R&D Credit Coalition
Take Credit for R&D: Permanency Now!

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On behalf of

The R&D Credit Coalition

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INTRODUCTION

Mr. Chairman, Senator Baucus, and members of the committee, my name is David Hernandez. I am Vice President, Taxes and General Counsel, for EDS. I am here today on behalf of The R&D Credit Coalition (the "Coalition"), which represents more than 1,000 small, medium and large U.S. companies and 85 professional and trade associations.

EDS provides a broad portfolio of business and technology solutions to help its clients worldwide improve their business performance. EDS' core portfolio comprises information-technology, applications and business process services, as well as information-technology transformation services. EDS' A.T. Kearney subsidiary is one of the world's leading high-value management consultancies. With more than $20 billion in annual revenue, EDS is ranked 87th on the Fortune 500. I am pleased to testify on behalf of the R&D Credit Coalition.

First, I want to express our appreciation for the Senate's longstanding commitment to a strong, vibrant, and permanent R&D credit. The Coalition commends Senators Hatch and Baucus and all the members of this committee, for your leadership in promoting U.S.-based research and for recognizing the value of an effective federal incentive to businesses that will result in more U.S. investment, jobs, innovation and economic growth. Last year, the Coalition worked with Senators Hatch, Baucus, and other members of this Committee on legislation[1] to make the current R&D credit permanent and add an alternative simplified credit option to encourage even more companies to increase their U.S.-based research activities. We fully endorsed the proposal that was unanimously adopted last year as an amendment to the Senate's JOBS Act.[2] While we were disappointed that the Senate's improvements to the current credit were removed in conference with the House, it was critically important that the current-law credit was extended so that ongoing research projects could proceed without interruption in 2004 and 2005.

IMPORTANCE OF INNOVATION

Before turning specifically to the R&D tax credit, I want to talk briefly about the broader importance of innovation to job growth, economic vitality, and increased standards of living.

Economists agree that, in the long run, productivity growth is the principal source of improvements in living standards. There is consensus that the productivity growth in recent years has been driven by the combination of accelerated technical progress and the resulting investments in capital assets, research and development, human capital, and public infrastructure. In order to continue this pattern of growth the focus of public policy must be on providing continued incentives to companies that invest, innovate, and create the new capital and knowledge that drive the U.S. economy.

In 2001, Federal Reserve Board Chairman Alan Greenspan told the Senate Budget Committee, "Had the innovations of recent decades, especially in information technologies, not come to fruition, productivity growth during the past five to seven years, arguably, would have continued to languish at the rate of the preceding twenty years."

[1] S. 664, as introduced in the 108th Congress.
[2] S.Amdt. 2647, as amended, to S. 1637, March 3, 2004.

U.S. businesses and federal policymakers should continue to work together to promote policies that will foster those same high levels of growth for decades to come.

Without a growing economy Americans' standard of living, and our ability to support the needs of our aging population, will be in jeopardy. Faced with a static or decreasing workforce as U.S. demographics shift, U.S. lawmakers must focus on encouraging technological developments to increase productivity, enabling a smaller workforce to support a growing population of retirees.

It will take the continued support of both public and private investment in research and development to foster the level of innovation needed to keep the United States economically competitive. Research confirms, however, that private-sector R&D funding generally falls below the optimal level of spending necessary to provide maximum benefits to the overall economy. Corporate research is high-risk, long-term and limited by the "free rider" problem in economics. The benefits of R&D will not fully accrue to those businesses conducting the research, so there must be an additional incentive for businesses to undertake the costly and risky investment in additional research that benefits the public good. Thus, it makes public policy sense for the U.S. government to do all it can to encourage companies to further increase R&D spending in the United States.

Foreign jurisdictions also have recognized the value and importance of R&D investments and the high-quality jobs that flow from that investment. Governments around the world are competing for corporate R&D investment to help create a better economic future for their citizens.

RESEARCH INCENTIVES

According to the OECD[3], "Support to business R&D remains a central feature of innovation policies across the OECD, especially as governments aim to boost business R&D spending. With the exception of several Eastern European countries, direct government support to business R&D has declined, both in absolute terms and as a share of business R&D, and greater emphasis is being placed on indirect measures, such as tax incentives for R&D."

[3] OECD Science, Technology and Industry (STI) Outlook 2004.

