[4830-01-P] Published July 29, 2003

DEPARTMENT OF THE TREASURY Correction October 22, 2003

Internal Revenue Service

26 CFR Part 1

REG-133791-02 and REG-105606-99

RIN 1545-BA88 and RIN 1545-AX05

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of public hearing; and withdrawal of previously proposed regulations.

SUMMARY: This document contains proposed regulations relating to the computation and allocation of the credit for increasing research activities for members of a controlled group of corporations or a group of trades or businesses under common control. These proposed regulations reflect changes made to section 41 by the Revenue Reconciliation Act of 1989 and the Small Business Job Protection Act of 1996, which introduced the alternative incremental research credit. This document also provides notice of a public hearing on these proposed regulations and withdraws the proposed regulations published in the **Federal Register** on January 4, 2000 (65 FR 258).

DATES: Written or electronic comments must be received by October 23, 2003. Requests to speak and outlines of the topics to be discussed at the public hearing scheduled for November 13, 2003, at 10 a.m. must be received by October 23, 2003.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-133791-02), room 5207, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be

hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-133791-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at: www.irs.gov/regs. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Jolene J. Shiraishi at (202) 622-3120 (not a toll-free call); concerning submissions of comments, the hearing, and to be placed on the building access list to attend the hearing, Guy Traynor at (202) 622-3693 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On January 4, 2000, Treasury and the IRS published in the **Federal Register** (65 FR 258) proposed amendments to the regulations under section 41(f) (2000 proposed regulations) relating to the computation and allocation of the credit for increasing research activities (research credit) for members of a controlled group of corporations or a group of trades or businesses under common control (controlled group). The 2000 proposed regulations reflected changes made to section 41 by the Revenue Reconciliation Act of 1989 (the 1989 Act) and the Small Business Job Protection Act of 1996. Treasury and the IRS received written comments from two commentators. A public hearing was held on April 26, 2000. After considering the written comments and the statements at the public

hearing, Treasury and the IRS are withdrawing the 2000 proposed regulations and are proposing new regulations.

Summary of Comments and Explanation of Provisions

Overview

These new proposed regulations for members of a controlled group under section 41(f) follow the research credit computation rule contained in the 2000 proposed regulations. The computation of the research credit for a controlled group (group credit) under these new proposed regulations is done by treating all of the members of a controlled group as a single taxpayer. Unlike the 2000 proposed regulations, these new proposed regulations then allocate the group credit among the members of the controlled group based on the relative amounts of each individual member's stand-alone entity credit -- the credit, if any, that a member of a controlled group would be entitled to claim if it were not a member of a controlled group. These new proposed regulations generally will apply to taxable years beginning on or after the date that final regulations are published in the **Federal Register**.

Computation of the Group Credit

Section 41(f)(1)(A)(i) provides that in determining the amount of the research credit under section 41, "all members of the same controlled group of corporations shall be treated as a single taxpayer." Section 41(f)(1)(B)(i) provides a similar rule for a group of trades or businesses under common control. Accordingly, for purposes of determining the amount of the group credit, the 2000 proposed regulations applied all of the section 41 computational rules on an aggregate basis. The commentators agreed that with respect to the computation of the group credit, the 2000 proposed regulations are consistent with the provisions of section 41(f). These new proposed regulations,

therefore, do not change the method for computing the group credit. These new proposed regulations, however, clarify the application of the start-up company rules under section 41(c)(3)(B) to a controlled group with respect to the computation of the group credit.

Allocation of the Group Credit Among Members of the Controlled Group

Section 41(f)(1)(A)(ii) provides that "the [portion of the group] credit (if any) allowable by this section to each such member shall be its proportionate shares of the qualified research expenses and basic research payments giving rise to the credit." Section 41(f)(1)(B)(ii) provides a similar rule for a group of trades or businesses under common control. These new proposed regulations apply these provisions by allocating the group credit based on the relative amounts of each individual member's stand-alone entity credit.

