

R&D CREDIT COALITION

COMMENTS ON THE TAX REFORM ACT OF 2014 DISCUSSION DRAFT

April 3, 2014

Introduction

The R&D Credit Coalition is a group of trade and professional associations along with small, medium and large companies that collectively represent millions of American workers engaged in U.S.-based research throughout major sectors of the U.S. economy, including aerospace, agriculture, biotechnology, chemicals, electronics, energy, information technology, manufacturing, medical technology, pharmaceuticals, software and telecommunications.

Although the R&D Credit Coalition is diverse, the member companies which the coalition represents share a major characteristic: they collectively spend billions of dollars annually on research and development, which provides high-wage and highly-skilled jobs in the United States. The high U.S. corporate income tax rate and the temporary nature of the U.S. R&D tax credit, compared to the lower corporate income tax rates and more stable, robust, and often permanent research incentives in most other developed countries, are key factors that companies consider in determining where they are going to create and maintain R&D jobs.

On February 26, House Ways and Means Committee Chairman Dave Camp released a discussion draft of the “Tax Reform Act of 2014” (the “Discussion Draft”) that proposed broad reforms to the Internal Revenue Code (the “Code”), including among other changes, a reduction in the statutory corporate tax rate and a permanent extension of the R&D tax credit. In addition, the Discussion Draft would significantly modify the R&D tax credit and require R&D expenditures to be amortized over 5 years.

Under current law, a taxpayer can deduct the cost of research expenses in the year incurred (Section 174 of the code). In addition, until December 31, 2013, the tax code provided a R&D tax credit for up to 20% of qualified research costs over a base amount (14% under an easier to calculate elective Alternative Simplified Credit (“ASC”)); 20% of basic research payments; and 20% for amounts for energy research (Section 41 of the code). However, if the taxpayer elected to utilize the R&D tax credit, the taxpayer’s deduction was reduced by the amount of any R&D tax credit (Section 280C of the Code).

The Coalition believes that the U.S. should provide a strengthened and permanent R&D tax credit as well as continue with the current law practice of allowing R&D costs to be deducted in the year incurred. In particular, the Coalition has strongly advocated for bipartisan legislation (H.R. 942, introduced by Rep. Brady (R-TX), Rep. Larson (D-CT) and others) to make the R&D tax credit permanent and increase to 20% the ASC. Although many taxpayers still use the regular 20% credit as it can provide more value, moving to a credit based only on the ASC would greatly simplify credit calculations and help improve credit administration. Importantly, increasing the ASC to 20% would counter the removal of the regular credit option and enhance the incentive effect of the credit.

Under the Discussion Draft, taxpayers would be required to amortize R&D expenditures over a 5 year period rather than allow the costs to be deducted in the year incurred. In addition, the R&D tax credit would be made permanent, but would be changed in several significant ways. First, calculation of the credit would be limited to the ASC at a 15% rate, while the traditional 20% credit and energy credit would be repealed. The basic research credit would be continued, but at a 15% credit rate. Both credits would be calculated as 15% of the qualified research expenses that exceed 50% of the average qualified research expenses for the 3 preceding years. Importantly, the definition of “qualified research” would be significantly modified to (1) exclude any research with respect to computer software and thus disqualify computer software from the credit and (2) remove amounts paid or incurred for supplies as qualified research expenses. Finally, the election to take a reduced credit in return for not offsetting the section 174 deduction would be repealed.

Discussion

The Coalition appreciates the objective contained in the Discussion Draft – to achieve a reduction in the corporate statutory rate – and the need to balance the rate reduction with offsetting reforms. Reducing the U.S. corporate tax rate from the highest in the world is a necessary reform to enhance the competitiveness of U.S. based businesses and to attract investment. In today’s global economy with greater demand for investment in research activities, there is significant global competition for R&D jobs. Companies have an array of choices on where to locate such jobs and where to invest research dollars as many countries have highly educated and skilled workforces. It is clear that investments in research and innovation have positive spillover effects in the U.S. economy. Likewise, incentives to attract that investment enhance those spillover effects.

