



Treasury Decisions
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DEPARTMENT OF THE TREASURY
Internal Revenue Service

26 CFR Parts 1 and 602

54 FR 21203

Credit for Increasing Research Activity

T.D. 8251

DATE: May 17, 1989

ACTION: Final regulations.

SUMMARY: This document contains final amendments to the income tax regulations to provide rules for the credit for increasing research activities. The research credit was added to the law by the Economic Recovery Tax Act of 1981. The research credit was subsequently amended by the Tax Reform Act of 1984, the Tax Reform Act of 1986, and the Technical and Miscellaneous Revenue Act of 1988. The regulations provide the public with guidance needed to comply with the applicable tax law.

DATES:

EFFECTIVE DATE: These regulations are effective for amounts paid or incurred after June 30, 1981, and before January 1, 1990.

ADDRESSES:

FOR FURTHER INFORMATION CONTACT: David S. Hudson, 202-566-4821 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On January 21, 1983, the Federal Register published (48 FR 2790) proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to the credit for increasing research activities. A large number of comments were received and a public hearing was held on April 14, 1983. The credit for increasing research activities was originally provided by section 44F of the Internal Revenue Code, as added by section 221 of the Economic Recovery Tax Act of 1981. Section 471(c) of the Tax Reform Act of 1984 redesignated section 44F as section 30. The Tax Reform Act of 1984 did not amend the research credit provisions substantively. Section 231 of the Tax Reform Act of 1986 redesignated section 30 as section 41. The Tax Reform Act of 1986 extended the credit to amounts paid or incurred before January 1, 1989; amended the definition of qualified research for taxable years beginning after December 31, 1985; provided a separate credit with respect to certain payments to qualified organizations for basic research; and amended the credit provisions in certain other aspects. The Technical and Miscellaneous Revenue Act of 1988 extended the credit to amounts paid or incurred before January 1, 1990.

The regulations provided in this document are promulgated under section 41 for conformity purposes. Where the law has changed the regulations contain separate provisions with their own effective dates. In general, those portions of the regulations relating to the Tax Reform Act of 1986 have been reserved.

Explanation of Provisions

Joint Ventures

Section 41 (b) (1) defines the term "qualified research expenses" as the sum of the taxpayer's in-house research expenses and the taxpayer's contract research expenses, that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer. If the taxpayer is not carrying on the trade or business for section 162 purposes to which the research relates, then the taxpayer is not entitled to the research credit for such expenditures. In the case of partnerships the carrying on a trade or business requirement must be satisfied at the partnership level without regard to the trade or business of any partner.

Section 1.44F-2(a)(4)(ii) of the proposed regulations provided an exception to the carrying on a trade or business requirement at the partnership level in the case of certain joint ventures if all the partners are entitled to the results of the research and the following is true with respect to each partner: If the partner had carried on the research that was in fact carried on by the partnership, all the research expense paid or incurred in carrying on the research would have been paid or incurred by the partner in carrying on a trade or business of the partner. Several commentators suggested that the regulations should not require each member of the joint venture to satisfy the "carrying on" test for the particular research being performed by the joint venture. They suggested that the regulations be modified to deny the credit only to those joint venturers who do not satisfy the "carrying on" test. Section 1.41-2(a)(4)(ii) of the final regulations removes the requirement that all partners must satisfy the "carrying on" test. However, to ensure that the removal of that requirement does not lead to abuse, the final regulations add certain limitations similar to those in section 168(h)(6) relating to tax-exempt use property.

Funded Research

Section 41(d)(4)(H) provides that the term qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity). Section 1.44F-4(d)(1) of the proposed regulations provided that amounts paid under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research are not treated as funding. Section 1.44F-4(d)(2) of the proposed regulations provided that, if a taxpayer performing research for another person retains no substantial rights in the research under the agreement providing for the research, the research is treated as fully funded, and none of the expenses paid or incurred by the taxpayer in performing the research is treated as paid or incurred for qualified research. One commentator stated that, in a case where the researcher does not retain substantial rights in the results of the research and the funder's payments are contingent on the success of the research, neither the researcher nor the funder is entitled to treat any of the expenditures as paid or incurred for qualified research. The commentator's reading of the interaction of the contingent payment and the substantial rights rules is the correct reading of the two provisions. The proposed regulations are finalized as proposed on this matter. Section 1.44F-4(d)(4) of the proposed regulations provided that independent research and development payments under certain government contracts are treated as funding the research to which the payments relate. Several commentators suggested that such payments are analogous to the recovery of overhead costs through the sale of products. The final regulations provide that such payments are not to be treated as funding except where they are properly severable from the underlying contract.

