



Written testimony of the  
**Coalition of Small Business Innovators**  
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Committee on Ways and Means  
Subcommittee on Select Revenue Measures  
on the *Small Business and Pass-Through Entity Tax Reform Discussion Draft*  
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The Coalition of Small Business Innovators (CSBI) is a national, non-partisan coalition of organizations dedicated to stimulating sustained, private investment in small companies focusing on the development of transformative, life-changing new technologies. With small businesses working to advance research, development, and manufacturing of technologies that have the potential to solve critical economic, environmental, and societal challenges around the world, the Coalition seeks to educate lawmakers and the public about the value of stimulating investment in these cutting-edge companies.

Small business innovators are mostly pre-revenue companies that require private investment and years of research and development in order to bring the next generation of groundbreaking ideas to market and become profitable. The current tax code does not adequately support this growing segment of small businesses, which means fewer high-quality research jobs and fewer revolutionary new products, medicines, and technologies available to the public. The Coalition is focused on small innovative companies with fewer than 250 employees that devote a significant percentage of their expenses to R&D-related activities. These companies rely on investors who are willing to carry investment risk over several years, which the current tax code does not support as well as it could.

Growing research companies are a leading force for innovation in the U.S. – and the discovery of next generation products is key to America's economic health and prosperity. These small businesses support high-paying, high-quality jobs across the country while also leading the search for the next scientific breakthroughs and revolutionary technologies. Industries relying on innovative IP support 40 million jobs in the United States and contribute over \$5 trillion to U.S. GDP. Small and new businesses are responsible for creating two out of every three net new jobs in America. These growing innovators devote their time and assets to important R&D, pushing the boundaries of science and technology during a long and costly development process. If Congress wants to spur investment in growing companies and stimulate breakthrough R&D to drive the U.S. economy, it must protect and promote small business innovation through the tax code.

### **Pre-Revenue Innovators and Tax Reform**

Comprehensive tax reform that fosters innovation by growing companies could spur investment and support the growth of an R&D-intensive, modern American economy. Many emerging research-centric businesses do not generate revenue, and therefore do not have tax liabilities at the early stages of their development. Lowering corporate tax rates and broadening the tax base will not help these companies in the near term. Considering the long term significance of innovative small businesses to the economy, the Coalition believes that tax reform should address their unique capital needs.

Targeted reforms to specific sections of the tax code can play a part in the broader effort to make America's tax system simpler and more efficient. CSBI supports a stable tax code, anchored by lower corporate tax rates, that makes the U.S. competitive with our global challengers. However, the tax code

can also support next generation research by providing incentives for other companies, individuals, and funds to invest in small businesses.

It is essential that investors in start-up businesses have reasons to invest early in a company's life cycle and hold that investment. A reformed tax code should include incentives for investors in high-risk industries, including provisions that allow investors to expand their options for liquidity or utilize a small company's tax assets that it cannot currently use.

Further, tax reform should recognize that most innovative companies are in a loss position, so existing credits and deductions in the tax code are not sufficient to stimulate their innovation. Small companies that are pre-revenue are unable to immediately utilize these incentives; instead, they are accumulated as deferred tax assets for later use to offset future profits. These deferred assets do not incentivize much-needed investments in pre-revenue companies because they do not provide immediate or short-term tax benefits to investors or to the companies themselves.

As Congress considers reforming the corporate tax code, it is important to remember that these pre-revenue innovators are not yet taxpayers, although they aspire to be. As such, tax reform that is defined only by lowering the corporate tax rate and broadening the tax base will not stimulate innovative R&D in the near term. CSBI strongly supports changes to the tax code that will protect and promote small business innovation.

### **Tax Reform Proposals to Stimulate Pre-Revenue Innovation**

The Coalition of Small Business Innovators believes that R&D and advanced manufacturing must be a cornerstone of any effort to reform the corporate tax system. The continued development of cutting-edge products helps maintain America's global competitiveness, sustains and creates American jobs, and encourages investments in the U.S. Because small business innovators are at the forefront of this effort, it is vital that tax reform specifically address the needs of growing R&D companies. Targeted reforms to the passive activity loss rules under Section 469, treatment of net operating losses under Section 382, and small business capital gains tax rates under Section 1202 will spur capital formation for small businesses and support vital pre-revenue innovation.

#### *Section 469 R&D Partnership Structures*

Prior to 1986 tax reform, many growing companies attracted investors by using R&D 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 cutting-edge 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.

CSBI supports a limited exception from the PAL rules for R&D-focused pass-through entities. Under this proposal, introduced in the 112<sup>th</sup> Congress as the High Technology Small Business Research Incentives Act (H.R. 6559), 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 382 Net Operating Loss (NOL) Reform*

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 which have undergone an “ownership change.” The law was enacted to prevent NOL trafficking, but small innovative companies are caught in its scope – their reliance on outside financing and deals triggers the ownership change restrictions and their NOLs are rendered useless.

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.

#### *Section 1202 Capital Gains Reform*

Section 1202 allows investors to exclude from taxation a portion of their gain, temporarily set at 100%, 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 many 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.

In addition to making the 100% capital gains exclusion permanent, CSBI supports changing the QSB definition to include companies with gross assets up to \$150 million, with that cap indexed to inflation. CSBI also supports excluding the value of a company’s IP when calculating its gross assets. 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.

#### **Conclusion**

The Coalition of Small Business Innovators believes that Congress can and should incentivize research and development by groundbreaking small companies. Tax reform can improve America’s economic health by recognizing the importance of innovation and its potential to save lives, create new technologies, spur scientific advancement, and create vital jobs in growing businesses. Federal tax policy that recognizes the special demands placed on highly innovative pre-revenue companies will speed the development of products to vastly improve the lives of Americans and people around the world.



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