With increased global competition, it is vital to ensure that the U.S. is the best place for companies to do business and conduct research. There are many other countries that offer *both* lower corporate tax rates and more attractive R&D incentives¹. For example, Australia provides a 40% tax credit for all eligible R&D expenditures and a corporate tax rate of 30%. If the U.S. is to retain and attract global R&D activities across all sectors of the economy, there is a growing need for the certainty provided by a tax code that is favorable to R&D investment. Retaining current year expensing and providing a permanent and strengthened R&D tax credit would enhance the attractiveness of the U.S. for investment and stimulate job creation to grow the economy and keep the U.S. competitive.

R&D Tax Credit

The R&D tax credit has a significant impact on private R&D spending and the creation of valuable research jobs. A recent study by the Center for American Progress concludes that, “the credit is effective in the sense that each dollar of foregone tax revenue causes businesses to invest at least an additional dollar in R&D.”² In addition, according to a study by Ernst & Young, “In total, the overall policy – the existing credit plus strengthening the alternative simplified credit – is estimated to increase

¹ Deloitte, “Global Survey of R&D Tax Incentives,” March 2013.

² Center for American Progress, “The Corporate R&D Tax Credit and U.S. Innovation and Competitiveness,” by Laura Tyson and Greg Linden, January 2012, p.2.

annual private research spending by \$15 billion in the short-term and \$33 billion in the long-term.”³ Moreover, it is important to note that the R&D tax credit is largely a *jobs* credit—70 percent of credit dollars are used to pay the salaries of high skilled R&D workers in the U.S. The EY study also stated that, “the credit and its enhancement is estimated to increase research-related employment by 140,000 in the short term and 300,000 in the long-term.”⁴

The U.S. must maintain a globally competitive tax system that supports high-skilled, high-paying jobs. The R&D tax credit, originally enacted in 1981, was designed to be an important incentive in spurring private sector investment in innovative research by companies of all sizes and in a variety of industries. The enactment of this incentive helped establish the U.S. as a world leader in cutting-edge research that created high-paying jobs here in the U.S. During the 1980s, the U.S. was the leader among OECD countries in providing the best R&D incentives for companies. However, in recent years, many other countries have instituted more generous and often permanent R&D incentives. For example, South Korea has a 40% tax credit for current year R&D spending that exceeds the 3-year average and Canada has a 15% tax credit for all eligible R&D spending. As a result, according to an OECD study, if the R&D credit was in effect, the U.S. would rank 22nd in research incentives among industrialized countries.⁵

Several OECD countries have enacted a variety of tax incentives to attract research activities, including tax credits that can be as high as 40% of research expenses, super deductions that can be as high as 200% of research expenses, as well as other incentives to encourage research spending. A National Science Board report concluded that the United States’ lead in science and technology is “rapidly shrinking” as R&D jobs and overall R&D spending continue to increase faster outside the U.S. than here at home. The report shows that “between 1999 and 2009...the U.S. share of global research and development (R&D) dropped from 38 percent to 31 percent, whereas it grew from 24 percent to 35 percent in the Asia region during the same time.”⁶

Concerns with the Proposal

While the Discussion Draft would make the credit permanent, a long overdue necessity, and increases the ASC to 15%, the definition of qualified research would be unnecessarily restricted. In particular, the Coalition is concerned that the Discussion Draft would unfairly disqualify an entire industry from participating in the credit. Software development activities contribute billions of dollars to the U.S. economy and employ millions of highly skilled workers. Removing computer software completely from credit eligibility implies that computer software is not innovative, not technological or that there is nothing new to discover. This could not be farther from the truth. Companies, universities and other organizations spend billions of dollars a year in research activities to develop new computer software and create new applications for existing software that is innovative. For example, the National Science

³ Ernst & Young, “The R&D Credit: An effective policy for promoting research spending,” September 2011, p. i.

⁴ Ernst & Young, “The R&D Credit: An effective policy for promoting research spending,” September 2011, p.11.

⁵ OECD, “Science, Technology and Industry Scoreboard,” December 2013, p. 107.

⁶ National Science Foundation press release, “New Report Outlines Trends in U.S. Global Competitiveness in Science and Technology,” January 17, 2011.

