions to implement Provision 13902, *Increase in Research Credit Against Payroll Tax for Small Businesses*, of the Inflation Reduction Act.
- Determined whether the IRS has sufficient controls in place to verify the accuracy and eligibility of the Qualified Small Business Payroll Tax Credit.
- Determined whether the IRS post-processing compliance initiatives are sufficient.

Performance of This Review

This review was performed with information obtained from the Small Business/Self-Employed Division Headquarters located in Washington, D.C., during the period August 2024 through September 2025. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We limited our scope to Payroll Tax Credit claims on Forms 941 as the volume of taxpayers using Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*, and Form 944, *Employer's Annual Federal Tax Return*, to claim the Payroll Tax Credits were not substantial.

Data Validation Methodology

During this review, we obtained extracts from the Business Master File, Business Return Transaction File, and Modernized Tax Return Database that were available on TIGTA's Data Center Warehouse. Before relying on the data, we ensured that each file contained the specific data elements we requested. In addition, we selected judgmental samples of each extract and verified that the data in the extracts were the same as the data captured in the Integrated Data Retrieval System.¹ We also performed analysis to ensure the validity and reasonableness of our data, such as ranges of dollar values and obvious invalid values. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the processes and procedures used to verify the accuracy and eligibility of the Qualified Small Business Payroll Tax Credit. We

¹ A judgmental sample is a nonprobability sample, the results of which cannot be used to project to the population.

**Controls for the Qualified Small Business Payroll Tax Credit Were Updated,
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evaluated these controls by reviewing policies and procedures, meeting with IRS management, and performing data analysis.

Outcome Measure

This appendix presents detailed information on the measurable impact that our recommended corrective action will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Funds Put to Better Use – Potential; \$1.4 million in erroneous Qualified Small Business Payroll Tax Credits claimed by 40 ineligible businesses (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

We obtained extracts from the Modernized Tax Return Database for Processing Year 2024 as of December 2024. Our analysis of 7,297 e-filed business tax returns identified 40 businesses with a Form 6765 election for TY 2023 that did not meet the gross receipts eligibility requirement to use the Payroll Tax Credit to offset payroll taxes. The 40 businesses claimed \$3,106,848 in erroneous Qualified Small Business Payroll Tax Credit elections in TY 2023. The businesses received \$1,378,516 in credit for TYs 2023 and 2024. In addition, these businesses can carry forward \$1,728,332 in unused Qualified Small Business Payroll Tax Credit in subsequent quarters. These 40 businesses did not meet the eligibility criteria as a qualified small business.

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

March 4, 2026

MEMORANDUM FOR DIANA M. TENGESDAL
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Lia Colbert **Amalia C. Colbert** Digitally signed by Amalia C. Colbert
Commissioner, Small Business/Self-Employed Division Date: 2026.03.05 11:30:18 -05'00'

SUBJECT: Draft Audit Report – Controls for the Qualified Small Business
Payroll Tax Credit Were Updated, but Ineligible Taxpayers
Continue to Receive the Credit (Audit No.: 2024408029)

Thank you for the opportunity to respond to your draft audit report. We appreciate your recognition of the steps we have taken to strengthen controls over the Qualified Small Business Payroll Tax Credit. This credit allows eligible small businesses to use a portion of their research credit to offset payroll taxes, giving newer or growing businesses access to the benefit even if they do not yet owe income tax.

As your report notes, we fixed prior business rule concerns that caused some returns to be rejected unnecessarily, [REDACTED] and confirmed those controls are functioning as intended. After the Inflation Reduction Act, we updated programming to reflect the increased \$500,000 credit limitation and implemented a temporary workaround to ensure taxpayers could timely claim the full amount allowed. These actions reflect our commitment to providing timely service to taxpayers while protecting Federal revenue.

We use several levels of review to validate Payroll Tax Credit claims. These include automated checks before a return is accepted and reviews during processing. Verifying eligibility, however, requires reviewing a business's gross receipts [REDACTED]

**Controls for the Qualified Small Business Payroll Tax Credit Were Updated,
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As your report notes, of approximately 7,300 Tax Year 2023 e-filed business returns that included a Form 6765 election, 40 were identified as not meeting the gross receipts eligibility requirement—approximately one-half of one percent of the population reviewed. While any instance of noncompliance is taken seriously, this limited number of cases is [REDACTED]

We recognize that payroll taxes support the Social Security and Medicare trust funds and remain committed to safeguarding the integrity of the credit while providing timely service to eligible taxpayers. We agree with your recommendation and plan to review the cases you identified. We also agree with the outcome measure.

Our response to your recommendation is enclosed. If you have any questions, please contact me, or Richard L. Tierney, Director, Examination, Small Business/Self-Employed Division.

Attachment

**Controls for the Qualified Small Business Payroll Tax Credit Were Updated,
but Ineligible Taxpayers Continue to Receive the Credit**

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division should review the 40 businesses identified as ineligible for the Qualified Small Business Payroll Tax Credit and recover any erroneously claimed credit.

CORRECTIVE ACTION:

We agree. We will review the 40 cases and determine what action, if any, is appropriate.

IMPLEMENTATION DATE:

March 15, 2027

RESPONSIBLE OFFICIAL:

Director, Examination Case Selection, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

Glossary of Terms

Term	Definition
Business Master File	The IRS database that consists of federal tax-related transactions and accounts for businesses. These include employment taxes, business income taxes, and excise taxes.
Business Return Transaction File	The IRS database that receives business tax return data, reformats, and posts returns to the Return Transaction File, and does periodic file maintenance.
Business Rule	Business rules are used to validate information included on e-filed tax returns for acceptance into tax return processing. The IRS will reject e-filed tax returns from processing when the tax return does not meet a business rule.
Data Center Warehouse	A TIGTA repository of IRS data.
Error Resolution System	A real-time computer system used to identify and address paper and e-filed tax returns with an error condition.
Integrated Data Retrieval System	An IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Modernized Tax Return Database	The official repository of all electronic returns processed through the Modernized e-file system.
Processing Year	The calendar year in which the IRS processes the tax return or document.
Tax Year	A 12-month accounting period for keeping records of income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

Abbreviations

e-file(d)	Electronically File(d)
IRS	Internal Revenue Service
TIGTA	Treasury Inspector General for Tax Administration
TY	Tax Year



**To report fraud, waste, or abuse,
contact our hotline on the web at
<https://www.tigta.gov/reportcrime-misconduct>.**

**To make suggestions to improve IRS policies, processes, or systems
affecting taxpayers, contact us at
TIGTACommunications@tigta.treas.gov.**

Information you provide is confidential, and you may remain anonymous.