of each month, an institution that promotes the payment of overdrafts on July 1, 2006 must provide the disclosures required by § 230.11(a)(1) of this part on subsequent periodic statements for that consumer beginning with the statement reflecting the period from July 16, 2006 through August 15, 2006. Only depository institutions that promote the payment of overdrafts in an advertisement on or after July 1, 2006 must provide disclosures on periodic statements under § 230.11(a)(1) of this part.

(a)(5) Acquired accounts

1. *Examples.* As provided in § 230.11(a)(5) of this part, an institution that acquires deposit accounts through merger or acquisition must provide the disclosures required by paragraph (a)(1) of this section for the first statement period that begins after the institution promotes the payment of overdrafts in an advertisement that applies to the acquired account. If the acquiring institution does not advertise the payment of overdrafts, or the advertisement does not apply to the acquired accounts, the institution need not provide the disclosures required by § 230.11(a)(1) of this part for the acquired accounts even if the depository institution that previously held the accounts advertised the payment of overdrafts with respect to those accounts.

(b) Advertising Disclosures in Connection With Overdraft Services

1. *Examples of institutions promoting the payment of overdrafts.* A depository institution would be required to include the advertising disclosures in § 230.11(b)(1) of this part if the institution:

i. Promotes the institution's policy or practice of paying overdrafts (unless the service would be subject to the Board's Regulation Z (12 CFR part 226)). This includes advertisements using print media such as newspapers or brochures, telephone solicitations, electronic mail, or messages posted on an Internet site. (But see § 230.11(b)(2) of this part for communications that are not subject to the additional advertising disclosures);

ii. Includes a message on a periodic statement informing the consumer of an overdraft limit or the amount of funds available for overdrafts. For example, an institution that includes a message on a periodic statement informing the consumer of a $500 overdraft limit or that the consumer has $300 remaining on the overdraft limit, is promoting an overdraft service.

iii. Discloses an overdraft limit or includes the dollar amount of an overdraft limit in a balance disclosed on an automated system, such as a telephone response machine, ATM screen or the institution's Internet site. (See, however, § 230.11(b)(3) of this part.).

2. *Transfer services.* The overdraft services covered by § 230.11(b)(1) of this part do not include a service providing for the transfer of funds from another deposit account of the consumer to permit the payment of items without creating an overdraft, even if a fee is charged for the transfer.

3. *Electronic media.* The exception for advertisements made through broadcast or electronic media, such as television or radio, does not apply to advertisements posted on an institution's Internet site, on an ATM screen, provided on telephone response machines, or sent by electronic mail.

4. *Fees.* The fees that must be disclosed under § 230.11(b)(1) of this part include per-item fees as well as interest charges, daily or other periodic fees, and fees charged for maintaining an account in overdraft status, whether the overdraft is by check or by other means. The fees also include fees charged when there are insufficient funds because previously deposited funds are subject to a hold or are uncollected. The fees do not include fees for transferring funds from another account to avoid an overdraft, or fees charged when the institution has previously agreed in writing to pay items that overdraw the account and the service is subject to the Board's Regulation Z, 12 CFR part 226.

5. *Categories of transactions.* An exhaustive list of transactions is not required. Disclosing that a fee may be imposed for covering overdrafts ''created by check, in-person withdrawal, ATM withdrawal, or other electronic means' would satisfy the requirements of § 230.11(b)(1)(ii) of this part where the fee may be imposed in these circumstances. See comment 4(b)(4)–5 of this part.

6. *Time period to repay.* If a depository institution reserves the right to require a consumer to pay an overdraft immediately or on demand instead of affording consumers a specific time period to establish a positive balance in the account, an institution may comply with § 230.11(b)(1)(iii) of this part by disclosing this fact.

7. *Circumstances for nonpayment.* An institution must describe the circumstances under which it will not pay an overdraft. It is sufficient to state, as applicable: ''Whether your overdrafts will be paid is discretionary and we reserve the right not to pay. For example, we typically do not pay overdrafts if your account is not in good standing, or you are not making regular deposits, or you have too many overdrafts.''

8. *Advertising an account as ''free.''* If the advertised account-related service is an overdraft service subject to the requirements of § 230.11(b)(1) of this part, institutions must disclose the fee or fees for the payment of each overdraft, not merely that a cost is associated with the overdraft service, as well as other required information. Compliance with comment 8(a)–10.v. is not sufficient.

By order of the Board of Governors of the Federal Reserve System, May 19, 2005.

Jennifer J. Johnson,

Secretary of the Board.

[FR Doc. 05–10348 Filed 5–23–05; 8:45 am]

BILLING CODE 6210–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9205]

RIN 1545–BE17

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the computation and allocation of the credit for increasing research activities for members of a controlled group of corporations or a group of trades or businesses under common control. These temporary regulations reflect changes made to section 41 by the Revenue Reconciliation Act of 1989 (1989 Act), which introduced the current computational regime for the credit, and the Small Business Job Protection Act of 1996, which introduced the alternative incremental research credit. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective May 24, 2005.

Applicability Dates: For dates of applicability see §§ 1.41–6T(j) and 1.41–8T(b)(5).

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

SUPPLEMENTARY INFORMATION:

Background

On July 29, 2003, the Treasury Department and the IRS published in the **Federal Register** (68 FR 44499) proposed amendments to the regulations under section 41(f) (REG–133791–02) (the 2003 proposed regulations) relating to the computation and allocation of the credit for increasing research activities (research credit) under section 41 for members of a controlled group of corporations or a group of trades or businesses under common control (controlled groups). The 2003 proposed regulations withdrew the proposed regulations published in the **Federal Register** on January 4, 2000 (65 FR 258) (REG–105606–99) (the 2000 proposed regulations). In general, the 2000 proposed regulations required

controlled groups to compute a group credit and then to allocate that group credit among the members of the controlled group. The allocation of the group credit under the 2000 proposed regulations was based on the relative increases of each member's qualified research expenses (QREs) over a base amount that was computed by multiplying that member's most recent average annual gross receipts by the controlled group's fixed-base percentage.

Although the 2003 proposed regulations did not modify the rules relating to the computation of the group credit, the 2003 proposed regulations did modify the rules relating to the allocation of the group credit among the members of the controlled group. In particular, the 2003 proposed regulations allocated the group credit in proportion to 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 (the stand-alone entity credit). In addition, based on the comments to the 2000 proposed regulations, the 2003 proposed regulations did not propose special rules that would apply to consolidated groups that were members of a controlled group. A public hearing on the 2003 proposed regulations was held on November 13, 2003. After considering the written comments and the statements at the public hearing, the Treasury Department and the IRS are withdrawing the 2003 proposed regulations and are issuing temporary regulations and proposed regulations cross-referencing the temporary regulations. In substantial part, the temporary regulations retain the rules contained in the 2003 proposed regulations with certain modifications discussed below.

Summary of Comments and Explanation of Provisions

Computation of the Group Credit

Section 41(f)(1)(A)(i) provides that ''all members of the same controlled group of corporations shall be treated as a single taxpayer'' in determining the amount of the research credit under section 41. Section 41(f)(1)(B)(i) provides a similar rule for a group of trades or businesses under common control. The 2003 proposed regulations applied the section 41 computational rules on an aggregate basis for purposes of determining the amount of the group credit. Additionally, a controlled group would have been treated as a start-up company for purposes of determining the group's fixed-base percentage only if each member of the group qualified as a start-up company. Therefore, a controlled group with only two members would have been subject to the start-up rules if one member of the group had QREs but no gross receipts in 1983 and the other member had gross receipts but no QREs in 1983.