Between 2002 and 2004, Belgium, Ireland, and Norway established new R&D tax incentive regimes, bringing to 18 the number of OECD countries employing tax incentives for R&D. Canada, which offers a 20-percent flat tax credit for R&D spending, continues on its mission of inducing U.S. companies to locate R&D operations in that country. The United Kingdom also developed an R&D tax incentive for large firms, complementing the incentives currently provided for small firms. Countries are also making efforts to stimulate entrepreneurship and boost R&D activities in small and medium-sized enterprises (SMEs) by, for instance, supporting venture capital and providing preferential support to SMEs.

In 2004, the European Commission requested the International Bureau of Fiscal Documentation to carry out an information survey on the current tax treatment of research and development expenditures in the 25 EU Member States and the United States and Japan. A stated purpose for this study was to provide information that would enable the European Commission to find an incentive to increase the R & D spending within the Member States that would be competitive with other countries such as the United States and Japan.[4]

The federal R&D tax credit, according to many government and private sector experts, has been a proven, effective means of encouraging increased research and development activity in the United States. Other countries are looking at our system and actively trying to compete for U.S. business' R&D investment.

Just this week, the Work Economic Forum released its annual Global Information Technology Report. The rankings, which measure the propensity for countries to exploit the opportunities offered by information and communications technology (ICT), revealed that Singapore has displaced the United States as the top economy in information technology competitiveness. As a matter of fact, the United States has dropped from first to fifth place in this ranking. Iceland, Finland and Denmark are the countries ranked two, three and four out of the 104 countries surveyed. Iceland moved up from tenth last year.

We should respond to this development by acting this year to strengthen and make permanent our R&D tax credit so that we can regain our competitive edge.

[4] International Bureau of Fiscal Documentation, *Tax Treatment Of Research & Development Expenses*, December 2004, 230 pages.
http://europa.eu.int/comm/taxation_customs/resources/documents/eu_rd_final_rep_dec_2004.pdf

There is a significant body of evidence produced by the General Accounting Office, Bureau of Labor Statistics, National Bureau of Economic Research, and others that concludes that the R&D credit represents a very sound investment in U.S. economic growth.[5]

In 1998, Coopers & Lybrand (now PricewaterhouseCoopers) completed a study, Economic Benefits of the R&D Tax Credit, which dramatically illustrates the significant economic benefits provided by the credit. According to the study, making the R&D credit permanent would stimulate substantial amounts of additional R&D in the United States, increase national productivity and economic growth almost immediately, and provide U.S. workers with higher wages and after-tax income.

It is clear that the current R&D tax credit reduces the cost of investing in additional U.S.-based research for companies that qualify under the current formulation. For these companies that undertake that research, that assistance can often mean the difference between a project getting the green light or being put back on the shelf. The fate of that additional research project not only matters to the researchers, and technical personnel who would be hired to do the research, but it also matters to the unrelated small or medium size company that might be hired to help take a product to market. Often, the discussion of the R&D tax credit centers on large companies that claim the credit. What has been overlooked, unfortunately, are those companies that don't claim the R&D credit, but whose livelihoods are linked to the products and services developed as a result of this additional research. Technology-based productivity increases benefit all businesses – even businesses that do no R&D.

Let me illustrate. Ace Clearwater Enterprises, Inc., a Torrance, California company, makes many of the component parts that are used by large aerospace companies. When the large companies do more R&D in new and improved products and need to build and test more prototypes, Ace Clearwater does more business and hires more people. As R&D increases, so too does the need for suppliers, manufacturers, and ultimately a host of others when products are finally taken to market. Those firms and their employees are spread out in every community and every state and their contribution to economic prosperity is vital.

[5] See, e.g., Hall, Bronwyn H. and John Van Reenen. *"How Effective Are Fiscal Incentives for R&D: A Review of the Evidence."* Working Paper 7098. Cambridge MA, National Bureau for Economic Research, April 1999; U.S. General Accounting Office (GAO), *Tax Policy and Administration: Review of Studies of the Effectiveness of the Research Tax Credit*, May 1996, 26 pages.; Office of Technology Assessment, Congress of the United States, *The Effectiveness of Research and Experimentation Tax Credits*, OTA-BP-ITC-174, September 1995, Washington, D.C., 65 pages.

