

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 The legislative history to the research credit, as originally enacted in 1981, indicates that the group credit rules were enacted to ensure that the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.