



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.

Increase and Make Permanent the Research Tax Credit

By: Chloe Chen, *MST Student*

In 2011, Senate Finance Committee Chairman Max Baucus (D-MT.) and Ranking Member Orrin Hatch (R-UT) introduced The GROWTH Act (Greater Research Opportunities With Tax Help) (S.1577; 112th Congress). This legislation would amend IRC §41 of the Internal Revenue Code to raise the rate for the “alternative simplified credit” from 14% to 20%. S.1577 would also modify the rules for calculating the credit and make this credit permanent.

Senate Bill 1577 makes various changes to IRC §41, including the termination of standard research credit formula and basic research payment calculation (§41(e)), a change on determination of expenditures (to aggregate qualified research expenses) and a few other modifications of special rules. S. 1577 also proposes an inclusion of qualified research expenses of an acquired person (§41(f)), which has been included in the extension of the credit with the American Taxpayer Relief Act of 2012.

The research and development tax credit under IRC §41 was first enacted in 1981 and has been extended fourteen times. It will expire for the fifteenth time on December 31, 2013.

The Obama Administration included a proposal in its fiscal year 2012 budget to expand the research tax credit and make it permanent. The plan is estimated to cost the government about \$106 billion over the next ten years, according to the Treasury Department.

S.1577 was introduced to simplify and update the research credit. It was also proposed to give businesses certainty by eliminating the possibility of expiration and to create more job opportunities. Senator Hatch stated that:¹

“By giving businesses a leg up on the competition in this global economy, we can help them grow and create the jobs American families need. Our workers are facing competition from countries across the globe, so this boost to innovation and research here at home is critical to our economy,” Baucus said. “Making the research and development tax credit simple and permanent gives innovative American businesses the certainty they need to make job-creating investments and the ability to compete in markets across the globe.”

He also noted in a 2011 Finance Committee Press Release that, “A permanent R&D tax credit rewards innovation and entrepreneurship, and gives American businesses the certainty

¹ U.S. Department of the Treasury. (2011, Feb). *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*. p. 32 & Table 1. Retrieved from <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf>

they need to invest, grow and hire. This legislation makes sense, has strong bipartisan support, and is essential to ensuring our nation's job creators have the tools they need to compete around the world.”²

The policy analysis below uses the ten principles of good tax policy outlined in the AICPA Statement #1, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposal, to analyze S.1577*.

² U.S. Senate Committee on Finance. (2011, Sept. 19). Baucus, Hatch Look to Boost Innovative American Industries, Provide Certainty with Permanent Research and Development Credit. Retrieved from <http://www.finance.senate.gov/newsroom/chairman/release/?id=cd16c8e7-2423-4f13-bf62-45e3d3527b31>.

Principles of Good Tax Policy Evaluation

Equity and Fairness

Similarly situated taxpayers should be taxed similarly.

R&D tax credits are potentially available to all industries, regions and firms regardless of size.

Companies of all sizes and in all industries can claim the R&D tax credit. Although the distribution of firms might be scattered, R&D tax credits are equally available to all industries, regions and firms that incur “qualified research expenditures.”

The principle is not completely entirely fair with respect to horizontal and vertical equity, as explained next.

The R&D tax credit may favor research activities over others by companies with similar financial conditions. For example, a manufacturer and a service agency may be taxed differently because the manufacturer is more likely to be involved with researching activities and thus has a greater chance of obtaining the R&D tax credit. At the same time, the manufacturer also has the greater investment in uncertainty and spillover effects, causing the inequity.

In addition, new small firms are comparatively at an unfavorable position because they are in the early years of an R&D project; which means they might have little or even no taxable income. Consequently, since the credit is not refundable, they may not be able to use the credit until a future year when they have taxable income.

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.

The legislation is certain; it would amend the IRC §41 to raise the “alternative simplified credit” from 14% to 20%. S.1577 would also make the R&D tax credit permanent, which would increase the stability of the R&D tax credit and strengthen the impact of the R&D policy on relevant investment. The proposal would further enhance the value of the credit. Companies would know the R&D credit would be available consistently for the duration of their R&D project.

In addition, the legislation includes the termination of base amount and basic research payment calculation, making the simplified credit the only formula. Certainty will increase with the simplification because it will be easier to determine the amount of the credit.

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.

The R&D tax credit is comparatively easy to claim. The firms can claim qualified R&D tax expenses by attaching Form 6765 to their tax return. S.1577 only increased the “alternative simplified credit”, so the convenience of payment wouldn’t change.

However, determining qualified research and qualified research expenditures is still a complex process with the difficulty of identifying and tracking qualified research expenditures still remaining.

Economy of Collection

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

Senate Bill .1577 will reduce the claiming cost of R&D tax credits. The administrative and audit time will be reduced with the termination of basic research payment calculation. At the same time, less time will be needed to determine the credit amount since there will be only one formula to select. The only possible cost for government for the legislation will be the modification of forms.

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.

