Testimony of Michael D. Rashkin

United States Senate Committee on Finance

Tax Reform Options: Incentives for Innovation

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Chairman Baucus, Ranking Member Hatch, and distinguished Members of the Committee:

My name is Michael D. Rashkin. I am author of the *Practical Guide to Research and Development Tax Incentives: Federal, State, and International*. It is a great honor to appear before this committee and assist in the legislative process. I have been practicing tax law for almost 40 years. During that time I have worked for Digital Equipment, which invented the minicomputer, Apple Computer, which developed the personal computer, and Marvell Semiconductor, which created the plug computer. So I have been able to view the development of the information age from inside companies whose technologies helped create the information age. The testimony I give today is on my own behalf and not on behalf of any company or organization.

I. The Tax Code and Innovation

Congress has long used the tax code to spur innovation. Since 1954, R&D costs could be currently expensed, and since 1981 a tax credit has been provided for R&D expenditures. The code provides several other R&D incentives, such as faster write-offs of R&D equipment and the favorable treatment of stock option costs, among others.

II. Current Economic Environment

However, our changing economic environment requires that we find new and unconventional ways of encouraging innovation. American companies used to develop and make their products in the U.S., but we are now witnessing a debilitating outsourcing cycle where taxpayer subsidized R&D is used to create overseas jobs, in the following manner:

1. Government agencies such as the NSF subsidize basic research;

2. Congress provides tax and other subsidies to encourage companies to create products, often based upon government-funded basic research;
3. Through cost sharing and other arrangements, companies park the resulting intellectual property in tax havens; and
4. Attracted by foreign incentives and low U.S. taxation, companies manufacture overseas, creating few U.S. jobs and providing little U.S. tax revenue.

