The Contemporary Tax Journal

Volume 3
Issue 1 *Spring/Summer 2013*

Article 10

7-2013

Transferability of the Research Tax Credit

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Focus on Tax Policy: An Introduction

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This section of The Contemporary Tax Journal includes tax policy work of SJSU MST students. We offer it here and on the journal website to showcase the range of tax knowledge the students gain from the program and to provide a public service. We think the analysis of existing tax rules and proposals using objective tax policy criteria will be of interest to lawmakers and their staff, and individuals interested in better understanding taxation.

One of the learning objectives of the SJSU MST Program is: *To develop an appreciation for tax policy issues that underpin our tax laws.*

Students learn about principles of good tax policy starting in their first MST class - Tax Research and Decision-making. The AICPA's tax policy tool, issued in 2001,[1] which lays out ten principles of good tax policy, is used to analyze existing tax rules as well as proposals for change.

Beyond their initial tax course,SJSU MST students examine the principles and policies that underlie and shape tax systems and rules in the Tax Policy Capstone course. In other courses, such as taxation of business entities and accounting methods, students learn the policy underlying the rules and concepts of the technical subject matter in order to better understand the rules and to learn more about the structure and design theory of tax systems.

The seven tax policy analyses included in this section join the growing archive of such analyses on the journal website (under "Focus on Tax Policy").

1) Transferability of the Research Tax Credit.
2) Return of the 20% Capital Gains Rate for Certain High Income Individuals.
3) Surtax on Millionaires.
4) Excessive Compensation – How Much is Too Much?
5) Increase and Make Permanent the Research Tax Credit.
6) Preferential Treatment of Capital Gains.
7) Repeal of the Inclusion of Social Security Benefits in Gross Income.

1 AICPA. (2001) Tax Policy Concept Statement 1 – Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals. Available here. Professor Nellen was the lead author of this AICPA document.

Transferability of the Research Tax Credit

By: Erika Codera,
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The Credit for Increasing Research Activities (IRC §41) has a long and tumultuous history. In 1981, the credit made its debut in the Internal Revenue Code. Congress hoped the credit would help stimulate productivity, growth and competiveness of U.S. companies. Since its beginning, the statutory credit amount, definitions and formulas have been frequently modified. The credit has also been allowed to expire and has been retroactively reinstated over ten times. Between January 2011 and January 2012 there were more than eleven proposals to revise the research credit[1]. In early 2013, the "Create Jobs by Expanding the R&D Tax Credit Act of 2013"[2] (H.R. 120) was introduced. This Act would extend the availability of the credit through December 31, 2014, increase the rate of the regular credit from 20% to 30% or from 14% to 20% for the alternative simplified credit, and allow the credit to be assigned or transferred from a qualified taxpayer who earns the credit to another taxpayer designated by the qualified taxpayer.

Many agencies have researched and analyzed the need for compensation for the spillover benefits of research and development (R&D) activities,and the strengths and areas for improvement of IRC§41 and its overall effectiveness. It is clear that private market bias against research demands government intervention across all sectors to produce optimal levels of technological development.[3] The Government Accountability Office (GAO) has suggested the need to modify the credit to ensure that it is available formarginal projects, with the benefit for windfall projects reduced. Marginal projects are those which a taxpayer may not invest in without the tax benefits provided by the government; they are nearly impossible to determine. Projects that will be pursued regardless of government subsidies are windfall projects.[4]

Evidence suggests "the credit has delivered no more than a modest stimulus to domestic business R&D investment."[5] Despite this, every Administration has supported the R&D credit since its enactment,[6] and there is broad bipartisan support for extending the research credit.[7]

Policy makers should consider the results of years of discussion and analysis in developing their proposals. It is also important to consider principles of good tax policy in developing any proposal. The analysis below examines the efficiency and effectiveness of adding a provision to IRC §41 for qualified taxpayers (small business concerns as defined by the Small Business Act) to transfer credits earned under the provision to a person designated by the taxpayer. Under the proposal, amounts received by the taxpayer for the credits transferred are not included in gross income.

This paper provides an overview of H.R. 120 (113th Congress) and analyzes it using the ten principles of good tax policy outlined in the AICPA Statement #1, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.

