

KEYS TO UNDERSTANDING AND UTILIZING THE FEDERAL AND CALIFORNIA RESEARCH TAX CREDITS

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WHY THE CREDIT EXISTS

The federal research tax credit was created in 1981 and was intended to:

- encourage businesses to incur costs for research projects despite the reluctance owing to uncertain rewards and significant costs.
- serve as an incentive to stimulate productivity to lead to greater private activity in research.
- address the decline in R&D activities in the U.S. that adversely affects economic growth and competitiveness in world markets.
- encourage taxpayers to conduct research in the U.S.

Instead of applying to all research, the credit only applies to limited specified expenses of “qualified research” that exceed a base amount. The rationale for the incremental nature of the credit was to not reward research that would have been done anyway (represented by the “base amount”). The credit was limited to direct wage, supply and contract research expenses because Congress viewed these principal types of research expenditures as distinctly reflecting the extent of increased activities.

NON-PERMANENCY

The research credit was originally set to expire on December 31, 1985 so that Congress could study the effectiveness of the credit before making it a permanent part of the law. Since enacted, the credit been temporarily extended and has expired ten times. Every time except for once, it was reinstated back to its expiration date. It is currently set to expire on June 30, 2004. There are active discussions in the 107th Congress, supported by President Bush, to make the credit permanent as part of a 2001 tax package. The revenue cost of permanency may be an issue though.

BRIEF LEGISLATIVE HISTORY

1. Economic Recovery Tax Act of 1981 – added IRC §44F, *Credit for Increasing Research Activities* (currently IRC §41). ERTA also brought us the rapid depreciation rules of ACRS. ERTA was a “tax reduction program [to] help

upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy..." Congress was concerned that the economy was not operating at its full potential and that companies were not spending enough on R&D and the U.S. non-military R&D spending was a smaller percentage of GNP relative to Germany and Japan. So, they desired a substantial incentive to encourage more R&D activity.

- Credit = 25% x (qualified research expenses - base period research expenses).
- Qualified Research Expenses (QRE): In-house research expenses (wages, supplies, amount paid or incurred for right to use personal property in conduct of qualified research) + Contract expenses (65% of amount paid or incurred to any person for qualified research, including certain basic research by colleges, universities and certain research organizations if pursuant to a written research agreement).
- Base period research expenses: Average of QRE for each year in the base period which consisted of the 3 tax years immediately preceding the tax year for which the credit was being calculated; thus, the credit was calculated based on a rolling average of prior year research expenditures.
- Minimum base period research expense - could not be less than 50% of QRE for the credit year.
- "Qualified research" meant research or experimental expenditures under §174. However, the following research was excluded: 1) research conducted outside the U.S., 2) research in the social sciences or humanities, and 3) funded research.
- In reviewing the legislative history of §44F, be aware that the language in the Blue Book to ERTA does not refer to the actual bill that was passed on the House floor. The version of §44F passed in the House was very short and only referred to §174 in defining "qualified research."

The formula was changed in 1989 and the definition of "qualified research" was tightened up in 1986.

2. Tax Reform Act of 1986—First Extension + Tightening of the Definition of Qualified Research

- Substantial changes were made to the research credit because Congress believed that the definition of research that qualifies for the credit had been applied too broadly. To tighten up the definition of "qualified research," additional requirements were created and new terminology added to §41 (see next section). In addition, limitations were placed on the availability of the credit for costs of developing internal-use software.

3. The Revenue Reconciliation Act of 1989 (RRA '89) (P.L. 101-239)—Change to the Formula

- The 3-year rolling average was replaced with a base amount that considers the taxpayer's "research intensity" (aggregate QRE/aggregate gross receipts for 1984 – 1988). The problem with the rolling base was that it presented an odd incentive because it could actually encourage companies to decrease R&D in the second and third years in order to get a larger credit in the fourth year.
- Gross receipts were factored into the formula "because businesses often determine their research budgets as a fixed percentage of gross receipts" – therefore, Congress found it appropriate to index each taxpayer's base amount to the average growth in its gross receipts.