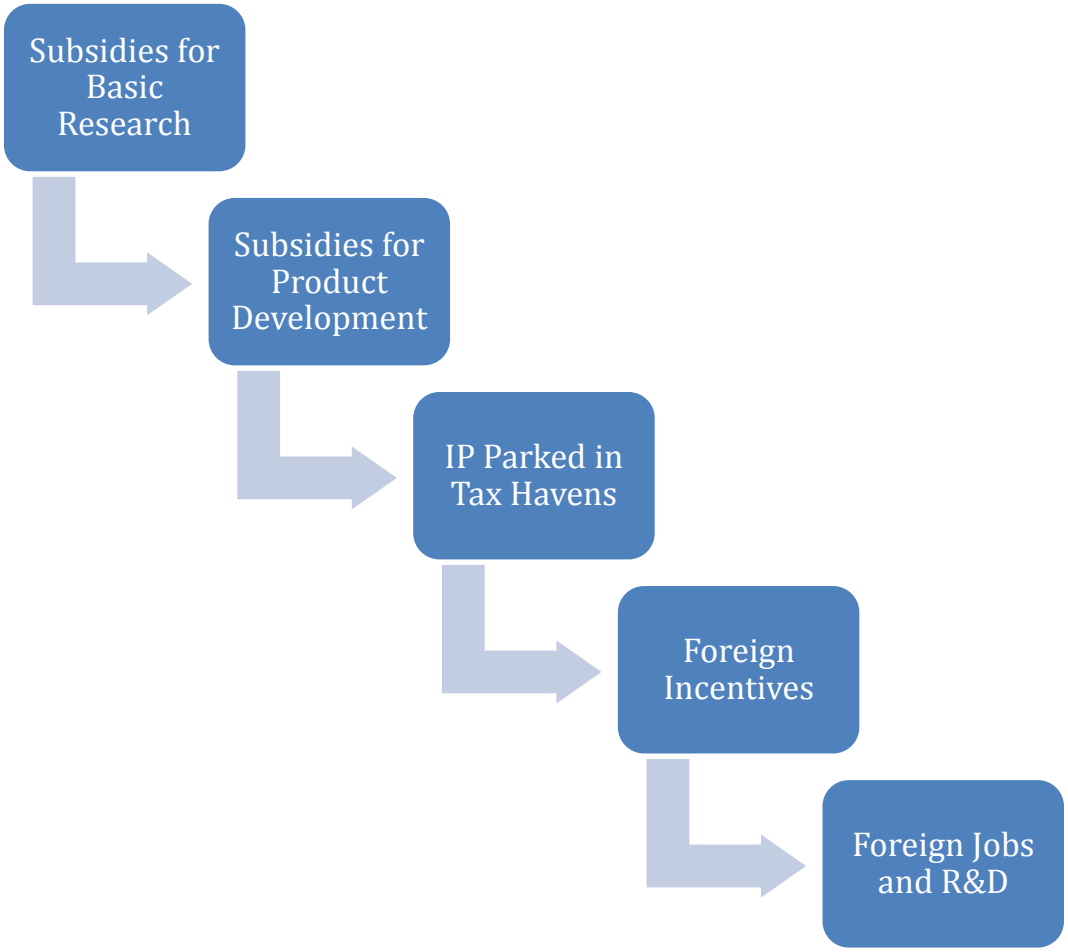

Fig. 1: The Job-Loss Cycle

Is it any wonder that we have an employment and deficit problem?

The impact of this cycle is especially deleterious because **the loss of U.S. manufacturing portends the eventual loss of U.S. R&D activity.** If allowed to continue, this cycle becomes irreversible, and it already has in some industries.

III. Breaking and Reversing the Cycle

Our tax system helped create this cycle and we can reverse it with the following three-step program:

Step One: **Eliminate tax deferral for tax haven profits**.

This is an essential first step in stopping the job hemorrhaging. By allowing companies to generate tax-free profits in tax havens, the tax code strongly invites them to set up R&D and manufacturing operations outside the US. **Under any international tax reform, tax haven profits must be taxed**. Why should our tax system provide an artificial advantage to overseas operations? Additionally, if we concurrently reduced the corporate tax rate to 25%, we would improve our national competitiveness and gain the support of corporate America.

Step Two: Increase the R&D tax credit rate to 30%, but make the credit applicable only to innovative research and breakthrough products.

Breakthrough products create new industries and jobs, and we should encourage such research with a tax incentive. We should not incentivize routine, risk free research because that is the function of the free market. The current credit provides a tax benefit of about 5% (although the nominal rate is 20%), which hardly makes a difference. By increasing the credit rate to 30%, and making other changes I will describe later, the U.S. would become a magnet for advanced research.

Step Three: Provide a zero or low-income tax rate for products developed in the U.S. that are manufactured in the U.S.

By providing this incentive to manufacturers and their suppliers, and by removing the tax haven advantage, we would reverse the foreign outsourcing trend and reinvigorate the U.S. manufacturing industry. This incentive is similar to but broader and less restrictive than the patent box arrangements that have been initiated in some European countries.