1 Guenther, G. (2011, Nov. 29). Research Tax Credit: Current Law, Legislation in the 112th Congress, and Policy Issues. Congressional Research Service.

2 H.R. 120 (113th Congress) (2013, Jan. 3). Create Jobs by Expanding the R&D Tax Credit Act of 2013. Retrieved from http://thomas.loc.gov/cgi-bin/bdquery/z?d113:h.r.00120:

3 Staff of the Joint Committee on Taxation. (2011, Sep. 16). Tax Incentives for Research, Experimentation, and Innovation. Retrieved from https://www.jct.gov/publications.html?func=startdown&id=4358

4 Government Accountability Office. (2009, Nov. 6). Report to the Committee on Finance, U.S. Senate, Tax Policy: The Research Tax Credits Design and Administration can be Improved. Retrieved from http://www.gao.gov/new.items/d10136.pdf

5 Guenther, 2011.

6 R&D Credit Coalition (2011, Jun. 2). Research and Development Incentives in the U.S. and Abroad Submitted for the Record of the Hearing on "How Business Tax Reform Can Encourage Job Creation" before the Committee on Ways and Means. Retrieved from http://waysandmeans.house.gov/uploadedfiles/research_and_development_incentives_in_the_u.s._and_abroad.pdf

7 R&D Credit Coalition, (2013, Apr. 15). Comments for the Ways and Means Tax Reform Working Group on Manufacturing, Retrieved from http://waysandmeans.house.gov/uploadedfiles/r_and_d_credit_coalition.pdf

Principles of Good Tax Policy Evaluation

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

Allowing the R&D tax credit to be transferred for a price would decrease the perception of equity and fairness. The public will see corporations that potentially have no R&D activities, yet have sufficient profits to purchase R&D tax credits, are able to reduce their average effective tax rates. Taxpayers may feel at a disadvantage because although these corporations have high taxable income, they are paying taxes at potentially low average effective rates. Only a small number of taxpayers, directly impacted by the inherent problem of generating credits that cannot be used currently, would likely see a direct benefit and perceive the policy as equitable and fair.

The policy would also negatively impact vertical equity. Shifting the tax benefit from the entity that rightfully earned it violates the ability to pay principle. Although corporations with large profits and tax liabilities have a greater ability to pay, if they can afford to purchase tax credits, they will not be subject to their "fair share" of the tax burden.

Earning R&D tax credits without the opportunity to obtain immediate benefits is unfair. Quite often, small companies invest heavily in R&D and have little or no tax liabilities for an extended period of time. Such companies are not able to materialize R&D credits (in their current form) until they generate taxable income, which can be years down the line, when the need for the subsidy may be lessened. Compare this to a large multinational company that has income producing activities that can fund R&D. Such a company is able to utilize credits earned immediately to offset their tax burdens generated from existing profitable lines of business. The two taxpayers described above are not "situated similarly" and, therefore, should have differing rules on how the R&D tax credits function. This proposal mitigates this horizontal inequity.

However, the proposal does not eliminate horizontal inequity. The smaller taxpayer assigning the credits faces a loss on the transaction. It would likely not get paid the full value of the credits earned, and it would have additional costs related to marketing the credit. The larger company buying the credits makes a profit on the transaction because they pay less than the full benefit they receive and their costs to participate in the transaction may be less.

Certainty

The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.

This proposal does not impact the mechanics of qualifying for the credit, calculating the credit, or limiting use of the credit. Amounts paid to purchase credits are not included in income of the seller.

Guidance would be needed on how to treat the costs of the taxpayer acquiring the tax credits.

There is some uncertainty as to who qualifies to transfer or use the credit. The ability of taxpayers to transfer credits is limited. Such limitations increase taxpayer uncertainty. One company comparing itself to another company may be confused why the rules are applied differently. It is not well defined who would be eligible to purchase the credits. The IRS would have to issue regulations that would provide more detailed guidance.

Convenience of payment

A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.