These firms may not be the first thing that comes to mind when you hear about the R&D tax credit, but they certainly are among the first beneficiaries of increased investments in research and could be the first casualties if those levels of investment decline or move offshore.

Currently, companies of all sizes, across a wide range of industries and in every state claim the R&D tax credit. A 2004 study[6] by Washington Council Ernst & Young showed that the credit is highly beneficial to small firms. According to this study, in 2000:

- Nearly 16,000 companies claimed the R&D credit.
- More than 4,500 firms with assets of less than $1 million (25 percent of all firms) claimed the credit. For the smallest firms in the study, those with assets between $1,000 and $99,000, on average the value of the credit claimed equaled 9.4 percent of their assets.
- Employees of companies in the manufacturing, services, retail and wholesale trade, construction, and real estate sectors were among the greatest beneficiaries of that investment.

If we want to maintain and improve that track record, it is important for Congress to adopt the changes embodied in S. 664, which was introduced in the last Congress by Senators Hatch and Baucus, that would—on a permanent basis--maintain the traditional credit, increase the Alternative Incremental Credit (AIRC) rates and provide for an Alternative Simplified Credit (ASC) in order to induce even more research-intensive businesses to undertake additional U.S.-based research spending.

Now, let me focus on the R&D credit and the proposed improvements, included in legislation overwhelmingly endorsed by the Senate last year, that the business community firmly believes will strengthen the incentive value of the credit.

HISTORY OF THE R&D TAX CREDIT

[6] Koch, Cathy. *Supporting Innovation and Economic Growth: The Broad Impact of the R&D Tax Credit,* Washington Council Ernst & Young, April 2004, 15 pages.
http://www.nam.org/s_nam/bin.asp?CID=155&DID=230921&DOC=FILE.PDF

Congress first enacted the R&D credit in 1981 to provide an incentive for companies to increase their U.S. R&D activities. The federal R&D tax credit is available only for research done in the United States. The bulk of the qualified expenditures are the salaries of workers directly involved in R&D.

The initial credit rate was equal to 25 percent of a company's incremental "qualified R&D expenditures" (QREs) in excess of a rolling base amount equal to average QREs for the prior three years. Currently, the credit rate is 20 percent of a company's QREs and the base amount calculation is linked to the taxpayer's gross receipts.

The original credit was scheduled to expire at the end of 1985. Recognizing the importance and effectiveness of the R&D credit, Congress decided to extend it and has extended it on ten subsequent occasions. In addition, the credit's focus has been narrowed by further limiting both qualifying activities and eligible expenditures – increasing the credit's incentive leverage. With each extension, the Congress indicated its strong bipartisan support for the R&D credit.

In 1996, Congress added the elective Alternative Incremental Research Credit ("AIRC") to the statute, making the credit available to R&D intensive industries that could not qualify for the credit under the regular formula. The AIRC adds flexibility to the credit to address changes in business models and R&D spending patterns that are a normal part of a company's life cycle.

In 1999, the credit was extended until June 30, 2004, and a modest increase in the AIRC rates was adopted to bring the AIRC's incentive effect more into line with the incentive provided by the regular credit.

Most recently, in 2004, as part of the Working Families Tax Relief Act of 2004 (P.L. 108-311), the credit was seamlessly extended for the period beginning July 1, 2004 through December 31, 2005. This seamless extension was particularly important, as it ensured there was no disruption in ongoing research projects.

THE CURRENT CREDIT NEEDS TO BE STRENGTHENED ND MADE PERMANENT

In order to maximize its incentive effect, the R&D credit should be permanent. Research projects cannot be turned off and on like a light switch and generally represent multi-year commitments; if corporate managers are going to take the benefits of the R&D credit into account in planning future research projects and future hiring needs, they need to know that the credit will be available to their companies for the years in which the research is to be performed. Research projects have long horizons and extended gestation periods. Furthermore, firms generally face longer lags in adjusting their R&D investments compared, for example, to adjusting their investments in physical capital. The 12-months gap in the credit from July 1995 to June 1996 reduced the business community's willingness to plan based on assumed future extensions of the temporary credit.

