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Protect American Jobs & Innovation: Congress Urged to Reverse Harmful Tax Change

Background: A change in the tax treatment of research and experimentation (R&E) expenses, that went into effect January 1, 2022 is having significant negative impacts on American employers. While the Tax Cuts and Jobs Act of 2017 (TCJA) largely lowered taxes for American businesses, the bill also modified Internal Revenue Code (IRC) Section 174 regarding the treatment of R&E expenditures.

The modification requires research expenses to be capitalized and amortized over multiple years (five years for U.S.-based expenses and 15 years for foreign research expenses). As a result, many small- and medium-size businesses are facing 2022 tax bills that are on average four times more expensive than previous years. What is worse is that U.S. companies that are doing the most to keep America at the forefront of innovation are the ones getting hit the hardest by this change in tax treatment. The larger the investment in R&E, the larger the tax hike in 2022.

While some Members of Congress are aware of the negative impacts of Sect. 174, there was broad belief this issue would "go away." However, as the implementation date neared, Congress did not take appropriate action to repeal this legislation and companies are now faced with significant unplanned expenses.

Senators Hassan (D-NH) and Todd Young (R-IN) recently introduced a bill in the Senate (S.866) that would reverse the TCJA implementation of Sect. 174, allowing businesses to fully deduct R&E expenses in the year they are made, as well as expand the refundable research and development (R&D) tax credit.

Congressmen Ron Estes (R-KS) and John Larson (D-CT) are reintroducing the American Innovation and R&D Competitiveness Act during the week of April 17th, which will allow R&D expenses to be deductible in the year that they were incurred.

<u>Congress must act now on this legislation, thereby enabling small- and mid-size businesses to continue investing in innovation, saving jobs, and protecting America as the world leader in innovation</u>. Senators are urged to cosponsor S.866 and House Members are encouraged to contact Congressmen Estes or Larson to become an original cosponsor of the House bill.

<u>IRC Section 174 Overview and TCJA Implications</u>

Congress passed IRC Section 174 in 1954 to allow for the immediate deduction of expenses related to research and experimental expenditures. The rationale behind this policy was clear – encourage competitive STEM applications and drive innovation within the United States. For nearly seventy years, this policy remained unchanged until now. Under the TCJA, U.S.-based research and experimental expenditures must now be amortized and deducted over a five-year period; however, because of the way the legislation is written, it turns into a deductible period of 6 years (given the "mid-year convention" in the legislation).

The unintended consequences of amortization are crippling small and mid-sized businesses. Every tax year through 2021, taxpayers were able *to fully deduct* all research expenses. Beginning in tax year 2022, TCJA requires the amortization of these expenses. Due to the mid-year convention, taxpayers are *only be able to deduct 10% of those expenses* for the year in which they are incurred. As a result, the taxpayer's ordinary business income drastically increases, exponentially increasing overall tax liability.

ABGI review of current taxpayer financials is demonstrating that affected businesses are facing increases in overall tax liability of three to four times normal tax liability.

Small to mid-size businesses simply do not have the ability to pay this extreme increase in tax liability. This amortization policy is not only anti-business, but it also acts as anti-worker as these businesses will be forced to drastically cut payroll through layoffs or simply close their doors.

Perhaps most disappointing in this legislation is the fact that **the more research and development a US company undertakes, the more detrimental the overall impact.** Thus, the unintended consequences will likely result in millions of layoffs of high-quality STEM jobs while punishing small- and mid-size companies that invest in U.S. innovation.

Included below are "real-life" examples of current ABGI clients, illustrating the impact implementation of Sect. 174 is having on multiple sectors of the American economy. (See: Case Examples, Page 3.)

Legislative Action

There is bipartisan support for repealing IRC Section 174 amortization and reinstating the rules previously in place. However, immediate action is needed to reverse these changes before American companies are forced to make layoffs or shutter businesses.

Sens. Maggie Hassan (D-NH) and Todd Young (R-IN) introduced S.866 on March 16, 2023 that would repeal the R&D amortization requirement. The bill has been referred to the Senate Finance Committee. Similar legislation will be introduced in the House by Congressmen Ron Estes (R-KS) and John Larson (D-CT) the week of April 17th.

On behalf of the millions of American innovation workers, we respectfully encourage Congress to take immediate action to repeal IRC Section 174 amortization.