The R&D tax credit will be simpler with the repeal of the regular formula and the basic research credit of IRC §41(e). For example, there will no longer be a need to measure gross receipts or have data from the 1984 to 1988 base years.

In addition, with the amendments of IRC §41(f), the credit will be determined by the aggregate qualified research expenses instead of “the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums”, making the R&D tax credit simpler for controlled groups.

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 legislation is not supposed to be completely neutral since the R&D tax credit was designed to encourage R&D activities.

Greater government support might make the United States a more attractive location for R&D investments. An increased R&D tax credit may encourage more foreign innovative activities to take place in the United States.

However, increasing the tax credits does not necessarily provide the start-up firms more incentives to invest in R&D in their early years because it is unlikely for them to have taxable income.

At the same time, research-oriented employment in the U.S. would be greater with the increased alternative simplified credit. A study in 2008 by Ernst & Young shows that the combination of the existing credit and the strengthening of the alternative simplified credit would result in an increase of 130,000 jobs in the short-term and 300,000 jobs in the long term.³ According to the Milken Institute’s report, Jobs for America (2010),⁴ if the credit were strengthened and made permanent, total

³ Ernst & Young LLP. (2008, Apr.). Supporting Innovation and Economic Growth. Retrieved from <http://www.investinamericasfuture.org/PDFs/R&DTaxCreditStudy2008final.pdf>.

⁴ Milken Institute. (2010, Jan.). Jobs for America. Retrieved from <http://www.milkeninstitute.org/pdf/JFAMilkenInstitute.pdf>

employment would rise by 510,000 in 2017.

The only unintended negative effect the incremental credit may have is in tax planning as some firms might distort the timing of R&D expenditure in order to maximize the amount of tax relief.

Transparency and Visibility

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

Because the increased rate for the credit will be indicated on the tax form for the credit, companies that have formerly claimed the R&D tax credit will easily notice the increase when they claim the credit.

However, publicity for an increase is still needed to be sure all companies consider it in their R&D investment and location decisions.

Economic Growth and Efficiency

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

Research and development is crucial in the economic growth of a country as a strong national security needs the support of innovations which leads to increased productivities.

However, the United States only ranked 24 among 38 industrialized countries offering R&D tax incentives in 2009; the U.S. share of global R&D dropped from 38% in 1999 to 31%.⁵ It is time to provide more tax incentives in order to attract more R&D investment into the U.S. market.

As mentioned in the above section regarding neutrality, S.1577 will provide a stronger incentive for research activities to be located in the United States. This may help the U.S. to attract more multinational R&D investment and consolidate the leading position in the global competition since innovation is known to be an important driver of economic growth and investment.

Nonetheless, if the incremental R&D tax credit causes a big increase in the wages of scientists and engineers because of the inelastic supply of them, then some of the potential benefits in R&D projects will be offset by an increase in the cost.

Additionally, some R&D projects supported by an R&D tax credit might have decreasing marginal productivity. There is no way to avoid the additional activities of such projects whose prospects are questionable. If the innovation is not successful, resulting in commercialization and wide adoption, the tax credit will become a government expenditure with no return.

⁵ National Association of Manufacturers.(2012, Aug). ManuFACTS: R&D Tax Credit. Retrieved from <http://www.investinamericasfuture.org/PDFs/TalkingPointsbytheNAM.pdf>

Minimum Tax Gap

A tax should be structured to minimize non-compliance.

An increased credit may encourage some firms to reclassify their expenditures in order to maximize their R&D tax credit. If firms improperly classify some of their non-R&D activities as R&D investment, it will result in a spurious measurement of R&D expenses

Appropriate Government Revenue

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

There will be an increase in the tax cost for the increased credit. It should be fairly easy to determine how much additional tax credit will be claimed based on the information collected from prior year's Forms 6765 and other government data on private R&D.

The tax credit encourages the R&D activities that will likely raise the relevant businesses' revenue and therefore the government tax revenue. However, the evaluations of these positive impacts are difficult because of the lag in time between R&D investments and the innovative results of the credit.

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 increase in and permanence of the R&D tax credit is expected to lead to an increase in investments in R&D projects, and eventually to an increase in innovation outcomes. This may also have some indirect effects, such as increasing the wages of research workers and location of R&D activities. The proposal meets the principles of certainty, economy in collection, simplicity, neutrality, economic growth, efficiency and transparency. However, improvements could still be made in order to increase the equity and efficiency of R&D tax credits and minimize the tax gap.

First of all, in order to improve equity, the tax credit should be fully or partially refundable in order to help more start-up companies that have lower income to get more tax credit. Also, it is important to be able to evaluate the R&D outputs in order to increase the efficiency and thus the value of the R&D tax credit. For example, outputs based on the time duration of a project and the number of patents the company gained should be measured so that the rate of return of the R&D tax credit can be evaluated. In addition, more audits are needed to eliminate the abuses, such as the reclassification of R&D expenses, although it will increase the administrative cost of the tax credit.

Overall, the legislation to increase the R&D tax credit is a good legislation since it accords with most principles of good tax policy.