2000 proposed regulations

The 2000 proposed regulations allocated the group credit based on the amounts by which each individual member's qualified research expenses (QREs) exceeded a base amount for that member. An individual member's base amount, for purposes of allocating the group credit under the 2000 proposed regulations, was determined by applying the controlled group's fixed-base percentage to the member's average annual gross receipts for the four taxable years preceding the credit year. The group credit was allocated to a member having an excess amount of QREs by multiplying the group credit by a fraction having the individual member's excess amount as the numerator and the aggregate excess amount of all the members of the controlled group as the denominator. A similar allocation method was provided for the credit for basic research payments and for the alternative incremental research credit.

The preamble to the 2000 proposed regulations stated that the purpose of this method was to

allocate the group credit to "those members whose share of current year qualified research expenses exceeds their share of the [controlled group's] base amount." In particular, the preamble noted that in providing a rule that reflects the incremental nature of the research credit, Treasury and the IRS declined to follow comments noting that amendments to section 41 made by the 1989 Act required that the allocation of the group credit be based on the relative amounts of total QREs incurred separately by members of the controlled group:

> In proposing rules for the allocation of the credit, Treasury and the IRS considered, but were not persuaded by, certain taxpayers' argument that the elimination of the word "increase" from the allocation rule in the statute requires that the credit be allocated on the basis of the gross amount of qualified research expenses incurred by the various members of the controlled group. Treasury and the IRS believe that elimination of the word "increase" was necessitated by the 1989 statutory amendments to the computation of the research credit, which afford a credit in certain circumstances even where the taxpayer (or each member of a controlled group) is decreasing its gross amount of qualified research expenses (e.g., because the taxpayer's gross receipts also are decreasing). However, there is no indication that the elimination of the word "increase" was intended to suggest that the credit be allocated without regard to its incremental nature. To the contrary, the statutory prescription that the credit be allocated according to each member's proportionate share of the qualified research expenses "giving rise to" the credit supports a rule that allocates the credit to those members whose share of current year qualified research expenses exceeds their share of the base amount.

Comments on the 2000 proposed regulations

Two commentators submitted a series of comments in response to the 2000 proposed regulations. As noted above, both commentators agreed that the method for computing the group credit contained in the 2000 proposed regulations is consistent with the provisions of section 41(f). The commentators diverged significantly, however, with respect to the method for allocating the group credit. The first commentator supported the allocation rule contained in the 2000 proposed regulations.

The second commentator reiterated the earlier expressed view that the allocation of the group credit should be done on the basis of each member's total QREs (gross QREs method).

The second commentator set out a number of reasons why a gross QREs method should be adopted instead of the method contained in the 2000 proposed regulations. In particular, the commentator stated that a gross QREs method is the only method consistent with the plain meaning of section 41(f). As a related point, the commentator claimed that a statutory amendment made by the 1989 Act supports its plain meaning argument. The commentator also noted that the allocation method contained in the 2000 proposed regulations, by incorporating both individual member and controlled group elements, was at odds with the computation method provided by the statute and failed to allocate rationally the group credit.

Treasury and the IRS continue to believe that, compared to a gross QREs method, an allocation method based on a group member's QREs in excess of a base amount more fully carries out the purposes of section 41 in general and the section 41(f) controlled group credit rules. The research credit is not, and has never been, a credit computed as a percentage of total qualifying expenses. Rather, the research credit generally is allowed only when a taxpayer's QREs exceed a base amount. Prior to the 1989 Act, the research credit was computed by multiplying the credit rate by the excess of the taxpayer's current year QREs over the taxpayer's average QREs for the preceding three years. The 1989 Act significantly modified the computation of the research credit while retaining the incremental approach of the pre-1989 Act credit. In general, the research credit computation is based on whether and the extent to which a taxpayer increases the proportion of its QREs relative to its recent gross receipts, compared to a historical base period. Ultimately, this computation measures the extent

to which a taxpayer's current year QREs exceed a base amount.

