

in the credit computation provided that substantially all of the research activities constitute elements of a process of experimentation for a qualified purpose. After consideration of the comments received, the Treasury Department and the IRS have concluded that the substantially all requirement can be satisfied even if some portion of a taxpayer's activities are not for a qualified purpose.

Accordingly, these final regulations clarify the substantially all rule and provide that the substantially all requirement is satisfied if 20 percent or less of a taxpayer's research activities do not constitute elements of a process of experimentation for a purpose described in section 41(d)(3), so long as these remaining activities satisfy the requirements of section 41(d)(1)(A) and are not otherwise excluded under section 41(d)(4). Example (6) of § 1.41-4(a)(8) of the 2001 proposed regulations has been modified to illustrate the application of this rule, and appears as example (4) in these final regulations.

#### *Other Issues*

##### *Patent Safe Harbor*

Section 1.41-4(a)(3)(iii) of the 2001 proposed regulations generally provided that the issuance of certain patents is conclusive evidence that a taxpayer has discovered information that is technological in nature that is intended to eliminate uncertainty concerning the development or improvement of a business component. Some commentators requested that this patent safe harbor be expanded to cover all requirements contained in sections 41(d)(1) and (3). After consideration of these comments, and in light of the clarifications being made in these final regulations to the provisions relating to the process of experimentation requirement, the Treasury Department and the IRS continue to believe that the patent safe harbor is appropriately limited and, therefore, have not changed the patent safe harbor provision.

##### *Shrinking-Back Rule*

Some commentators expressed concern that the language of the shrinking-back rule in § 1.41-4(b)(2) of the 2001 proposed regulations implied that not all of a taxpayer's qualified research expenses would be eligible for the research credit as a result of the application of the rule. This provision has been revised in these final regulations to clarify that the rule is not intended to exclude qualified research expenses from the credit, but rather is intended to ensure that expenses attributable to qualified research

activities are eligible for the research credit for purposes of section 41(d)(1).

##### *Research After Commercial Production*

Some commentators requested additional clarification regarding the scope of the research after commercial production, adaptation, and duplication exclusions set out in section 41(d)(4)(A), (B) and (C), and § 1.41-4(c)(2), (3) and (4) of the 2001 proposed regulations. After consideration of these comments, the Treasury Department and the IRS believe that the multitude of factual situations to which these exclusions might apply make it impractical to provide additional clarification that is both meaningful and of broad application. The Treasury Department and the IRS believe these three specific exclusions do not cover research activities that otherwise satisfy the requirements for qualified research. Taxpayers, however, should carefully review (including, as appropriate, the application of the shrinking-back rule) research activities that might otherwise fall within these exclusions to ensure that only eligible activities are being included in their credit computations.

One commentator expressed concern that the language of § 1.41-4(c)(2)(iv), relating to the clinical testing of pharmaceutical products, could exclude from credit eligibility clinical trials performed under an arrangement where the Food and Drug Administration has granted conditional approval for a pharmaceutical product contingent upon the results of additional clinical trials. Another commentator expressed concern that the language would exclude otherwise qualifying activities because the research was not required to be approved by the Food and Drug Administration. Section 1.41-4(c)(2)(iv) is not a rule of exclusion. As stated above, the Treasury Department and the IRS believe that the research after commercial production exclusion (as well as the adaptation and duplication exclusions) do not cover research activities, including these additional clinical trials, so long as such trials satisfy the requirements for qualified research.

##### *Gross Receipts*

These final regulations retain the broad definition of gross receipts contained in TD 8930. In response to Notice 2001-19, a number of commentators reiterated earlier comments that this definition was overly broad. As stated in the preamble to the 2001 proposed regulations, the Treasury Department and the IRS continue to believe that the definition of gross receipts should be construed

broadly, and, accordingly, no change has been made in these final regulations to the definition contained in TD 8930.

##### *Examples*

The examples in the regulations have been changed to remove references to "readily discernible and applicable." While the Treasury Department and the IRS continue to believe that the activities in *Examples 4* and *5* of § 1.41-4(a)(8) of the 2001 proposed regulations would not qualify under the final regulations, these examples were removed as the only purpose of these examples was to illustrate the "readily discernible and applicable" standard. Minor changes to the facts in *Example 4* of § 1.41-4(a)(8) in the final regulations (*Example 6* of § 1.41-4(a)(8) of the 2001 proposed regulations) were made to illustrate more clearly the application of the substantially all requirement of § 1.41-4(a)(6). These changes do not indicate that the Treasury Department and the IRS believe that the integration activities removed from the example, as contained in the 2001 proposed regulations, are or are not qualified activities standing alone. The determination of whether activities are qualified research is based on the specific facts and circumstances of those activities.

Additionally, minor changes were made to the examples in § 1.41-4(c)(10) to remove references to "readily discernible and applicable" and to make some clarifications based on comments received. *Example 1* of § 1.41-4(c)(10) was modified to remove the conclusion regarding qualification of expenses under section 174. Although the Treasury Department and the IRS continue to believe that the conclusion in the 2001 proposed regulations is correct, the Treasury Department and the IRS believe that the point illustrated in the removed portion of the example would be more appropriately addressed in guidance issued under section 174, rather than in guidance under section 41.

##### *Effective Date*

Notice 2001-19 stated, in relevant part, that the provisions of TD 8930, including any changes to TD 8930, would be effective no earlier than the date when the completion of the Treasury Department and the IRS' review of TD 8930 was announced. The 2001 proposed regulations provided, in relevant part, that final regulations would apply to taxable years ending on or after December 26, 2001, the date the proposed regulations were published in the **Federal Register**.