

[JOINT COMMITTEE PRINT]

**DESCRIPTION OF TAX BILLS
(S. 1857 and S. 2165)**

SCHEDULED FOR A JOINT HEARING

BEFORE THE

**SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT**

AND THE

**SUBCOMMITTEE ON SAVINGS,
PENSIONS, AND INVESTMENT POLICY**

OF THE

COMMITTEE ON FINANCE

ON FEBRUARY 24, 1984

PREPARED BY THE STAFF

OF THE

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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	3
II. DESCRIPTION OF THE BILLS.....	9
1. S. 1857 (Senators Durenberger, Moynihan, Bradley, Matsunaga, Lugar, Packwood, Tsongas, D'Amato, Riegle, and Heinz): Liberalize charitable deduction rules for private nonoperating foundations; amendments to foundation excise tax provisions	9
a. Liberalizing charitable deduction rules	9
b. Narrowing definition of family members ..	10
c. Increasing reliance on IRS classification of donee organizations.....	11
d. Exemption from expenditure responsibility requirements.....	12
e. Abatement of first-tier excise taxes	12
2. S. 2165 (Senators Danforth, Bentsen, Chafee, Mitchell, Symms, Packwood, Wilson, Tsongas, Wallop, Pell, Dodd, and Bingaman): "High Technology Research and Scientific Education Act" ...	13
a. Extension of credit for increased research expenditures; modification of qualified research definition; equipment depreciation under credit, ACRS provisions; modification of trade or business requirement	13
b. Increased credit for corporate support of basic research at universities	24
c. Expanded special deduction for transfers to universities of scientific equipment for certain research or educational purposes	28
d. Tax treatment of payments and loan forgiveness received by certain graduate science students.....	33

INTRODUCTION

The bills described in this pamphlet have been scheduled for a joint hearing on February 24, 1984, before the Senate Finance Subcommittees on Taxation and Debt Management and on Savings, Pensions, and Investment Policy.

The two bills scheduled for the hearing are S. 1857 (liberalize charitable deduction rules for private nonoperating foundations; amendments to foundation excise tax provisions) and S. 2165 ("High Technology Research and Scientific Education Act").

The first part of the pamphlet is a summary of the bills. This is followed in the second part by a more detailed description of the bills, including present law, explanation of provisions, and effective dates.

I. SUMMARY

1. S. 1857—Senators Durenberger, Moynihan, Bradley, Matsunaga, Lugar, Packwood, Tsongas, D'Amato, Riegle, and Heinz

Liberalize Charitable Deduction Rules for Private Nonoperating Foundations; Amendments to Foundation Excise Tax Provisions

Liberalizing charitable deduction rules

The bill would conform the income tax treatment of contributions by individuals to private nonoperating (grantmaking) foundations to that provided under present law for contributions by individuals to public charities or private operating foundations (Code sec. 170), effective for contributions made after 1982.

Under the bill, contributions of cash or ordinary-income property to private nonoperating foundations would be deductible up to 50 percent of the donor's adjusted gross income, and contributions of capital-gain property, up to 30 percent, rather than up to 20 percent as under present law. Also, excess contributions to nonoperating foundations could be carried forward for five years. Finally, the full fair market value of capital-gain property donated to nonoperating foundations generally would be deductible; under present law, the amount deductible equals the fair market value reduced by 40 percent of the unrealized appreciation.

Narrowing definition of family members

Present law contains a number of restrictions imposed on private foundations which depend on determinations of "disqualified persons." This term includes a substantial contributor, a foundation manager, or a member of the family of such individuals (sec. 4946). A member of the family includes the spouse, ancestors, and lineal descendants (and spouses of lineal descendants) of the individual.

The bill would narrow the category of disqualified persons by limiting family members to the spouse, ancestors, children, and grandchildren (and the spouses of children and grandchildren) of the substantial contributor, etc., effective January 1, 1983.

Increasing reliance on IRS classification of donee organizations

Under present law, Treasury regulations and IRS rulings establish guidelines under which a private foundation may rely on an IRS classification of a donee organization as a public charity or private operating foundation.

The bill would provide that a grant (made after 1982) to an organization which the IRS has determined to be a public charity (or private operating foundation) would be treated as a grant to such an organization, even though the donee organization loses such status, if (1) the grant was made prior to the earlier of the date of publication by the IRS that the donee organization has lost its

qualified status, or the date on which the foundation acquires actual knowledge that the donee organization has been notified by the IRS of loss of its qualified status, and (2) the donor foundation was not responsible for (other than by making grants) or aware of the change in the donee's status.

Exemption from expenditure responsibility requirements

Under present law, a private foundation must exercise "expenditure responsibility" over grants to organizations other than public charities. In order to ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the IRS on the grants (sec. 4945(h)).

The bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant (made after 1982) to an organization if the aggregate amount of grants made during the taxable year by the foundation (and all related foundations) to that organization does not exceed \$25,000.

Abatement of first-tier excise taxes

Under present law, any violation of the foundation rules results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). In general, this first-tier tax applies automatically when a foundation rule is violated.

The bill would waive the first-tier excise tax imposed under sections 4941-4945 on the foundation (or disqualified person, in the case of self-dealing) if the IRS determines that the violation (1) was due to reasonable cause and not to intentional disregard of rules and regulations, and (2) the violation is "corrected" with the specified period. This provision would apply to post-1982 taxable years.

2. S. 2165—Senators Danforth, Bentsen, Chafee, Mitchell, Symms, Packwood, Wilson, Tsongas, Wallop, Pell, Dodd, and Bingaman

"High Technology Research and Scientific Education Act"

a. Extension of credit for increased research expenditures; modification of qualified research definition; equipment depreciation under credit, ACRS provisions; modification of trade or business requirement

Present law

An income tax credit is allowed for certain qualified research expenditures incurred in carrying on a trade or business (Code sec. 44F, enacted in ERTA). The credit applies only to the extent that the taxpayer's qualified research expenditures for the taxable year exceed the average amount of yearly qualified research expenditures in a specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

For purposes of the section 44F credit, the definition of research is the same as that used for purposes of the special deduction rules under section 174, but subject to certain exclusions. (Treasury regulations define qualifying expenditures under section 174 as "research and development costs in the experimental or laboratory sense.") A taxpayer's research expenditures eligible for the section 44F incremental credit consist of (1) "in-house" expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Cost-recovery (depreciation) allowances on research equipment are not eligible for the section 44F credit, but are deductible under section 174. The cost of research equipment is recoverable over three years; such equipment is also eligible for a six-percent investment tax credit.

Under present law, the section 44F credit will not apply to research expenditures after December 31, 1985.

Title I of the bill

Extension of credit.—The bill would make permanent the section 44F credit for increased research expenditures.

Research definition.—The bill would provide a separate, statutory definition of qualified research for purposes of the credit, effective for post-1983 taxable years. This definition would not affect the category of research expenditures qualifying for the section 174 deduction.

Under the bill, only expenditures to develop new or significantly improved business items (including costs of the design, construction, and testing of prototypes, models, and pilot plants) would qualify for the credit. To meet this test, the business item must be developed by a process of experimentation, and the performance or cost aspects of the new or improved characteristics must outweigh the stylistic, cosmetic, or seasonal design aspects. Under a special rule in the bill, computer software that is separately developed by the taxpayer solely for its own internal use could qualify as a business item only if used in (1) qualified research undertaken by the taxpayer, (2) a production process, or (3) the performance for customers of services of which such software together with the corresponding hardware is the predominant component, or otherwise to the extent allowed by Treasury regulations.

Depreciation.—The bill would add cost-recovery allowances on tangible personal property used in the conduct of qualified research to the categories of research expenditures which are eligible for the section 44F credit. Where a taxpayer pays others to do research for it, the percentage of contract payments eligible for the credit would be increased from 65 to 75 percent. These changes would be effective for post-1983 taxable years.

In addition, the bill would provide that the cost of research equipment—which now is recoverable over three years, with a six percent investment tax credit—would be recoverable over five years, with a ten percent investment credit. This provision would apply to property placed in service in post-1983 taxable years.