Commentators generally agreed with the proposed rules for computing the group credit. Commentators were concerned, however, with perceived ambiguities related to the application of the start-up company rules to a controlled group. For example, commentators asked that the regulations clarify what a controlled group's start-up date is if all the members of the group are start-up companies with different start-up dates.

These temporary regulations retain the rules in the 2003 proposed regulations for the computation of the group credit, except for the start-up company rules. The temporary regulations state that a controlled group is treated as a start-up company for purposes of computing the group credit if (A) the first taxable year in which at least one member of the group had gross receipts and at least one member of the group had QREs begins after December 31, 1983, or (B) there were fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which at least one member of the group had gross receipts and at least one member of the group had QREs. Consistent with this approach, the first taxable year in which a controlled group has gross receipts for purposes of the start-up company rules is the first year in which at least one member of the group has gross receipts. Likewise, the first taxable year in which a controlled group has QREs for purposes of the start-up company rules is the first year in which at least one member of the group has QREs. The Treasury Department and the IRS believe that this approach is more consistent with treating a controlled group as a single taxpayer because a controlled group with two members is not subject to the start-up rules if one member of the group had QREs but no gross receipts in 1983 and the other member had gross receipts but no QREs in 1983. Additionally, the temporary regulations specifically state that for purposes of determining the fixed-base percentage, the first taxable year after December 31, 1993, for which a controlled group has QREs is the first taxable year in which at least one member of the group has QREs.

Allocation of the Group Credit

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. The 2003 proposed regulations apply these provisions by allocating the group credit based on the relative amounts of each individual member's stand-alone entity credit.

A number of commentators requested changes to the method of allocating the group credit contained in the 2003 proposed regulations. In general, these comments reflected dissatisfaction either with the stand-alone entity credit method in the 2003 proposed regulations or with any single, prescribed method. Consequently, commentators either proposed specific alternatives or stated that final regulations should allow members to allocate the group credit using any reasonable method. One commentator advocated that a method that allocates the group credit based on the relative amounts of each member's total QREs (gross QREs method) is the only allocation method permitted under the statute. Another commentator urged the Treasury Department and the IRS to adopt an allocation method that, based on techniques of differential calculus, allocates the group credit based on the marginal contribution to the group credit of each member's QREs for the current year, QREs for the base years, and gross-receipts for the base years, as well as the controlled group's fixed-base percentage and the growth in gross receipts for the controlled group (marginal contribution method). Other commentators suggested that no single allocation method can appropriately allocate the group credit in all cases; therefore, members of a controlled group should be permitted to use any reasonable method to allocate the group credit. For the reasons discussed below, these temporary regulations generally retain the stand-alone entity credit method of the 2003 proposed regulations with some modifications.

The preamble to the 2003 proposed regulations sets out at length the reasons why the Treasury Department and the IRS believe that the allocation method under section 41(f) should be based on a group member's QREs in excess of a base amount. The stand-alone entity credit method reflects the incremental nature of the credit and also is consistent with the Treasury Department and the IRS' view of the purpose of section 41(f). As stated in the preamble to the 2003 proposed regulations:

The legislative history to the research credit, as originally enacted in 1981, indicates that the group credit computation and aggregation rules were enacted to ensure that the research credit would be allowed only for actual increases in research expenditures. These aggregation 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, 1981–3 C.B. (Vol. 2) 364, and Sen. Rep. 97–144, 1981–3 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.

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. Final regulations issued in 1989, prescribing rules for the allocation of the group credit prior to the 1989 Act, allocated the group credit based on what effectively would have been each member's stand-alone entity credit (without giving effect to the minimum base period amount in computing each member's stand-alone entity credit). The 1989 Act significantly modified the computation of the credit while retaining the incremental approach of the pre-1989 Act credit. Congress did not indicate in either the statute or the legislative history that either the purpose or the application of section 41(f) was being changed. Although the phrase ''increase in'' in sections 41(f)(1)(A)(ii) and 41(f)(1)(B)(ii) was deleted by the 1989 Act, for the reasons set out in the preamble to the 2003 proposed regulations, the Treasury Department and the IRS concluded that this change to the statute was intended to reflect only the fact that a taxpayer's entitlement to the research credit after the 1989 Act no longer depended on whether the taxpayer had increased its current year QREs over its average QREs for the preceding three years.

With respect to the alternative allocation methods suggested by the commentators, the Treasury Department and the IRS conclude that these methods are inconsistent with the purpose of section 41 generally and section 41(f) specifically. A gross QREs method is at odds fundamentally with the incremental nature of the research credit, and the Treasury Department and the IRS continue to believe that neither the statute nor the legislative history suggests that Congress intended that the allocation of the group credit be based solely on a member's total QREs without reference to whether those QREs exceed a base amount.

Similarly, the Treasury Department and the IRS do not believe that the suggested marginal contribution method is consistent with section 41(f). The Treasury Department and the IRS recognize the potential for that method to more closely associate the amount of group credit allocated to a particular member to the contributions of that member's QREs for the current year, gross receipts for the current year, QREs for the base years, and gross receipts for the base years to the amount of the group credit. The marginal contribution method proposed, however, has significant flaws that would change the function of the aggregation rules in section 41(f) in a manner that the Treasury Department and the IRS do not believe was intended by Congress. First, the method would allow allocations of credit to members that have no QREs, a result the Treasury Department and the IRS believe is contrary to the statutory directive to allocate the group credit in proportion to a member's share of QREs giving rise to the credit. Second, the method uses different formulas for groups that are affected by special rules, such as the maximum fixed-base percentage rule. As a result, it is possible that a member of a group that increases its QREs by a relatively small amount, that is enough to make the group subject to a special rule, could be allocated proportionately less credit than if the member had not increased its QREs. Finally, by relying on the group's gross receipts and the group's fixed-base percentage, the marginal contribution method appears to encourage planning and shifting among group members, a result that is inconsistent with the purpose of section 41(f). The Treasury Department and the IRS believe that an appropriate allocation method should encourage a member to focus on incrementally increasing its own research efforts.

The Treasury Department and the IRS also decline to adopt an allocation rule that would permit the members of a controlled group to use any reasonable method to allocate the group credit. Neither the statute nor the legislative history indicates that Congress intended the allocation of the group credit to be based on any reasonable method selected by a member individually or the controlled group collectively. Furthermore, a rule permitting the use of any reasonable method to allocate the credit could result in continuing controversy. As discussed in the preamble to the 2003 proposed regulations, the Treasury Department and the IRS believe that the purpose of section 41(f) is undermined if the members of a controlled group use different allocation methods to claim more than 100 percent of the group credit. The Treasury Department and the IRS believe that a single, prescribed method is necessary to preclude such potential for abuse.

Accordingly, the Treasury Department and the IRS continue to believe that the purposes of the research credit statute generally and the provisions of section 41(f) specifically are best furthered by an allocation method that allocates the group credit based on each member's stand-alone entity credit.

