Forbes

R&D Tax Credit

An Update On A Lifeline For Small And Medium Business

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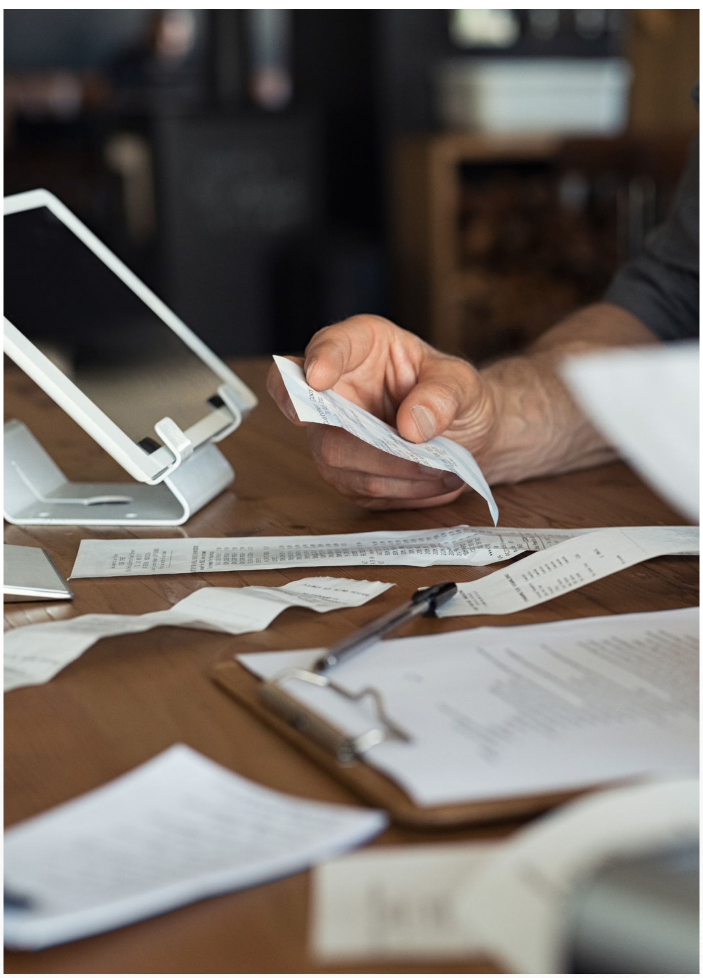
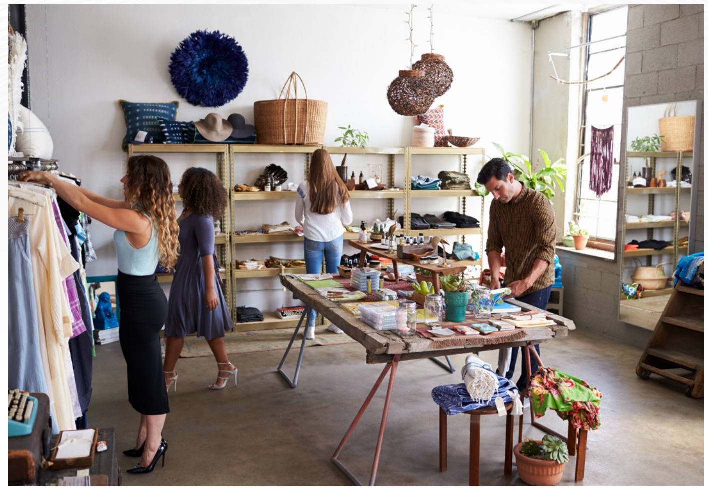
A cornerstone of U.S. tax policy (and for many other countries) has been to encourage and support research and development (R&D) in this country. Policymakers on both sides of the aisle have long recognized the importance of incentivizing companies to engage in R&D. Innovation and improved productivity are the hallmarks of a growing economy, job creation and higher wages.

The tax code has supported R&D primarily through two policies: 1) allow for companies to elect to expense R&D costs (i.e. deduct in the first year); and, 2) provide for a tax credit for certain R&D expenses.