4. The Small Business Job Protection Act of 1996 (SBJPA) (P.L. 104-188)—New Elective Alternative Formula

- The credit was extended, but, for the first time, it was not retroactively extended and thus, July 1, 1995 through June 30, 1996 is a gap period in which no federal research tax credit was available.
- The Act created an elective alternative incremental research credit (AIRC) designed to provide an incentive to certain firms that despite increasing QRE, were denied a credit because of rapidly increasing gross receipts, or a very high research intensity for the base period. The AIRC uses a 3-tiered fixed-base percentage that is lower than the standard fixed-base percentage (see later example).

5. The Tax and Trade Relief Extension Act of 1998 (P.L. 105-277)—Clarification + 1 Year Extension

- Congress provided further clarification as to the meaning of "qualified research" in response to some recent court decisions.

6. The Tax Relief Extension Act of 1999 (P.L. 106-170)—Further Clarification of “Qualified Research” + 5 Year Extension

- The three percentages used to compute the alternative incremental research credit (AIRC) were also increased by one percentage point (to 2.65, 3.2, and 3.75) (effective for tax years beginning after June 30, 1999).

OPERATION OF THE CREDIT

- Formula: The credit is computed on Form 6765. The calculation itself is relatively straightforward. The problems in dealing with the credit are with the numerous definitions, lack of guidance, and recordkeeping. The formula per §41(a):

$$20\% \times [\text{QRE less base amount}] + 20\% \times \text{basic research payments}^1$$

Computed on Form 6765.

- AIRC: The Small Business Jobs Protection Act of 1996 added an alternative incremental research credit (AIRC) that a taxpayer could irrevocably elect to use in place of the regular credit. This credit benefits taxpayers who do not have adequate records to compute a base year (perhaps due to an acquisition), or who obtain a regular credit of zero due to the special features of that credit, such as how it factors in a taxpayer’s “research intensity” for prior years (percentage of QRE to gross receipts).

- Definitions for the regular credit:

a) QRE = Qualified Research Expenses = total of,
In-house research expenses (wages per §3401(a) + supplies)²
+ 65% of contract research expenses³
[The above must be incurred for "qualified research."]

b) Qualified Research per §41(d) means research—

- that falls under §174;
 - which is undertaken to discover information (i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
 - substantially all of the activities of which constitute elements of a process of experimentation for a purpose that relates to a new or improved function, performance, or reliability or quality. [Note: certain purposes do not qualify—those that relate to style, taste, cosmetic, or seasonal design factors.]
- Certain activities are specifically excluded from qualifying for the credit (§41(d)(4) & §1.41-4(c)):
 - Research after commercial production;
 - Adaptation of existing business components;
 - Duplication of existing business component from examination of the business component or from plans or publicly available information;⁴
 - Survey, studies, and data collections;
 - Software developed primarily for internal use by the taxpayer other than for use in an activity constituting qualified research or a production process, or as specified in regulations;⁵

¹ Basic research payments are explained at §41(e) and basically pertain to certain payments made a corporation to universities and other qualified research organizations.

² See §1.41-2(b), (c), and (d). Wages can include the spread from the exercise of non-qualified stock options. *Apple Computer*, 98 TC 232 (1992); acq. 1992-31 I.R.B. 4. Wages can also include the spread resulting from disqualifying dispositions of incentive stock options (ISO). *Sun Microsystems Inc. v. Comm'r.*, T.C. Memo 1995-69, acq. 1997-2 C.B. 1.

³ See §1.41-2(e).

⁴ In TAM 9346006 (8/13/93), the IRS held that research with respect to the development of generic drugs was not qualified research because of the exclusion for duplication procedures. Also see FSA 1999-1023.

- Research conducted outside the United States, Puerto Rico or a U.S. possession;
- Research in the social sciences, arts, or humanities;⁶ or
- Research to the extent it is funded by any grant, contract or by some other person, including a governmental entity.⁷

c) Base Amount—see examples below.

- Special rules for start-up companies: QRE must be paid or incurred in carrying on a trade or business. A special rule at §41(b)(4) allows certain startup ventures to disregard this "carrying on" requirement for in-house research expenses (wages and supplies). Thus, a start-up may not include contract research expenses in calculating the research credit. Special rules also apply to start-up companies in computing their base amount. [§41(c)(3)(B)]
- Prevention of double benefit: To help pay for renewal of the credit and to prevent a double benefit for R&E expenditures (deduction and credit), §280C(c) requires taxpayers to reduce their §174 amount by the amount of the research credit, or to instead elect to take a reduced credit.