Special Allocation Rule for Excess Group Credit Situations

Under the 2003 proposed regulations, if the group credit exceeded the sum of the stand-alone entity credits of the members of a controlled group, the members with stand-alone entity credits would be entitled to the entire group credit. In addition, if no member of the controlled group had a stand-alone entity credit, none of the group credit would be allocated to the members of the controlled group.

To address these situations, these temporary regulations modify the allocation method of the 2003 proposed regulations in cases in which the group credit exceeds the sum of the members' stand-alone entity credits, including cases in which no member has a stand-alone entity credit. If the group credit exceeds the sum of the members' stand-alone entity credits, each member is allocated an amount of group credit equal to that member's stand-alone entity credit. The remaining, or excess, amount of group credit is then allocated among all the members of the controlled group based on the ratio of an individual member's QREs to the sum of all the members' QREs.

Computation of Stand-Alone Entity Credits

Commentators questioned whether members must use the same method, *i.e.,* the method described in section 41(a) (regular credit method) or the alternative incremental research credit (AIRC) method described in section 41(c)(4), in computing the stand-alone entity credit as that used to compute the group credit. The Treasury Department and the IRS do not believe that requiring taxpayers to be consistent in the method used to compute the group credit and the stand-alone entity credit would serve the purpose of section 41. Section 41(f) was intended to encourage taxpayers to increase their individual research efforts to maximize the group credit and thus their share of the group credit. The Treasury Department and

the IRS believe that allowing the members to compute their stand-alone entity credits without regard to the method used to compute the group credit will encourage increasing research efforts. Thus, the temporary regulations provide that a member's stand-alone entity credit must be computed using whichever method results in the greater stand-alone entity credit for that member, without regard to the method used to compute the group credit.

Commentators also pointed out that the computation of the stand-alone entity credits under the 2003 proposed regulations would no longer require the intra-group transaction rules of § 1.41–6(e) (re-designated in these temporary regulations as § 1.41–6(i)) to apply. Although the intent of the stand-alone entity credit rule is to compute a credit that is similar to that to which a member would be entitled if there were no research credit aggregation rules for controlled groups, the intent was not to render the intra-group transaction rules or the acquisition/disposition rules of section 41(f)(3) inapplicable. Therefore, these temporary regulations specifically provide that taxpayers must apply the intra-group transaction rules and the acquisition/disposition rules when computing the stand-alone entity credits. For example, to the extent that a member's gross receipts and QREs have been reduced for purposes of computing the group credit as a result of the application of the acquisition/disposition rules, the member's stand-alone entity credit must be computed using the same gross receipts and QREs.

Special Allocation Rule for Consolidated Groups

The preamble to the 2003 proposed regulations states that the Treasury Department and the IRS considered comments requesting a special allocation rule for consolidated groups, but decided not to adopt such a rule. Several commentators further commented on that issue. One commentator suggested that if the group credit were allocated in proportion to QREs, no special consolidated group rule would be necessary. Given that this commentator's proposed allocation method is not the one adopted in these temporary regulations, the Treasury Department and the IRS are not persuaded that a special consolidated group rule is unnecessary. Another commentator suggested that a consolidated group should be treated as a single member of a controlled group for purposes of allocating the group credit and that the failure to treat the consolidated group in such a manner would result in abuse.

The Treasury Department and the IRS believe that treating a consolidated group as a single member of a controlled group for purposes of allocating the group credit is consistent with the treatment of a consolidated group as a single taxpayer under a number of the consolidated return regulations. Therefore, these temporary regulations provide that, for purposes of allocating the group credit, a consolidated group whose members are members of a controlled group is treated as a single member of the controlled group. Accordingly, a consolidated group whose members are members of a controlled group is treated as a single member of the controlled group and a single stand-alone entity credit is computed for the consolidated group. If the consolidated group is the only member of the controlled group, the stand-alone entity credit computed for the consolidated group is equal to the group credit.

The portion of the group credit allocated to a consolidated group must be allocated among the members of the consolidated group. The Treasury Department and the IRS believe that the method of allocating among the members of the consolidated group the portion of the group credit allocated to the consolidated group should be no different than the method of allocating the group credit among members of the controlled group. Therefore, a stand-alone entity credit is computed for each member of the consolidated group, and the portion of the group credit allocated to the consolidated group is allocated among the members of the consolidated group in proportion to the stand-alone entity credits of the members of the consolidated group. One commentator argued that separately computing the stand-alone credit for each member of a consolidated group would be prohibitively burdensome. The Treasury Department and the IRS, however, do not believe that computing a stand-alone entity credit for each member of a consolidated group imposes a greater burden than computing a stand-alone entity credit for a corporation that is not a member of a consolidated group. Moreover, providing a rule for allocating the portion of the group credit allocated to a consolidated group among its members that is different than the method used for allocating the controlled group credit would create additional administrative complexity that seems unwarranted.

Alternative Incremental Research Credit

Section 41(c)(4) provides an election to determine the research credit using the AIRC computation. Section 41(c)(4)(B) provides that the election to use the AIRC applies to all succeeding taxable years unless revoked with the consent of the Secretary. Many issues have arisen regarding how the AIRC election is made in the case of a consolidated group and in the case of a controlled group, all members of which are not included on a single consolidated federal income tax return. These issues include: (1) How is an AIRC election made by members of a controlled group for purposes of computing the group credit under section 41(f)(1); (2) what happens when a controlled group has made an AIRC election and a member leaves the group or a member that has not made an AIRC election enters the group; (3) what happens if a member that has made an AIRC election joins a controlled group that has not made an AIRC election; and (4) when will a request to revoke an AIRC election be granted.

Generally, the Treasury Department and the IRS assume that taxpayers will elect to use the AIRC method if the AIRC method provides more credit than the regular method, or if a taxpayer does not have the books and records necessary to compute the base amount under the regular method. Once a taxpayer elects the AIRC method, the Treasury Department and the IRS believe that the AIRC method will continue to be the better method in the future as well, unless the taxpayer has a substantial change in its trade or business, such as the acquisition or disposition of an entire trade or business. If such a substantial change occurs, the Treasury Department and the IRS believe that it is appropriate to allow the taxpayer to revoke its AIRC election. The IRS has received many requests for consent to revoke AIRC elections from taxpayers in such situations. To reduce the burden on taxpayers, provide simplification, and ease administrative burden, the Treasury Department and the IRS have determined that it is appropriate to grant automatic consent to revoke an AIRC election on a prospective basis in situations in which a taxpayer makes the revocation on an original return. The Treasury Department and the IRS do not believe, however, that allowing an AIRC election or revocation on an amended return furthers the goal of simplification and ease of administration.

Therefore, these temporary regulations provide that a taxpayer that has made an AIRC election is deemed to

have requested and been granted consent to revoke the election if the taxpayer completes the portion of Form 6765, ''Credit for Increasing Research Activities,'' relating to the regular credit and attaches the completed form to the taxpayer's timely filed original return for the year to which the revocation applies. This provision is similar to the provisions in the existing regulations for making an AIRC election, which require the taxpayer to complete the portion of Form 6765 relating to the AIRC and attach the completed form to the taxpayer's timely filed original return for the year to which the election applies. Once an election/revocation is made for a taxable year, the taxpayer may not change the election/revocation on an amended return.