Trade or business test.—The bill would in effect repeal the trade or business requirement of present law for most corporations. As a result, research expenditures of start-up corporations would be eligible for the credit, as would expenditures of established corporations incurred in research endeavors that are not directly related to their existing trades or businesses. With respect to research expenses of a partnership, the bill would provide that the trade or business test used to determine whether such expenses qualify for the credit is to be applied at the partnership level, without regard to the trade or business of any partner. This rule would be modified for certain corporate and other joint ventures.

b. Increased credit for corporate support of basic research at universities

Present law

Under present law, corporations may take into account, for purposes of computing the section 44F credit for a taxable year, 65 percent of university basic research expenditures for that year; similarly, this percentage amount is treated as qualified research expenditures in a base period year when the corporation calculates the credit in subsequent years. If any basic research payment made during a year is attributable to research to be conducted by the university in a later year, that amount is treated, pursuant to a prepayment limitation rule in present law, as paid in the year or years when the research is actually conducted.

This special rule for basic research applies only to corporate expenditures (including grants or contributions) paid or incurred pursuant to a written research agreement between the taxpayer corporation and a college or university, certain tax-exempt scientific research organizations, or certain qualified funds.

Section 201 of the bill

The bill would provide more favorable tax treatment for corporate expenditures (including grants or contributions) for basic research performed at universities or at certain scientific research organizations, by (1) increasing, from 65 to 75 percent, the percentage of such expenditures which are eligible for a credit; (2) applying a new 25-percent credit to the excess of the percentage amount over a fixed floor based on 1981-83 expenditures, rather than over a moving base period average; and (3) making the prepayment limitation of present law inapplicable to such expenditures.

The new 25-percent credit, effective for taxable years beginning after 1983, would apply to the excess of (1) 75 percent of qualifying university basic research expenditures over (2) the *greater* of the average yearly amount of credit-eligible university basic research expenditures for the corporation's 1981-1983 taxable years or one percent of the average yearly amount of the corporation's total in-house, contract, and other credit-eligible research expenditures for

those years. The 1981-83 fixed floor would not be adjusted to reflect inflation.

The amount exceeding the floor, to which the new credit would apply, would not also enter into the computation of the present-law incremental credit under section 44F. The amount of credit-eligible basic research expenditures up to the floor would remain eligible for the present-law incremental credit under section 44F (and would in later years enter into the base period amounts for purposes of computing the incremental credit).

Under the bill, no amount of property transferred to universities, etc. for basic research for which an augmented deduction (described below) would be provided would also be eligible for the new credit or the existing incremental credit.

c. Expanded special deduction for transfers to universities of scientific equipment for certain research or educational purposes

Present law

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)). For example, a manufacturer which makes a charitable contribution of its inventory generally may deduct only its basis in the property.

However, under a provision enacted in ERTA, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment to a college or university for research use in the physical or biological sciences (sec. 170(e)(4)). This increased deduction is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event is the augmented deduction allowed for an amount which exceeds twice the basis of the property.

Section 202 of the bill

In place of the augmented charitable deduction rule enacted in ERTA, the bill would enact a new deduction provision, generally of broader scope, outside the charitable deduction rules. The provision would be effective for taxable years beginning after 1983.

Under the new provision, corporations would receive special deductions for amounts in excess of basis for transfers, without consideration, of scientific or technical equipment to colleges or universities or certain associations of such educational institutions, for use in either research or education in certain sciences, technologies, or equipment operation fields. Unlike present law, an increased deduction would apply to transfers of property which has been used in the transferor's business (if not for more than three years), and to transfers of computer software. In addition, special deductions would be allowed under the bill for the value of performing certain maintenance and repair services in connection

with qualified equipment transfers. Except for computer software and replacement parts, only an item having a value exceeding \$250 generally would be eligible for the new special deduction.

The special deduction under the bill generally would not be allowed to the extent that, determined on a product-by-product basis, the number of transferred items exceeds 20 percent of the number of such items sold by the taxpayer during the year. Also, while the transfers would not be required to qualify as charitable contributions in order for the special deduction to apply, the taxpayer's aggregate deduction in one year for both charitable contributions and transfers under the new provision would be limited to 10 percent of taxable income (computed with certain modifications), with a five-year carryforward of any excess.

d. Tax treatment of payments and loan forgiveness received by certain graduate science students

Present law

Scholarship exclusion.—Subject to several limitations, gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (Code sec. 117).

In general, scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future employment services or for services subject to the direction or supervision of the grantor, or if the funded studies or research are primarily for the benefit of the grantor (Treas. Reg. sec. 1.117-4(c)). However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the recipient agrees to perform future services as a Federal employee or in a health manpower shortage area (sec. 117(c)).

Forgiveness of debt.—As a general rule, income is realized when indebtedness is forgiven or cancelled (sec. 61(a)(12)).

Section 203 of the bill

The bill would provide a new Code section under which gross income would not include amounts received by graduate students in certain scientific fields as a scholarship, fellowship grant, or qualified student loan forgiveness, notwithstanding that the recipient is required, as a condition of receiving such amounts, to perform future teaching services for any of a broad class of colleges or universities.

The scholarship and loan forgiveness provisions of the bill would apply to taxable years beginning after 1983.

II. DESCRIPTION OF THE BILLS

1. S. 1857—Senators Durenberger, Moynihan, Bradley, Matsunaga, Lugar, Packwood, Tsongas, D'Amato, Riegle, and Heinz

Liberalize Charitable Deduction Rules for Private Nonoperating Foundations; Amendments to Foundation Excise Tax Provisions

a. Liberalizing charitable deduction rules

Present law

In general.—Present law generally provides more favorable income tax treatment for contributions by individuals to public charities or private operating foundations than for such contributions to private nonoperating (grantmaking) foundations (Code sec. 170).

Percentage limitations.—For contributions of cash or ordinary-income property to public charities or operating foundations, the maximum amount which an individual may deduct in one year is 50 percent of his or her adjusted gross income. The 50-percent limitation applies to private nonoperating foundations only if the donees either redistribute all contributions within a specified period after receipt or qualify as a “pooled fund” foundation. For contributions of capital-gain property to organizations otherwise qualifying for the 50-percent limitation, the limitation generally is 30 percent. In the case of contributions of cash or property to private nonoperating foundations other than the two categories eligible for the 50-percent/30-percent limitations, and for certain other charitable contributions, the limitation is 20 percent.

Carryover.—Amounts in excess of the 50-percent/30-percent limitations may be carried forward and deducted over the following five years (subject to applicable percentage limitations in those years). Under present law, there is no carryover of excess deduction amounts where the 20-percent limitation applies.

Appreciated property.—In the case of donations by individuals of capital-gain property to private nonoperating foundations where the 20-percent limitation applies, the amount deductible equals the asset's fair market value reduced by 40 percent of the unrealized appreciation, i.e., by 40 percent of the amount by which the value exceeds the donor's basis in the property. In the case of donations by individuals of capital-gain property to public charities, etc., where the 30-percent limitation applies, there is no reduction from fair market value (except with respect to donated tangible personal property if use by the donee of the property is unrelated to the donee's tax-exempt purposes).

Explanation of provision

Section 1 of the bill would provide the same charitable deduction rules for contributions by individuals to all private nonoperating foundations as now apply for contributions to public charities and private operating foundations. Thus, the 50-percent/30-percent limitations would apply instead of the 20-percent limitation; any contribution amounts exceeding the limitations could be carried forward five years; and the full fair market value of donated capital-gain property generally could be deducted.

The amendments made by section 1 of the bill would apply to taxable years beginning after 1982.

b. Narrowing definition of family members*Present law*

Present law contains a number of restrictions imposed on private foundations (such as prohibitions on self-dealing and excess business holdings) which depend on determinations of "disqualified persons." A "disqualified person" includes a substantial contributor, a foundation manager, or a member of the family of either a substantial contributor or foundation manager (sec. 4946). For this purpose, a member of the family includes the spouse, ancestors, and lineal descendants (and spouses of lineal descendants) of the individual.

