PRESENT LAW AND BACKGROUND RELATING TO THE RESEARCH AND EXPERIMENTATION TAX CREDIT

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

of the

SENATE COMMITTEE ON FINANCE

on April 3, 1995

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

March 31, 1995

JCX-20-95

CONTENTS

INTRODUCTION

The Subcommittee on Taxation and Internal Revenue Service (IRS) Oversight of the Senate Committee on Finance has scheduled a hearing on April 3, 1995, on the research and experimentation ("R&E") tax credit. The R&E tax credit, which was enacted in 1981 and extended several times since, is currently scheduled to expire after June 30, 1995.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present-law tax rules (Part I) and legislative background of the R&E tax credit (Part II).

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[1] This document may be cited as follows: Present Law and Background Relating to the Research and Experimentation Tax Credit (JCX-20-95), March 31, 1995.

I. PRESENT LAW

General rule

Section 41 of the Internal Revenue Code provides for a research tax 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 research tax credit is scheduled to expire such that it will not apply to amounts paid or incurred after June 30, 1995.

A 20-percent research tax credit also applies to the excess of (1) 100 percent of corporate cash expenditures (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. This separate credit computation is commonly referred to as the "university basic research credit" (see sec. 41(e)).

Computation of allowable credit

Except for certain university basic research payments made by corporations, the research tax credit applies only to the extent that the taxpayer's qualified research expenditures 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 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 bears to its total gross receipts for that period (subject to a maximum ratio of .16). All other taxpayers (so-called "start-up firms") are assigned a fixed-base percentage of .03.[2]

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[2] The Omnibus Budget Reconciliation Act of 1993 included a special rule 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 (i.e., any taxpayer that did not have gross receipts in at least three years during the 1984-1988 period) will be assigned a fixed base percentage of .03 for each of its first five taxable years after 1993 in which it incurs qualified research expenditures. In the event that the research credit is extended beyond the scheduled June 30, 1995 expiration date, a start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenditures will be a phased-in ratio based on its actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage will be its actual ratio of qualified research expenditures to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years (sec. 41(c)(3)(B)).

In computing the credit, a taxpayer's base amount may not be less than 50 percent of its current-year qualified research expenditures.

Eligible expenditures

Qualified research expenditures 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 by the taxpayer for qualified research conducted on the taxpayer's behalf (so-called "contract research expenses").

To be eligible for the credit, the research must not only satisfy the requirements of present-law section 174 but 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 must pertain to 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 (sec. 41(d)(3)). In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control (sec. 41(d)(4)).

Expenditures attributable to research that is conducted outside the United States do not enter into the credit computation. 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).

Relation to deduction

Deductions for expenditures 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. Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed (sec. 280C(c)(3)).

II. LEGISLATIVE BACKGROUND

The research tax credit initially was enacted in the Economic Recovery Tax Act of 1981 as a credit equal to 25 percent of the excess of qualified research expenses incurred in the current taxable year over the average of qualified research expenses incurred in the prior three taxable years. The research tax credit was modified in the Tax Reform Act of 1986, which (1) extended the credit through December 31, 1988, (2) reduced the credit rate to 20 percent, (3) tightened the definition of qualified research expenses eligible for the credit, and (4) enacted the separate, university basic research credit.

The Technical and Miscellaneous Revenue Act of 1988 ("1988 Act") extended the research tax credit for one additional year, through December 31, 1989. The 1988 Act also reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 50 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1989 ("1989 Act") effectively extended the research credit for nine months (by prorating qualified expenses incurred before January 1, 1991). The 1989 Act also modified the method for calculating a taxpayer's base amount (i.e., by substituting the present-law method which uses a fixed-base percentage for the prior-law moving base which was calculated by reference to the taxpayer's average research expenses incurred in the preceding three taxable years). The 1989 Act further reduced the deduction allowed under section 174 (or any other section) for qualified research expenses by an amount equal to 100 percent of the research tax credit determined for the year.

The Omnibus Budget Reconciliation Act of 1990 extended the research tax credit through December 31, 1991 (and repealed the special rule to prorate qualified expenses incurred before January 1, 1991).

The Tax Extension Act of 1991 extended the research tax credit for six months (i.e., for qualified expenses incurred through June 30, 1992).[3]

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") extended the research tax credit for three years -- i.e., retroactively from July 1, 1992 through June 30, 1995. The 1993 Act also provided a special rule for start-up firms, so that the fixed-base ratio of such firms eventually will be computed by reference to their actual research experience (see

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[3] For an analysis of the issues presented by the extensions and modifications of the research tax credit, see Joint Committee on Taxation, Description and Analysis of Tax Provisions Expiring in 1992 (JCS-2-92), at 60-68.

footnote 2 supra).[4] The three-year extension of the research tax credit provided for by the 1993 Act was estimated by the Joint Committee on Taxation to reduce Federal Government receipts by $4.851 billion during the 1994-1998 fiscal year period.

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[4] The 1993 Act also provided a temporary rule for allocation of research expenses between U.S. and foreign income. The 1993 Act rule generally is identical to temporary rules in effect prior to the enactment of the 1993 Act for allocating research expenses, except that the percentage of U.S.-incurred research expenses allocated to U.S. source income (and the percentage of foreign-incurred research expenses allocated to foreign source income) is 50 instead of 64. The 1993 Act provision applies to the taxpayer's first taxable year (beginning on or before August 1, 1994) beginning immediately after the taxpayer's last taxable year to which Revenue Procedure 92-56 applies, or would have applied had the taxpayer elected the benefits of the Revenue Procedure (which generally applied to a taxpayer's first two taxable years beginning after August 1, 1991).