Foundation funds numerous research projects related to software development, including in the area of cyber security, and has noted that “...scientific discovery and innovation are advancing along fundamentally new pathways opened by the development of increasingly sophisticated software. Software is also directly responsible for increased scientific productivity and significant enhancement of researchers' capabilities.”⁷

Software development is a critical component of numerous products and services and is critical to just about every industry segment, including medical, manufacturing, automotive, aerospace and defense, telecommunications, and others. In particular, software is a key element in advanced manufacturing and the U.S. is a leader in software development. Denying the credit to computer software risks moving existing software development jobs outside the U.S. and would disadvantage new investment in the U.S. No other country specifically denies credit eligibility for all software costs. On the contrary, some countries single out software development and other highly innovative activities as a means to incentivize additional investment in these activities. In addition, removing software development from the activities eligible for the credit would invite significant future controversy as taxpayers would need to separately track and distinguish between the costs of software and everything else. As software is integral to a vast array of products and utilized in many research projects, the Discussion Draft would create new recordkeeping burdens and a new source of controversy between taxpayers and the Internal Revenue Service.

The Coalition recommends that research expenditures related to the use and development of computer software continue to be treated as qualified research expenditures eligible for the credit.

In addition, the Discussion Draft would disallow the credit for the cost of supplies used in the conduct of qualified research. Numerous industries that engage in research activities would be impacted by this narrowing of what qualifies under the credit, but most of the impact would unfairly and disproportionately hit manufacturers that conduct a significant amount of research in the U.S. Research activities require people, mainly highly skilled scientists, to conduct research, but also require testing equipment, raw materials, instruments and a variety of inputs necessary to carry out the process of experimentation. Since the original enactment of the credit, Congress has recognized that supplies can be an integral part of conducting scientific research and thus are treated as qualified research expenses. While it has been clear that supplies qualify for the credit, the lack of clear guidance on the issue has created uncertainty in complying with the credit. Recent guidance has helped to clarify the prior uncertainties regarding the treatment of supplies. Given this history, it is not appropriate to now eliminate completely the qualification of supplies as a means to simply reduce the cost of the credit. This is especially true in today's environment of ever increasing costs. U.S. companies must continually invest in process and product improvements to maintain competitiveness in the worldwide market, and eliminating supplies will create a significant disincentive for ongoing research.

The Coalition recommends that research expenditures related to supplies continue to be treated as qualified expenditures eligible for the credit.

The combination of these changes to the credit has the effect of reducing the value of the credit, nearly

⁷ National Science Foundation, Software Infrastructure for Sustained Innovation program.

in half. Clearly, reducing the value of the credit will lessen the effectiveness of the credit as a means to incentivize additional research investment in the U.S. At a time when many countries provide enhanced tax incentives for R&D, despite the credit being proposed to be made permanent, these significant reductions in the value of the credit will make the U.S. a less attractive place for investment in R&D activities. The Coalition is willing to work with the Congress to provide improvements to the credit that both maintain its value as an investment incentive and provide for better administration and simplification of the credit.

Section 174 Deduction

In enacting section 174 “Congress was pursuing two related objectives One was to encourage firms to invest more in R&D than they otherwise would. The second objective was to eliminate or lessen the difficulties, delays, and uncertainties encountered by businesses seeking to write off their research expenditures”⁸ Expensing R&D costs reflects the tax and accounting realities inherent in bringing a new product to market. With R&D, amounts are expended to create an asset with a future benefit. In most other instances this would result in the capitalization and recovery through amortization of such costs. The inherent issue with expenses incurred in research and development is whether an asset of any value is being (or will be) created. At the time the amounts are expended, such a determination is often impossible. Further, research and development costs usually are incurred with the goal of creating a new or improved product, service, process or technique, but more often than not, the efforts do not result in success. As such, U.S. GAAP does not require the capitalization and amortization of R&D costs.

Concerns with the Proposal

Proposals to limit the ability of companies to deduct the costs of U.S. based research activities will act as a disincentive to research investment, particularly for small firms with limited cash flow, some of which may not benefit from the credit, and further risks the movement of these investments and jobs abroad. It is clear that R&D activities will likely continue; the question is where those R&D jobs will be located. It is unclear why the Discussion Draft would require companies to spread R&D costs over 5 years. This change has a tax cost of nearly \$193 billion, a tax increase on research intensive companies, mostly manufacturers and other innovative companies, which is five times larger than the cost to make the R&D tax credit permanent. The Coalition believes that, given the inherent uncertainty around experimental research, these costs should be allowed to be written off quickly and will work with Congress to better align the incentive in the context of broader tax changes.