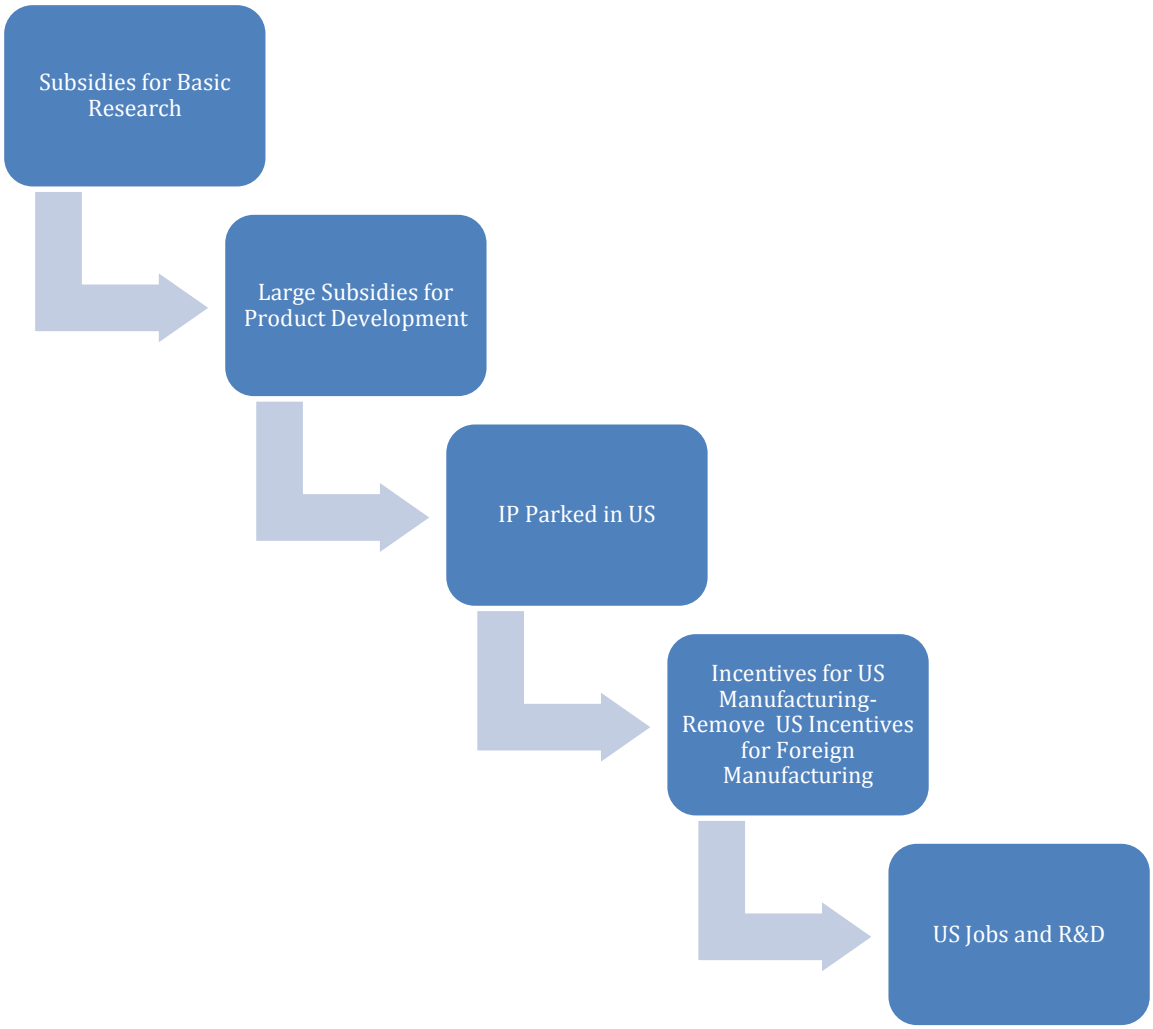

Fig. 2: Breaking The Cycle

IV. Reforming the Ineffective R&D Credit

The R&D credit has been our primary tool for encouraging industrial research. Unfortunately, **it has been ineffective and has not increased R&D spending**. Economic studies report a paltry one-to-one benefit, but even this is overstated because these studies overlook that R&D spending is strategic in nature and does not respond to minor tax incentives.

But with some modifications, in addition to the ones previously discussed, the credit can be greatly improved and become very effective.

1. **We should make the credit refundable or transferable for small businesses.** The credit now benefits large cash-rich companies, but not cash-deprived start-ups.

2. **The credit is too complex.** We must simplify the credit by:

    a. Eliminating incrementality;
    b. Limiting the credit to wages of technical personnel;
    c. Eliminating the loss of the §174 deduction; and
    d. Eliminating the separate basic research credit.

3. **Stock option compensation should not qualify for the credit**. Since there is no employer cash outlay, there is no justification for subsidizing stock option compensation.

The tax expenditure savings from limiting the credit to innovative research and eliminating stock option expense should more than make up for the increase in credit rate and the other enhancements.

V. Summary

By adopting these proposals, we would dramatically enhance the tax environment for innovation in the United States. I look forward to your questions.