Example: Corporation with has a marginal tax rate of 34%, QRE of \$16,000 and a credit of \$1,600. It must reduce its R&E deduction by \$1,600. If instead, the corporation elects to take a reduced credit:

1st - compute §41 credit [\$1,600]

2nd - multiply credit by 35% [\$560]

3rd - reduce credit by amount from step 2 [\$1,040]

CREDIT CALCULATION EXAMPLES

1. *Standard Credit Calculation*: Disk Drive, Inc. (DD) - a publicly-traded corporation that designs and manufactures disk drives for personal computers.

Research credit data:

<u>Year</u>	<u>Gross Receipts (GR)</u>	<u>Qualified Research Exp. (QRE)</u>
1984	\$28,000,000	\$3,000,000
1985	\$32,000,000	\$4,200,000
1986	\$31,000,000	\$5,000,000
1987	\$34,000,000	\$6,200,000
1988	\$43,000,000	\$6,800,000
[1989 – 1995 – information omitted]		
1996	\$48,000,000	\$8,400,000
1997	\$60,000,000	\$10,200,000
1998	\$68,000,000	\$11,000,000
1999	\$76,000,000	\$12,000,000
2000	\$80,000,000	\$10,000,000

Research Credit Calculation for DD:

Step 1 - determine the fixed base percentage:

Fixed base percentage = $\frac{\text{total qualified research expenses 1984 - 1988}}{\text{total gross receipts 1984 - 1988}}$

⁵ See *United Stationers, Inc. v. U.S.*, 99-1 USTC ¶50,136, 82 AFTR2d 98-7488 (7th Cir.), cert. denied S.Ct. Dkt. No. 98-1870 (6/21/99); *Norwest Corp., et al. v. Comm'r.*, 110 T.C. 454 (1998); §1.41-4(c)(6); and Notice 87-12, 1987-1 C.B. 432.

⁶ See *TSR, Inc. and Subs. v. Commissioner*, 96 T.C. 903 (1991).

⁷ Guidance on the meaning of "funded research" can be found at TAM 9410007 (Nov. 30, 1993), *Fairchild Industries v. Comm'r.*, 95-2 USTC ¶50,633, 76 AFTR2d ¶95-5683 (Fed. Cir. 1995), rev'g 94-1 USTC ¶50,164 (Ct. Cls.) and *Lockheed Martin Corp., et al. v. U.S.*, 82 AFTR2d 98-7141, 98-2 USTC ¶50,887 (Fed Cls). *Fairchild* case: "inquiry turns on who bears the research costs upon failure, not on whether the researcher is likely to succeed in performing the project."

$$= \frac{\$3,000,000 + 4,200,000 + 5,000,000 + \$6,200,000 + 6,800,000}{\$28,000,000 + 32,000,000 + 31,000,000 + 34,000,000 + 43,000,000}$$

$$= \frac{\$25,200,000}{\$168,000,000} = 15.00\%$$

Because 15.00% is below the maximum fixed base percentage of 16%, 15.00% is used.

Step 2 - determine base amount:

Base amount = fixed base % X average annual gross receipts of DD for the four preceding tax years

Average annual gross receipts from 1996 to 1999 =

$$[\$48,000,000 + 60,000,000 + 68,000,000 + 76,000,000] \div 4 = \$63,000,000$$

Base amount = 15.00% x \$63,000,000 = \$9,450,000

Minimum allowable base amount is 50% of the current year QRE:

$$50\% \times \$10,000,000 = \$5,000,000$$

Because \$9,450,000 is greater than the minimum base amount, \$9,450,000 must be used.

Step 3 - determine credit:

20% x [qualified research expense - base amount] + 20% of basic research payments

$$20\% \times [\$10,000,000 - \$9,450,000] + 20\% \times \$0 = \underline{\$110,000}$$

Thus, the \$10,000,000 of 2000 QRE generated a \$110,000 credit (1.10% of QRE).