The temporary regulations provide special rules for controlled groups under section 41(f)(1) (in which one or more of the members do not join in filing a consolidated return). As discussed above, in this situation many questions have arisen regarding which members of a controlled group must make (or revoke) an AIRC election to have a valid election (or revocation) for the controlled group. Attempting to track elections across members of a controlled group, in which one or more of the members do not join in filing a consolidated return would create additional administrative complexity and increase the potential for controversy. Thus, to reduce the additional administrative complexity created by the additional computation, these temporary regulations provide that in the case of a controlled group, all the members of which are not included on a single consolidated return, the designated member must make (or revoke) an AIRC election on behalf of the members of the group. The election (or revocation) by the designated member is binding on all of the members of the group for the taxable year to which the election (or revocation) relates. The temporary regulations provide that the *designated member* is that member of the group that is allocated the greatest amount of the group credit. In the event the members of a group compute the group credit using different methods (either the regular method or the AIRC method) and at least two members of the group qualify as the *designated member,* the designated member is the member that computes the group credit using the method that yields the greater group credit. The Treasury Department and the IRS believe that these rules will simplify the election and revocation of the AIRC method. Furthermore, granting automatic consent to revoke an AIRC election also simplifies acquisitions and dispositions of members of controlled groups. For example, when a new member joins a group, the member must use the method used by the controlled group. In the taxable year after a member leaves a group, the member is free to use either method, assuming the member has not joined another controlled group. If all members of a controlled group are members of a single consolidated group, the AIRC election is made by the agent of the consolidated group, determined pursuant to the rules of § 1.1502–77.

Effective Date

The preamble to the 2003 proposed regulations stated that the Treasury Department and the IRS intended to make those regulations effective for taxable years beginning on or after the date that final regulations are published in the **Federal Register**. The preamble to the 2003 proposed regulations also addressed the limited application of final regulations to taxable years prior to that effective date to prevent abuse. Because the Treasury Department and the IRS have decided to retain the general rules for the computation and allocation of the group credit contained in the 2003 proposed regulations, with the modifications described above, these regulations are being issued in temporary form and will be effective for taxable years ending on or after May 24, 2005.

For taxable years prior to those covered by these temporary regulations, a taxpayer generally may use any reasonable method of computing and allocating the group credit. For the reasons set out in the preamble to the 2003 proposed regulations, the Treasury Department and the IRS believe that these temporary regulations should be retroactive in limited circumstances to prevent abuse. Accordingly, paragraph (b) of these temporary regulations, relating to the computation of the group credit, and paragraph (c) of these temporary regulations, relating to the allocation of the group credit, apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group are deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

Since the issuance of the 2003 proposed regulations, questions have arisen regarding what constitutes a reasonable method of allocating the group credit. Any allocation method used by a member of a controlled group that is consistent with either the 2000 proposed regulations, the 2003 proposed regulations, these temporary regulations, or subsequent final regulations will be accepted by the IRS as reasonable if the same allocation method was used by all members of the controlled group. In addition, for taxable years ending before December 29, 1999, any such method will be accepted by the IRS as reasonable regardless of the allocation method or methods used by other members of the controlled group and regardless of whether the members of the controlled group, in the aggregate, claimed more than 100 percent of the group credit. Although the reasonableness of any other allocation method may depend on the particular facts and circumstance of that taxpayer, in general, the IRS, solely for purposes of what constitutes a reasonable method of allocating the group credit for taxable years ending before December 29, 1999, will treat as reasonable a gross QREs method even if the members of the controlled group use inconsistent allocation methods to claim, in the aggregate, more than 100 percent of the group credit. Such treatment of a gross QREs method as reasonable for such years is for administrative convenience only.

Special Analyses

It has been determined that this Treasury Department decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. 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. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-reference notice of the proposed rulemaking published in the Proposed Rules section in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Nicole R. Cimino, Office of Associate Chief Counsel (Passthroughs and Special Industries).

However, personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 1.41–6T also issued under 26 U.S.C. 1502. * * *

■ **Par. 2.** In § 1.41–0, the table of contents is amended by removing the entries for § 1.41–6 and § 1.41–8 and adding entries for § 1.41–6T and § 1.41–8T to read as follows:

§ 1.41–0 Table of contents.

* * * * *

§ 1.41–6T Aggregation of expenditures (temporary).

(a) Controlled groups of corporations; trades or businesses under common control.
(1) In general.
(2) Consolidated groups.
(3) Definitions.
(b) Computation of the group credit.
(1) In general.
(2) Start-up companies.
(c) Allocation of the group credit.
(1) In general.
(2) Stand-alone entity credit.
(d) Special rules for consolidated groups.
(1) In general.
(2) Start-up company status.
(3) Special rule for allocation of group credit among consolidated group members.
(e) Examples.
(f) For taxable years beginning before January 1, 1990.
(g) Tax accounting periods used.
(1) In general.
(2) Special rule when timing of research is manipulated.
(h) Membership during taxable year in more than one group.
(i) Intra-group transactions.
(1) In general.
(2) In-house research expenses.
(3) Contract research expenses.
(4) Lease payments.
(5) Payment for supplies.
(j) Effective date.

* * * * *

§ 1.41–8T Special rules for taxable years ending on or after January 3, 2001 (temporary).

(a) Alternative incremental credit.
(b) Election.
(1) In general.
(2) Time and manner of election.
(3) Revocation.
(4) Special rules for controlled groups.
(5) Effective date.

§ 1.41–6 [Removed]

■ **Par. 3.** Section 1.41–6 is removed.

■ **Par. 4.** Section 1.41–6T is added to read as follows:

§ 1.41–6T Aggregation of expenditures (temporary).

(a) *Controlled group of corporations; trades or businesses under common control*—(1) *In general.* To determine the amount of research credit (if any) allowable to a trade or business that at the end of its taxable year is a member of a controlled group, a taxpayer must—

(i) Compute the group credit in the manner described in paragraph (b) of this section; and

(ii) Allocate the group credit among the members of the group in the manner described in paragraph (c) of this section.

(2) *Consolidated groups.* For special rules relating to consolidated groups, see paragraph (d) of this section.

(3) *Definitions.* For purposes of this section:

(i) *Trade or business.* A trade or business is a sole proprietorship, a partnership, a trust, an estate, or a corporation that is carrying on a trade or business (within the meaning of section 162). Any member of a commonly controlled group shall be deemed to be carrying on a trade or business if any other member of that group is carrying on any trade or business.

(ii) *Controlled group.* The terms *group* and *controlled group* mean a controlled group of corporations, as defined in section 41(f)(5), or a group of trades or businesses under common control. For rules for determining whether trades or businesses are under common control, see § 1.52–1 (b) through (g).

(iii) *Group credit.* The term *group credit* means the research credit (if any) allowable to a controlled group.

(iv) *Consolidated group.* The term *consolidated group* has the meaning set forth in § 1.1502–1(h).

(v) *Credit year.* The term *credit year* means the taxable year for which the member is computing the credit.

(b) *Computation of the group credit*—(1) *In general.* All members of a controlled group are treated as a single taxpayer for purposes of computing the research credit. The group credit is computed by applying all of the section 41 computational rules on an aggregate basis. All members of a controlled group must use the same method of computation, either the method described in section 41(a) or the alternative incremental research credit (AIRC) method described in section 41(c)(4), in computing the group credit for a credit year.

