

between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (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: <http://www.irs.gov/regs>. The public hearing will be held in the IRS Auditorium (7th Floor), 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) 622-7180 (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