Per IRC §280C(c), DD must reduce its R & E expense deduction on its 2000 return by \$110,000 (the amount of the credit), or, it may chose instead to take a reduced credit and not change its R & E deduction. Note that DD would have had a higher credit if its 2000 research expenses were greater, its base years' research expenses were less, its base years' gross receipts were more, and/or its gross receipts in the prior four years was less.

2. *Start-up company*: ABC Corporation was formed in 1999 and had the following revenue and expenses:

	1999	2000
Sales revenue	\$20,000	\$45,000
Interest income	\$1,000	\$1,000
Section 174 expenses	\$35,000	\$55,000
QRE	\$22,000	\$39,000

2000 research credit calculation:

Step 1: Fixed base percentage = 3%

$$\text{Step 2: Base amount} = 3\% \times \frac{(\$20,000 + \$45,000)}{2} = \$975$$

Minimum base amount = 50% of 2000 QRE = \$19,500

Step 3: Credit =

$$20\% \times [\$39,000 - \$19,500] = \$3,900$$

or, ABC may elect to take a reduced research credit:

$$\$3,900 \times 35\% = \$1,365$$

$$\text{Credit} = \$3,900 - \$1,365 = \$2,535$$

Thus, ABC obtained a credit equal to 6.5% of its QRE ($\$2,535 \div \$39,000$). This is the maximum credit amount available.

If ABC does not elect to take a reduced research credit, it must reduce its §174 amount by \$3,900.

3. *Alternative Incremental Credit*: Example: Research credit data for T Corporation:

<u>Year</u>	<u>Gross Receipts (GR)</u>	<u>Qualified Research Exp. (QRE)</u>
1984	\$ 28,000,000	\$ 4,400,000
1985	\$ 30,000,000	\$ 6,300,000
1986	\$ 31,000,000	\$ 6,400,000
1987	\$ 31,000,000	\$ 7,200,000
1988	\$ 32,000,000	\$ 7,600,000
1989	\$ 42,000,000	\$ 8,800,000
1990	\$ 56,000,000	\$ 8,900,000
1991	\$ 68,000,000	\$ 9,000,000
1992	\$ 81,000,000	\$10,000,000
1993	\$ 99,000,000	\$11,000,000
1994	\$117,000,000	\$12,000,000
1995	\$122,000,000	\$13,000,000
1996	\$134,000,000	\$14,000,000
1997	\$156,000,000	\$16,000,000

1) Determine fixed base percentage:

$$= \frac{\text{total QRE 1984 - 1988}}{\text{total gross receipts 1984 - 1988}} = \frac{\$31,900,000}{\$152,000,000} = 20.99\%$$

Because 20.99% is above the maximum fixed base percentage of 16%, 16.00% is used.

2) Determine the base amount:

$$= \text{fixed base percentage} \times \text{average annual GR for the 4 preceding tax years}$$

$$= 16.00\% \times \$118,000,000 = \$18,880,000$$

Minimum allowable base amount is 50% of the current year QRE:

$$\$16,000,000 \times 50\% = \$8,000,000$$

Because $\$18,880,000 >$ the minimum base amount, $\$18,880,000$ must be used.

3) Determine the credit amount:

$$20\% \times [\$16,000,000 - \$18,880,000] + 20\% \times \$0 = \$0$$

Thus, the \$16,000,000 of QRE generates no research tax credit for 1997.

Alternative incremental credit calculation:

Preliminary amounts needed:

$$1\% \times \$118,000,000 = \$1,180,000$$

$$1.5\% \times \$118,000,000 = \$1,770,000$$

$$2\% \times \$118,000,000 = \$2,360,000$$

Calculation - credit equals the sum of the following amounts:*

(a) QRE in excess of \$1,180,000, but not in excess of

$$\begin{array}{r} \underline{\$1,770,000} \\ \$ 590,000 \\ \underline{\times 1.65\%} \\ \$ 9,735 \end{array}$$

(b) QRE in excess of \$1,770,000, but not in excess of

$$\begin{array}{r} \underline{\$2,360,000} \\ \$ 590,000 \\ \underline{\times 2.2\%} \\ \$ 12,980 \end{array}$$

(c) QRE in excess of

$$\begin{array}{r} \$ 2,360,000 \\ \underline{\$16,000,000} \\ \$13,640,000 \\ \underline{\times 2.75\%} \\ \$ 375,000 \end{array}$$

Total = **\$397,815**

* The Tax Relief Extension Act of 1999 (P.L. 106-170) increased each of the three percentages used to compute the AIRC by one percentage point (to 2.65, 3.2, and 3.75) effective for tax years beginning after June 30, 1999.

