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## Mid-Size Initiative: Pathway to Growth

### Legislative: Congress should act to allow companies to deduct Research and Development (R&D) expenses and expenditures from total revenue for size determination

A long-standing goal of the government is to foster small business and broad economic growth by providing fair access to opportunities for federal contracts. However, successful businesses that have outgrown their small status frequently encounter difficulties continuing their growth. Businesses larger than their industry size standard, which tops out at \$38.5 million in revenues or 1,500 employees, must compete with the largest businesses (over \$500 million in revenue) for contract opportunities, thus putting many contracts out of reach.

#### Recommendation

Congress should act to allow companies to deduct Research and Development (R&D) expenses and expenditures from total revenue for size determination.

The common perception that a company's revenue determines how well it can compete in the marketplace is incorrect. A company's personnel, infrastructure, teaming relationships, and cost structure determines competitiveness. R&D is not typically an investment in present value or its competitiveness, but is an investment in the future that benefits both the company and its customers. This holds true because investing in R&D typically siphons resources away from operational divisions and bid opportunities, therefore decreasing its present competitiveness.

Allowing companies to deduct R&D expenses and expenditures from total revenue would accomplish a nationally recognized goal: incentivizing small business innovation through increased R&D investment. A small business needs to leverage every ounce of its budget to remain competitive and have a chance at survival in the future when competing in the open marketplace. Allowing a business to deduct R&D expenses from its annual revenue for size determination would alleviate some of the negative consequences of these investments. According to TRCG Advisors, midsize companies are investing an average of 20%-40% of their direct labor costs toward R&D activities. Incentivizing this investment would allow them to continue to compete for small business set-aside work before being forced to survive in the open marketplace.

Historically, states offer limited R&D tax credits to help offset a small portion of the incurred costs. Based on 2016 data, qualifying Maryland companies applied for approximately \$34.9 million in Basic Credits and \$47.2 million in Growth Credits. As an example of how limited this credit is for companies, a midsize Maryland based technology company incurred over \$1.8 million in R&D expenses in tax year 2015 and was awarded only \$7,300 by the state to help offset those incurred costs. Allowing companies to deduct these expenses from total recognized revenue, as the initiative suggests, would more accurately reflect true annual revenue.

The following is an example of how our initiative would work for a midsize company. Assume that “Small Business A” had the following revenue: \$20 million in annual revenue in 2014, \$26 million in 2015, and \$38 million in 2016, resulting in an average revenue of \$28 million during 2017. “Small Business A’s” principal NAICS code has a size standard of \$26.5 million, so it is ineligible to bid on set-aside work in its primary industry. “Small Business A” invested in internal research and development in 2015 and 2016. As declared to the IRS in its tax returns, “Small Business A” expended \$4 million dollars in qualified R&D expenses during 2016 and \$2 million during 2015. If “Small Business A” could deduct these expenses from its annual revenue in the relevant years, it would result in an average annual revenue of \$26 million, below the \$26.5 million size standard. Thus, this business could continue to compete for set-asides in its primary industry because of its R&D investment. Had it not been able to take advantage of this provision, it would have lost its small size status, thus hampering its ability to compete and grow.

Not only would companies benefit from the change, so would the government. Federal agencies struggle with acquiring the most advanced solutions for their needs quickly and if small businesses are able to invest in R&D without undue penalty or status change, the new desired technologies can be brought to market much faster. The demand for innovations at the small business level is demonstrated by the sheer number of Washington DC area business accelerators, whose primary purpose is to connect small, cutting edge companies in the bio-tech, cyber and artificial intelligence space with federal customers. Adoption of the proposed change would increase business investment in future growth.

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