Treasury and the IRS conclude that the controlled group allocation rules set out in section 41(f) were not intended to result in the allocation of the group credit to individual members of the group in a manner wholly at odds with the incremental nature of the research credit. The legislative history to the research credit, as originally enacted in 1981, indicates that the group credit rules were enacted to ensure that the research credit would be allowed only for actual increases in research expenditures. These rules were intended to prevent taxpayers from creating artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. H. Rep. No. 97-201, 1981-2 C.B. (Vol. 2) 364, and S. Rep. 97-144, 1981-2 C.B. (Vol. 2) 442. In effect, the group credit computation rule serves as a cap on the maximum amount of credit that the members of the group, in the aggregate, may claim. A rule that then allocates the group credit based solely on the total amount of QREs incurred by each individual member, however, would be inconsistent with the incremental nature of the credit and would not further the purpose of the section 41(f) group credit rules.

As during the consideration of the 2000 proposed regulations, Treasury and the IRS do not find persuasive the second commentator's argument that a plain reading of the statute, following the deletion of the phrase "increase in" in sections 41(f)(1)(A)(ii) and 41(f)(1)(B)(ii) by the 1989 Act, mandates a gross QREs method for allocating the group credit. Prior to the 1989 Act, for example, section 41(f)(1)(A)(ii) provided that the research credit, if any, allowable to each member of a controlled group was the member's "proportionate share of the increase in qualified research expenses giving rise to the credit." The phrase "increase in" was deleted by the 1989 Act. The commentator maintained that a

gross QREs method gives effect to the phrase "giving rise to the credit" as well as to the deletion of the phrase "increase in" from the statute by the 1989 Act because "each dollar of the group's QREs gives rise to [the] excess over the group's base amount" or "(s)tated otherwise, if you eliminate a dollar of qualified research expenses from any member of the group, the group's credit will be reduced proportionately."

The reason for the deletion of the phrase "increase in" is not addressed in the legislative history to the 1989 Act. The changes to the computation of the research credit made by the 1989 Act, however, made a taxpayer's QREs for prior years, other than taxable years beginning after December 31, 1983, and before January 1, 1989 (base years), irrelevant to the computation of the credit. Instead, the amount of the research credit now depends on whether and the extent to which a taxpayer increases the proportion (compared to that of the base years) of its QREs relative to its average annual gross receipts from the prior four years. Accordingly, although the research credit is still based on the amount by which current year QREs exceed a base amount, that base amount, unlike the general research credit computation prior to the 1989 Act, is not a rolling average of QREs incurred in the three years prior to the credit year. Treasury and the IRS, therefore, conclude that the deletion of the phrase "increase in" was intended to reflect this change, and not to indicate that the allocation of the group credit was to be made using a gross QREs method.

The second commentator noted, in arguing that the allocation method in the 2000 proposed regulations impermissibly mixed controlled group and individual member calculations, that the allocation method favors those members whose current ratio of QREs to recent gross receipts exceeds the controlled group's fixed-base percentage, regardless of whether that member's ratio, in fact, was

increasing or decreasing. As stated by the commentator, "[t]he group's fixed-base percentage can be wildly different from the fixed-base percentage for an individual member depending on the individual member's separate QREs and separate gross receipts during the [base years]. In other words, the amount of group credit that would be allocated to an individual member under the 2000 proposed regulations may bear little or no relationship to what the individual member would be entitled to on a stand-alone basis, depending on how similar the individual member's separate fixed-base percentage was to the group's fixed-base percentage.

Proposed allocation rule

After considering the statute, the legislative history, the written comments, and the statements at the public hearing, Treasury and the IRS have determined that the allocation method contained in the 2000 proposed regulations does not fully carry out the purpose of the research credit statute and, in particular, the amendments made by the 1989 Act. Treasury and the IRS continue to believe that the method for allocating the group credit must take into account the incremental nature of the credit. In considering the consequences of the allocation method contained in the 2000 proposed regulations, as highlighted by the commentators, Treasury and the IRS believe that the method may not, in certain cases, appropriately balance the purpose of the group credit computation and allocation rules contained in section 41(f) with the general purpose of the research credit, which is to encourage research activities.