Historically, U.S. tax incentives for R&D have been near the top of the leader board among OECD nations, but according to Information Technology and Innovation Foundation (ITIF) who studies this all closely, the U.S. R&D tax credit ranks just 24th as other countries have upped their game (for example, China's R&D tax subsidy is 2.7 times more generous than the U.S. according to ITIF).





Amortization – A Disaster for Innovation and Jobs in the U.S.

Adding to the problems, Congress in its 2017 tax bill put in place a revenue raising provision (intended to be a placeholder) requiring R&D costs be amortized (over 5 years) and no longer expensed. This change in law requiring amortization – effective date January 1, 2022 – has placed a major tax burden on businesses. Particularly hard hit are our nation's most innovative small and medium businesses. ITIF estimates that the amortization requirement drops the U.S. to 32nd of 34 OECD nations in terms of tax incentives for R&D and one of only a handful of countries that doesn't allow for expensing of R&D. In short, a disaster.

Small and medium businesses are just now getting the tax bills thanks to amortization of R&D – and the numbers are blinking. For example, a Midwest dairy farm (yes – wake up - there can be a lot of R&D in farming) with revenues of $15 million will see its tax bill increase by $546,000; a steel fabrication company with 120 employees in Missouri will see a tax hike of over $830,000; an engineering company with revenues of $8.8 million will see a $1.3 million dollar tax increase. These aren't outliers. This is over-the-plate. The amortization provision is going to impact jobs, wages and economic growth – as the House Ways and Means Committee heard first-hand in its recent field hearing in Atlanta, GA.

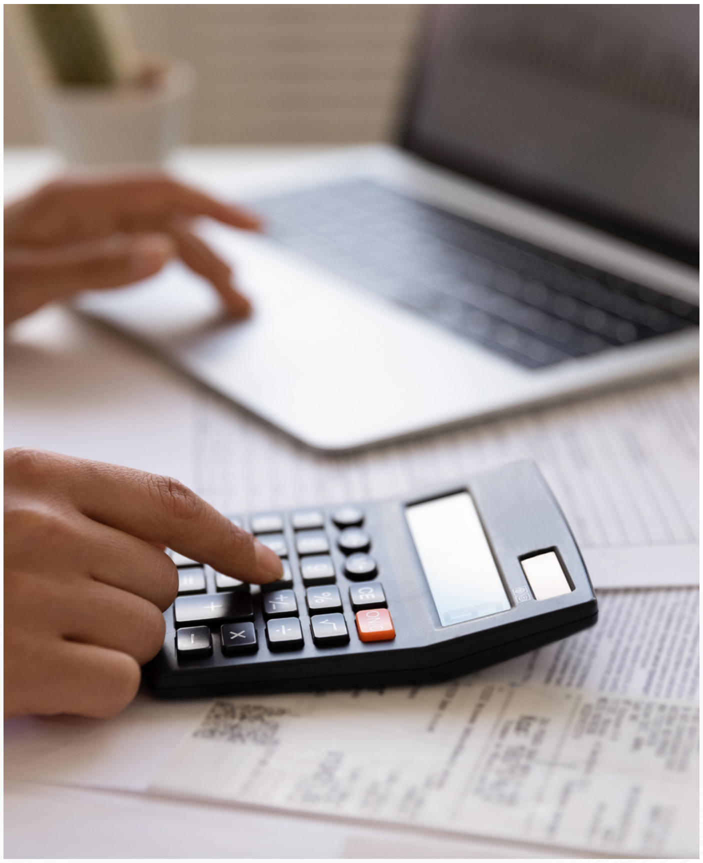
While the R&D tax credit continues in place and can provide significant benefit to qualifying small and medium businesses – there is no question that amortization is a big damper.