Explanation of provision

Section 2(a) of the bill would narrow the category of "disqualified persons" by limiting family members to the spouse, ancestors, children, and grandchildren (and the spouses of children and grandchildren) of the substantial contributor, etc. The effect of this amendment would be to exclude from the definition of family member any lineal descendant who is more than two generations from the substantial contributor, etc. Thus, for example, a foundation could engage in commercial transactions with the great-grandchild of a substantial contributor which, under present law, would constitute self-dealing transactions.

The amendment made by section 2(a) of the bill would take effect on January 1, 1983.

c. Increasing reliance on IRS classification of donee organizations*Present law*

The tax status of a donee organization as a public charity or private operating foundation is important to a donor private foundation because (1) foundation grants to operating foundations generally may be counted by the donor foundation as qualifying distributions in satisfaction of the section 4942 payout rules, while grants to nonoperating foundations do not so qualify (with certain exceptions); and (2) a donor foundation must exercise expenditure responsibility (sec. 4945) over grants to operating or nonoperating foundations, but not over grants to public charities.

Pursuant to Treasury regulations under section 4945, once an organization has been classified as publicly supported, the determina-

tion of whether a grant is subject to the expenditure responsibility requirements generally will not be affected by the donee's subsequent loss of classification as a publicly supported organization until notice of loss of classification is published.

However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-3(c)).

To facilitate reliance on published classifications, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization (Rev. Proc. 81-6, 1981-1 C.B. 620).¹ In addition, the Internal Revenue Service has published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported (Rev. Proc. 81-7, 1981-1 C.B. 621).²

Explanation of provision

Section 2(b) of the bill would provide that a grant to an organization which the Internal Revenue Service has determined to be a public charity (or private operating foundation) would be treated as a grant to such an organization, even though the donee organization loses such status, if (1) the grant was made prior to the earlier of the date of publication by the Service that the donee organization has lost its qualified status, or the date on which the foundation acquires actual knowledge that the donee organization has been notified by the Service of loss of its qualified status, and (2) the donor foundation was not responsible for (other than by making grants) or aware of the change in the donee's status.

The amendment made by section 2(b) of the bill would apply to grants made after 1982.

¹ Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant. In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax liability for failure to exercise expenditure responsibility).

² Under these guidelines, a grant generally will be considered unusual where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses.

d. Exemption from expenditure responsibility requirements*Present law*

To avoid imposition of excise taxes under Code section 4945, a private foundation must exercise "expenditure responsibility" over grants to organizations other than public charities. In order to ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants (sec. 4945(h)). There is no exception in present law from the expenditure responsibility requirements for grants below a specified dollar amount.

Explanation of provision

Section 2(c) of the bill would provide that a private foundation is not required to exercise expenditure responsibility over a grant to an organization if the aggregate amount of grants made during the taxable year by the foundation (and all related foundations) to that organization does not exceed \$25,000. This exemption would apply to grants made after 1982.

e. Abatement of first-tier excise taxes*Present law*

The Tax Reform Act of 1969 established a two-tier system of excise taxes intended to ensure compliance with the private foundation rules set forth in Code sections 4941-4945.

Under present law, any violation of the foundation rules results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). In general, this first-tier tax applies automatically when a foundation rule is violated, even if the violation in a particular instance could be deemed inadvertent. However, where a foundation fails to satisfy the section 4942 payout requirements solely as a result of an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period.

If a violation of the foundation rules is not "corrected" within a specified period, an additional excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person).

Explanation of provision

Section 2(d) of the bill would waive the first-tier excise tax imposed under sections 4941-4945 on the foundation (or disqualified person, in the case of self-dealing) if the Internal Revenue Service determines that the violation (1) was due to reasonable cause and not to intentional disregard of rules and regulations, and (2) the violation is "corrected" with the specified period.

The amendments made by section 2(d) of the bill would apply to taxable years beginning after 1982.

2. S. 2165—Senators Danforth, Bentsen, Chafee, Mitchell, Symms, Packwood, Wilson, Tsongas, Wallop, Pell, Dodd, and Bingaman

“High Technology Research and Scientific Education Act”

- a. Extension of credit for increased research expenditures; modification of qualified research definition; equipment depreciation under credit, ACRS provisions; modification of trade or business requirement

Present Law

Current deduction for certain research expenditures

General rule.—As a general rule, business expenditures to develop or create an asset which has a useful life that extends beyond the taxable year, such as expenditures to develop a new product or improve a production process, must be capitalized. However, Code section 174 permits a taxpayer to elect to deduct currently the amount of “research or experimental expenditures” incurred in connection with the taxpayer’s trade or business. For example, a taxpayer may elect to expense the costs of wages paid for services performed in qualifying research activities, and of supplies and materials used in such activities, even though these research costs otherwise would have to be capitalized.

The section 174 election does not apply to expenditures for the acquisition or improvement of depreciable property, or land, to be used in connection with research.³ Thus, for example, the total cost of a research building or of equipment used for research cannot be currently deducted under 174 in the year of acquisition. However, the amount of depreciation (cost recovery) allowance for a year with respect to depreciable property used for research may be deducted in that year under the election. Under ACRS, machinery and equipment used in connection with research and experimentation are classified as three-year recovery property and are eligible for a six-percent regular investment tax credit.

Qualifying expenditures.—The Code does not specifically define “research or experimental expenditures” eligible for the section 174 deduction election (except to exclude certain costs). Treasury regulations (sec. 1.174-2(a)) define this term to mean “research and development costs in the experimental or laboratory sense.” This includes generally “all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula,

³ Also, the statute excludes expenditures to ascertain the existence, location, extent, or quality of mineral deposits, including oil and gas, from eligibility for section 174 elections (sec. 174(d)). However, expenses of developing new and innovative methods of extracting minerals from the ground may be eligible for sec. 174 elections (Rev. Rul. 74-67, 1974-1 C.B. 63). Also, certain expenses for development of a mine or other natural deposit (other than an oil or gas well) may be deductible under sec. 616.

an invention, or similar property”, and also the costs of obtaining a patent on such property.

The present regulations provide that qualifying research expenditures do not include expenditures “such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions.” Also, the section 174 election cannot be applied to costs of acquiring another person’s patent, model, production, or process or to research expenditures incurred in connection with literary, historical, or similar projects (Reg. sec. 1.174-2(a)).

Credit for increasing certain research expenditures

Overview

General rule.—An income tax credit is allowed for certain qualified research expenditures paid or incurred by a taxpayer during the taxable year in carrying on a trade or business of the taxpayer (Code sec. 44F, enacted in the Economic Recovery Tax Act of 1981). The credit applies only to the extent that the taxpayer’s qualified research expenditures for the taxable year exceed the average amount of the taxpayer’s yearly qualified research expenditures in the specified base period (generally, the preceding three taxable years). The rate of the credit is 25 percent of the incremental research expenditure amount.

Under present law, the section 44F credit applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

Qualifying expenditures.—For purposes of the section 44F credit, the definition of research is the same as that used for purposes of the special deduction rules under section 174, but subject to certain exclusions. A taxpayer’s research expenditures eligible for the section 44F incremental credit consist of (1) “in-house” expenditures by the taxpayer for research wages and supplies used in research, plus certain amounts paid for research use of laboratory equipment, computers, or other personal property; (2) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer’s behalf; and (3) if the taxpayer is a corporation, 65 percent of the taxpayer’s expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations.

Relation to deduction.—The credit is available for incremental qualified research expenditures for the taxable year whether or not the taxpayer has elected under section 174 to deduct currently research expenditures. The amount of any section 174 deduction to which the taxpayer is entitled is not reduced by the amount of any credit allowed for qualified research expenditures.

Trade or business limitations

The section 44F credit is available only for research expenditures paid or incurred in carrying on a trade or business of the taxpayer. With one exception (described below), the “carrying on” test for purposes of the credit is the same as for purposes of the business

deduction provisions of section 162. Thus, for example, the credit generally is not available to a limited partnership (or to any partners in such partnership, including a general partner which is an operating company) for partnership expenditures for "outside" or contract research intended to be transferred by the partnership to another (such as to the general partner) in return for license or royalty payments.

