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Tax Benefits for R&D: States Deliver, Will Washington Catch Up?

BY DEAN ZERBE

For several years running, we have heard State of the Union speeches wishing for an expanded research and development (R&D) tax credit; if wishes were legislation, the United States would have the finest R&D tax credit in the world—as opposed to the reality of being 27th among 42 countries (down from 23rd) according to the Information Technology and Innovation Foundation (ITIF).

However, while Washington has found fiddles, the states are acting. Several states—from Arizona to New Hampshire and Texas in between—are now looking hard at expanding (or creating) their own R&D tax credit.

States are recognizing that at the end of the day the R&D tax credit is not only about encouraging innovation but also supporting jobs.

The state R&D tax credits are often not insignificant. For example, we work with hundreds of businesses in California who are able to wipe out their state income tax liability with the California R&D tax credit.

Why does all this matter? One word: jobs. The key to maintaining and expanding jobs in manufacturing, engineering, architecture, computers, and a host of other industries is through constant innovation—especially innovation that involves applied science, taking scientific principles and bringing them to the task at hand.

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States are recognizing that at the end of the day the R&D tax credit is not only about encouraging innovation but also supporting jobs—good paying, technical jobs. As a summer 2012 article in the *Washington Post* highlighted, one of the greatest long-term concerns for our economy is that the United States is not creating sufficient jobs for our graduating engineers and scientists. The R&D tax credit is effectively a jobs credit for hiring those new engineers and scientists.

Startup Eligibility Offers Added Benefits

Of particular interest is that a number of states—including Maryland and Arizona—are looking at making their R&D tax credit available for startups and small businesses that are not yet making a profit. Allowing startups to take the R&D tax credit is a double barrel benefit.

The National Bureau of Economic Research (NBER) made clear in a recent 2010 study that the biggest engine for job growth is new businesses. Furthermore, some of our best and most exciting innovation comes from startups as well.

In our work, we have seen firsthand that where states do allow startups to benefit from the R&D tax credit—Minnesota, Louisiana, and New York—startups have additional cash-in-hand, which has been a godsend for these business owners in keeping doors open and creating more jobs.

Self-Censorship Stops Claims

However, it sadly remains the case that one of the biggest roadblocks for businesses taking the R&D tax credit is self-censorship. It was recently reported in the *Wall Street Journal* that 19 out of 20 small and medium businesses that are eligible for tax incentives, such as the R&D tax credit, fail to take advantage.

In the case of the R&D tax credit this is overwhelmingly due to self-censorship—with small and medium business owners thinking that only Nobel Prize winners and rocket scientists need apply.

Happily, in the rare example of Congress getting it right, the R&D tax credit is intended to support a broad range of industries and is focused on encouraging not only the new thing but also improvements and modifications to existing products and processes and based on known scientific and engineering principles. States would do well to not only look at expanding or creating

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their own R&D tax credit but also educating and informing their small and medium business owners about the availability of the R&D tax credit at the federal and state level.

Florida, Virginia, and Vermont are among the states that have newly enacted the R&D credit, while New Jersey and Georgia have expanded their credit to reach a wider range of companies and help spur the local economy.

Signs of Progress in Washington

While the states are acting, it should be noted that there are some good signs of progress coming from Washington, D.C., when it comes to the R&D tax credit. A number of senators—John Cornyn (R-Texas), Charles Grassley (R-Iowa), and Pat Roberts (R–Kan.)—all raised questions to Treasury Secretary Jacob J. Lew during his confirmation about making the simpler version of the R&D tax credit (the alternative simplified credit, or ASC) available on amended returns (as is the regular R&D tax credit).

So many of our best businesses are cut off from taking full advantage of the R&D tax credit because of this nonsensical job-killing Treasury regulation. Hopefully common sense will prevail and this ban on taking the ASC on amended returns—that hurts mostly small and medium businesses—will be removed (there is no need to wait for legislation, Treasury could do it tomorrow if it wished). Jobs and innovation would be the winners.

Perhaps the biggest sign that Washington may move forward on improving and strengthening the R&D tax credit is the recent bipartisan legislation—the Startup Innovation Credit Act of 2013 (SICA; S. 193)—introduced by Sen. Christopher Coons (D-Del.) (who has shown tremendous leadership in this area).

The key is that this legislation allows for the federal R&D tax credit to count against businesses taxes (not just income taxes) and will thus allow startups for the first time to utilize the R&D tax credit.

Here is wishing that SICA becomes law. In the meantime, the states are pushing forward, and businesses need to make sure they are sharpening their pencils during this tax season to take full advantage.

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