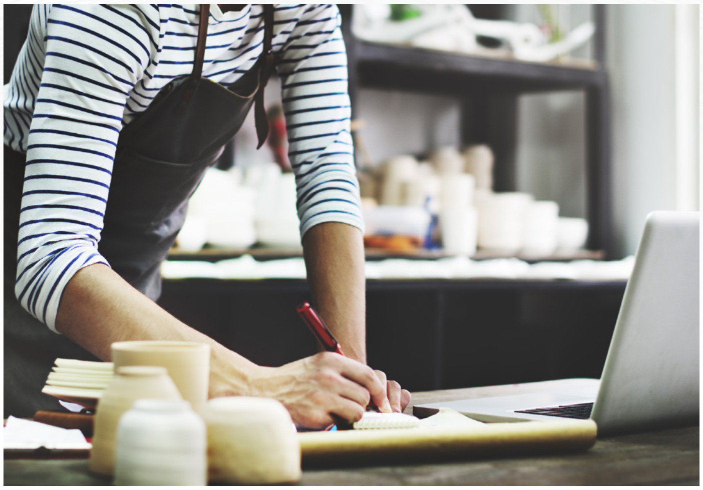
Congress Saddling Up

Congress on a bipartisan basis – in both houses – recognizes that the amortization provision is a disaster. Senators Hassan (D-NH) and Young (R-IN) introduced legislation to repeal amortization in the Senate recently and Congressmen Estes (R-KS) and Larson (D-CT) introduced similar legislation in the House. Both bills have a host of cosponsors.

So, what is the hold-up? In the Senate there has been a desire by some to tie the R&D relief to an extension of the Covid-relief child tax credit. The proposal to pair the two tax provisions has not been greeted with hosannas by many. My sense is that leadership in the Senate recognizes that – and that a more doable pairing would be, for example, R&D amortization fix with expansions/improvements in tax policy for housing and LIHTC. The more that these enormous quarterly tax bills are coming in for small and medium businesses – policy makers are going to feel pressed to be responsive.

When the fix does finally come in – at this point – I still anticipate it will be seamless going back to the beginning of the year.





Banks Tighten Purse Strings – Tax Credits (Including R&D) A Key Source of Dollars

Just as many small and medium businesses are being hit by the tax bill for amortization — they are also facing the reality of banks shutting their purses. As the *Wall Street Journal* recently reported — lending has slowed and tightened, quoting the Philadelphia Fed report that some banks "focused on lending to existing customers and became more prudent in lending to new customers."

There is an alternative. We've found in practice that the R&D tax credit is especially important for many small and medium businesses because the credit serves essentially as a means of financing growth and expansion of these businesses that qualify. Recall – even though there is now amortization – the R&D tax credit is still available both at the federal level and most states have a state R&D tax credit as well.

However, at the same time banks have been tightening their purse strings with rising interest rates and events like the Silicon Valley Bank failure, the IRS has heightened the requirements to claim the R&D tax credit – particularly for amended returns. In short, determining whether your company can qualify for the R&D tax credit takes informed and knowledgeable navigation of the tax code, regulations and IRS guidance (many companies do not qualify for a number of different reasons). Even if your company is a good candidate possibly for the R&D tax credit – then making certain that you've presented your claim for the credit to the IRS correctly (checking all the right boxes) is its own joy.

The benefits of the tax credits (such as the R&D) are significant and valuable and can provide meaningful relief as small and medium companies search for financing and improved cash flow – but business owners and their CPA partners need to be eyes open.

Small and medium businesses look out at a world where bank credit is tightening in the wake of the Silicon Valley Bank failure (and collateral damage) – and with a potential recession on the horizon coupled with increased labor costs and pressure from global competitors. However, it is vital that small and medium businesses in this country – the wellspring of innovation in this country – continue to invest in R&D for new products and manufacturing processes. In particular, the efforts to increase reshore manufacturing and move the supply chain to this country are spurring significant R&D efforts in manufacturing. Policymakers in Washington, DC need to support this effort.

Hopefully it will be brighter days sooner rather than later for innovative companies as the Congress addresses the issue of amortization and research and development expenses. In the meantime, the R&D tax credit continues to provide meaningful benefits to small and medium businesses.

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