Accordingly, these new proposed regulations allocate the group credit among the members of the controlled group by first computing each individual member's stand-alone entity credit and then multiplying the group credit by the ratio that the member's stand-alone entity credit bears to the sum of

the stand-alone entity credits of all the members of the controlled group. This new allocation method ensures that the amount of group credit allocated to each individual member will be proportionate to the amount of research credit that the individual member would have been entitled to claim had it not been part of a controlled group. This new allocation method therefore addresses the concerns expressed by the commentators that the allocation method contained in the 2000 proposed regulations could result in individual members receiving little or no research credit – or, conversely, a disproportionately greater amount of research credit – compared to what they would have been entitled to on a stand-alone basis, solely as a result of being part of a controlled group.

Special Allocation Rule for Consolidated Groups

In the preamble to the 2000 proposed regulations, Treasury and the IRS requested comments with respect to a special rule that would treat all members of a consolidated group within a controlled group as a single member for purposes of allocating the group credit among the members of a controlled group. After considering the comments received, Treasury and the IRS have decided not to propose a special allocation rule for consolidated groups.

Effective Date

The 2000 proposed regulations provided that they would be effective, when finalized, for taxable years ending on or after the date the proposed regulations were filed with the **Federal Register** (i.e., December 29, 1999). The 2000 proposed regulations, however, were proposed to be retroactive in certain instances to prevent abuse:

> To prevent taxpayers that are members of a controlled group from together claiming in excess of 100% of the credit with respect to prior taxable years, the rules for allocating the group credit would apply to any taxable year beginning after December 31, 1989,

> in which, as a result of inconsistent methods of allocation, the members of a controlled group as a whole claimed more than 100% of the allowable group credit. In the case of a group whose members have different taxable years and whose members used inconsistent methods of allocation, the members of the group as a whole shall be deemed to have claimed more than 100% of the allowable group credit.

The two commentators disagreed as to the appropriateness of this proposed effective date. In particular, the second commentator stated that it would be "unconscionable" for final regulations containing the allocation method set out in the 2000 proposed regulations to be applied retroactively. The second commentator therefore proposed that final regulations be applied prospectively and that for prior years, taxpayers be permitted to rely on final regulations or any other method that is reasonable, including a gross QREs method. Finally, the second commentator disputed "that there is a potential for abuse if members of a controlled group take inconsistent methods of allocation for past years. The fact that members of the same controlled group may, in the aggregate, claim more than 100% of the group's Research Credit should not make any difference."

The group credit rules in section 41(f) provide for a total group credit. There is nothing in the statute or the legislative history that suggests that it then should be permissible for the members of the controlled group to claim, in the aggregate, an amount of research credit exceeding the group credit. Treasury and the IRS continue to believe that the purpose of the section 41(f) group credit rules would be undermined if the members of a controlled group applied different allocation methods to claim more than 100 percent of the group credit. The preamble to the 2000 proposed regulations and those proposed regulations themselves eliminated any ambiguity that may have existed with respect to the Treasury and IRS position on this point. Accordingly, Treasury and the IRS propose that final regulations be effective for taxable years beginning on or after the date that these regulations are

published in the **Federal Register** as final regulations. Treasury and the IRS further propose that the final regulations be retroactive in limited circumstances to prevent abuse. Generally, a taxpayer may use any reasonable method of computing and allocating the credit for taxable years beginning before the date these regulations are published in the **Federal Register** as final regulations. However, paragraph (b) relating to the computation of the group credit and paragraph (c), relating to the allocation of the group credit, will apply to taxable years ending on or after December 29, 1999**,** if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

Special Analyses

It has been determined that these proposed regulations do not constitute a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these proposed regulations. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-105606-99) published in the **Federal Register** on January 4, 2000, (65 FR 258) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.41-0, the table of contents is amended as follows:

1. A new entry is added for §1.41-6(a)(4).

2. The entries for §1.41-6(b) through (e) are revised.

3. New entries are added for §1.41-6(f) through (i).

The revisions and additions read as follows:

§1.41-0 Table of contents.

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§1.41-6 Aggregation of expenditures.

(a)* * *
(4) Definition of group credit.
(b) Computation of the group credit.
(1) In general.
(2) Start-up companies.
(c) Allocation of the group credit.
(1) In general.
(2) Stand-alone entity credit.
(d) Examples.