As the only exception to the rule that the trade or business test for purposes of section 44F is the same as for purposes of section 162, the Treasury Department is to issue regulations, for credit purposes only, which will allow the credit in the case of a research joint venture between taxpayers which both (1) themselves satisfy the carrying on test (e.g., the research must be in a particular trade or business already being carried on by the taxpayer) and also (2) themselves are entitled to the research results.

Thus, the credit is not available for research expenditures paid or incurred by a taxpayer merely in connection with, but not in carrying on, a trade or business. Similarly, the credit is not available with respect to expenditures paid or incurred by a taxpayer as part of a financing arrangement or hobby. Also under the trade or business test, research expenditures of a taxpayer are eligible for the credit only if paid or incurred in a particular trade or business already being carried on (within the meaning of sec. 162) by the taxpayer.

Furthermore, in cases where an organization conducting research is deemed to be carrying on a trade or business under these rules (so that the credit is available for incremental research expenditures), the Congress determined that individual taxpayers with interests in the organization should not be able to utilize passthroughs of the credit to offset tax on income from unrelated sources. Thus, individuals (including partners and S corporation shareholders) to whom the credit is properly allocable may use the credit in a particular year only to offset the amount of tax attributable to that portion of the individual's taxable income which is applicable or apportionable to such interest. (A 15-year carryover is allowed for any unused credit.) Also, allocations of the credit among partners, etc., must be in accordance with rules prescribed in Treasury regulations.

Explanation of incremental credit

Definition of qualified research

General rule.—Subject to certain exclusions, the credit provision adopts the definition of research as used in section 174. That is, the term "qualified research" for purposes of section 44F has the same meaning, subject to the specified exclusions, as has the term "research or experimental" under section 174 (described above).

While the definition of research generally is the same for purposes both of section 174 deduction election and the credit, particular research expenditures which qualify for the section 174 deduction election may be ineligible for the credit, e.g., because the expenditures fail to satisfy the section 162 trade or business requirement for the credit, because the expenditures do not fall within the categories of research expenditures (such as direct research wages)

which qualify for the credit, or because the expenditures fall within one of the exclusions from the credit.

Computer software development costs.—The Internal Revenue Service has taken the position that certain costs of developing computer software may be treated in a manner similar to costs incurred in product development which are subject to the section 174 deduction election (Rev. Proc. 69-21, 1969-2 C.B. 303). This treatment applies to costs incurred in developing new or significantly improved programs or routines that cause computers to perform desired tasks (as distinguished from other software costs where the operational feasibility of the program or routine is not seriously in doubt).

For purposes of the section 44F credit, otherwise qualifying types of expenditures (for example, direct wage expenditures) which are part of the costs of otherwise qualifying research for the development of new or significantly improved computer software are intended to be eligible for the credit to the extent that such expenditures (1) are treated as similar to costs, incurred in product research, which are deductible as research expenditures under section 174; (2) satisfy the requirements of new section 44F which apply to research expenditures;⁴ and (3) do not fall within any of the specific exclusions in new section 44F. That is, expenditures for developing new or significantly improved computer programs which otherwise would qualify for the section 44F credit are not to be disqualified solely because such costs are incurred in developing computer "software", rather than in developing "hardware".

Nonresearch expenditures.—The section 44F credit is not available for expenditures such as the costs of routine or ordinary testing or inspection of materials or products for quality control; of efficiency surveys or management studies; of consumer surveys (including market research), advertising, or promotions (including market testing or development activities); or of routine data collection. Also, costs incurred in connection with routine, periodic, or cosmetic alterations or improvements (such as seasonal design or style changes) to existing products, to production lines, or to other ongoing operations, or in connection with routine design of tools, jigs, molds, and dies, do not qualify as research expenditures under the credit.⁵

Exclusions

There are three express exclusions from the definition of qualified research for purposes of the section 44F credit.

First, expenditures for research which is conducted outside the United States do not enter into the credit computation.

⁴ Thus, the credit limitations and definitional restrictions (such as the distinctions between research and nonresearch expenditures, and between direct and indirect expenditures) which apply in the case of product research costs also apply in the case of the costs of developing new or significantly improved computer software.

⁵ The credit is not available for such expenditures as the costs of construction of copies of prototypes after construction and testing of the original model(s) have been completed; of pre-production planning and trial production runs; of engineering follow-through or troubleshooting during production; or of adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity. For example, the costs of adapting existing computer software programs to specific customer needs or uses, as well as other modifications of previously developed programs, are not eligible for the credit.

Second, the credit is not available for research in the social sciences or humanities (including the arts), such as research on psychological or sociological topics or management feasibility studies.

Third, the credit is not available for research to the extent funded by any grant, contract, or otherwise by another person (or any governmental entity).

In-house research expenditures

Employee wages qualify for the credit to the extent paid for engaging in the actual conduct of research, in the immediate supervision of the actual conduct of qualified research, or in the direct support of the actual conduct (or of the immediate supervision of the actual conduct) of qualified research. No amount of wages paid for overhead or for general and administrative services, or of indirect research wages, qualifies for the credit.

In addition, amounts paid for supplies used in the conduct of qualified research are eligible for the credit. The term "supplies" means any tangible property other than property of a character subject to the allowance for depreciation (cost recovery), land, or improvements to land. Neither the cost of acquisition of, nor the amount of depreciation (cost recovery) allowances with respect to, property which is of a character subject to the depreciation (cost recovery) allowance is eligible for the credit under present law, whether or not amounts of depreciation are deductible during the year under section 174.

Finally, amounts paid for the right to use personal property in the conduct of qualified research generally qualify for the credit, if such amounts are paid to a person other than the taxpayer or certain related persons.

Contract research expenditures

In addition to the three categories of in-house research expenditures, 65 percent of amounts paid by the taxpayer for qualified research performed on behalf of the taxpayer enters into the incremental credit computation. The research firm, university, or other person which conducts the research on behalf of the taxpayer cannot claim any amount of the credit for its expenditures in performing the contract.

If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, that amount is treated, pursuant to a prepayment limitation, as paid or incurred during the period during which the qualified research is actually conducted.⁶

⁶ For example, if on December 1, 1983, a calendar-year taxpayer paid \$100,000 to a research firm pursuant to a contract for qualified research to be performed on behalf of the taxpayer, and if the research firm conducts all of such qualified research during 1984, no amount is eligible for a credit for 1983, and \$65,000 (65 percent of the total contract price) is treated as research expenditures of the taxpayer paid during 1984. Amounts which are treated as contract research expenditures during a particular taxable year pursuant to the prepayment limitation rule, and hence which count as expenditures for such year entering into the credit computation for such taxable year, also are treated as having been made during that same taxable year for purposes of determining average yearly base period expenditures in later year credit computations. Thus, in the example given above, \$65,000 enters into the taxpayer's 1984 credit base.

Expenditures for university basic research

A special rule treats as qualified research expenditures 65 percent of certain corporate expenditures (including grants or charitable contributions) for basic research to be performed at a college, university, or other qualified organization pursuant to a written research agreement. Under this rule (described further below), a corporate taxpayer takes into account, for purposes of computing the incremental credit, 65 percent of qualifying basic research expenditures (subject to the contract research prepayment limitation).

*Computation of allowable credit**General rule*

As a general rule, the section 44F credit applies to the amount of qualified research expenditures for the current taxable year which exceeds the average of the yearly qualified research expenditures in the preceding three taxable years. The base period amount is not adjusted for inflation.

For the taxpayer's first taxable year to which the new credit applied (and which ended in 1981 or 1982), the credit applied to the amount of qualified research expenditures for that year which exceeded the amount of such expenditures in the preceding taxable year. Also, for the taxpayer's second taxable year to which the new credit applied (and which ended in 1982 or 1983), the credit applied to the amount of qualified research expenditures for that year which exceeded the average of yearly qualified research expenditures in the preceding two taxable years.⁷

New businesses

For a base period year during which it was not in existence, a new business is treated as having research expenditures of zero in such year, for purposes of computing average annual research expenditures during the base period. However, the taxpayer may be deemed to have expenditures in such a base period year pursuant to the 50-percent limitation rule (described below).