Definition of Research and Experimental Expenditures

Section 41(d)(1) provides, in part, that the term "qualified research" means research with respect to which expenditures may be treated as expenses under section 174. Section 1.174-2 of the proposed regulations that was originally proposed on January 21, 1983, included extensive clarifications of the regulations under section 174, including a clarification of the treatment of computer software.

This portion of the proposed regulations is not being finalized by this document. The proposed amendments to § 1.174-2 have been revised and superseded by a separate notice of proposed rulemaking.

Special Analyses

The amendment of the regulations proposed by notice of proposed rulemaking on January 21, 1983, and adopted by this Treasury decision is interpretative. Accordingly, the Regulatory Flexibility Act (5 U.S.C. chapter 6) did not apply to the notice of proposed rulemaking and no Regulatory Flexibility Analysis was required. The Commissioner of Internal Revenue has determined that this rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required.

Drafting Information

The principal author of these proposed regulations is David R. Haglund of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, personnel from other offices of the Internal Revenue Service and the Treasury Department participated in their development.

List of Subjects

26 CFR 1.0-1 through 1.58-8

Income taxes, Tax liability, Credits.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

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

PART 602 -- [AMENDED]

Paragraph 1. The authority for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 2. In the table of control numbers in § 602.101, the language "§ 1.41-4 (b) and (c)...1541-0074" is removed and the language "§ 1.41-4A (b) and (c)...1545-0074" is added in its place.

PART 1 -- INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Par. 3. The authority for Part 1 continues to read in part:

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

§§ 1.41-0A through 1.41-8A [Redesignated from 1.41-0 through 1.41-8 Respectively]

Par. 4. Sections 1.41-0 through 1.41-8 are redesignated §§ 1.41-0A through 1.41-8A, respectively, and the following center heading is added to precede § 1.41-0A: "Taxable Years Beginning Before January 1, 1987".

§ 1.41-0A [Amended]

Par. 5. In § 1.41-0A as redesignated, the language "1.41-1 through -8" is removed and the language "1.41-1A through -8A" is added in its place.

§ 1.41-1A [Amended]

Par. 6. In § 1.41-1A(a) as redesignated, the language "§ 1.41-3(a)" is removed and the language "§ 1.41-3A(a)" is added in its place.

§ 1.218-0 [Amended]

Par. 7. In § 1.218-0, the language "1.41-0 through 1.41-8" is removed and the language "1.41-0A through 1.41-8A" is added in its place.

Par. 8. The following new center heading and §§ 1.41-0 through 1.41-9 are added in the appropriate places.

Taxable Years Beginning After December 31, 1986

§ 1.41-0 Table of contents.

This section lists the paragraphs contained in sections 1.41-0 through 1.41-9.

§ 1.41-0 Table of Contents.

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 - (c) Qualified services.
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- § 1.41-3 Base period research expense
- (a) Number of years in base period.
 - (b) New taxpayers.
 - (c) Definition of base period research expenses.
 - (d) Special rules for short taxable years.
 - (1) Short determination year.
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(3) Years overlapping the effective dates of section 41 (section 44F).

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(e) Examples.

§ 1.41-4 Qualified research for taxable years beginning after December 31, 1985. [Reserved]

§ 1.41-5 Qualified research for taxable years beginning before January 1, 1986

(a) General rule.

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(iii) Project-by-project determination.

(4) Independent research and development under the Federal Acquisition Regulations System and similar provisions.

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§ 1.41-6 Basic research for taxable years beginning after December 31, 1985. [Reserved]

§ 1.41-7 Basic research for taxable years beginning before January 1, 1986

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(2) Agreement between a corporation and a qualified organization after June 30, 1983.

