



D SQUARED Tax Strategies
Exponentially Creative Policy Services

alliantgroup
5400 Westheimer Court, Suite 800
Houston, TX
(713) 877 9600

Making the R&D Tax Credit Work for Small and Medium Businesses

alliantgroup welcomes the opportunity to submit comments for the record for the House Ways and Means Committee's review of current federal income tax law within the Committee's 11 Tax Reform Working Groups.

alliantgroup is the national leader in working with small and medium businesses and their accountants -- assisting them in qualifying for the Research and Development (R&D) tax credit.

We are proud to have worked with thousands of companies across the country in the last 10 years to ensure that they benefit from this important incentive provided by Congress --resulting in the creation of thousands of jobs. Our comments are based on our unmatched experience working with small and medium businesses seeking to benefit from the R&D tax credit.

We commend the Committee for forming these Tax Reform Working Groups and undertaking this review of current law. The purpose of this statement is to highlight those changes that we encourage the Committee to consider that will greatly enhance the benefit of the R&D credit for small and medium businesses.

As the Committee likely knows, a number of countries provide additional incentives for small and medium-size enterprises. By contrast, the US R&D tax credit provides no additional incentives for small and medium businesses. In fact, US tax policy actually erects barriers that limit these businesses from enjoying the incentives of the R&D tax credit.

The negative impact of these barriers is made clear by the findings of the GAO 2009 report to the Senate Finance Committee on the R&D tax credit which highlighted the small amount of overall dollars of the R&D tax credit that go to small and medium businesses.

These roadblocks in the tax code and regulations work against small and medium businesses taking the R&D tax credit and act directly against our nation's goals of fostering economic productivity and encouraging job growth. This is especially troubling in light of the testimony the Senate Finance Committee heard back on September 20, 2011 from OECD that small firms are more responsive to R&D tax incentives. Thus, current tax law and regulations operates against

small and medium businesses taking the R&D tax credit and is especially prejudicial against the very firms that would be most responsive to such a credit

The good news is that with a few minor changes in the law and regulations, the R&D tax credit will provide significant benefits to small and medium businesses. These changes should be considered by the Ways and Means Committee to make the R&D credit permanent as well as any extensions of the R&D credit and any jobs bill.

ALLOW THE R&D TAX CREDIT AGAINST THE AMT

The top barrier for small and medium businesses taking the R&D credit is that the credit cannot be used to reduce the business owners' alternative minimum tax (AMT). This means, that a business owner of a pass-thru entity that is subject to the AMT cannot use the R&D credit to reduce her taxes. Alliantgroup has found in reviewing tens of thousands of tax returns that 8 out of 10 businesses that would otherwise benefit from taking the R&D credit will receive little to no benefit from the R&D credit because the credit cannot be used to reduce AMT. Given that the vast majority of small and medium businesses are organized as pass-thru entities, the potential benefit of the R&D tax credit to encourage innovation and create jobs is greatly diminished.

The Senate Finance Committee made the right policy call in allowing the R&D tax credit to be taken against AMT in enacting the Small Business Jobs Act of 2010. We have seen first-hand that this simple change in the law has translated into providing significant benefit to thousands of small and medium businesses and helped create a small city worth of jobs. The only drawback is that this legislation was good for only one year – 2010. Alliantgroup encourages the Committee to make this common sense change permanent in its proposed legislation. We are pleased to note that the Senate Finance Committee also heard support from its witnesses at the hearing on September 20, 2011 for allowing the R&D tax credit against the AMT.

ALLOW TAXPAYERS TO ELECT ASC ON AN AMENDED RETURN

As the Ways and Means Committee considers proposals to change the R&D tax credit to allow solely for the alternative simplified credit (ASC), it is vital that the statute make clear that the ASC can be elected by businesses on amended returns. Currently, businesses can elect to take only the traditional R&D tax credit on an amended return not the ASC.

Congress created the ASC in Section 104 of the Tax Relief and Health Care Act of 2006 (P.L. 109-432). The ASC was intended to broaden the number of companies that would be eligible to take advantage of the incentives provided by the R&D tax credit.

The policy intent of the ASC – expanding the number of companies eligible for the R&D tax credit – has been largely successful. The ASC has been especially beneficial for small and medium companies that could not take the regular R&D tax credit because of difficulties with the base years (and often substantiating expenditures in the base years).