50-percent limitation rule

Base period research expenditures are treated as at least equal to 50 percent of qualified research expenditures for the current year.⁸ This 50-percent limitation applies both in the case of existing businesses and in the case of newly organized businesses.

⁷ Because the credit became effective for qualified research expenditures paid or incurred after June 30, 1981, a special rule was provided for computing base period expenditures for the taxpayer's taxable year which included July 1, 1981. A similar rule is to apply in the case of a taxpayer's first taxable year including December 31, 1985 (when the credit is scheduled to terminate).

⁸ For example, assume that a calendar-year taxpayer is organized on January 1, 1983; makes qualified research expenditures of \$100,000 for 1983; and makes qualified research expenditures of \$260,000 for 1984. The new-business rule provides that the taxpayer is deemed to have base period expenditures of zero for pre-1983 years. Without regard to the 50-percent limitation, the taxpayer's base period expenditures for purposes of determining any credit for 1984 would be the average of its expenditures for 1981 (deemed to be zero), 1982 (deemed to be zero), and 1983 (\$100,000), or \$33,333. However, by virtue of the 50-percent limitation, the taxpayer's average base period expenditures are deemed to be no less than 50 percent of its current year expenditures (\$260,000), or \$130,000. Accordingly, the amount of 1984 qualified research expenditures to which the credit applies is limited to \$130,000, and the amount of the taxpayer's credit for 1984 is \$32,500.

Aggregation rules

To ensure that the section 44F credit will be allowed only for actual increases in research expenditures, special rules apply under which research expenditures of the taxpayer are aggregated with research expenditures of other persons for purposes of computing any allowable credit. These rules are intended to prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons.

Changes in business ownership

Special rules apply for computing the credit where a business changes hands, under which qualified research expenditures for periods prior to the change of ownership generally are treated as transferred with the trade or business which gave rise to those expenditures. These rules are intended to facilitate an accurate computation of base period expenditures and the credit by attributing research expenditures to the appropriate taxpayer.

*Limitations and carryover**General limitation*

The amount of credit which may be used in a particular taxable year is limited to the taxpayer's income tax liability reduced by certain other nonrefundable credits.

Additional limitation on individuals

In the case of an individual who owns an interest in an unincorporated trade or business, who is a beneficiary of a trust or estate, who is a partner in a partnership, or who is a shareholder in an S corporation, the amount of credit that can be used in a particular year also cannot exceed an amount (separately computed with respect to the person's interest in the trade or business or entity) equal to the amount of tax attributable to that portion of the person's taxable income which is allocable or apportionable to such interest.⁹

Carryover

If the amount of credit otherwise allowable exceeds the applicable limitation, the excess amount of credit can be carried back three years (including carrybacks to years before enactment of the credit) and carried forward 15 years, beginning with the earliest year.

⁹ For example, if in a particular year an individual partner derives no taxable income from a partnership which had made incremental qualified research expenditures, the individual may not use in that year any tax credit resulting from incremental qualified research expenditures of such partnership which otherwise would have been properly allowable to the partner (e.g., where the partnership had paid such research expenditures in carrying on a trade or business of the partnership and where any credit allowable to the partnership with respect to such expenditures had been properly allocated among the partners pursuant to Treasury regulations). If in this example the partner had derived taxable income allocable or apportionable to his or her partnership interest, then the amount of credit which may be used in that year by the individual partner may not exceed the lesser of the general limitation amount (described above) or the separately computed additional limitation amount applicable to individuals.

Effective date

Under present law, the section 44F credit applies to qualified research expenditures paid or incurred after June 30, 1981 and before January 1, 1986.

*Explanation of Title I of the Bill**Extension of incremental credit*

Section 101 of the bill would make permanent the section 44F credit for increased research expenditures.

*Modification of definition of qualified research**Overview*

Present law defines qualified research for purposes of the section 44F credit principally by a cross-reference to the definition of research developed in Treasury regulations under section 174, which allows a current deduction for certain "research or experimental expenditures" (as described above). The bill would instead provide a separate, statutory definition of qualified research for purposes of the credit, effective for post-1983 taxable years. This definition would not affect the category of research expenditures qualifying for the section 174 deduction.

Qualified research

Under the bill, qualified research would be defined to mean either—

(A) a planned search or critical investigation (including basic research) undertaken for the purpose of discovering information which may be potentially useful in the development of a new or significantly improved business item of the taxpayer, or

(B) applying the results obtained from such research activity, or other knowledge, to develop a new or significantly improved business item of the taxpayer. The definition would include as research the conceptual formulation, design, testing, and reformulation of possible business item alternatives and the design, construction, and testing of prototypes, models, and pilot plants.

Business item definitions

The bill would generally define the term "business item" to mean a product (whether or not constituting tangible personal property), process, technique, formula, invention, or a significant component part or element of a product or process, for sale, lease, license, or use by the taxpayer in a trade or business. Under a special rule in the bill, computer software that is separately developed by the taxpayer solely for its own internal use would qualify as a business item (and hence the development costs of such software would be eligible for the credit) only if the software is used in (1) qualified research undertaken by the taxpayer, (2) a production process, or (3) the performance for customers of services of which such software together with the corresponding hardware is the predominant component, or if not so used, only to the extent allowed by Treasury regulations.

A business item which the taxpayer seeks to develop or improve would be treated under the bill as new or significantly improved if both (1) the business item is developed by means of the process of experimentation, including testing in search for or evaluation of alternatives, and also (2) the predominant portion of the new characteristics or improvement relates to such factors as function, performance, reliability, quality, or cost, rather than to style, taste, cosmetic, or seasonal design factors. After a new or significantly improved business item has been fully developed to the point where it both constitutes a finished business item which meets the specific functional and economic requirements of the taxpayer for that item and also is ready for commercial sale or use, then no further expenditures with respect to that item would be eligible for the credit.

The bill would exclude from the definition of qualified research any development of plant processes, machinery, or techniques for commercial production of a new or significantly improved business item, except where such process, machinery, or technique itself constitutes a new or significantly improved business item. The adaptation of an existing business item to a particular requirement or customer's need as part of a continuing commercial activity, unless such adaptation will result in a new or significantly improved business item, would not qualify as research.

Additional exclusions

As in the case of present law, the bill would exclude from eligibility for the credit expenditures for research (1) which is conducted outside the United States; (2) in the social sciences, arts, or humanities; or (3) to the extent funded by any grant, contract, or otherwise by any person (or any governmental entity). Also as under present law, the credit would not be available for the costs of efficiency surveys, management studies, market research, market testing and development (such as advertising or promotions), routine data collections, or routine or ordinary testing or inspection of materials or business items for quality control, or for the costs of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas).¹⁰

Effective date

The modifications to the definition of credit-eligible research expenditures made by section 102 of the bill would apply to taxable years beginning after 1983.

Treatment of equipment depreciation for credit, ACRS purposes

Credit extended to depreciation

Under present law, neither the cost of acquisition of, nor the amount of depreciation (cost recovery) allowances with respect to, property which is of a character subject to the depreciation (cost recovery) allowance is eligible for the credit, whether or not amounts of depreciation are deductible during the year under section 174. Under section 103(a) of the bill, the amount of depreci-

¹⁰ See note 3, *supra*.

ation or cost recovery allowances (under secs. 167 or 168) in respect of tangible personal property used in the conduct of qualified research would be qualified research expenditures, i.e., would enter into the incremental credit computation.

The amendment made by this provision would be effective, for purposes both of computing the credit and also of computing base period research expenses, for taxable years beginning after 1983.

Change in ACRS treatment

Under ACRS as enacted in ERTA, personal property used in connection with research and experimentation is classified as three-year recovery property (sec. 168(c)(2)(A)). The regular investment tax credit for property in the three-year class is six percent.