(2) *Start-up companies*—(i) *In general.* For purposes of computing the group credit, a controlled group is treated as a start-up company for purposes of section 41(c)(3)(B)(i) if—

(A) The first taxable year in which at least one member of the group had gross receipts and at least one member of the group had qualified research expenditures (QREs) begins after December 31, 1983; or

(B) There were fewer than 3 taxable years beginning after December 31, 1983, and before January 1, 1989, in which at least one member of the group had gross receipts and at least one member of the group had QREs.

(ii) *Example.* The following example illustrates the principles of paragraph (b)(2)(i) of this section:

Example. A, B, and C, all of which are calendar year taxpayers, are members of a controlled group. During the 1983 taxable year, A had QREs, but no gross receipts; B had gross receipts, but no QREs; and C had no QREs or gross receipts. The 1984 taxable year was the first taxable year for which each of A, B, and C had both QREs and gross receipts. Because the first taxable year for which each of A, B, and C had both QREs and gross receipts began after December 31, 1983, each of A, B, and C is a start-up company under section 41(c)(3)(B)(i) and each is a start-up company for purposes of computing the stand-alone entity credit. During the 1983 taxable year, at least one member of the group, A, had QREs and at least one member of the group, B, had gross receipts, thus, the group had both QREs and gross receipts in 1983. Therefore, the controlled group is not a start-up company because the first taxable year for which the group had both QREs and gross receipts did not begin after December 31, 1983.

(iii) *First taxable year after December 31, 1993, for which the controlled group had QREs.* In the case of a controlled group that is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section, for purposes of determining the group's fixed-base percentage under section 41(c)(3)(B)(ii), the first taxable year after December 31, 1993, for which the group has QREs is the first taxable year in which at least one member of the group has QREs.

(iv) *Example.* The following example illustrates the principles of paragraph (b)(2)(iii) of this section:

Example. D, E, and F, all of which are calendar year taxpayers, are members of a controlled group. The group is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section. The

first taxable year after December 31, 1993, for which D had QREs was 1994. The first taxable year after December 31, 1993, for which E had QREs was 1995. The first taxable year after December 31, 1993, for which F had QREs was 1996. Because the 1994 taxable year was the first taxable year after December 31, 1993, for which at least one member of the group, D, had QREs, for purposes of determining the group's fixed-based percentage under section 41(c)(3)(B)(ii), the 1994 taxable year was the first taxable year after December 31, 1993, for which the group had QREs.

(c) *Allocation of the group credit*—(1) *In general.* (i) To the extent the group credit (if any) computed under paragraph (b) of this section does not exceed the sum of the stand-alone entity credits of all of the members of a controlled group, computed under paragraph (c)(2) of this section, such group credit shall be allocated among the members of the controlled group in proportion to the stand-alone entity credits of the members of the controlled group, computed under paragraph (c)(2) of this section:

$$\text{group credit that does not exceed sum of all the members' stand-alone entity credits} \times \frac{\text{member's stand-alone entity credit}}{\text{sum of all the members' stand-alone entity credits.}}$$

(ii) To the extent that the group credit (if any) computed under paragraph (b) of this section exceeds the sum of the stand-alone entity credits of all of the members of the controlled group, computed under paragraph (c)(2) of this section, such excess shall be allocated among the members of a controlled group in proportion to the QREs of the members of the controlled group:

$$(\text{group credit} - \text{sum of all the members' stand-alone entity credits}) \times \frac{\text{member's QREs}}{\text{sum of all the member's QREs.}}$$

(2) *Stand-alone entity credit.* The term *stand-alone entity credit* means the research credit (if any) that would be allowable to a member of a controlled group if the credit were computed as if section 41(f)(1) did not apply, except that the member must apply the rules provided in paragraphs (d)(1) (relating to consolidated groups) and (i) (relating to intra-group transactions) of this section. Each member's stand-alone entity credit for any credit year must be computed under whichever method (the method described in section 41(a) or the method described in section 41(c)(4)) results in the greater stand-alone entity credit for that member, without regard to the method used to compute the group credit.

(d) *Special rules for consolidated groups*—(1) *In general.* For purposes of applying paragraph (c) of this section, a consolidated group whose members are members of a controlled group is treated as a single member of the controlled group and a single stand-alone entity credit is computed for the consolidated group.

(2) *Start-up company status.* A consolidated group's status as a start-up company and the first taxable year after December 31, 1993, for which a consolidated group has QREs are determined in accordance with the principles of paragraph (b)(2) of this section.

(3) *Special rule for allocation of group credit among consolidated group members.* The portion of the group credit that is allocated to a consolidated group is allocated to the members of the consolidated group in accordance with the principles of paragraph (c) of this section. However, for this purpose, the stand-alone entity credit of a member of a consolidated group is computed without regard to section 41(f)(1), but with regard to paragraph (i) of this section.

(e) *Examples.* The following examples illustrate the provisions of this section. Unless otherwise stated, no members of a controlled group are members of a consolidated group, and except as provided in *Example 6,* the group has not made an AIRC election:

Example 1. Group credit is less than sum of members' stand-alone entity credits—(i) *Facts.* A, B, and C, all of which are calendar-year taxpayers, are members of a controlled group. Neither A, B, nor C made any basic research payments for their taxable year ending December 31, 2004. For purposes of computing the group credit for the 2004 taxable year (the credit year), A, B, and C had the following:

	A	B	C	Group aggregate
Credit Year QREs	$200x	$20x	$110x	$330x
1984–1988 QREs	$40x	$10x	$100x	$150x
1984–1988 Gross Receipts	$1,000x	$350x	$150x	$1,500x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$300x	$1,700x

(ii) *Computation of the group credit*—(A) *In general.* The research credit allowable to the group is computed as if A, B, and C were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($330x) over the group's base amount ($170x). The group credit is 0.20 × ($330 − $170×), which equals $32x.

(B) *Group's base amount*—(1) *Computation.* The group's base amount equals the greater of: The group's fixed-base percentage (10 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($1,700x), or the group's minimum base amount ($165x). The group's base amount, therefore, is $170x, which is the greater of: 0.10 × $1,700x, which equals $170x, or $165x.

(2) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $330x, which equals $165x.

(3) *Group's fixed-base percentage.* The group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bear to

the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 10 percent, which is the lesser of: $150x/$1,500x, which equals 10 percent, or 16 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, each member's stand-alone entity credit must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for each of A, B, and C is greater using the method described in section 41(a). Therefore, the stand-alone entity credit for each of A, B, and C must be computed using the method described in section 41(a). A's stand-alone entity credit is $20x. B's stand-alone entity credit is $2x. C's stand-alone entity credit is $11x. The sum of the members' stand-alone entity credits is $33x. Because the group credit of $32x is less than the sum of the stand-alone entity credits of all the members of the group ($33x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The $32x group credit is allocated as follows:

	A	B	C	Total
Stand-Alone Entity Credit	$20x	$2x	$11x	$33x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/33	2/33	11/33	
Multiplied by: Group Credit	$32x	$32x	$32x	
Equals: Credit Allocated to Member	$19.39x	$1.94x	$10.67x	$32x

Example 2. Group credit exceeds sum of members' stand-alone entity credits—(i) *Facts.* D, E, F, and G, all of which are calendar-year taxpayers, are members of a controlled group. Neither D, E, F, nor G made any basic research payments for their taxable year ending December 31, 2004. For purposes of computing the group credit for the 2004 taxable year (the credit year), D, E, F, and G had the following:

	D	E	F	G	Group Aggregate
Credit Year Qualified Research Expenses (QREs)	$580x	$10x	$70x	$15x	$675x
1984–1988 QREs	$500x	$25x	$100x	$25	$650x
1984–1988 Gross Receipts	$4,000x	$5,000x	$2000x	$10,000x	$21,000x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$5,000x	$5,000x	$2,000x	$5,000x	$17,000x

(ii) *Computation of the group credit*—(A) *In general.* The research credit allowable to the group is computed as if D, E, F, and G were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($675x) over the group's base amount ($526.19x). The group credit is $0.20 \times (\$675x - \$526.19x)$, which equals $29.76x.