However, a significant limitation for businesses – especially small and medium businesses – is the restriction in the regulations, published temporarily in 2008 and made permanent earlier this year, that do not allow a taxpayer to elect the ASC on an amended return. 1.41-9 (b)(2) (“An election under section 41(c)(5) may not be made on an amended return.”). There is nothing in the statute that requires such a limitation.

alliantgroup sees first-hand the negative impact of this regulation. We are aware of thousands of companies that are performing activities that qualify for the R&D tax credit but are being prevented by this regulation from benefitting fully from this important tax incentive – and at times are discouraged from even taking the ASC on their current return.

Therefore, because of this regulation, thousands of our nation’s most innovative small and medium businesses are not receiving the assistance intended by Congress through the R&D tax credit.

While the regulation bars all companies regardless of size from electing ASC on an amended return, we find in practice this limitation falls especially heavily on small and medium business.

Small and medium business owners do not have the benefit of sophisticated in-house tax departments and aren’t aware of the R&D tax credit or don’t know they are eligible for this tax incentive. A 2009 Government Accountability Office (GAO) underscores the fact that the R&D credit has primarily benefitted the largest corporations -- noting that the largest corporations have dominated the use of the research credit. GAO found that 65 percent of the credits were claimed by 549 large corporations.¹

It is often only after the company has been engaging in R&D for a number of years that they may learn for the first-time that they are eligible for the R&D tax credit. These small and medium companies should not be punished for failing to have a large tax department and for focusing their time trying to expand and grow their business rather than poring over the tax code.

The current regulation effectively places small and medium businesses at a disadvantage to larger business. Further, the regulation is denying the tax incentive intended by Congress and supported by the administration to encourage innovation and new technology – creating new jobs and strengthening our economy.

In reviewing the issue of allowing an ASC election on an amended return, GAO found:

IRS officials agreed that permitting changes in credit elections could require examiners to audit some taxpayers’ credits twice; however, **they saw no problem with allowing taxpayers to claim either alternative credit on an amended return if the taxpayer had not previously filed a regular credit claim for the same tax year.** (P. 35 emphasis added).

¹ Tax Policy: The Research Tax Credit’s Design and Administration Can Be Improved. GAO-10-136 P. 13 (November 2009).

GAO further noted:

Taxpayers that fail to claim the research credit on timely filed tax returns are **materially disadvantaged by the election limitations** that apply to any subsequent claims they file on amended returns. **There appears to be no reason to prohibit taxpayers from electing either the ASC or AIRC method of credit computation on an amended return** for a given tax year, as long as they have not filed a credit claim using a different method on an earlier return for that same tax year. (P. 35-36 emphasis added).

Allowing taxpayers immediately to make an election to ASC on an amended return will mean that more taxpayers will choose the easier path – sparing both themselves and the IRS the arduous and painful process of looking at books and records from 1984-1988.

It is understandable given the GAO's findings that the GAO report recommended that in order to allow more taxpayers to benefit from the reduced recordkeeping requirements offered by ASC, that the Secretary of Treasury should:

Modify credit regulations to permit taxpayers to elect any of the computational methods prescribed in the IRC in the first credit claim that they make for a given tax year, **regardless of whether that claim is made on an original or amended return.** (p. 39 emphasis added).

For the benefit of jobs and innovation, alliantgroup would encourage the House Ways and Means Committee to consider changing this job killing regulation and in the alternative to make clear in any jobs bill or extension of the R&D credit that the ASC can be elected on amended return. As background, the statute creating ASC makes no requirement that the ASC election can only be made on an original return (i.e. not allowed on an amended return):

An election under this paragraph shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Secretary. IRC 41(c)(5)(C).

A fairer reading of the statute, and consistent with basic principles of tax administration, is that an election can be made on any open tax year. The statute is clear that the election applies to any succeeding tax year – and says nothing of limiting that election only to an original return. The regulation is creating a significant limitation to making the election that is without support in the statute.

The Joint Committee on Taxation “bluebook” description of the legislation similarly provides no support for barring an ASC election on an amended return: “An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the secretary.”²

² General Explanation of Tax Legislation Enacted in the 109th Congress, Joint Committee on Taxation, p. 669 (JCS-1-07), January 17, 2007.

