COALITION OF SMALL BUSINESS INNOVATORS

S. 341, the Start-up Jobs and Innovation Act

The Start-up Jobs and Innovation Act, sponsored by Sens. Pat Toomey (R-PA), Robert Menendez (D-NJ), Pat Roberts (R-KS), and Tom Carper (D-DE), is designed to spur capital formation for growing R&D businesses.

The vast majority of small, research-intensive companies are not yet profitable. Their long development timelines and high-risk research mean that it could take more than a decade to sell a product or realize a profit. Further, the capital burden necessary to fund years of groundbreaking research is significant. Thus, innovative firms rely heavily on private investment rather than product revenue to fund their promising research. Policies designed to stimulate private investment in cutting-edge R&D will speed the development process and create high-quality research jobs.

The Start-up Jobs and Innovation Act recognizes this unique feature of innovative small businesses by including key reforms to Section 469 of the tax code, which governs the treatment of operating losses and tax credits generated by a growing innovators. Because many small R&D businesses are pre-revenue, they accumulate both net operating losses from their extended development timeline and tax credits for their research as deferred tax assets. These incentives are designed to be beneficial once a company becomes profitable; however, product revenue remains on a distant horizon for small innovators, and these deferred assets do not encourage much-needed immediate investments in important R&D.

Prior to the 1986 Tax Reform Act, innovative R&D was often conducted through so-called “R&D Limited Partnerships,” in which individual investors financed R&D projects through entities that were taxed as pass-throughs. These individual investors were then able to offset other income with the losses and tax credits generated by the R&D project. However, the enactment of the passive activity loss (PAL) rules under Section 469 of the tax code significantly restricted the ability of losses and credits to flow from project to investor.

The Start-up Jobs and Innovation Act would relax the PAL limitations for R&D-focused pass-through entities. Under the bill, small businesses would be able to enter into a joint venture with an R&D project’s investors via R&D Partnership Structures. The losses and credits generated by the research would then flow through to the company and investors, who would be able to use the tax assets to offset other income.

The bill would apply to entities that devote a significant percentage of their expenses to R&D, have fewer than 250 employees, and have less than $150 million in gross assets. These emerging, pre-revenue businesses are vital to growing America’s innovation economy.

The Start-up Jobs and Innovation Act would also allow investors in these companies to benefit from a decreased capital gains tax rate under Section 1202. Currently, only investors in companies with gross assets below $50 million are eligible for this provision, but this legislation would increase the gross assets limit to $150 million, incentivizing investment in a wider pool of growing innovators.

Improving capital gains treatment and 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. By making targeted changes for small, R&D-intensive companies, the Start-up Jobs and Innovation Act would stimulate capital formation for growing innovative businesses and speed the development of groundbreaking technologies.