ISSUES

1. The credit has expired 10 times since it was first enacted in 1981 – should it be made permanent?

2. Should the base period (1984 – 1988) be updated? Should the 50% minimum base rule be repealed?

- Basically, a credit is generated if current QRE exceeds research intensity (QRE/GR) for base period (capped at 16%) applied to average gross receipts for the prior 4 years.
- However, the base amount cannot be less than 50% of current year QRE. This serves as a cap on the credit (basically limits it to 10% of QRE – which is then further reduced to 6.5% by §280C(c)). This 50% base rule serves to limit the credit for companies with a large increase in QRE over the base amount.

Example: Base amount = \$10
 Current QRE = \$20
 Credit = 20% x \$10 = \$2

Modification: Base amount = \$10
 Current QRE = \$30
 Credit = 20% x \$15 = \$3 (so additional \$10 of current QRE only generated \$1 of credit --- 10%, not 20%)

- A 1995 GAO study found that almost 60% of corporations were subject to the 50% minimum base rule. Query: Is the incremental nature of the credit being carried out if almost 60% of firms, in effect, calculate the research tax credit at 10% of current year QRE?
- Additional issues with the current base: (1) provides little incentive for companies, such as defense firms, with QRE in the base period that is unrealistically high for them today; (2) doesn't reward companies that have

become more efficient in their R&D activities; and (3) incentive is diminished if company has changed its business focus such that it doesn't make sense to devote the same percentage of GR to R&D as in the base period (such as a company that has added new lines of business in the finance area).

3. Is a maximum of 6.5% credit on a subset of §174 expenditures the appropriate incentive? Because a company may not receive all of the return from its research investment, but will instead share some of it with society, there is justification for public support of such research. Query: How much? Also, since many countries are seeking U.S. R&D activities and offer a variety of incentives, what is the appropriate incentive to keep the R&D in the U.S.?
4. The credit cannot be used to reduce AMT and is not a refundable credit.
5. There is much dispute as to what constitutes qualified research.

Recent cases involving a research credit claimed for internal-use software (which must cross more hurdles than other types of research) has raised some issues as to the meaning of QRE. A few courts have taken a very narrow interpretation of "discovering information that is technological in nature." For example, in *Norwest Corp. v. Commissioner*, 110 T.C. 454 (1998), a case involving internal-use software, the court stated: "The fact that the information is new to the taxpayer, but not new to others, is not sufficient for such information to come within the meaning of discovery for purposes of this test. The purpose of the R&E credit was to stimulate capital formation and improve the U.S. economy—not merely the taxpayer's business."⁸

Issues: Did Congress intend for the research credit to only be available where the taxpayer can show that it discovered something that was new to everyone? Did Congress intend that software development would have to expand or refine the field of computer science, or somehow go beyond the preexisting knowledge of the principles of computer science? If yes, who is to determine if this level of discovery has been achieved? The legislative history to §41(d) states that the "determination of whether the research is undertaken for the purpose of discovering information that is technological in nature depends on whether the process of experimentation utilized in the research fundamentally relies on principles of the physical or biological sciences, engineering, or computer science⁹—in which case the information is deemed technological in nature—or on other principles, such as those of economics—in which case the information is not be treated as technological in nature."¹⁰

Does this language imply a separate discovery test, or does the "deemed" language mean that if the research is in an appropriate field, it is deemed technological in nature (which along with the other requirements and limitations of §41, arguably causes the credit to be allowed only for appropriate expenses and research activities)? Given that many software processes are protected by trade secret, how can a taxpayer know if they have expanded the field of computer science?