Section 103(b) of the bill would remove research equipment from the three-year class. Accordingly, research equipment would constitute five-year recovery property and would be eligible for a ten-percent investment tax credit.

The amendment made by this provision would apply to property placed in service in taxable years beginning after 1983.

Increase in qualifying percentage of contract research expenditures

The bill would increase, from 65 percent to 75 percent, the percentage of a taxpayer's contract research expenditures which enter into the computation of the section 44F credit. This provision would be effective, for purposes both of computing the credit and also of computing base period research expenses, for taxable years beginning after 1983.

Availability of credit to start-up corporations, partnerships, and other joint ventures

Under section 104 of the bill, all otherwise qualifying in-house and contract research expenses paid or incurred by a corporation¹¹ would be treated as qualified research expenses for credit purposes without regard to the trade or business test of present law. Thus, the research expenditures of a start-up corporation whose activities have not yet reached the level of constituting a trade or business (as defined for purposes of sec. 162) would be eligible for the credit. Also, the bill would make the credit available for corporate expenditures for research endeavors that are not directly related to any of the corporation's existing trades or businesses.

With respect to in-house and contract research expenses paid or incurred by a partnership, the bill would provide that, as a general rule, the trade or business test is to be applied at the partnership level without regard to the trade or business of any partner. If at the partnership level the test is met, any available credit would be apportioned among the partners in accordance with the partnership allocation rules of the Code (sec. 704). Under these rules, the allocation of partnership credits, like the allocation of partnership overall income and loss and items of income, loss, and deduction, is generally determined by the partnership agreement if the alloca-

¹¹ For this purpose, the term corporation would not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

tion has substantial economic effect; if not, the allocation is made in accordance with the partners' interests determined by taking into account all facts and circumstances.

Under the bill, a partnership could elect in two cases to treat an in-house or contract research expense it has paid or incurred other than in carrying on a trade or business of the partnership as a qualified research expense. First, a partnership could so elect if each partner is a corporation;¹² thus, the bill would allow corporate joint venturers to treat in-house and contract research expenses paid or incurred by the partnership as qualified research expenses without regard to the trade or business requirement. Second, a partnership (all of whose partners are not regular corporations) could so elect if all of the in-house or contract research expenses paid or incurred by the partnership would have satisfied the trade or business requirement as applied to each of the partners had each of the partners directly conducted the research. In either of these two cases, the qualified research expense would be treated as paid or incurred directly by the partners and would be apportioned among the partners in accordance with the Code partnership allocation rules described above.

The amendments made by this provision would be effective for taxable years beginning after 1983.

¹² See note 11, *supra*.

b. Increased credit for corporate support of basic research at universities

Present Law

General rule

Under present law, a corporation¹³ may take into account, for purposes of computing the section 44F credit for a taxable year, 65 percent of qualifying basic research expenditures for that year (subject to the contract research prepayment limitation).¹⁴ Similarly, this percentage is treated as research expenditures in a base period year when calculating the credit in subsequent years.

The special rule for basic research applies only to expenditures paid or incurred pursuant to a written research agreement between the taxpayer corporation and a college or university, certain tax-exempt scientific research organizations, and certain qualified funds (organized exclusively to make basic research grants to colleges and universities).

For purposes of this special rule, the term "basic research" means any original investigation for the advancement of scientific knowledge not having a specific commercial objective. However, the term basic research does not include expenditures for any activity excluded from the section 44F definition of qualified research, e.g., expenditures for basic research in the social sciences or humanities (including the arts).

Illustration of computation

Assume that a corporation makes qualified in-house research expenditures totalling \$120 million in each of the years 1980, 1981, and 1982. In addition, in 1981 the corporation makes a \$6 million grant to a university for qualifying basic research; all of this amount is expended by the university in that year. In 1983, the corporation makes qualified in-house research expenditures totalling \$130 million and also contributes \$3 million to a university for basic research pursuant to a written research agreement. The university expends 50 percent of the 1983 contribution funds during 1983 and the rest during 1984.

Under these facts, the corporation's qualified research expenditures for 1983 would equal \$130 million plus 65 percent of \$1.5 million (\$975,000). The corporation's base period expenditures with respect to 1983 would be the average of its qualified research expenditures for 1980, 1981, and 1982, or \$121,300,000. Accordingly, the 25-percent credit for 1983 would apply to the excess of total current-

¹³ See note 11, *supra*.

¹⁴ If any contract research amount paid or incurred during a taxable year is attributable to qualified research to be conducted after the close of that taxable year, that amount is treated as paid or incurred in the year or years during which the qualified research is actually conducted. See note 6, *supra*.

year expenditures (\$130,975,000) over the base period average (\$121,300,000), or \$9,675,000.

Assume further that in 1984 the total of the corporation's qualified in-house research expenditures increases to \$135 million, and that the corporation makes no new basic research expenditures. The corporation is treated as having qualifying basic research expenditures in 1984 equal to 65 percent of \$1.5 million, or \$975,000. The corporation's base period expenditures with respect to 1984 would be the average of qualified research expenditures for 1981 (\$123,900,000), 1982 (\$120 million), and 1983 (\$130,975,000). Accordingly, under present law the 25-percent credit for 1984 would apply to the excess of current-year expenditures (\$135,975,000) over the base period average (\$124,958,333), or \$11,016,667.

Explanation of Section 201 of the Bill

Overview

Under present law, research expenditures entering into the computation of the section 44F incremental credit include 65 percent of a corporation's expenditures (including grants or contributions) pursuant to a written research agreement for basic research to be performed by universities or certain scientific research organizations. Section 201 of the bill would provide more favorable tax treatment for corporate expenditures for basic research performed at universities or at certain scientific research organizations by (1) increasing, from 65 to 75 percent, the percentage of such expenditures which is eligible for a credit; (2) applying a new 25-percent credit to the excess of the percentage amount over a fixed floor based on 1981-83 expenditures, rather than over a moving base period average; and (3) making the prepayment limitation of present law inapplicable to university basic research expenditures.

The excess credit-eligible expenditures over the fixed floor under the bill, to which the new credit would apply, would not also enter into the computation of the present-law incremental credit under section 44F. The amount of credit-eligible basic research expenditures up to the floor would remain eligible for the present-law incremental credit.

Qualifying expenditures

For purposes of the new credit and the incremental credit, qualifying university basic research expenditures would be expenditures paid or incurred pursuant to a written agreement between the taxpayer corporation¹⁵ and a university, scientific research organization, or certain other qualified organizations for basic research to be performed by the qualified organization (or by universities receiving funds through the initial recipient qualified organizations). Such corporate expenditures for university basic research would be deemed to satisfy the trade or business test (described above), whether or not the basic research is in the same field as the trade or business of the corporation.

¹⁵ The new basic research credit would not be available with respect to university basic research expenditures by corporations that are S corporations (sec. 1371(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

Under the bill, qualifying expenditures would include both grants or contributions by the corporation which constitute charitable contributions under section 170, and also payments for contract research to be performed by the university on behalf of the corporation. The bill would make inapplicable to university basic research expenditures the prepayment limitation of present law, under which corporate expenditures for university basic research enter into the incremental credit computation only when the university actually expends the funds for basic research.

As under present law, the term "basic research" would be defined as any original investigation for the advancement of scientific knowledge not having a specific commercial objective, other than basic research in the social sciences or humanities (including the arts) or basic research conducted outside the United States.

Qualified organizations

To be eligible for a credit, the corporate expenditures must be for basic research to be conducted by a qualified organization. For this purpose, the term qualified organization generally would include colleges or universities, tax-exempt scientific research organizations, and certain qualified funds which are treated as qualified organizations under present law.

The first category of qualified organizations would consist of educational organizations that both are described in section 170(b)(1)(A)(ii)¹⁶ and constitute institutions of higher education as defined in section 3304(f).¹⁷ Scientific organizations that would qualify are tax-exempt organizations that (1) are organized and operated primarily to conduct scientific research, (2) are described in section 501(c)(3) (relating to exclusively charitable, educational, scientific, etc. organizations), and (3) are not private foundations. Also, certain tax-exempt funds which qualify under present law would continue to qualify under the bill.