When Congress desires to limit a taxpayer's ability to make a claim on an amended return – it has certainly shown the ability to write that limitation into the statute. For example, in IRC 280C(c)(3)(C) the statute provides:

An election under this paragraph for any taxable year shall be made not later than the time for filing the return of tax for such year (including extensions), shall be made on such return, and shall be made in such manner as the Secretary may prescribe.

No such limiting language on filing an election on an amended return was included with the creation of the ASC and IRC 41(c).

When the temporary regulations were put forward in 2008, there was little official discussion as to why the bar on claiming the ASC on an amended return was put in place. The comment did not point to any statutory support for the provision and simply noted that the bar was in conformance with the alternative incremental credit. For a regulation that causes significant harm to thousands of small and medium businesses by denying them the incentives of the R&D Tax Credit and kills thousands of jobs, it is the thinnest of reeds to justify all this damage under the rubric of consistency. It is time for this hobgoblin to go.

It was good news for small and the medium businesses that Sen. Grassley raised this issue of taking the ASC on amended return during the Senate Finance Committee hearing back on September 20, 2011. We appreciate the Senator underscoring the importance of this issue and the need for change and also note that in Senator Grassley's questions to the witnesses they agreed that businesses should not be subject to such a barrier in taking the ASC.

ALLOW NEW AND SMALL BUSINESSES TO TAKE THE R&D CREDIT AGAINST THE EMPLOYER PAYROLL TAX

While the AMT exclusion for the R&D tax credit would greatly benefit a large number of small and medium businesses, many startups would still be ineligible for the credit because they are not making a profit. Several states, and particularly Louisiana, Minnesota, New York and Arizona have had great success with an R&D tax credit that is provided even if a company doesn't owe tax.

Alliantgroup, working with companies in these states, has witnessed that an expanded, refundable R&D credit has meant companies starting up, keeping their doors open or expanding and creating new jobs.

The House Ways and Means Committee needs to bear in mind that while the engines for job growth are small and medium businesses, it is particularly new businesses that are key to an increase in jobs. The importance of encouraging entrepreneurship and startups for job growth was underscored by an August 2010 NBER Working Paper, *Who Creates Jobs? Small v. Large v. Young*. In addition, studies have shown that a great deal of innovation is concentrated in new

businesses. Therefore, an R&D credit that is also available to new businesses will bolster both innovation and jobs.

As the Senate Finance Committee read in the written testimony from the OECD of September 20, 2011 it is not only the states that have looked at a refundable R&D tax credit. The OECD testimony notes that a recent trend is for countries to target R&D tax incentives to offset employer Social Security contributions and other taxes on labor income. The OECD testimony highlights that “Increasing cash flow is important for small, research intensive firms with little revenue but high investment in intellectual and human capital.” Further, we note that Senate Finance Committee hearing witnesses Prof. Nellen and Mr. Rashkin in their testimony also called for a refundable/transferable credit for small and startup businesses.

An R&D tax credit – refundable against payroll taxes paid by companies – and capped at \$250,000 could provide much-needed cash for credit-starved innovative startups. Such a proposal would ensure that some of our most cutting edge new companies would actually receive the benefit of the R&D tax credit – as opposed to being on the outside looking in.

A MORE GENEROUS TAX CREDIT IF MANUFACTURED IN THE US

A policy goal of the R&D tax credit is to also support domestic manufacturing. The committee should encourage R&D that translates into US manufacturing jobs by providing a greater credit to those companies that conduct a significant percentage of their manufacturing domestically. An enhanced R&D credit for domestic manufacturers would particularly benefit small and medium businesses that rarely have manufacturing facilities outside the US. We encourage the House Ways and Means Committee to consider a 25% bonus in the R&D tax credit for US companies that conduct a significant percentage of their manufacturing in the US. Such a credit would potentially create tens thousands of manufacturing jobs domestically and discourage companies from moving offshore.

Thank you for giving alliantgroup the opportunity to submit this statement. We appreciate the Committee’s leadership in the R&D tax credit and look forward to working with you to ensure that the credit provides good benefit to all businesses.