(i) In general.

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(3) Agreement between a qualified fund and a qualified educational organization after June 30, 1983.

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- (f) Procedure for making an election to be treated as a qualified fund.

§ 1.41-8 Aggregation of expenditures.

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- (1) In general.
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§ 1.41-9 Special rules.

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- (1) Corporation making an election under subchapter S.
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 - (ii) Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.
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- (i) In general.
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- (c) Special rule for pass-through of credit.
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§ 1.41-1 Introduction to regulations under section 41.

Sections 1.41-2 through 1.41-9 deal only with certain provisions of section 41. The following table identifies the provisions of section 41 that are dealt with, and lists each with the section of the regulations in which it is covered:

Section of the regulations	Section of the Code
§ 1.41-2	41(b)(1) 41(b)(2)(A)(ii) 41(b)(2)(A)(iii) 41(b)(2)(B) 41(b)(3)
§ 1.41-3	41(c)(2) 41(f)(4)
§ 1.41-5	41(d)
§ 1.41-7	41(e)
§ 1.41-8	41(f)(1)
§ 1.41-9	41(f)(2) 41(f)(3) 41(g)

Sections 1.41-4 and 1.41-6 deal with the definition of qualified research and basic research for taxable years beginning after December 31, 1985. Section 1.41-3 also deals with the special rule in section 221(d)(2) of the Economic Recovery Tax Act of 1981 relating to taxable years overlapping the effective dates of section 41. Section 41 was formerly designated sections 30 and 44F. The regulations refer to these sections as section 41 for conformity purposes. Of course, whether section 41, 30 or 44F applies to a particular expenditure depends upon when the expenditure was paid or incurred.

§ 1.41-2 Qualified Research Expenses.

(a) *Trade or business requirement* -- (1) *In general.* An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase "in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

(2) *New business.* Expenses paid or incurred prior to commencing a new business (as distinguished from expanding an existing business) may be paid or incurred in connection with a trade or business but are not paid or incurred in carrying on a trade or business. Thus, research expenses paid or incurred by a taxpayer in developing a product the sale of which would constitute a new trade or business for the taxpayer are not paid or incurred in carrying on a trade or business.

(3) *Research performed for others* -- (i) *Taxpayer not entitled to results.* If the taxpayer performs research on behalf of another person and retains no substantial rights in the research, that research shall not be taken into account by the taxpayer for purposes of section 41. See § 1.41-5(d)(2).

(ii) *Taxpayer entitled to results.* If the taxpayer in carrying on a trade or business performs research on behalf of other persons but retains substantial rights in the research, the taxpayer shall take otherwise qualified expenses for that research into account for purposes of section 41 to the extent provided in § 1.41-5(d)(3).

(4) *Partnerships* -- (i) *In general.* An in-house research expense or a contract research expense paid or incurred by a partnership is a qualified research expense of the partnership if the expense is paid or incurred by the partnership in carrying on a trade or business of the partnership, determined at the partnership level without regard to the trade or business of any partner.

(ii) *Special rule for certain partnerships and joint ventures.* (A) If a partnership or a joint venture (taxable as a partnership) is not carrying on the trade or business to which the research relates, then the general rule in paragraph (a)(4)(i) of this section would not allow any of such expenditures to qualify as qualified research expenses.

(B) Notwithstanding paragraph (a)(4)(ii)(A) of this section, if all the partners or venturers are entitled to make independent use of the results of the research, this paragraph (a)(4)(ii) may allow a portion of such expenditures to be treated as qualified research expenditures by certain partners or venturers.

(C) First, in order to determine the amount of credit that may be claimed by certain partners or venturers, the amount of qualified research expenditures of the partnership or joint venture is determined (assuming for this purpose that the partnership or joint venture is carrying on the trade or business to which the research relates).

