

R&D CREDIT COALITION

SUBMISSION TO THE SENATE COMMITTEE ON FINANCE

BUSINESS INCOME TAX WORKING GROUP

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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.

Under current law, a taxpayer can deduct the cost of research expenses in the year incurred (Section 174 of the Internal Revenue Code). In addition, until December 31, 2014, 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 in both the Senate and House to make the R&D tax credit permanent and increase to 20% the ASC. (Examples include, H.R. 880, introduced by Rep. Brady (R-TX) and Rep. Larson (D-CT) and adopted by the House Ways and Means Committee on February 12, 2015 and S. 1577, introduced by Senators Hatch (R-UT) and Baucus (D-MT) in 2012. The Coalition has supported past credit extensions, such as the EXPIRE Act in 2014 to extend the credit for 2 years, as a bridge to enact a permanent credit as part of tax reform). Although many taxpayers still use the regular 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 higher rate

regular credit option and enhance the incentive effect of the credit.

The Coalition is concerned about proposals that would reduce the attractiveness of investing in U.S. research projects such as previous proposals to limit the use of the R&D tax credit or require lengthy amortization of research costs. For example, on November 21, 2013, then Senate Finance Chairman Max Baucus (D-MT) released a staff discussion draft that proposed to require taxpayers to amortize R&D expenditures over a 5 year period rather than allow the costs to be deducted in the year incurred. In addition, former House Ways and Means Committee Chairman Dave Camp (R-MI) included in his 2014 comprehensive tax reform bill (H.R. 1) proposals to require R&D expenditures to be amortized over a 5 year period rather than allow the costs to be deducted in the year incurred and to significantly narrow the definition of “qualified research” 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.

Discussion

The Coalition appreciates that an objective of tax reform is to achieve a reduction in the corporate statutory rate and 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, tax or other 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. According to a study by Ernst & Young (EY), “In total, the overall policy – the existing credit plus strengthening the alternative simplified credit – is estimated to increase annual private

¹ Deloitte, “Global Survey of R&D Tax Incentives,” March 2014.

research spending by \$15 billion in the short-term and \$33 billion in the long-term.”² 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.”³ In addition, a 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.”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 As a result of the R&D credit expiring December 31, 2014, the U.S. now ranks last among industrialized countries.

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

The Coalition supports a permanent R&D credit that strengthens the ASC to 20 percent, increasing domestic innovation, job creation, economic growth, and U.S. competitiveness. Along with enhancing the credit, current eligibility for the types of research expenditures that qualify for the credit must be retained.

Any proposal to remove computer software from credit eligibility implies that computer software is not

² Ernst & Young, “The R&D Credit: An effective policy for promoting research spending,” September 2011, p. i.

³ Ernst & Young, “The R&D Credit: An effective policy for promoting research spending,” September 2011, p.11.

⁴Center 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.

⁵OECD, “Science, Technology and Industry Scoreboard,” October 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.

innovative, not technological or that there is nothing new to discover. This could not be farther from the truth. Software development activities contribute billions of dollars to the U.S. economy and employ millions of highly skilled workers. 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. 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.

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, disallowing the credit for the cost of supplies used in the conduct of qualified research would negatively impact numerous industries that engage in research activities with most of the impact unfairly and disproportionately hitting 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. 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.

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”⁷ 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

⁷Senate Budget Committee, *Tax Expenditures, Compendium of Background Material on Individual Provisions*, 2012, p. 90 (The Compendium).

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.

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.

The Coalition believes that, given the inherent uncertainty around experimental research, these costs should be allowed to be written off quickly.

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 seamless strengthened and permanent research and development tax credit that is enacted 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>

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