

**DESCRIPTION OF H.R. _____,
THE “AMERICAN RESEARCH AND
COMPETITIVENESS ACT OF 2015”**

Scheduled for Markup
by the
HOUSE COMMITTEE ON WAYS AND MEANS
on February 12, 2015

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. _____, the “American Research and Competitiveness Act of 2015,” on February 12, 2015. This document,¹ prepared by the staff of the Joint Committee on Taxation, provides a description of the bill.

¹ This document may be cited as follows: Joint Committee on Taxation, *Description of H.R. _____, the “American Research and Competitiveness Act of 2015”* (JCX-42-15), February 11, 2015. This document can also be found on the Joint Committee on Taxation website at 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.² 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.³

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.⁴ This separate credit computation commonly is referred to as the basic research credit.

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.⁵ 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, 2014.⁶

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

² Sec. 41(a)(1). Except where otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

³ Sec. 41(c)(5).

⁴ Sec. 41(a)(2) and (e). The base period for the basic research credit generally extends from 1981 through 1983.

⁵ Sec. 41(a)(3).

⁶ 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).⁷ In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

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.⁸ The rate is reduced to six percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.⁹ An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.¹⁰

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).¹¹ Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or

⁷ 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).

⁸ Sec. 41(c)(5)(A).

⁹ Sec. 41(c)(5)(B).

¹⁰ Sec. 41(c)(5)(C).

¹¹ 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).

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.¹² 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).¹³

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.¹⁴ Taxpayers may alternatively elect to claim a reduced research tax credit amount under section 41 in lieu of reducing deductions otherwise allowed.¹⁵

Specified credits allowed against alternative minimum tax

For any taxable year, the general business credit (which is the sum of the various business credits) generally may not exceed the excess of the taxpayer's net income tax¹⁶ over the greater of (1) the taxpayer's tentative minimum tax or (2) 25 percent of so much of the taxpayer's net regular tax liability¹⁷ as exceeds \$25,000.¹⁸ Any general business credit in excess of this

¹² Sec. 41(d)(3).

¹³ Sec. 41(d)(4).

¹⁴ Sec. 280C(c).

¹⁵ Sec. 280C(c)(3).

¹⁶ The term "net income tax" means the sum of the regular tax liability and the tax imposed by section 55, reduced by the credits allowable under subparts A and B of this part. Sec. 38(c)(1).

¹⁷ The term "net regular tax liability" means the regular tax liability reduced by the sum of credits allowable under subparts A and B of this part. Sec. 38(c)(1).

limitation may be carried back one year and forward up to 20 years.¹⁹ The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.²⁰ Generally, the tentative minimum tax of a C corporation with average annual gross receipts of less than \$7.5 million for prior 3-year periods is zero.²¹

In applying the tax liability limitation to certain specified credits that are part of the general business credit, the tentative minimum tax is treated as being zero.²² Thus, the specified credits may offset both regular and alternative minimum tax liability (“AMT”).

For taxable years beginning in 2010, eligible small businesses were allowed to offset both the regular and alternative minimum tax liability with specified credits.²³ For this purpose, an eligible small business was, with respect to any taxable year, a corporation, the stock of which was not publicly traded, or a partnership, which met the gross receipts test of section 448(c), substituting \$50 million for \$5 million each place it appears.²⁴ In the case of a sole proprietorship, the gross receipts test was applied as if it were a corporation. Credits determined with respect to a partnership or S corporation were not treated as eligible small business credits by a partner or shareholder unless the partner or shareholder met the gross receipts test for the taxable year in which the credits were treated as current year business credits.²⁵

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

¹⁸ Sec. 38(c)(1).

¹⁹ Sec. 39(a)(1).

²⁰ See sec. 55(b). For example, assume a taxpayer has a regular tax of \$80,000, a tentative minimum tax of \$100,000, and a research credit determined under section 41 of \$90,000 for a taxable year (and no other credits). Under present law, the taxpayer’s research credit is limited to the excess of \$100,000 over the greater of (1) \$100,000 or (2) \$13,750 (25% of the excess of \$80,000 over \$25,000). Accordingly, no research credit may be claimed ($\$100,000 - \$100,000 = \$0$) for the taxable year and the taxpayer’s net tax liability is \$100,000. The \$90,000 research credit may be carried back or forward under the rules applicable to the general business credit.

²¹ Sec. 55(e).

²² See section 38(c)(4)(B) for the list of specified credits, which does not presently include the research credit determined under section 41.

²³ Sec. 38(c)(5)(B).

²⁴ Sec. 38(c)(5)(C).

²⁵ Sec. 38(c)(5)(D).

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 provision repeals the traditional 20 percent research credit calculation method.

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.

The proposal also provides that, in the case of an eligible small business (as defined in section 38(c)(5)(C)), the research credit determined under section 41 for taxable years beginning after December 31, 2014 is a specified credit. Thus, the research credits of an eligible small business may offset both regular and AMT liability.²⁶

Effective Date

The proposal is generally effective for taxable years beginning after December 31, 2014. The proposal to make the research credit permanent applies to amounts paid or incurred after December 31, 2014.

²⁶ Using the above example, under this provision, the limitation would be the excess of \$80,000 over the greater of (1) \$0 or (2) \$13,750. Since \$13,750 is greater than \$0, the \$80,000 would be reduced by \$13,750 such that the research credit limitation would be \$66,250. Hence, the taxpayer would be able to claim a research credit of \$66,250 against its net income tax liability, as well as its AMT liability, which would result in \$33,250 of total tax owed (\$100,000 - \$66,250). The remaining \$23,750 of its research credit (\$90,000 - \$66,250) may be carried back or forward, as applicable.

B. Estimated Revenue Effects

Fiscal Years
[Millions of Dollars]

| <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>2025</u> | <u>2015-20</u> | <u>2015-25</u> |
|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|----------------|----------------|
| -4,716 | -8,768 | -11,042 | -13,212 | -15,270 | -17,229 | -19,085 | -20,824 | -22,577 | -23,894 | -24,989 | -70,237 | -181,609 |

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