(e) For taxable years beginning before January 1, 1990.
(f) Tax accounting periods used.
(1) In general.
(2) Special rule where timing of research is manipulated.
(g) Membership during taxable year in more than one group.
(h) Intra-group transactions.
(1) In general.
(2) In-house research expenses.
(3) Contract research expenses.
(4) Lease payments.
(5) Payment for supplies.
(i) Effective date.

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Par. 3. Section 1.41-6 is amended as follows:

1. Paragraph (a)(1) is revised.

2. New paragraph (a)(4) is added.

3. Paragraph (b) is revised.

4. Paragraphs (c), (d), and (e) are redesignated as paragraph (f), (g), and (h), respectively.

5. New paragraphs (c), (d), and (e) are added.

6. Newly designated paragraph (f)(1) is revised.

7. New paragraph (i) is added.

The revisions and additions read as follows:

§1.41-6 Aggregation of expenditures.

(a) * * * (1) In general. To determine the amount of research credit (if any) allowable to a trade or business that at the end of its taxable year is a member of a controlled group of corporations or a group of trades or businesses under common control, a taxpayer must --

(i) Compute the group credit in the manner described in paragraph (b) of this section, and

(ii) Allocate the group credit among the members of the group in the manner described in paragraph (c) of this section.

* * * * *

(4) Definition of group credit. For purposes of this section, the term group credit means the research credit (if any) allowable to a controlled group of corporations or a group of trades or businesses under common control.

(b) Computation of the group credit -- (1) In general. All members of a controlled group of corporations or a group of trades or businesses under common control are treated as a single taxpayer for purposes of computing the research credit. The group credit is computed by applying all of the section 41 computational rules on an aggregate basis.

(2) Start-up companies. A controlled group of corporations or a group of trades or businesses under common control is treated as a start-up company for purposes of determining the group's fixed-base percentage under section 41(c)(3)(B)(ii) only if each member of the group qualifies as a start-up company under section 41(c)(3)(B)(i).

(c) Allocation of the group credit -- (1) In general. To determine the amount of the group credit (if any) computed under paragraph (b) of this section that is allocated to a member of the group, a taxpayer must --

(i) Compute the member's stand-alone entity credit; and

(ii) Multiply the group credit by the ratio that the member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group:

$$\text{group credit} \times \frac{\text{member's stand-alone entity credit}}{\text{sum of all the members' stand-alone entity credits}}$$

(2) Stand-alone entity credit. For purposes of this section, the term stand-alone entity credit means the research credit (if any) that would be allowable to a member of a group if the credit were computed without regard to section 41(f). In computing a member's stand-alone entity credit, a taxpayer must use the same method (i.e., the computation method provided in section 41(a) or the elective method provided in section 41(c)(4)) that was used to compute the group credit. Therefore, if the research credit determined under section 41(a) is not allowable to the group and the group credit is computed using the alternative incremental research credit (AIRC) rules of section 41(c)(4), each member's stand-alone entity credit also must be computed using the AIRC rules, even if the research credit determined under section 41(a) would be allowable to a member if that member were not a part of the group.

(d) Examples. The following examples illustrate the provisions of this section:

Example 1. Research credit -- (i) Facts. A, B, and C, all of which are calendar-year taxpayers, are members of a controlled group of corporations. Neither A, B, nor C made any basic research payments for their taxable year ending December 31, 2003. For purposes of computing the group credit for the 2003 taxable year (the credit year), A, B, and C had the following:

	A	B	C	Group Aggregate
Credit Year Qualified Research Expenses (QREs)	$200x	$20x	$110x	$330x
1984-1988 QREs	$40x	$10x	$100x	$150x
1984-1988 Gross Receipts	$1,000x	$350x	$150x	$1,500x

Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$300x	$1,700x

(ii) Computation of the group credit -- (A) In general. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($330x) over the group's base amount ($170x). The group credit is 0.20 × ($330x - $170x), which equals $32x.

(B) Group's base amount -- (1) Computation. The group's base amount equals the greater of: the group's fixed-base percentage (10 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($1,700x), or the group's minimum base amount ($165x). The group's base amount, therefore, is $170x, which is the greater of: 0.10 x $1,700x, which equals $170x, or $165x.

