

**DESCRIPTION OF H.R. 4438,  
THE “AMERICAN RESEARCH AND  
COMPETITIVENESS ACT OF 2014”**

Scheduled for Markup  
by the  
HOUSE COMMITTEE ON WAYS AND MEANS  
on April 29, 2014

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



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## INTRODUCTION

The House Committee on Ways and Means has scheduled a committee markup of H.R. 4438, the “American Research and Competitiveness Act of 2014,” on April 29, 2014. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. 4438, the “American Research and Competitiveness Act of 2014”* (JCX-38-14), April 25, 2014. This document can also be found on our website at [www.jct.gov](http://www.jct.gov).

**A. Research Credit Simplified and Made Permanent  
(sec. 41 of the Code)**

**Present Law**

**General rule**

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.<sup>2</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit.<sup>3</sup>

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.<sup>4</sup> This separate credit computation commonly is referred to as the basic research credit.<sup>5</sup>

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.<sup>6</sup> This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The research credit, including the basic research credit and the energy research credit, expires for amounts paid or incurred after December 31, 2013.<sup>7</sup>

**Computation of general research credit**

The general research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both

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<sup>2</sup> Sec. 41(a)(1).

<sup>3</sup> Sec. 41(c)(5).

<sup>4</sup> Sec. 41(a)(2).

<sup>5</sup> Sec. 41(e).

<sup>6</sup> Sec. 41(a)(3).

<sup>7</sup> Sec. 41(h).

incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).<sup>8</sup> In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses. Slightly different rules apply in calculating the basic research credit, which generally has a base period that extends from 1981 through 1983.

### **Alternative simplified credit**

The alternative simplified research credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years.<sup>9</sup> The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.<sup>10</sup> An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.<sup>11</sup>

### **Eligible expenses**

Qualified research expenses eligible for the research tax credit consist of: (1) in-house expenses of the taxpayer for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).<sup>12</sup> Notwithstanding the limitation for

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<sup>8</sup> The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually recompute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. Sec. 41(c)(3)(B).

<sup>9</sup> Sec. 41(c)(5)(A).

<sup>10</sup> Sec. 41(c)(5)(B).

<sup>11</sup> Sec. 41(c)(5)(C).

<sup>12</sup> Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in section 501(c)(3) (other than a private foundation) or section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. Sec. 41(b)(3)(C).

contract research expenses, qualified research expenses include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or Federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of section 174, but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.<sup>13</sup> In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for internal use by the taxpayer; (6) conducted outside the United States, Puerto Rico, or any U.S. possession; (7) in the social sciences, arts, or humanities; or (8) funded by any grant, contract, or otherwise by another person (or government entity).<sup>14</sup>

### **Relation to deduction**

Deductions allowed to a taxpayer under section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.<sup>15</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.<sup>16</sup>

### **Description of Proposal**

The proposal makes permanent the alternative simplified method for calculating the research credit and increases the rate to 20 percent. That is, the research credit is equal to 20 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years. The rate is reduced to 10 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years. The proposal repeals the traditional 20-percent research credit calculation method.

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<sup>13</sup> Sec. 41(d)(3).

<sup>14</sup> Sec. 41(d)(4).

<sup>15</sup> Sec. 280C(c).

<sup>16</sup> Sec. 280C(c)(3).

The proposal also makes permanent the basic research credit and the energy research credit (both with credit rates of 20 percent), and changes the base period for the basic research credit from a fixed period to a three-year rolling average.

**Effective Date**

The proposal to make various components of the research credit permanent is effective for amounts paid or incurred after December 31, 2013. The other elements of the proposal are effective for taxable years beginning after December 31, 2013.

**B. Estimated Revenue Effects**

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Fiscal Years [Billions of Dollars]												
<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2014-19</u>	<u>2014-24</u>
-4.9	-8.6	-10.2	-11.7	-13.1	-14.4	-15.8	-17.0	-18.5	-19.9	-21.3	-62.9	-155.5

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**NOTE:** Details do not add to totals due to rounding.