(B) *Group's base amount*—(1) *Computation.* The group's base amount equals the greater of: the group's fixed-base percentage (3.1 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($17,000x), or the group's minimum base amount ($337.50x). The group's base amount, therefore, is $526.19x, which is the greater of: $0.031 \times \$17,000x$, which equals $526.19x, or $337.50x.

(*2*) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is $0.50 \times \$675x$, which equals $337.50x.

(*3*) *Group's fixed-base percentage.* The group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bear to the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 3.10 percent, which is the lesser of: $650x/$21,000x, which equals 3.10 percent, or 16 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, each member's stand-alone entity credit must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credits for D ($19.46x) and F ($1.71x) are greater using the AIRC method. Therefore, the stand-alone entity credits for D and F must be computed using the AIRC method. The stand-alone entity credit for G ($0.50x) is greater using the method described in section 41(a). Therefore, the stand-alone entity credit for G must be computed using the method described in section 41(a). E's stand-alone entity credit computed under either method is zero. The sum of the members' stand-alone entity credits is $21.67x. Because the group credit of $29.76x is greater than the sum of the stand-alone entity credits of all the members of the group ($21.67), each member of the group is allocated an amount of the group credit equal to that member's stand-alone entity credit. The excess of the group credit over the sum of the members' stand alone entity credits ($8.09) is allocated among the members of the group based on the ratio that each member's QREs bear to the sum of the QREs of all the members of the group. The $29.76x group credit is allocated as follows:

	D	E	F	G	Total
Group Credit					$29.76×
Minus: Sum of Stand-Alone Entity Credits	$19.467x	$0.00x	$1.71x	$0.50x	$21.67x
Equals: Excess Group Credit					$8.09x
Excess Group Credit	8.09x	8.09x	8.09x	8.09x	
Multiplied By Allocation Ratio: QREs/Sum of QREs	580/675	10/675	70/675	15/675	
Excess Group Credit Allocated	$6.95x	$0.12x	$0.84x	$0.18x	
Plus: Stand-Alone Entity Credit	$19.46x	$0.00x	$1.71x	$0.50x	
Equals: Credit Allocated to Member	$26.41x	$0.12x	$2.55x	$0.68x	$29.76x

Example 3. Consolidated group within a controlled group—(i) *Facts.* The facts are the same as in *Example 2*, except that D and E file a consolidated return.

(ii) *Allocation of the group credit*—(A) *In general.* For purposes of allocating the controlled group's research credit of $29.76x among the members of the controlled group, D and E are treated as a single member of the controlled group.

(B) *Computation of stand-alone entity credits.* The stand-alone entity credit for the

consolidated group is computed by treating D and E as a single entity. Under paragraph (c)(2) of this section, the stand-alone entity credit for each member must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for each of the DE consolidated group ($17.55x) and F ($1.71x) is greater using the AIRC method. Therefore, the stand-alone entity credit for each of the DE consolidated group and F must be computed using the AIRC method. The stand-alone entity credit for G ($0.50x) is greater using the method described in section 41(a). Therefore, the stand-alone entity credit for G must be computed using the method described in section 41(a). The sum of the members' stand-alone entity credits is $19.76x.

(C) *Allocation of controlled group credit.* Because the group credit of $29.76x is greater than the sum of the stand-alone entity credits of all the members of the group ($19.76x), each member of the group is allocated an amount of the group credit equal to that member's stand-alone entity credit. The excess of the group credit over the sum of the members' stand alone entity credits ($10.00x) is allocated among the members of the group based on the ratio that each member's QREs bear to the sum of the QREs of all the members of the group. The group credit of $29.76x is allocated as follows:

	DE	F	G	Total
Group Credit				$29.76x
Minus: Sum of Stand-Alone Entity Credits	$17.55x	$1.71x	$0.50x	$19.76x
Equals: Excess Group Credit				$10.00x
Excess Group Credit	10.00x	10.00x	10.00x	
Multiplied By Allocation Ratio: QREs/Sum of QREs	590/675	70/675	15/675	
Excess Group Credit Allocated	$8.74x	$1.04x	$0.22x	
Plus: Stand-Alone Entity Credit	$17.55x	$1.71x	$0.50x	
Equals: Credit Allocated to Member	$26.29x	$2.75x	$0.72x	$29.76x

(iii) *Allocation of the group credit allocated to consolidated group*—(A) *In general.* The group credit that is allocated to a consolidated group is allocated among the members of the consolidated group in accordance with the principles of paragraph (c) of this section.

(B) *Computation of stand-alone entity credits.* Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the consolidated group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for D ($19.46x) is greater using the AIRC method. Therefore, the stand-alone entity credit for D must be computed using the AIRC method. The stand-alone entity credit for E is zero under either method. The sum of the stand-alone entity credits of the members of the consolidated group is $19.46x.

(C) *Allocation among members of consolidated group.* Because the amount of the group credit allocated to the consolidated group ($26.29x) is greater than $19.46x, the sum of the stand-alone entity credits of all the members of the consolidated group, the amount of the group credit allocated to the consolidated group is allocated to each member of the consolidated group in an amount equal to the member's stand-alone entity credit. The excess of the group credit allocated to the consolidated group over the sum of the consolidated group members' stand alone entity credits ($6.83x) is allocated among the members of the consolidated group based on the ratio that each member's QREs bear to the sum of the QREs of all the members of the consolidated group. The group credit of $26.29x allocated to the DE consolidated group is allocated between D and E as follows:

	D	E	Total
Group Credit			$26.29x
Minus: Sum of Stand-Alone Entity Credits	$19.46x	$0.00x	$19.46x
Excess Group Credit			$6.83x
Excess Group Credit	6.83x	6.83x	
Multiplied By Allocation Ratio: QREs/Sum of QREs	580/590	10/590	
Excess Group Credit Allocated	$6.71x	$0.12x	
Plus: Stand-Alone Entity Credit	$19.46x	$0.00x	
Equals: Credit Allocated to Member	$26.17x	$0.12x	$26.29x

Example 4. Member is a start-up company—(i) *Facts.* H, I, and J, all of which are calendar-year taxpayers, are members of a controlled group. The first taxable year for which J has both QREs and gross receipts begins after December 31, 1983, therefore, J is a start-up company under section 41(c)(3)(B)(i). The first taxable year for which H and I had both QREs and gross receipts began before December 31, 1983, therefore, H and I are not start-up companies under section 41(c)(3)(B)(i). Neither H, I, nor J made any basic research payments during the 2004 taxable year. For purposes of computing the group credit for the 2004 taxable year (the credit year), H, I, and J had the following:

	H	I	J	Group Aggregate
Credit Year QREs	$200x	$20x	$50x	$270x
1984–1988 QREs	$55x	$15x	$0x	$70x
1984–1988 Gross Receipts	$1,000x	$400x	$0x	$1,400x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$0x	$1,400x

(ii) *Computation of the group credit*—(A) *In general.* The research credit allowable to the group is computed as if H, I, and J were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($270x) over the group's base amount ($135x). The group credit is 0.20 × ($270x − $135x), which equals $27x.