Given that the number of OECD countries offering some incentive for research has grown dramatically in recent years as countries attempt to become leaders in research, the U.S. tax system must evolve in order to provide globally competitive R&D incentives that can be counted on by businesses. As noted above, many other countries offer *both* lower corporate tax rates and more attractive R&D incentives⁹. Accordingly, the U.S. should not engage in an “either/or” debate with respect to lower marginal rates and boosting U.S. job creation through R&D incentives when looking at options to reform the

⁸Senate Budget Committee, *Tax Expenditures, Compendium of Background Material on Individual Provisions*, 2012, p. 90 (The Compendium).

⁹ Deloitte, “Global Survey of R&D Tax Incentives,” March 2013.

corporate tax code. To remain competitive in the global economy, the U.S. can and should provide an effective and permanent incentive for R&D even if the corporate tax rate is reduced.

In contrast to the incentives offered by a number of other countries, the temporary nature of the U.S. R&D tax credit makes it a less powerful incentive in terms of a company's R&D budget and decisions about where to locate new R&D activities. The certainty of a strengthened, permanent credit and the continued option to deduct research expenses quickly rather than amortize those costs over several years, is critical to maintaining U.S. leadership in advanced research and encouraging companies to continue to spend R&D funds here in the U.S.

Conclusion

R&D incentives, such as the tax credit and the expensing of research costs, are designed to ensure that companies from varied industries, including manufacturers and services businesses, conduct their research activities in the United States and create well-paying, highly skilled jobs. The original purpose of the tax credit still holds true today. It is vitally important that U.S. policy makers support proposals that enhance the attractiveness of the U.S. as a place to invest in research activities. A strengthened and permanent research and development tax credit that is seamlessly extended as soon as possible and the continued ability to quickly deduct research expenses are critical to competitiveness, innovation and U.S. jobs. In the global economy many companies have a choice as to where they are going to do their research—and with many other countries offering *both* lower corporate income tax rates and more robust R&D incentives, the U.S. tax system must provide globally competitive R&D incentives that can be counted on by businesses. Broad and sweeping changes to the tax credit that leave out innovative research activities and diminish the value of credit reduce its effectiveness. The R&D Credit Coalition looks forward to assisting Congress in gaining a more detailed understanding of the competitive pressures faced by companies as well as of the research and development tax credit and its impact on U.S. jobs. We also look forward to working together to advance legislation to extend, strengthen and make permanent the R&D tax credit.

Links to Studies:

Center for American Progress, “The Corporate R&D Tax Credit and U.S. Innovation and Competitiveness”

http://www.americanprogress.org/issues/2012/01/corporate_r_and_d.html

Ernst & Young, “The R&D Credit: An effective policy for promoting research spending”

http://www.investinamericasfuture.org/PDFs/EY_R&D_Credit_Report_2011_09_16.pdf

Deloitte, “Global Survey of R&D Tax Incentives,”

<http://www.investinamericasfuture.org/PDFs/Global%20RD%20Survey%20Final%20-%202011.pdf>

National Science Foundation press release, “New Report Outlines Trends in U.S. Global Competitiveness in Science and Technology”

http://www.nsf.gov/nsb/news/news_summ.jsp?cntn_id=122859&org=NSB&from=news

OECD, Ministerial Report on the OECD Innovation Strategy, May 2010

<http://www.oecd.org/dataoecd/51/28/45326349.pdf>

OECD, “Science, Technology and Industry Scoreboard,” October 2013

<http://www.oecd.org/sti/scoreboard.htm>

U.S. Department of the Treasury, “*Investing in U.S. Competitiveness: The benefits of Enhancing the Research and Experimentation (R&E) Tax*

Credit” <http://www.investinamericasfuture.org/PDFs/TreasuryRDReportMarch25.PDF>

###

CONTACT INFORMATION:

Wes Coulam or Tara Bradshaw

202-293-7474

R&D Credit Coalition

1001 Pennsylvania Avenue, NW

Suite 601 North

Washington, DC 20004

www.investinamericasfuture.org