In addition, the bill would treat as qualified any tax-exempt organization which is organized primarily to promote scientific research by colleges or universities pursuant to written research agreements, which expends on a current basis substantially all its funds through grants and contracts for basic research by colleges and universities and which is described in either section 501(c)(3) (charitable, educational, etc. organizations) or section 501(c)(6) (trade associations).

¹⁶ An educational organization is described in sec. 170(b)(1)(A)(ii) "if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities", and includes both public and private schools (Treas. Reg. sec. 1.170A-9(b)(1)).

¹⁷ Sec. 3304(f) defines "institution of higher education" as an educational institution which (1) admits as regular students only individuals having a certificate of graduation from a high school, or the recognized equivalent of such a certificate; (2) is legally authorized to provide a program of education beyond high school; (3) provides an educational program for it which awards a bachelor's or higher degree, or provides a program which is acceptable for full credit toward such a degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and (4) is a public or other nonprofit institution.

Computation rules for new credit

The fixed floor in computing university basic research expenditures to which the new credit would apply would be the *greater* of—

(A) the average of all credit-eligible basic research expenditures under Code section 44F(e)(1) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983; *or*

(B) one percent of the average of the sum of all in-house research expenses, contract research expenses, and credit-eligible university basic research expenditures under Code section 44F(e)(1) for each of the three taxable years immediately preceding the taxable year beginning after December 31, 1983. The amount of credit-eligible expenditures over the fixed floor, to which the new credit would apply, would not also enter into the computation of the present-law incremental credit under section 44F. The amount of credit-eligible basic research expenditures up to the floor would enter into the present-law incremental credit computation under section 44F (and would in subsequent years enter into the base period amounts for purposes of computing the incremental credit). The fixed floor would not be adjusted to reflect inflation.

Disallowance of double benefit

Under the bill, no amount for which a special deduction would be provided under section 202 of the bill (relating to transfers of scientific equipment to universities for certain research or educational purposes) would also be eligible for the new credit under the bill or the existing incremental credit.

Effective date

The amendments made by section 201 of the bill would apply to taxable years beginning after 1983.

c. Expanded special deduction for transfers to universities of scientific equipment for certain research or educational purposes

Present Law

General reduction rule for donations of property

In general, the amount of charitable deduction otherwise allowable for donated property must be reduced by the amount of any ordinary gain which the taxpayer would have realized had the property been sold for its fair market value at the date of the contribution (Code sec. 170(e)).

Thus, a donor of inventory or other ordinary-income property (property the sale of which would not give rise to long-term capital gain) generally may deduct only the donor's basis in the property, rather than its full fair market value. In the case of property used in the taxpayer's trade or business (sec. 1231), the charitable deduction must be reduced by the amount of depreciation recapture which would be recognized on sale of the donated property.

Special rule for certain research equipment donations

Under a special rule, corporations are allowed an augmented charitable deduction for donations of newly manufactured scientific equipment or apparatus to a college or university for research use in the physical or biological sciences (sec. 170(e)(4), added by ERTA).¹⁸

This increased deduction is generally for the sum of (1) the corporation's basis in the donated property and (2) one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the contribution and the donor's basis in the property). However, in no event is the deduction under the special rule allowed for an amount which exceeds twice the basis of the property.

To qualify for this special deduction rule, a corporate contribution of scientific equipment to a college or university must satisfy the following requirements:

- (1) The property contributed was constructed by the corporate donor;
- (2) The contribution is made within two years of substantial completion of construction of the property;
- (3) The original use of the property is by the college or university;
- (4) Substantially all (at least 80 percent) of the use of the scientific equipment or apparatus by the college or university is for re-

¹⁸ Under a special rule enacted in 1976, an augmented charitable deduction also is allowed for corporate contributions of certain types of ordinary income property donated for the care of the needy, the ill, or infants (sec. 170(e)(3)).

search (within the meaning of sec. 174), or for research training, in the United States in the physical or biological sciences;¹⁹

(5) The property is not transferred by the donee in exchange for money, other property, or services; and

(6) The taxpayer receives the donee's written statement representing that the use and disposition of the property contributed will be in accordance with the last two requirements.

For purposes of the first requirement listed above, property is treated as constructed by the taxpayer only if the cost of parts (other than parts manufactured by the taxpayer or a related person) used in construction does not exceed 50 percent of the taxpayer's basis in the property.

Explanation of Section 202 of the Bill

Overview

The bill would delete from the section 170 charitable deduction rules the special provision (Code sec. 170(e)(4), enacted in ERTA), which allows an augmented charitable deduction up to twice the taxpayer's basis for corporate donations of newly manufactured scientific equipment to colleges or universities for research use in the physical or biological sciences. The bill would enact a new deduction provision, generally of broader scope, outside the charitable deduction rules.

Under the new provision, a corporation would receive special deductions for amounts in excess of its basis for transfers, without consideration, of scientific or technical equipment (including property used in the transferor's business, computer software, and replacement parts) to colleges or universities, for use in either research or education in certain sciences, technologies, or equipment operation fields. In addition, special deductions would be allowed for the value of performing certain maintenance and repair services in connection with such equipment transfers. Except for computer software and replacement parts, only an item having a value exceeding \$250 generally would be eligible for the new deduction.

The special deduction under the bill generally would not be allowed to the extent that, determined on a product-by-product basis, the number of transferred items exceeds 20 percent of the number of such items sold by the taxpayer during the year. Also, while the transfers would not be required to qualify as charitable contributions²⁰ in order for the special deduction to apply, the taxpayer's aggregate deduction in one year for both charitable contributions and transfers under the new provision would be limited to 10 percent of taxable income (computed with certain modifications), with a five-year carryforward of any excess.

¹⁹ For purposes of this limitation on research use, and on research training use, the physical sciences include physics, chemistry, astronomy, mathematics, and engineering, and the biological sciences include biology and medicine.

²⁰ Court cases have held that if a transfer to a charitable organization results in a benefit to the donor, no charitable deduction is allowed under section 170. For example, the U.S. Court of Claims has upheld denial of charitable deductions claimed by a manufacturer for discounts on purchase of sewing machines by schools, where the court had found that the discounts were offered for the predominant purpose of enlarging the market for the manufacturer's brand of sewing machines (*Singer Co. v. U.S.*, 449 F.2d 413 (Ct. Cl. 1971)).

Transfers of qualified scientific property or services

The special deduction would apply to a transfer, without consideration, by a corporation²¹ of tangible personal property that is inventory (sec. 1221(1)), of tangible personal property used in the transferor's business (sec. 1231(b)), or of computer software, and to the performance, without consideration, of services in connection with such transferred property, if such transfer of property satisfies all of the following requirements.

(1) Qualified scientific property

The transferred property must be scientific or technical equipment or apparatus, or replacement parts for such equipment. In the case of transferred inventory, the equipment must be at least 50 percent assembled by the taxpayer, and the taxpayer must be regularly engaged in the business of assembling and selling or leasing scientific equipment of that type.

Substantially all (at least 80 percent) the use of the transferred equipment must be for the direct education of students or faculty, for research (within the meaning of sec. 174), or for research training. Also, the use of the equipment must be in the United States and must be in mathematics; the physical or biological sciences; engineering; computer science; physical, biological, computer, or engineering technologies; or electronic or automated industrial, medical, or agricultural equipment and instrumentation operation.

Except for replacement parts, or computer software, only single units of qualified scientific equipment having a value in excess of \$250 would qualify for the special deduction. Property which had been used in the transferor's business would qualify only if it is functional and usable without need of any repair, reconditioning, or other similar investment by the recipient. All transferred equipment would have to be accompanied by the same warranties as normally provided by the manufacturer in connection with a sale of the transferred equipment.

(2) Qualified services

The bill would define qualified services as the performance of maintenance, repair, reconditioning, or similar services which the transferor furnishes, pursuant to a standard contract with the recipient, in connection with a transfer of qualified scientific property.