(B) *Group's base amount*—(*1*) *Computation.* The group's base amount equals the greater of: The group's fixed-base percentage (5 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($1,400x), or the group's minimum base amount ($135x). The group's base amount, therefore, is $135x, which is

the greater of: 0.05 x $1,400x, which equals $70x, or $135x.

(*2*) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 x $270x, which equals $135x.

(*3*) *Group's fixed-base percentage.* Because the first taxable year in which at least one member of the group has QREs and at least one member of the group has gross receipts does not begin after December 31, 1983, the group is not a start-up company. Therefore, the group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bear to the group's aggregate gross receipts for the same period, or 16 percent (the statutory maximum). The group's fixed-base percentage, therefore, is 5 percent, which is the lesser of: $70x/$1,400x, which equals 5 percent, or 16 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credits for H ($20x), I ($2x), and J ($5x) are greater using the method described in section 41(a). Therefore, the stand-alone entity credits for each of H, I, and J must be computed using the method described in section 41(a). The sum of the stand-alone entity credits of the members of the group is $27x. Because the group credit of $27x is equal to the sum of the stand-alone entity credits of all the members of the group ($27x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The group credit of $27x is allocated as follows:

	H	I	J	Total
Stand-Alone Entity Credit	$20x	$2x	$5x	$27x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/27	2/27	5/27	
Multiplied by: Group Credit	$27x	$27x	$27x	
Equals: Credit Allocated to Member	$20x	$2x	$5x	$27x

Example 5. Group is a start-up company—(i) *Facts.* K, L, and M, all of which are calendar-year taxpayers, are members of a controlled group. The taxable year ending on December 31, 1999, is the first taxable year in which each of K, L, and M had both QREs and gross receipts. Therefore, the taxable year ending on December 31, 1999, is the first taxable year in which at least one member of the group had QREs and at least one member of the group had gross receipts. The 2004 taxable year is the fifth taxable year beginning after December 31, 1993, for which at least one member of the group had QREs. Neither K, L, nor M made any basic research payments during the 2004 taxable year. For purposes of computing the group credit for the 2004 taxable year (the credit year), K, L, and M had the following:

	K	L	M	Group Aggregate
Credit Year QREs	$255x	$25x	$100x	$380x
1984–1988 QREs	$0x	$0x	$0x	$0x
1984–1988 Gross Receipts	$0x	$0x	$0x	$0x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,600x	$340x	$300x	$2,240x

(ii) *Computation of the group credit*—(A) *In general.* The research credit allowable to the group is computed as if K, L, and M were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($380x) over the group's base amount ($190x). The group credit is 0.20 × ($380x − $190x), which equals $38x.

(B) *Group's base amount*—(*1*) *Computation.* The group's base amount equals the greater of: the group's fixed-base percentage (3 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($2,240x), or the group's minimum base amount ($190x). The group's base amount, therefore, is $190x, which is the greater of: 0.03 ''$2,240x, which equals $67.20x, or $190x.

(*2*) *Group's minimum base amount.* The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 '' $380x, which equals $190x.

(*3*) *Group's fixed-base percentage.* Because the first taxable year in which at least one member of the group has QREs and at least one member of the group has gross receipts begins after December 31, 1983, the group is treated as a start-up company under section 41(c)(3)(B)(i) and paragraph (b)(2)(i) of this section. Because the 2004 taxable year is the fifth taxable year beginning after December 31, 1993, for which at least one member of the group had QREs, under section 41(c)(3)(B)(ii)(I), the group's fixed-base percentage is 3 percent.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the consolidated group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for each of K ($25.5x), L ($2.5x), and M ($10x) is greater using the method described in section 41(a). Therefore the stand-alone entity credits for each of K, L, and M must be computed using the method described in section 41(a). The sum of the stand-alone entity credits of all the members of the group is $38x. Because the group credit of $38x is equal to sum of the stand-alone entity credits of all the members of the group ($38x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The $38x group credit is allocated as follows:

	K	L	M	Total
Stand-Alone Entity Credit	$25.5x	$2.5x	$10x	$38x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	25.5/38	2.5/38	10/38	
Multiplied by: Group Credit	$38x	$38x	$38x	
Equals: Credit Allocated to Member	$25.5x	$2.5x	$10x	$38x

Example 6. Group alternative incremental research credit—(i) *Facts.* N, O, and P, all of which are calendar-year taxpayers, are members of a controlled group. The research credit under section 41(a) is not allowable to the group for the 2004 taxable year because

the group's aggregate QREs for the 2004 taxable year are less than the group's base amount. The group credit is computed using the AIRC rules of section 41(c)(4). For purposes of computing the group credit for the 2004 taxable year (the credit year), N, O, and P had the following:

	N	O	P	Group aggregate
Credit Year QREs	$0x	$20x	$110x	$130x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$300x	$1,700x

(ii) *Computation of the group credit.* The research credit allowable to the group is computed as if N, O, and P were one taxpayer. The group credit is equal to the sum of: 2.65 percent of so much of the group's aggregate QREs for the taxable year as exceeds 1 percent of the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year, but does not exceed 1.5 percent of such average; 3.2 percent of so much of the group's aggregate QREs as exceeds 1.5 percent of such average but does not exceed 2 percent of such average; and 3.75 percent of so much of such QREs as exceeds 2 percent of such average. The group credit is [0.0265 − [($1,700x x 0.015) − ($1,700x x 0.01)]] + [0.032 − [($1,700x x 0.02)—($1,700x x 0.015)]] + [0.0375 − [$130x − ($1,700x − 0.02)]], which equals $4.10x.

(iii) *Allocation of the group credit.* Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the group must be computed using the method that results in the greater stand-alone entity credit for that member. The stand-alone entity credit for N is zero under either method. The stand-alone entity credit for each of O ($0.66x) and P ($3.99x) is greater using the AIRC method. Therefore, the stand-alone entity credits for each of O and P must be computed using the AIRC method. The sum of the stand-alone entity credits of the members of the group is $4.65x. Because the group credit of $4.10x is less than the sum of the stand-alone entity credits of all the members of the group ($4.65x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The $4.10x group credit is allocated as follows:

	N	O	P	Total
Stand-Alone Entity Credit	$0.00x	$0.66x	$3.99x	$4.65x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	0/4.65	0.66/4.65	3.99/4.65	
Multiplied by: Group Credit	$4.10x	$4.10x	$4.10x	
Equals: Credit Allocated to Member	$0.00x	$0.58x	$3.52x	$4.10x

(f) *For taxable years beginning before January 1, 1990.* For taxable years beginning before January 1, 1990, see § 1.41–6 as contained in 26 CFR part 1, revised April 1, 2005.

