DESCRIPTION OF PROPOSALS RELATING TO ALLOWING RESEARCH TAX CREDIT FOR EXPENSES OF DEVELOPING GENERIC ALTERNATIVES AND OFFSETTING OF FEDERAL TAX REFUNDS FOR PAST-DUE STATE TAX OBLIGATIONS (H.R. 4138)

Scheduled for a Hearing

by the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on October 6, 1994

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a public hearing on October 6, 1994, on two miscellaneous tax proposals: (1) modify the research tax credit to allow the credit for expenses of developing generic alternatives to brand-name products; and (2) H.R. 4138 (Messrs. Jacobs, Rangel, Stark, Grandy, McCrery, and others), to provide a Federal tax refund offset for past-due, legally enforceable State tax obligations.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and the proposals.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Proposals Relating to Allowing the Research Tax Credit for Expenses of Developing Generic Alternatives and Offsetting of Federal Tax Refunds for Past-Due State Tax Obligations (JCX-24-94), October 4, 1994.

DESCRIPTION OF PROPOSALS

1. Allow Research Tax Credit for Expenses of Developing Generic Alternatives to Brand-Name Products

Present Law

The research and experimentation tax credit (research tax credit) provides a credit equal to 20 percent of the amount by which a taxpayer s qualified research expenditures for a taxable year exceed its base amount for that year. The credit is scheduled to expire and (absent extension by Congress) will not apply to amounts paid or incurred after June 30, 1995.

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 incurred qualified research expenditures 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 expenditures for the 1984-1988 period bear to its total gross receipts for that period (subject to a maximum ratio of 16 percent). All other taxpayers (such as start-up firms) are assigned a fixed-base percentage of three percent for a five-year, start-up period, after which such firms must compute their fixed-base percentage on the basis of their actual research experience. In computing the credit, a taxpayer s base amount may not be less than 50 percent of its current-year qualified research expenditures.[2]

Research expenditures eligible for the credit consist of: (1) in-house expenses of the taxpayer for research wages and supplies used in qualified research ; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid by the taxpayer to a third party (other than an employee) for qualified research conducted on the taxpayer s behalf.

Only expenses attributable to qualified research are eligible for the credit. Section 41(d) defines qualified

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[2] Deductions for qualified research expenditures allowed to a taxpayer under section 174 are reduced by an amount equal to 100 percent of the taxpayer s research credit determined for that year. Taxpayers alternatively may elect to claim a reduced research credit amount in lieu of reducing deductions otherwise allowed (sec. 280C(c)).

research as research (1) with respect to which expenditures may be treated as expenses under section 174, (2) which is undertaken for the purposes of discovering information (a) which is technological in nature, and (b) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and (3) substantially all of the activities of which constitute elements of a process of experimentation for (a) a new or improved function, (b) performance, or (c) reliability or quality (sec. 41(d)(1)). Section 41(d)(4)(C) specifically provides that the term qualified research does not include

> [a]ny research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component. [3]

Applying the language of section 41(d)(4)(C), the IRS concluded in a private letter ruling that expenses incurred to develop generic drugs for approval by the Food and Drug Administration (FDA) through a process known as an abbreviated new drug application (ANDA) are not eligible for the research tax credit.[4]

The research tax credit is not available for expenditures attributable to research that is conducted outside the United States (sec. 41(d)(4)(F)). In addition, the credit is not available for research in the social sciences, arts, or humanities, nor is it available for research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity) (secs. 41(d)(4)(G) and (H)).

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[3] In 1986, Congress amended section 41(d) to provide an express, narrower definition of qualified research for purposes of the credit. Prior to that time, qualified research had the same meaning as the term research and experimental under section 174 (except that research conducted outside the United States, social sciences or humanities research, and research funded by any grant, contract, or otherwise by a third party were not eligible for the credit).

[4] LTR 9346006 (August 13, 1993). Under the ANDA procedure, a generic drug manufacturer must demonstrate that the generic drug is bioequivalent to the listed (i.e., brand name) drug and that the active ingredient, route of administration, dosage form, strength, and conditions of use are the same as the listed drug. The ANDA for a generic drug need not contain data demonstrating the safety or effectiveness of the drug (which was previously demonstrated by clinical testing of the listed drug). Id.

In addition, the 20-percent research tax credit also applies to the excess of (1) 100 percent of cash expenditures (including grants or contributions) paid by a corporation to a universities (or certain other tax-exempt scientific research organizations) for basic research over (2) the sum of (a) the greater of two fixed 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 (sec. 41(e)). This separate credit computation for certain basic research payments is commonly referred to as the university basic research credit.

Description of Proposal

The proposal would amend section 41(d)(4)(C) to provide that the ineligibility for the research tax credit for research expenses related to duplication of an existing business component shall not apply to research related to the development of a business component of the taxpayer that is an original alternative to achieve the equivalent result of a competitor s product. The legislative history would state that the proposal clarifies that duplication for purposes of section 41(d)(4)(C) consists of reproduction of a competitor s product by imitation, but does not include duplication of performance by the development of alternative products to achieve similar results. For example, research to develop a generic drug product would be qualified if it seeks to test an alternative unique formulation of excipients to achieve the bioequivalent delivery of a known active ingredient contained in a listed drug in order to satisfy procedures for an FDA abbreviated new drug application (ANDA).

Effective Date

The proposal would be effective for expenditures paid or incurred in taxable years beginning after December 31, 1994. No inference would be intended with respect to the proper interpretation of section 41 for expenses paid or incurred in taxable years beginning prior to 1995.

2. H.R. 4138 (Messrs. Jacobs, Rangel, Stark, Grandy, McCrery, and Others)

Refund Offset for Past-Due, Legally Enforceable State Tax Obligations

Present Law

Federal tax refunds must be offset against past due child support payments (Code sec. 6402). In the case of families receiving specified public assistance payments (primarily AFDC payments), these past due support payments are assigned to the State that makes the public assistance payments. Federal tax refunds must also be offset for the amount of any past due, legally enforceable debt to a Federal agency. Federal tax refunds may not be offset against past-due, legally enforceable State tax obligations.

If a refund is subject to offset both under the Federal agency provision and because of past due child support, the offset for past due child support that has been assigned to a State is to be implemented first, the offset for past due debts owed to Federal agencies second, and the offset for past due child support not assigned to a State (but owed to the family) last. No court of the United States has jurisdiction to hear any action brought to restrain or review a refund offset made because of either past due child support or a nontax Federal debt.

Description of Bill

The bill would require that the Internal Revenue Service (IRS) reduce the amount of an overpayment of Federal tax otherwise payable to a person by the amount of past-due, legally enforceable State tax obligations of such person and pay those amounts to the State. The bill would impose several procedural requirements on the States before the IRS could offset a refund. These procedural requirements are generally parallel to present-law procedural requirements imposed on the Federal Government prior to offsetting a refund for nontax Federal debts. The bill would apply to all types of State taxes and to any local tax that is administered by the chief tax administration agency of the State.

If a refund were subject to offset under multiple provisions, the present-law offset for past due child support that has been assigned to a State would be implemented first, the present-law offset for other past due debts to Federal agencies would be implemented second, the proposed offset for

State taxes would be implemented third, and the present-law offset for past due support owed to the family (that has not been assigned to a State) would be implemented last.

The bill would permit disclosure of the following otherwise confidential tax information to the States, relating to the refund offset for State tax obligations: whether or not a reduction has been made, the amount of the reduction, and identifying information regarding the person against whom a reduction was or was not made.

Effective Date

The bill would be effective for Federal tax refunds payable after December 31, 1994.