file R+D tax credit

CORETECH COUNCIL ON RESEARCH AND TECHNOLOGY

MEMORANDUM

To: John Podesta

From: Ken Kay

Re: Changes to R&D Tax Credit

Date: May 4, 1993

Following up on our conversation of last night, I am attaching a summary of the Danforth-Baucus legislation that highlights the provisions of the R&D credit reform package. If should go without saying that permanence is the single most important issue. As you requested, here are my observations about the other provisions:

1. Companies -- Our members have two priorities beyond permanence:

   - Alternative Minimum Tax Changes -- This is critical. 40% of our companies don't feel the incentive effect of the credit if this change is not made. (See #2)

   - Base Period Changes -- Many electronics, semiconductor, aerospace and other companies have argued that the current base period is "quirky." These changes would help ameliorate that problem. (See #3 & #5)

2. Universities -- Currently, many companies cannot utilize the basic research credit because of the 1% floor. The proposal removes that provision and would substantially increase corporate investment in university research. (See #8)

3. Small Business -- The AEA strongly supports the flat rate credit for small companies. The concept of a simpler credit for smaller companies makes sense, but the 10% figure may be too rich. (i.e., be sure to check the revenue estimates on this one.) (See #6)

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4. Aerospace -- The Aerospace Industries Association is strongly supporting a provision which would allow a company to remove "defense" R&D from base period calculations. Although only a few of our members are effected by this provision, it strikes me as a good "defense conversion" proposal and consistent with the Clinton-Gore Administration's interests in that subject.

5. Collaborative R&D -- This proposal is primarily being supported by the large consortia and those who contribute to them. Personally, I think an incentive for collaborative R&D makes sense. Additionally, it is consistent with Clinton-Gore Administration statements laudatory of consortia. However, a 20% flat rate credit is very rich relative to the other incentives on the books. (i.e., watch the revenue estimate on this one too.) (See #10)

I believe the Ways and Means Committee may not have time to consider these changes, but it would be helpful if Treasury were in a position to speak favorably about them if asked. I am certain that these changes will come up in the Finance markup in June.

John, thanks for your help with this. Let me know if there is anything else I can do to be helpful.

Attachment

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MEMORANDUM

April 6, 1993

TO: CORETECH Tax Committee

FROM: Paul W. Oosterhuis
Roseann M. Cutrone

RE: Description of S. 666

On Friday, March 26, Senators Danforth and Baucus introduced S. 666, a bill to permanently extend and modify the R&E credit. The bill contains most of CORETECH's major priorities listed in our December 1992 memorandum. The bill did not include all of the items listed, such as an increased credit rate and an expansion of the types of eligible expenses, largely due to a concern over revenue. Below is a description of each of the proposals included in S. 666 and the rationale for each.

There has not yet been a revenue estimate performed for the bill. We expect that the Senators will ask for a separate estimate for each feature of the package. We expect that some features of the bill may be quite costly as drafted. Therefore, substantial revisions to those features are possible.

1. Permanent. The bill would make the credit permanent and would restore the credit for the last half of 1992. We expect, in the context of a large revenue estimate, that the retroactivity piece of the bill is the most vulnerable to being deleted.

2. Offset for AMT. Under the bill, the research credit would be creditable against 50 percent of a taxpayer's AMT liability (after the application of the foreign tax credit). While CORETECH asked for an 80 percent credit offset, the Joint Committee indicated that most R&D credits would be absorbed with a 25 percent credit. Thus, the bill compromised between these two

positions. Mark Weinberger indicated that if necessary, some revenue offset could be achieved by lowering the 50 percent AMT offset limit downward toward the 25 percent amount.

3. Liberalization of the Fixed Base Percentage. The bill modifies the current rules for computing the fixed base period. Under current rules, a taxpayer must separately add its qualified R&D and gross receipts from all five taxable years which begin after Dec. 1983 and before January 1989, and divide the total R&D figure by the total gross receipts figure in determining its fixed base percentage.

The bill would allow taxpayers to use the lowest R&D to gross receipts percentage calculated from any four consecutive year period during the 9 year period beginning after December 1983 and before January 1, 1993. CORETECH had requested that the taxpayer be permitted to choose any five years during this expanded 9 year period. The Joint Committee had apparently insisted on a consecutive period rule based on the view that R&D is cyclical, and a consecutive requirement insures that the percentage is more of a realistic amount rather than a lowest possible amount. To compensate for the restrictiveness of this consecutive requirement, the number of years in the base period was reduced from 5 to 4.