(g) *Tax accounting periods used*—(1) *In general.* The credit allowable to a member of a controlled group is that member's share of the group credit computed as of the end of that member's taxable year. In computing the group credit for a group whose members have different taxable years, a member generally should treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. For example, Q, R, and S are members of a controlled group of corporations. Both Q and R are calendar year taxpayers. S files a return using a fiscal year ending June 30. For purposes of computing the group credit at the end of Q's and R's taxable year on December 31, S's fiscal year ending June 30, which ends within Q's and R's taxable year, is treated as S's credit year.

(2) *Special rule when timing of research is manipulated.* If the timing of research by members using different tax accounting periods is manipulated to generate a credit in excess of the amount that would be allowable if all members of the group used the same tax accounting period, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return may require each member of the group to calculate the credit in the current taxable year and all future years as if all members of the group had the same taxable year and base period as the computing member.

(h) *Membership during taxable year in more than one group.* A trade or business may be a member of only one group for a taxable year. If, without application of this paragraph, a business would be a member of more than one group at the end of its taxable year, the business shall be treated as a member of the group in which it was included for its preceding taxable year. If the business was not included for its preceding taxable year in any group in which it could be included as of the end of its taxable year, the business shall designate in its timely filed (including extensions) return the group in which it is being included. If the return for a taxable year is due before July 1, 1983, the business may designate its group membership through an amended return for that year filed on or before June 30, 1983. If the business does not so designate, then the appropriate Internal Revenue Service official in the operating division that has examination jurisdiction of the return will determine the group in which the business is to be included.

(i) *Intra-group transactions*—(1) *In general.* Because all members of a group under common control are treated as a single taxpayer for purposes of determining the research credit, transfers between members of the group are generally disregarded.

(2) *In-house research expenses.* If one member of a group performs qualified research on behalf of another member, the member performing the research shall include in its QREs any in-house research expenses for that work and shall not treat any amount received or accrued as funding the research. Conversely, the member for whom the research is performed shall not treat any part of any amount paid or incurred as a contract research expense. For purposes of determining whether the in-house research for that work is qualified research, the member performing the research shall be treated as carrying on any trade or business carried on by the member on whose behalf the research is performed.

(3) *Contract research expenses.* If a member of a group pays or incurs contract research expenses to a person outside the group in carrying on the member's trade or business, that member shall include those expenses as QREs. However, if the expenses are not

paid or incurred in carrying on any trade or business of that member, those expenses may be taken into account as contract research expenses by another member of the group provided that the other member—

(i) Reimburses the member paying or incurring the expenses; and

(ii) Carries on a trade or business to which the research relates.

(4) *Lease payments.* The amount paid or incurred to another member of the group for the lease of personal property owned by a member of the group is not taken into account for purposes of section 41. Amounts paid or incurred to another member of the group for the lease of personal property owned by a person outside the group shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member; or

(ii) The amount of the lease expenses paid to the person outside the group.

(5) *Payment for supplies.* Amounts paid or incurred to another member of the group for supplies shall be taken into account as in-house research expenses for purposes of section 41 only to the extent of the lesser of—

(i) The amount paid or incurred to the other member; or

(ii) The amount of the other member's basis in the supplies.

(j) *Effective date.* These temporary regulations are applicable for taxable years ending on or after May 24, 2005. Generally, a taxpayer may use any reasonable method of computing and allocating the credit for taxable years beginning before the date these regulations are published in the **Federal Register** as final regulations. However, paragraph (b), relating to the computation of the group credit, and paragraph (c), relating to the allocation of the group credit, will apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

§ 1.41–8 [Removed]

■ **Par. 5.** Section 1.41–8 is removed.

■ **Par. 6.** Section 1.41–8T is added to read as follows:

§ 1.41–8T Special rules for taxable years ending on or after January 3, 2001 (temporary).

(a) *Alternative incremental credit.* At the election of the taxpayer, the credit determined under section 41(a)(1) equals the amount determined under section 41(c)(4).

(b) *Election*—(1) *In general.* A taxpayer may elect to apply the provisions of the alternative incremental research credit (AIRC) in section 41(c)(4) for any taxable year of the taxpayer beginning after June 30, 1996. If a taxpayer makes an election under section 41(c)(4), the election applies to the taxable year for which made and all subsequent taxable years unless revoked in the manner prescribed in paragraph (b)(3) of this section.

(2) *Time and manner of election.* An election under section 41(c)(4) is made by completing the portion of Form 6765, ''Credit for Increasing Research Activities,'' relating to the election of the AIRC, and attaching the completed form to the taxpayer's timely filed (including extensions) original return for the taxable year to which the election applies. An election under section 41(c)(4) may not be made on an amended return.

(3) *Revocation.* An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer is deemed to have requested, and to have been granted, the consent of the Commissioner to revoke an election under section 41(c)(4) if the taxpayer completes the portion of Form 6765 relating to the regular credit and attaches the completed form to the taxpayer's timely filed (including extensions) original return for the year to which the revocation applies. An election under section 41(c)(4) may not be revoked on an amended return.

(4) *Special rules for controlled groups*—(i) *In general.* In the case of a controlled group of corporations, all the members of which are not included on a single consolidated return, the designated member must make (or revoke) an election under section 41(c)(4) on behalf of the members of the group. An election (or revocation) by the designated member under this paragraph (b)(4) of this section shall be binding on all the members of the group for the credit year to which the election (or revocation) relates.

(ii) *Designated member.* For purposes of this paragraph (b)(4) of this section, for any credit year, the term *designated member* means that member of the group that is allocated the greatest amount of the group credit under paragraph (c) of § 1.41–6T. If the members of a group compute the group credit using different methods (either the method described in section 41(a) or the AIRC method of section 41(c)(4)) and at least two members of the group qualify as the designated member, then the term *designated member* means that member that computes the group credit using the method that yields the greater group credit. For example, A, B, C, and D are members of a controlled group but are not members of a consolidated group. For the 2005 taxable year, the group credit using the method described in section 41(a) is $10x. Under this method, A would be allocated $5x of the group credit, which would be the largest share of the group credit under this method. For the 2005 taxable year, the group credit using the AIRC method is $15x. Under the AIRC method, C would be allocated $5x of the group credit, which is the largest share of the group credit computed using the AIRC method. Because the group credit is greater using the AIRC method and C is allocated the greatest amount of credit under that method, C is the designated member. Therefore, C's section 41(c)(4) election is binding on all the members of the group for the 2005 taxable year.

(5) *Effective date.* These temporary regulations are applicable for taxable years ending on or after May 24, 2005.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

Approved: May 16, 2005.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury.

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DEPARTMENT OF JUSTICE

28 CFR Part 75

[Docket No. CRM 103; AG Order No. 2765–2005]

RIN 1105–AB05

Inspection of Records Relating to Depiction of Sexually Explicit Performances

AGENCY: Department of Justice

ACTION: Final rule.

SUMMARY: This rule amends the record-keeping and inspection requirements of 28 CFR part 75 to bring the regulations up to date with current law, to improve understanding of the regulatory system, and to make the inspection process effective for the purposes set by Congress in enacting the Child Protection and Obscenity Enforcement