

Because these final regulations only clarify the provisions of the 2001 proposed regulations, these final regulations apply to taxable years ending on or after December 31, 2003. For taxable years ending before December 31, 2003, the IRS will not challenge return positions that are consistent with these final regulations.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Act Analysis is not required. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Nicole R. Cimino of the Office of Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, personnel from other offices of the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

■ Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART I—INCOME TAXES

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

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

■ **Par. 2.** Section 1.41–0 is amended by revising the entry for § 1.41–4 to read as follows:

The revision reads as follows:

§ 1.41–0 Table of contents.

§ 1.41–4 Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

- (a) Qualified research.
 - (1) General rule.
 - (2) Requirements of section 41(d)(1).
 - (3) Undertaken for the purpose of discovering information.
 - (i) In general.
 - (ii) Application of the discovering information requirement.
 - (iii) Patent safe harbor.
 - (4) Technological in nature.
 - (5) Process of experimentation.
 - (i) In general.
 - (ii) Qualified purpose.
 - (6) Substantially all requirement.
 - (7) Use of computers and information technology.
 - (8) Illustrations.
 - (b) Application of requirements for qualified research.
 - (1) In general.
 - (2) Shrinking-back rule.
 - (3) Illustration.
 - (c) Excluded activities.
 - (1) In general.
 - (2) Research after commercial production.
 - (i) In general.
 - (ii) Certain additional activities related to the business component.
 - (iii) Activities related to production process or technique.
 - (iv) Clinical testing.
 - (3) Adaptation of existing business components.
 - (4) Duplication of existing business component.
 - (5) Surveys, studies, research relating to management functions, etc.
 - (6) Internal use software for taxable years beginning on or after December 31, 1985. [Reserved].
 - (7) Activities outside the United States, Puerto Rico, and other possessions.
 - (i) In general.
 - (ii) Apportionment of in-house research expenses.
 - (iii) Apportionment of contract research expenses.
 - (8) Research in the social sciences, etc.
 - (9) Research funded by any grant, contract, or otherwise.
 - (10) Illustrations.
 - (d) Recordkeeping for the research credit.
 - (e) Effective dates.

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■ **Par. 3.** Section 1.41–4 is amended as follows:

- 1. The section heading and paragraphs (a)(2)(iii), (a)(3), (a)(4), (a)(5), (a)(6), (a)(8), (b)(2), (b)(3), (c)(2)(iv), (c)(4), (c)(7)(ii), (c)(10), (d), and (e) are revised.
- 2. The heading of paragraph (c)(6) is revised and the text is removed and reserved.

The revisions read as follows:

§ 1.41–4 Qualified research for expenditures paid or incurred in taxable years ending on or after December 31, 2003.

- (a) * * *
- (2) * * *
- (iii) Substantially all of the activities of which constitute elements of a process of experimentation that relates to a qualified purpose.

(3) *Undertaken for the purpose of discovering information*—(i) *In general.* For purposes of section 41(d) and this section, research must be undertaken for the purpose of discovering information that is technological in nature. Research is undertaken for the purpose of discovering information if it is intended to eliminate uncertainty concerning the development or improvement of a business component. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the business component, or the appropriate design of the business component.

(ii) *Application of the discovering information requirement.* A determination that research is undertaken for the purpose of discovering information that is technological in nature does not require the taxpayer be seeking to obtain information that exceeds, expands or refines the common knowledge of skilled professionals in the particular field of science or engineering in which the taxpayer is performing the research. In addition, a determination that research is undertaken for the purpose of discovering information that is technological in nature does not require that the taxpayer succeed in developing a new or improved business component.

(iii) *Patent safe harbor.* For purposes of section 41(d) and paragraph (a)(3)(i) of this section, the issuance of a patent by the Patent and Trademark Office under the provisions of 35 U.S.C. 151 (other than a patent for design issued under the provisions of 35 U.S.C. 171) 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. However, the issuance of such a patent is not a precondition for credit availability.

(4) *Technological in nature.* For purposes of section 41(d) and this section, information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. A taxpayer may employ existing technologies and may rely on existing principles of the physical or biological sciences, engineering, or computer science to satisfy this requirement.

(5) *Process of experimentation*—(i) *In general.* For purposes of section 41(d) and this section, a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or