(3) Eligible recipients

The qualified scientific property must be transferred to—
 (a) an educational organization (within the meaning of sec. 170(b)(1)(A)(ii))²² which is an institution of higher education (within the meaning of sec. 3304(f));²³ or
 (b) an association at least 80 percent of whose members are such institutions of higher education.

²¹ For this purpose, the term corporation would not include S corporations (sec. 1361(a)), personal holding companies (sec. 542), or service organizations (sec. 414(m)(3)).

²² See note 16, *supra*.

²³ See note 17, *supra*.

In either case, the transfer must be made through the recipient's governing body.

(4) Time of transfer/original use

In the case of inventory property, the transfer must be made within six months after substantial completion of assembly of the equipment. Also, the original use of the equipment must be by the recipient.

In the case of equipment which has been used in the transferor's business, the transfer must be made within three years after the property is first placed in service by the taxpayer.

(5) Restrictions on recipients

The bill would provide that the transferred equipment may not be retransferred by the recipient, in exchange for money, other property, or services, within five years after receipt.

The transferor must obtain a written statement from the recipient's governing body, executed under penalties of perjury, representing that the latter's use and disposition of the property will be in accordance with the requirements for the special deduction. In the case of a transfer of equipment which has been used in the taxpayer's business, the recipient must also state that the property will be functional and usable without need of any repair, reconditioning, or other investment.

Allowable deduction

The amount of deduction allowed for transfers of qualified scientific property or services meeting the requirements of the bill would be as follows:

(a) Tangible inventory property or computer software.—Fair market value, but limited to the *lesser* of (a) twice the taxpayer's basis in the property or (b) the sum of the taxpayer's basis in the property plus one-half of the unrealized appreciation (i.e., one-half of the difference between the property's fair market value determined at the time of the transfer and the basis in the property).

(b) Tangible property used in the transferor's business.—The *lesser* of (a) 150 percent of the taxpayer's basis in the property (computed without regard to depreciation adjustments), less accumulated depreciation, or (b) fair market value.

(c) Qualified services.—The *lesser* of (a) the fair market value of such services (as determined by the amount normally paid by customers for such services) or (b) 150 percent of the taxpayer's direct costs of providing such services, in either case reduced by the amount for which a deduction is allowed to the transferor under section 162, as ordinary and necessary business expenses, in respect of such services.

Special limitations

Equipment limitation.—Under the bill, the special deduction would not be allowed for transfers of scientific equipment (other than used equipment) to the extent that, determined on a product-by-product basis, the total of transfers in the taxable year by the taxpayer of such equipment exceeds 20 percent of the number of

units of such product sold by the taxpayer in the ordinary course of its business in that taxable year.

Overall limitation.—Also, while transfers of qualified scientific property or services would not have to qualify as charitable contributions²⁴ in order for the special deduction to apply under the bill, the corporation's aggregate deduction for charitable contributions under section 170 and transfers under the new provision could not exceed 10 percent of its taxable income (computed with certain modifications). Any amount of the special deduction exceeding this limitation could be carried forward in the same manner as an excess charitable deduction by a corporation (i.e., the excess could be carried forward to the five succeeding taxable years, subject to the percentage limitation in those years).

Effective date

The provisions of section 202 of the bill would be effective for taxable years beginning after 1983.

²⁴ See note 20, *supra*.

d. Tax treatment of payments and loan forgiveness received by certain graduate science students

Present Law

In general

Subject to several limitations, gross income does not include amounts received as a scholarship at an educational institution or as a fellowship grant (Code sec. 117). In general, a degree candidate may exclude the entire amount of the scholarship or fellowship grant, except for any portion which is regarded as payment for services in the nature of part-time employment. An individual who is not a candidate for a degree is limited to an exclusion of \$300 per month for a period of 36 months.

Future services as compensation

In general, scholarships or fellowship grants are not excludable from gross income if they constitute compensation for past, present, or future employment services or for services subject to the direction or supervision of the grantor, or if the funded studies or research are primarily for the benefit of the grantor (Treas. Regs. sec. 1.117-4(c)). However, amounts received under Federal programs that are used for qualified tuition and related expenses are not disqualified from the exclusion merely because the recipient agrees to perform future services as a Federal employee or in a health manpower shortage area (sec. 117(c)).

In 1977, the Internal Revenue Service ruled that awards made under the provisions of the National Research Service Awards Act to individuals who, in return for receiving the awards, must subsequently engage in health research or teaching or some equivalent service (and must allow the government to make royalty-free use of any copyrighted materials produced as a result of the research) are not excludable as scholarships or fellowship grants (Rev. Rul. 77-319, 1977-2 C.B. 48). However, this ruling was overturned by the Revenue Act of 1978 for awards made during calendar years 1974-1979, and by subsequent legislation for awards made through 1983.

Income from debt cancellation

As a general rule, income is realized when indebtedness is forgiven or cancelled (sec. 61(a)(12)). In the case of discharge from debt when the taxpayer is in bankruptcy or is insolvent or the discharge of qualified business indebtedness, the discharge amount instead may be applied to reduce tax attributes of the debtor (or in certain circumstances, may be excluded from income) (secs. 108, 1017).

The Tax Reform Act of 1976 provided a special income exclusion rule for cancellation of certain student loans. The exclusion under that rule applied to debt discharges (prior to 1979) pursuant to a

loan agreement under which the indebtedness would be discharged if the individual worked for a period of time in specified professions in certain geographical areas or for certain classes of employers. This rule applied to student loans made to an individual to assist in attending an educational institution only if the loan was made by a government unit or agency. The rule was extended by the Revenue Act of 1978 to such discharges occurring through 1982.

Explanation of Section 203 of the Bill

In general

The bill would provide a new Code section 117A, under which gross income would not include amounts received by certain graduate science students as a scholarship, fellowship grant, or qualified student loan forgiveness, including situations where the recipient is required as a condition of receiving such amounts to perform future teaching services for any of a broad class of qualified educational organizations.

Qualified recipients

Under the bill, the new provision would apply to a student who has a bachelor's degree or its equivalent and who is engaged in postgraduate study as a degree candidate in mathematics, engineering, the physical or biological sciences, or computer science at a qualified educational organization. The latter term would mean an educational institution that is described in section 170(b)(1)(A)(ii),²⁵ admits as regular students only individuals having a certificate of graduation from a high school (or the recognized equivalent of such certificate), is legally authorized to provide an educational program beyond high school, and provides an educational program for which it awards a bachelor's or higher degree.

Qualified student loan forgiveness would be defined as forgiveness of a loan received by a qualified student for the purpose of financing postgraduate study in mathematics, engineering, the physical or biological sciences, or computer science, but only to the extent that the loan was actually expended for qualified tuition and related expenses (as defined below), and where the student is required to perform teaching services for any of a broad class of qualified educational organizations on completion of the postgraduate course of study, under the terms of a written loan agreement and as a condition of receiving loan forgiveness.

Limitations on exclusion

The exclusion from gross income under the bills would not extend to amounts received as payment for teaching, research, or other services as part-time employment required during the period of postgraduate study as a condition to receiving the scholarship, fellowship grant, or qualified student loan. However, teaching, research, or other services would not be regarded as such part-time employment if such activities are required of all candidates (whether or not recipients of scholarships, fellowship grants, or qualified

²⁵ See note 16, *supra*.

student loans) for a particular degree as a condition to receiving the degree.

The bill provides that amounts otherwise qualifying for exclusion from gross income as a scholarship or fellowship grant under new Code section 117A would not be includible in gross income merely because of a requirement for performance of teaching services, after completion of the postgraduate course of study, for any of a broad class of qualified educational organizations. For this rule to apply, the recipient also must establish that the amount of the award or grant was used for qualified tuition and related expenses, which would be defined as tuition and fees required for enrollment or attendance, and fees, books, supplies, and equipment required for courses at the educational institution.

Effective date

Section 203 of the bill would apply to taxable years beginning after December 31, 1983.

