

change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with the procedures, prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4% unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the beneficiaries' consent was not required, or, if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not define income as a unitrust amount or if the situs was changed to such a state from State X.

Example 12. Equitable adjustments under state statute. The facts are the same as in *Example 11*, except that in 2002, State X amends its income and principal statute to permit the trustee to make adjustments between income and principal when the trustee invests and manages the trust assets under the state's prudent investor standard, the trust describes the amount that shall or must be distributed to a beneficiary by referring to the trust's income, and the trustee after applying the state statutory rules regarding allocation of receipts between income and principal is unable to administer the trust impartially. The provision permitting the trustees to make these adjustments is effective in 2002 for trusts created at any time. The trustee invests and manages the trust assets under the state's prudent investor standard, and pursuant to authorization in the state statute, the trustee allocates receipts between the income and principal accounts in a manner to ensure the impartial administration of the trust. The administration of the trust in accordance with the state statute will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13 of the Internal Revenue Code. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes. Similarly, the conclusions in this example would be the same if the change in administration of the trust occurred because the situs of the trust was changed to State X from a state whose statute does not authorize the trustee to make adjustments between income and principal or if the situs was changed to such a state from State X.

(ii) *Effective dates.* The rules in this paragraph (b)(4) are generally applicable on and after December 20, 2000. However, the rule in the last sentence of

paragraph (b)(4)(i)(D)(2) of this section and *Example 11* and *Example 12* in paragraph (b)(4)(i)(E) of this section regarding the administration of a trust and the determination of income in conformance with applicable state law applies to trusts for taxable years ending after January 2, 2004.

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Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: December 16, 2003.

Pamela F. Olson,

Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9104]

RIN 1545-AY82

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of qualified research under section 41(d) for the credit for increasing research activities. These final regulations reflect changes to section 41(d) made by the Tax Reform Act of 1986.

DATES: *Effective Dates:* These regulations are effective January 2, 2004.

Applicability Dates: For dates of applicability of these regulations, see § 1.41-4(e) and *Effective Dates* under **SUPPLEMENTARY INFORMATION.**

FOR FURTHER INFORMATION CONTACT: Nicole R. Cimino at (202) 622-3120 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 2, 1998, the Treasury Department and the IRS published in the **Federal Register** (63 FR 66503) a notice of proposed rulemaking (REG-10570-97, 1998-2 C.B. 729) under section 41 (1998 proposed regulations) relating to the credit for increasing research activities (research credit). The 1998 proposed regulations addressed, in relevant part, (1) the definition of qualified research under section 41(d), (2) the application of the exclusions from the definition of qualified research, and (3) the application of the shrinking-

back rule. Comments responding to the 1998 proposed regulations were received and a public hearing was held on April 29, 1999.

On January 3, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 280) final regulations relating, in relevant part, to the definition of qualified research under section 41(d) (TD 8930). In response to taxpayer concerns regarding TD 8930, on January 31, 2001, the Treasury Department and the IRS published Notice 2001-19 (2001-10 I.R.B. 784), announcing that the Treasury Department and the IRS would review TD 8930 and reconsider comments previously submitted in connection with the finalization of TD 8930. Notice 2001-19 also provided that, upon the completion of the review, the Treasury Department and the IRS would announce changes to the regulations, if any, in the form of proposed regulations.

On December 26, 2001, the Treasury Department and the IRS published in the **Federal Register** (66 FR 66362) a notice of proposed rulemaking (REG-112991-01) reflecting the Treasury Department and the IRS' review of TD 8930 (2001 proposed regulations). Comments responding to the 2001 proposed regulations were received and a public hearing was held on March 27, 2002. After considering the comments received and the statements made at the public hearing, portions of the 2001 proposed regulations are adopted as revised by this Treasury Decision.

Explanation of Provisions

This document amends 26 CFR part 1 to provide revised rules for the research credit under section 41. These final regulations generally retain the provisions of the 2001 proposed regulations but clarify the provisions relating to the requirement in section 41(d)(1)(C) that qualified research be research "substantially all of the activities of which constitute elements of a process of experimentation." These final regulations, however, do not contain final rules for research with respect to computer software "which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer" for purposes of section 41(d)(4)(E).

Process of Experimentation—In General

The Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) (the 1986 Act), which narrowed the definition of the term *qualified research*, amended the definition of qualified research by adding a process of experimentation requirement. Section 41(d)(1) provides