In the normal course of business operations, R&D investments take time and planning. Businesses must search for, hire, and train scientists, engineers and support staff, and in many cases invest in new physical plants and equipment. There is little doubt that some of the incentive effect of the credit has been lost over the past twenty-four years as a result of the constant uncertainty over the continued availability of the credit. This must be corrected so that the full potential of its incentive effect can be felt across all sectors of our economy.

In order to provide for the maximum potential for increased R&D activity, and for the government to maximize its return on tax dollars invested in the credit, the practice of periodically extending the credit for short periods, and then allowing it to lapse, must be changed by making the R&D credit permanent.

Although the current statutory incentive is effective for many companies, many others that spend significant amounts on R&D in the U.S. get little or no benefit. Consequently, a simple extension of present law will provide insufficient incentive to maintain or increase their R&D spending in the United States. Moreover, the R&D inducements outside the U.S. will look relatively more favorable to these taxpayers.

For example, many taxpayers are no longer able to qualify for the traditional credit because their sales increased significantly in the intervening years, or they entered into an additional line of business that generated additional gross receipts but performed little R&D, or they became more efficient in their R&D processes and were able to spend less to perform the same R&D activity.

In 1996, the addition of the AIRC at significantly reduced rates partially addressed this issue for many companies. It is time to take the next step by both increasing the AIRC rates and providing for an Alternative Simplified Credit (ASC) calculation that will improve the credit's incentive value for increased research activity and job creation in the United States.

The U.S. business community needs a stable, consistent, and improved R&D credit that will strengthen its incentive value, stimulate the nation's economic growth and sustain the basis for ongoing global technology. We urge the Congress to enact the Hatch/Baucus proposal in 2005.

PROPOSED CHANGES TO CURRENT LAW

In addition to the need for permanency for the R&D credit, changes to the statute need to be made in order to maximize the credit's incentive value. In order to extend an incentive for U.S.-based R&D to more companies, Congress should adopt the Alternative Simplified Credit ("ASC"). The ASC is an elective credit that equals 12 percent of the excess of current-year qualified research expenses ("QREs"), over 50 percent of the taxpayer's average QREs for the prior three years. These credit and base amounts are designed to provide an effective credit rate comparable to that provided on average by the traditional credit. Importantly, the ASC is calculated without reference to gross receipts, a feature of the traditional credit that, as discussed above, has left many research-intensive companies unable to qualify for the credit.

While the new ASC may provide a greater incentive for many AIRC companies over time, AIRC firms should be given a more meaningful incentive to continue and increase their research activities in the United States as they assess the value of the new regime. In order to move closer to the incentive value provided by the traditional credit, Congress should increase the AIRC rates to 3 percent, 4 percent and 5 percent, respectively, which will bring those rates in line with the levels envisioned when the AIRC was originally proposed in 1996.

While the ASC increases the incentive value of the credit for certain businesses, it is equally important to avoid disrupting the current incentive for companies that benefit under the traditional credit and AIRC. The traditional credit, in its current form, provides a strong incentive for many companies that continue to increase R&D activities in the United States at an equal or higher rate than revenue. For companies whose R&D investments continue to

increase, the traditional credit calculation may yield a higher credit amount for that company than under the new ASC.

Overall, the introduction of an elective new credit calculation is intended to provide a comparable incentive to other companies engaged in research that have been unable to qualify for the traditional credit—while avoiding penalizing those companies that have responded to the incentives provided by the traditional credit by significantly increasing their U.S.-based R&D spending.

IV. CONCLUSION

Private sector R&D in the United States stimulates investment in innovative products and processes that greatly contribute to overall economic growth, increased productivity, new and better U.S. jobs, and higher standards of living in the United States. By creating an environment favorable to private sector R&D investment in the United States, Congress can encourage companies to site new research projects here and maintain and attract the high-skill, high-wage jobs associated with those projects in the United States. Investment in R&D is an investment in U.S. jobs. A strong, vibrant, and permanent R&D credit is essential for the competitiveness of U.S. companies, as many foreign countries have chosen to offer direct financial subsidies and reduced capital cost incentives to "key" industries.

The R&D Credit Coalition applauds the Senate Finance Committee and the full Senate for its commitment to fostering economic growth through effective federal tax policies that support private sector investments in innovation and will continue to work with you to achieve a strong and permanent R&D credit.

Thank you for inviting me to speak on this important subject. I am happy to take any questions.