Also, from what perspective is the court's "discovery test" statement about the need for qualified research to stimulate capital formation and improve the U.S. economy to be applied? Arguably, the economy is improved by streamlined financial transactions. Witness the growth of Internet-based financial transactions (such as home banking and stock trading) and suggestions by governments for increased use of technology for transfers of funds to and from the government (such as EFT for tax deposits).

In contrast, a 2000 District Court case held that there was no separate "discovery test." In *Tax and Accounting Software Corporation v. U.S.*, 86 AFTR2d 2000-5752, 2000-2 USTC ¶50,672 (ND OK 2000), a case involving commercial software, the court found that the "discovering information that is technological in nature" test was satisfied. Per the court, the courts in *United Stationers* and *Norwest* "erroneously tried to divide this requirement into two tests with the first being whether the taxpayer's actions can be considered a 'discovery' in the scientific sense." Per the court, the "emphasis should be on whether the information qualifies as being 'technological in nature' (the Technology Test), not whether the work could be considered a revolutionary discovery in the scientific sense." Based on its reading of the TRA'86 legislative history, the court did not see a reason to put a

⁸ Similarly, see *United Stationers, Inc.*, 82 AFTR2d 98-7488, 99-1 USTC ¶50,136 (7th Cir.), *cert. denied* S.Ct. Dkt. No. 98-1870 (6/21/99).

⁹ This quote includes the following footnote: "Research does not rely on the principles of computer science merely because a computer is employed. Research may be treated as undertaken to discover information that is technological in nature, however, if the research is intended to expand or refine existing principles of computer science."

¹⁰ General Explanation of the Tax Reform Act of 1986, prepared by the staff of the Joint Committee on Taxation, page 133.

“scientific” spin on the word “discovery” when the intent of the requirement was to distinguish between technologically-based information and non-technologically-based information. The term “discovery” could also mean “detect,” “unearth” and “learn.”

The court also looked to the conference committee report to the Tax and Trade Relief Extension Act of 1998 (P.L. 105-277) where Congress stated that evolutionary research activities could qualify for the credit. Per the court, evolutionary research is not “revolutionary research.” “[Evolutionary research] suggests to the Court a pattern of research that is unfolding in a series of events rather than something that is a radical change from the norm.” In short, per the court, the “purpose of the ‘technology’ requirement of section 41 is to eliminate the ‘soft sciences’ from contention for the credit, not to focus on the word ‘discovery.’”

Update: In the preamble to the final §41 regulations issued in January 2001 (T.D. 8930), Treasury notes the *Norwest* and *United Stationers* cases, but does not mention the *TAASC* case. On January 31, 2001, Treasury Secretary O’Neill announced that Treasury was delaying the effective date of the final regulations and reopening the comment period.¹¹

6. How much documentation is needed? The final regulations under §41 provide that taxpayers must prepare “documentation before or during the early stages of the research project, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of [§1.41-4(a)(3) – “discovering information], and retains that documentation on paper or electronically” as prescribed in regulations or other administrative guidance. The taxpayer must also satisfy the recordkeeping requirement of §6001.¹²

Consideration should also be given to that fact that QRE must be of a type that qualifies, such as wages, and incurred in an activity or project that qualifies (research that meets the requirements of §174 and is technological in nature and is not an excluded activity under §41(d)(4)). Thus, in addition to tracking dollar amounts, information on the nature of the projects or activities to which the costs relate must also be collected. Terminology should also be evaluated. For example, certain job titles and account names may unnecessarily lead to problems during an audit by the Service. Labeling a worker as an administrative assistant when that person’s primary job is to document research activities in a lab will lead to unnecessary scrutiny by the Service.

The adviser should also consider what documents the IRS might ask to examine during an audit and be sure they are not confusing. For example, the IRS might ask for job descriptions and employee performance review files from the personnel office, as well as contracts that support contract research expenses. In addition, the IRS may ask for organizational charts, accounting manuals, copyright and patent applications, minutes of various meetings where R&D projects were discussed, and progress reports.¹³

7. Relative to the standard research tax credit, the AIRC rates are arguably still too low.

¹¹ Treasury press release of January 31, 2001, PO-18; <http://www.treas.gov/press/releases/po18.htm>. Per Notice 2001-19, 2001-10 I.R.B. ___, comments are requested by April 2, 2001.