Supporting Partners

ABGI is part of a larger group of voices on this issue. In addition to ABGI – on behalf of our affected clients – others urging Congress to reverse this harmful tax change include:

- The National Association of Manufacturers – Letter to House and Senate Leadership
- U.S. Chamber of Commerce – Prevent Stealth Tax Increases
- American Institute of CPAs – Letter to House Ways & Means Committee and Senate Finance Committee
- National Taxpayers Union – NTU Urges Estes Legislation; NTU "No Brainers"

American Companies Rely on Research & Innovation
Case Examples

To demonstrate the real-life practical impact the TCJA is having, included here are examples from three different sectors of the economy – Engineering, Architecture, and Manufacturing – that drive American innovation and have historically relied upon research and development incentives to drive such innovation. These sectors of the economy do not isolate in a vacuum; rather, they are interwoven into the economic fabric giving rise to new inventions, products, and software throughout the nation.

Note: These examples are from actual ABGI clients across the country, calculated for the 2022 tax year using the Sect. 174 amortization requirements from the TCJA.

Engineering Industry

The engineering industry encompasses a variety of disciplines including civil, mechanical, chemical, and industrial. The Research and Development Tax Credit is designed to incentivize companies in this industry nationwide to spur technological advancements in the design and construction of everything from wastewater treatment plants to components integral to nearly every industry in the country. The company represented in this example was awarded the 2019 Project of the Year Award by the Southwestern Branch of the Michigan APWA for creating a newly designed clarifier that extended the life of the final clarifiers by approximately 50 years.

In this example, the taxpayer will see its tax liability increase from $200,000 to $875,000 based solely on the disastrous mechanics of this TCJA provision. This represents a **438% increase in tax liability** for an engineering firm simply because it dared to engage in qualified research and elevate America's technological supremacy in the world.

With nearly 138,000 engineering firms nationwide,[1] few will be spared from the impact of the TCJA. The unintended consequence will lead to the immediate loss of millions of jobs for companies like this taxpayer who simply can neither afford nor withstand a 438% instantaneous increase in its tax liability.

Architecture Industry

The architecture industry encompasses the planning, design, and construction of buildings and other structures to reflect functional, technical, and environmental considerations. The Research and Development Tax Credit seeks to incentivize architecture firms throughout the country to continue pushing the envelope and create new, more functional designs for a more sustainable future. With innovation at is core, companies in the architecture industry leverage the Research and Development Tax Credit to grow their business and take on more challenging and complex projects.

The company represented in this example employs both designers and architects who create new and innovative spaces for clients and employees alike. It embraces new concepts such as experiential design

[1] https://www.ibisworld.com/industry-statistics/number-of-businesses/engineering-services-united-states/%23:~:text=There%20are%20143%2C722%20Engineering%20Services,increase%20of%200.8%25%20from%202022

and looks for new ways to incorporate this into its work. The company referenced here was responsible for the design of the World Equestrian Center in Ocala, Florida. This world-class multi-indoor and outdoor arena facility is the largest equestrian complex in the United States.

In this example, the company will see its tax liability increase from $31,500 to $267,750, again based solely on the mechanics of this provision of the TCJA. This represents an **850% increase in tax liability**, hardly the outcome envisioned by the TCJA.

With nearly 75,000 architecture firms throughout the United States, most will bear the direct brunt of this legislation and result in the immediate loss of countless jobs.

Manufacturing Industry

The manufacturing industry encompasses a large swath of nearly every market as it includes companies that engage in the mechanical, physical, or chemical transformation of materials, substances, or components into new products. It also includes the creation of new processes necessary to make products safer while increasing performance and efficiencies.

The company referenced below creates and produces fiberglass conduits with a ride range of applications to include chemical plants, bridges, tunnels and data centers. In fact, their designed fire-resistant fiberglass conduit can withstand two hours at 1850°F and was used exclusively to rehabilitate the Tuscarora Tunnel in Pennsylvania.

In this example, a Texas manufacturing company who is engaged in Research and Development would see its tax liability increase from $192,000 to $508,575 based on the mechanics of the TCJA, if not reformed with immediate effect. This represents nearly a **265% increase in taxable liability** for a manufacturing company, who like many others, has taken on the challenge of not deporting jobs to cheaper foreign countries.

With nearly 719,000 manufacturing companies nationwide, few will be spared from the impact of the TCJA. The job loss expected in this industry will be nothing short of catastrophic.[2]

[2] https://www.ibisworld.com/industry-statistics/number-of-businesses/manufacturing-united-states/