(2) Group's minimum base amount. The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $330x, which equals $165x.

(3) Group's fixed-base percentage. The group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bears to the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 10 percent, which is the lesser of: $150x/$1,500x, which equals 10 percent, or 16 percent.

(iii) Allocation of the group credit. The group credit of $32x is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the controlled group. The $32x group credit is allocated as follows:

	A	B	C	Total
Stand-Alone Entity Credit	$20x	$2x	$11x	$33x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/33	2/33	11/33	
Multiplied by: Group Credit	$32x	$32x	$32x	
Equals: Credit Allocated to Member	$19.39x	$1.94x	$10.67x	$32x

Example 2. Member is a start-up company -- (i) Facts. D, E, and F, all of which are calendar-year taxpayers, are members of a controlled group of corporations. F is a start-up company under section 41(c)(3)(B)(i). D and E are not start-up companies under section 41(c)(3)(B)(i). Neither D, E, nor F made any basic research payments during the 2003 taxable year. For purposes of computing the group credit for the 2003 taxable year (the credit year), D, E, and F had the following:

	D	E	F	Group Aggregate
Credit Year QREs	$200x	$20x	$50x	$270x
1984-1988 QREs	$55x	$15x	$0x	$70x
1984-1988 Gross Receipts	$1,000x	$400x	$0x	$1,400x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$0x	$1,400x

(ii) Computation of the group credit -- (A) In general. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($270x) over the group's base amount ($135x). The group credit is 0.20 × ($270x - $135x), which equals $27x.

(B) Group's base amount -- (1) Computation. The group's base amount equals the greater of: the group's fixed-base percentage (5 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($1,400x), or the group's minimum base amount ($135x). The group's base amount, therefore, is $135x, which is the greater of: 0.05 x $1,400x, which equals $70x, or $135x.

(2) Group's minimum base amount. The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $270x, which equals $135x.

(3) Group's fixed-base percentage. Because only one member of the group, F, is a start-up company under section 41(c)(3)(B)(i), the group is not a start-up company under paragraph (b)(2) of this section. Therefore, the group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bears to the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 5 percent, which is the lesser of: $70x/$1,400x, which equals 5 percent, or 16 percent.

(iii) Allocation of the group credit. The group credit of $27x is allocated among the members of

the group based on the ratio that each member's stand-alone entity credit bears to the sum of stand-alone entity credits of all the members of the controlled group. The $27x group credit is allocated as follows:

	D	E	F	Total
Stand-Alone Entity Credit	$20x	$2x	$5x	$27x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/27	2/27	5/27	
Multiplied by: Group Credit	$27x	$27x	$27x	
Equals: Credit Allocated to Member	$20x	$2x	$5x	$27x

Example 3. Group is a start-up company -- (i) Facts. G, H, and I, all of which are calendar-year taxpayers, are members of a controlled group of corporations. Each of G, H, and I qualifies as a start-up company under section 41(c)(3)(B)(i). The 2003 taxable year is the fifth taxable year beginning after December 31, 1993, for which each of G, H, and I has QREs. Because each of G, H, and I qualifies as a start-up company under section 41(c)(3)(B)(i), the group is treated as a start-up company under paragraph (b)(2) of this section. The 2003 taxable year is the fifth taxable year beginning after December 31, 1993, for which the group has QREs. Neither G, H, nor I made any basic research payments during the 2003 taxable year. For purposes of computing the group credit for the 2003 taxable year (the credit year), G, H, and I had the following:

	G	H	I	Group Aggregate
Credit Year QREs	$255x	$25x	$100x	$380x
1984-1988 QREs	$0x	$0x	$0x	$0x
1984-1988 Gross Receipts	$0x	$0x	$0x	$0x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,600x	$340x	$300x	$2,240x

(ii) Computation of the group credit -- (A) In general. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($380x) over the group's base amount ($190x). The group credit is 0.20 × ($380x - $190x), which equals $38x.

(B) Group's base amount -- (1) Computation. The group's base amount equals the greater of: the group's fixed-base percentage (3 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($2,240x), or the group's minimum base amount ($190x). The group's base amount, therefore, is $190x, which is the greater of: 0.03 x $2,240x, which equals $67.2x, or $190x.