4. New Start-Up Definition and Phase-In Rules. Under the bill the definition of a start-up company is revised so that a start-up includes any company with its first year of both qualified R&D and gross receipts occurring in a taxable year beginning after 1983. Under the current law definition, some companies that began during the base period were not considered start-ups even though they could have ratios in excess of 100% in some base period years.

The bill also creates phase-in rules which were largely modeled after the rules included in the 1989 Ways & Means Committee proposal. Under these rules a start-up is entitled to use a 3% ratio for its first five taxable years beginning with the first year it has both qualified R&D and gross receipts. For the 6th taxable year after such year, the fixed base percentage would be 1/6 of its actual percentage from its 4th and 5th such years. For its 7th taxable year, the base percentage would be 1/3 of its actual percentage from its 5th and 6th such years.

For its 8th taxable year, the base percentage would be 1/2 of its actual percentage from its 5th, 6th and 7th such years. For its 9th taxable year, the base percentage would be 2/3 of its actual percentage from its 5th, 6th, 7th and 8th such years. For its 10th taxable year, the base percentage would be 5/6 of its actual percentage from its 5th, 6th, 7th, 8th and 9th such years. For all years after its 10th taxable year, the base percentage would be computed with reference to any 4 consecutive taxable years selected by the taxpayer from its 5th through 10th such years.

5. Special Rules for Companies Needing a "Fresh-Start". Recognizing that even with the more liberalized base period computation, some companies in the future may experience changes in their businesses that could make their ratios during the 1984-1992 period completely unrelated to their R&D ratios in such later periods. As a result, the credit would permit special "fresh start" rules to apply to any company who receives no credit due to an inability for current R&D to exceed its R&D base, but whose R&D is continually increasing during these years as compared to the average amount of such expenses during the 3 taxable year period immediately preceding each such year. Any company that can qualify for the fresh start rules would then be permitted to use the 10 year phase-in rules available to start-up companies.

6. Flat Rate Credit for Small Business. Under the bill, small businesses with gross receipts not greater than $100 million would be permitted a 10% flat rate credit in lieu of the incremental R&D credit. This change was made to simplify the R&D credit calculation for small businesses.

7. Defense and Aerospace Industries Rules. In deference to the down sizing of the defense industry, the bill would allow firms to elect to compute the R&D credit separately with respect to (i) defense related R&D expenses and gross receipts and (ii) all other R&D expenses and gross receipts. Defense related activities are defined to mean any activity in connection with the development and production (pursuant to a contract or subcontract) of an arm, ammunition or other implement of war, to the extent such property is specifically designed, modified, or equipped for military purposes or any equipment for NASA. This had not been an issue CORETECH took

a position on, but was included largely at the request of the aerospace industry.

8. Basic Research Credit Base Period Change. Under current law, the base period for the basic research credit is the computed with reference to the greater of the taxpayers average qualified basic research payments for 1981-1983 or 1% of the taxpayers total in-house and contract research expenditures for those years. The 1% figure often produced an insurmountable threshold for taxpayers who are not generally inclined to make basic research payments. This threshold thus worked to keep such firms from even considering the basic research credit in making its R&D spending decisions. Under the bill, the 1% threshold would be dropped. Thus, all companies would look to the average of their actual basic research payments in 1981-1983. CORETECH had suggested making this change.

9. Expansion of Qualified Organizations to Include Hospitals. Under the bill, the definition of qualified organizations, the payments to which are eligible for the basic research credit would be expanded to include university affiliated hospitals. CORETECH had suggested making this change.

10. Cooperative Research Credit. Under the bill, a 20 percent flat rate credit would be given for a percentage of payments made to qualified cooperative research consortia. The percentage of the payments eligible for the payments would be determined based on the consortia's private funding ratio, which is equal to 50 percent of preceding year's funding ratio, 30 percent of the second preceding year's ratio and 20 percent of the third preceding year's ratio.

The funding ratio is the ratio of non-governmental contributions to all contributions made to the consortium. In addition to cash payments, eligible contributions would include non-cash contributions not in excess of cash contributions (and to the extent overhead costs allocated to service contributions do not exceed 25% of salary and benefits of such service providers).

The term qualified cooperative research consortium includes organizations registered under the National Cooperative Research Act of 1984 and which had either (i) at least 5 contributors (with no 3 members contributing more than 80 percent of non-governmental contributions and with no single member contributing more than 50 percent of total such contributions) or (ii) had either 3 or 4 contributors (with no single member contributing more than 50%, and no 2 members more than 80%, of total non-governmental contributions and the contributors are in the same trade or business). In either event, contributions in excess of one-third of the total non-governmental funds would cease to be eligible for the credit.

Any payment eligible for this credit would not be eligible for the regular credit or the basic research credit.