¹² Reg. §1.41-4(d) of T.D. 8930, January 3, 2001. On January 31, 2001, Treasury Secretary O’Neill announced that Treasury was delaying the effective date of the final regulations and reopening the comment period. Treasury press release of January 31, 2001, PO-18; <http://www.treas.gov/press/releases/po18.htm>. Per Notice 2001-19, 2001-10 I.R.B. ___, comments are requested by April 2, 2001.

¹³ In 1995, David W. Bernard, IRS National Issue Specialist for the Research Credit, released his recommended audit plan for the research tax credit. While the plan is not binding on examiners, it presents a good overview to how the IRS will likely verify the research credit and can be helpful in setting up adequate recordkeeping and documentation prior to the filing of each tax return. Distributed at Mr. Bernard’s presentation on “R&E Documentation” at the 11th Annual High Technology Tax Institute, San Jose, Nov. 14, 1995. Available from Lexis: *Full Text: IRS Specialist’s Paper on Audit Plan For Research Tax Credit*, Tax Notes Today, 95 TNT 225-40 (Nov. 17, 1995).

HAS THE RESEARCH TAX CREDIT ACCOMPLISHED ITS POLICY GOALS?

Both government and private studies have shown that the research tax credit has had an impact on the amount of research conducted. A 1989 General Accounting Office (GAO) report, "The Research Tax Credit Has Stimulated Some Additional Research Spending," stated that the research credit "raised corporate spending on R&E above the level that otherwise would have been achieved."¹⁴ This study, based on a sample of 800 corporations and economic models, concluded that the credit "stimulated between \$1 billion and \$2.5 billion of additional spending for the 5 years 1981 through 1985." Such an increase represented an increase of 15 cents to 36 cents for every dollar of foregone tax revenue due to the credit.¹⁵

A 1994 private study concluded that the GAO study underestimated the benefits of the research tax credit. This study estimated that the credit stimulated additional spending of about \$2 billion per year with foregone tax revenues of about \$1 billion per year.¹⁶

As noted in two government reports, studies of the research credit may not have captured its complete benefits because of the sometimes long lead times for research projects and changes made to the credit since 1981, particularly in 1989.¹⁷ A 1993 report noted that the 1989 changes likely increased the credit's incentive effect "substantially" and may have increased the credit's impact "beyond what is shown by the existing data."¹⁸

THE CALIFORNIA RESEARCH TAX CREDIT

- R&T §17052.12 and §23609.
- California Form 3523.
- Permanent provision in California law.
- Similar to the federal credit at IRC §41 except that an 15% rate is used instead of a 20% rate, IRC §41(a)(2) regarding payments to qualified organizations for basic research only applies to corporations and is a 24% rate for corporations (rather than the 20% rate allowed for the federal research credit).
- California conforms to the federal definition of QRE.
- Qualified research includes only research performed in California
- Gross receipts used for the credit calculation only includes receipts from sales that are delivered or shipped to a purchaser in California ("throwback" sales are not included).

¹⁴ "The Research Tax Credit Has Stimulated Some Additional Research Spending," by GAO, GAO/GGD-89-114, Sept. 1989, pg. 22.

¹⁵ 1989 GAO report, *supra*, pg. 22.

¹⁶ "R&D Tax Policy During the 1980s: Success or Failure," by Bronwyn H. Hall, National Bureau of Economic Research, Reprint No. 1872, April 1994, pg. 29. The author also noted that the investment incentives of the research tax credit should also consider the interaction of the foreign tax credit and the AMT. Pgs. 28 - 30.

¹⁷ Prior to the 1989 changes to the research tax credit, the amount of the credit was based on a rolling base period of research expenditures. There was some disincentive built into such a system because more dollars spent on research today would result in a smaller credit in future years. "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 4., also noted that the temporary nature of the credit "has detracted from its effectiveness" (pg. 1).

¹⁸ "The R&D Tax Credit: An Evaluation of Evidence On Its Effectiveness," A Staff Study prepared for the use of the Joint Economic Committee, 8/23/85, page 1 and Congressional Research Service Issue Brief "The Research and Experimentation Tax Credit," by D. Brumbaugh, November 17, 1993.