Promoting Innovation Through Tax Reform

The Coalition of Small Business Innovators (CSBI) supports a U.S. tax code that recognizes innovation as a crucial part of the 21st century American economy. By itself, a lower corporate tax rate will not support growth and innovation in America's small businesses, many of which are pre-revenue. Comprehensive tax reform should go further than "broadening the base and lowering the rate." Instead, policymakers should specifically promote innovative research-intensive businesses through incentives for other companies, individuals, and funds to invest in small companies and support their research.

Section 469 R&D Partnership Structures

Background: Prior to 1986 tax reform, many growing companies attracted investors by using R&D Limited Partnerships, in which individual investors would finance R&D projects and then utilize the operating losses and tax credits generated during the research process. These structures gave investors a tax incentive to support high tech research, which is entirely dependent on outside investors but often too risky or expensive to attract sufficient investment capital. The enactment of the passive activity loss (PAL) rules in 1986 prevented investors from using a company's losses to offset their other income, thus removing the incentive to support vital research.

Proposal: CSBI supports the Start-up Jobs and Innovation Act (S. 341) and the COMPETE Act (S. 537), which included a limited exception from the PAL rules for R&D-focused pass-thru entities. Under this proposal, small companies would be able to enter into a joint venture with an R&D project's investors. The losses and credits generated by the project would then flow through to the company and investors, who would be able to use the tax assets to offset other income. Relaxing the PAL rules to allow investors to enjoy a more immediate return on their investment, despite the long and risky timeline usually associated with groundbreaking research, would incentivize them to invest at an earlier stage, when the capital is most needed.

Section 1202 Capital Gains Reform

Background: Section 1202 allows investors to exclude from taxation 50% of their gain from the sale of a qualified small business (QSB) stock if they hold the stock for five years. This provision was designed to promote investment in growing businesses, but its overly restrictive size requirements prohibit innovative companies from accessing valuable investment capital. Currently, QSBs must have gross assets below $50 million. The high costs of research, coupled with valuable intellectual property and successive rounds of venture financing, often push growing innovators over the $50 million gross assets limit and out of the QSB definition.

Proposal: CSBI supports the Start-up Jobs and Innovation Act (S. 341), which includes a change to the QSB definition to include companies with gross assets up to $150 million, with that cap indexed to inflation. This bill would also restore the 100% exclusion that expired at the end of 2014 and make it permanent. These changes would allow more growing innovators to attract investors to fund their vital research. Providing incentives to invest in high tech research will increase the innovation capital available to research-intensive businesses and speed the development of groundbreaking technologies.

Section 382 Net Operating Loss (NOL) Reform

Background: Innovative companies often have a long, capital-intensive development period, meaning that they can undergo a decade of research and development without any product revenue prior to commercialization. During this time period, companies generate significant losses, which can be used to offset future gains if the company becomes profitable. However, Section 382 restricts the usage of NOLs by companies that have undergone an "ownership change." The law was enacted to prevent NOL trafficking, but small high tech companies are caught in its scope – their reliance on outside financing and deals triggers the ownership change restrictions and their NOLs are rendered useless.

Proposal: CSBI supports reform of Section 382 to exempt NOLs generated by qualifying research and development conducted by a small business from Section 382. This change would allow small companies the freedom to raise capital for innovative research without fear of losing their valuable NOLs. Additionally, the ability of a small business to maintain its NOLs makes it more attractive to investors and purchasers looking to take its research to the next level.