This proposal does not significantly impact the convenience of payment principle of good tax policy because it will not impact the current tax filing and payment rules. However, due to increased complexity of reporting credits earned, purchased, used or sold, there likely will be issues related to timing and substantiating credits which will negatively impact the convenience of payment principle

Economy of Collection

The costs to collect a tax should be kept to a minimum for both the government and taxpayers.

This proposal will cause increases in costs of auditing returns, decreasing the economy in collection. If a taxpayer that uses the credits did not earn them, the IRS would not be able to audit at that level the nature of the costs or the calculation of the credits. When the IRS audits taxpayers that earned the credits and sold them, if there is a change to the amount of the credit that had been previously transferred, it would be difficult to collect the additional tax due from the purchaser. Also, the high level of audit risk associated with R&D credits would likely impact the marketability of the transfers. The efficiency of these transactions would likely be low.

Simplicity

The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.

Several factors of the proposal increase complexity:

1. effective period is only two years,
2. applicability is limited to "qualified taxpayers," and
3. administrative burdens and taxpayer compliance costs are high.

Although this proposal attempts to simplify the definition of "qualified taxpayer" by referencing section 3 of the Small Business Act, it complicates this definition by adding an additional threshold of average number of employees during the year.

Neutrality

The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

The R&D tax credit is designed to encourage investment in R&D, thus making the general provision biased. The new marketability of credits may cause further distortions in taxpayer decisions. This proposal may potentially encourage some taxpayers to invest more in R&D activities if they have an option of monetizing the credits currently. Also, buyers of credits may infuse too much funding, causing an inefficient level of investment in R&D. These possible effects negatively impact the neutrality principle of good tax policy.

Economic Growth and Efficiency

Economy of Collection

The tax system should not impede or reduce the productive capacity of the economy.

Measuring economic efficiency is extremely difficult and uncertain. Because this proposal potentially distorts taxpayer behavior, it may impede economic growth and efficiency. However, positive externalities that occur with R&D activity impact the ability of companies to fully capture the financial benefits of their investments. Tax benefits are one way to make up for the spillover. This proposal also makes the tax benefits realizable more immediately, so it may help economic growth and efficiency because the influx of cash into businesses will provide them the opportunity to invest more.

Transparency and Visibility

Taxpayers should know that a tax exists and how and when it is imposed upon them and others

This proposal negatively impacts the transparency and visibility of the tax law. It significantly increases perceived inequities, increases administration costs, results in more errors, and is short lived, which causes frustration for taxpayers and advisors to plan transactions and comply with the law. The tax base and rate are not affected. However, shifting benefits between taxpayers makes it more difficult for lawmakers and policy analysts to see the impact of the subsidies provided by the government and determine if the policy is effective.

Appropriate Government Revenue

The tax system should enable the government to determine how much tax revenue will likely be collected and when.

Allowing the transfer of credits may make the determination of tax expenditures more predictable and reliable. Many taxpayers who claim credits are not able to currently use them, and it is difficult for the government to know when they will likely be able to use them. This causes uncertainty in timing of tax expenditures

Minimum Tax Gap

A tax should be structured to minimize non-compliance.

This proposal may encourage non-compliance. Taxpayers may be more aggressive in their determination of credits they have an option of transferring the credits to other taxpayers. Also, because the level of complexity is increased, unintentional noncompliance may increase. The consequence of errors (whether or not intentional) may not be clear. As a result, taxpayers may be more careless in their application of the proposed provisions.

Rating summary

Equity and Fairness	+/-
Certainty	-
Convenience of Payment	-
Economy in Collection	-
Simplicity	-
Neutrality	-
Economic Growth and Efficiency	+/-
Transparency and Visibility	-
Minimum Tax Gap	-
Appropriate Government	+

Conclusion

The transferability provision of H.R. 120 (113th Congress) does not represent good tax policy based on the analysis of the AICPA's ten guiding principles. It does not significantly contribute to the efficiency or effectiveness of IRC §41. Instead of getting another taxpayer involved in the transaction, the government can make the credits fully or partially refundable. The impact of the expenditure would essentially be the same; however, principles of good tax policy may be better served. Instead of using the tax law to meet the need of society to subsidize spillover costs of R&D, the government should consider programs like providing grants or financing, which could be more which efficient and effective in meeting their economic goals.