(2) Group's minimum base amount. The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $380x, which equals $190x.

(3) Group's fixed-base percentage. Each member of the group is a start-up company under section 41(c)(3)(B)(i), therefore, the group is a start-up company under paragraph (b)(2) of this section. Because the 2003 taxable year is the fifth taxable year beginning after December 31, 1993, for which the group has QREs, under section 41(c)(3)(B)(ii)(I), the group's fixed-base percentage is 3 percent.

(iii) Allocation of the group credit. The group credit of $38x is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of stand-alone entity credits of all the members of the controlled group. The $38x group credit is allocated as follows:

	G	H	I	Total
Stand-Alone Entity Credit	$25.5x	$2.5x	$10x	$38x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	25.5/38	2.5/38	10/38	
Multiplied by: Group Credit	$38x	$38x	$38x	
Equals: Credit Allocated to Member	$25.5x	$2.5x	$10x	$38x

Example 4. Group alternative incremental research credit -- (i) Facts. J, K, and L, all of which are calendar-year taxpayers, are members of a controlled group of corporations. The research credit under section 41(a) is not allowable to the group for the 2003 taxable year because the group's aggregate QREs for the 2003 taxable year are less than the group's base amount. The group credit is computed using the AIRC rules of section 41(c)(4). For purposes of computing the group credit for the 2003 taxable year (the credit year), J, K, and L had the following:

	J	K	L	Group Aggregate

Credit Year QREs	$0x	$20x	$110x	$130x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$300x	$1,700x

(ii) Computation of the group credit. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to the sum of: 2.65 percent of so much of the group's aggregate QREs for the taxable year as exceeds 1 percent of the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year, but does not exceed 1.5 percent of such average; 3.2 percent of so much of the group's aggregate QREs as exceeds 1.5 percent of such average but does not exceed 2 percent of such average; and 3.75 percent of so much of such QREs as exceeds 2 percent of such average. The group credit is [0.0265 × [($1,700x × 0.015) - ($1,700x × 0.01)]] + [0.032 × [($1,700x × 0.02) - ($1,700x × 0.015)]] + [0.0375 × [$130x - ($1,700x × 0.02)]], which equals $4.10x.

(iii) Allocation of the group credit. The group credit is allocated to each member of the group by multiplying the group credit by the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The $4.10x group credit is allocated as follows:

	J	K	L	Total
Stand-Alone Entity Credit	$0x	$.66x	$3.99x	$4.65x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	0/4.65	0.66/4.65	3.99/4.65	
Multiplied by: Group Credit	$4.10x	$4.10x	$4.10x	
Equals: Credit Allocated to Member	$0x	$.58x	$3.52x	$4.10x

(e) For taxable years beginning before January 1, 1990. For taxable years beginning before January 1, 1990, see §1.41-6 as contained in 26 CFR part 1, revised April 1, 2003.

(f) Tax accounting periods used -- (1) In general. The credit allowable to a member of a controlled group of corporations or a group of trades or businesses under common control is that member's share of the group credit computed as of the end of that member's taxable year. In

computing the group credit for a group whose members have different taxable years, a member generally should treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. For example, M, N, and O are members of a controlled group of corporations. M and N file a calendar year consolidated return. O files a separate return using a fiscal year ending June 30. For purposes of computing the group credit at the end of the M's and N's (the computing members') calendar year on December 31, O's fiscal year ending June 30, which ends within the M's and N's calendar year, is treated as O's credit year.

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(i) Effective date. Paragraphs (a)(1), (a)(4), (b), (c), (d), and (f)(1) of this section 1.41-6 are applicable for taxable years beginning on or after the date these regulations are published in the **Federal Register** as final regulations. Generally, a taxpayer may use any reasonable method of computing and allocating the credit for taxable years beginning before the date these regulations are published in the **Federal Register** as final regulations. However, paragraph (b) relating to the computation of the group credit and paragraph (c), relating to the allocation of the group credit, will apply to taxable years ending on or after December 29, 1999**,** if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

Robert E. Wenzel,
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