(D) Second, this amount is reduced by the proportionate share of such expenses allocable to those partners or venturers who would not be able to claim such expenses as qualified research expenditures if they had paid or incurred such expenses directly. For this purpose such partners' or venturers' proportionate share of such expenses shall be determined on the basis of such partners' or venturers' share of partnership items of income or gain (excluding gain allocated under section 704(c)) which results in the largest proportionate share. Where a partner's or venturer's share of partnership items of income or gain (excluding gain allocated under section 704(c)) may vary during the period such partner or venturer is a partner or venturer in such partnership or joint venture, such share shall be the highest share such partner or venturer may receive.

(E) Third, the remaining amount of qualified research expenses is allocated among those partners or venturers who would have been entitled to claim a credit for such expenses if they had paid or incurred the research expenses in their own trade or business, in the relative proportions that such partners or venturers share deductions for expenses under section 174 for the taxable year that such expenses are paid or incurred.

(F) For purposes of section 41, research expenditures to which this paragraph (a)(4)(ii) applies shall be treated as paid or incurred directly by such partners or venturers. See § 1.41-9(a)(3)(ii) for special rules regarding these expenses.

(iii) The following examples illustrate the application of the principles contained in paragraph (a)(4)(ii) of this section.

Example (1). A joint venture (taxable as a partnership) is formed by corporations A, B, and C to develop and market a supercomputer. A and B are in the business of developing computers, and each has a 30 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. C, which is an investment banking firm, has a 40 percent distributive share of each item of income, gain, loss, deduction, credit and basis of the joint venture. The joint venture agreement provides that A's, B's and C's distributive shares will not vary during the life of the joint venture, liquidation proceeds are to be distributed in accordance with the partners' capital account balances, and any partner with a deficit in its capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the joint venture. Assume in Year 1 that the joint venture incurs \$100x of "qualified research expenses." Assume further that the joint venture cannot claim the research credit for such expenses because it is not carrying on the trade or business to which the research relates. In addition A, B, and C are all entitled to make independent use of the results of the research. First, the amount of qualified research expenses of the joint venture is 100x. Second, this amount is reduced by the proportionate share of such expenses allocable to C, the venturer which would not have been able to claim such expenses as qualified research expenditures if it had paid or incurred them directly, C's proportionate share of such expenses is \$40x (40% of \$100x). The reduced amount is \$60x. Third, the remaining \$60x of qualified research expenses is allocated between A and B in the relative proportions that A and B share deductions for expenses under section 174. A is entitled to treat \$30x ($(30\% / (30\% + 30\%)) \$60x$) as a qualified research expense. B is also entitled to treat \$30x ($(30\% / (30\% + 30\%)) \$60x$) as a qualified research expense.

Example (2). Assume the same facts as in example (1) except that the joint venture agreement provides that during the first 2 years of the joint venture, A and B are each allocated 10 percent of each item of income, gain, loss, deduction, credit and basis, and C is allocated 80 percent of each item of income, gain, loss, deduction, credit and basis. Thereafter the allocations are the same as in example (1). Assume for purposes of this example that such allocations have substantial economic effect for purposes of section 704 (b). C's highest share of such items during the life of the joint venture is 80 percent. Therefore C's proportionate share of the joint venture's qualified research expenses is \$80x (80% of \$100x). The reduced amount of qualified research expenses is \$20x ($\$100x - \$80x$). A is entitled to treat \$10x ($(10\% / (10\% + 10\%)) \$20x$) as a qualified research expense in Year 1. B is also entitled to treat \$10x ($(10\% / (10\% + 10\%)) \$20x$) as a qualified research expense in Year 1.

(b) *Supplies and personal property used in the conduct of qualified research -- (1) In general.* Supplies and personal property (except to the extent provided in paragraph (b)(4) of this section) are used in the conduct of qualified research if they are used in the performance of qualified services (as defined in section 41(b)(2)(B)), but without regard to

the last sentence thereof) by an employee of the taxpayer (or by a person acting in a capacity similar to that of an employee of the taxpayer; see example (6) of § 1.41-2(e)(5)). Expenditures for supplies or for the use of personal property that are indirect research expenditures or general and administrative expenses do not qualify as inhouse research expenses.

(2) *Certain utility charges -- (i) In general.* In general, amounts paid or incurred for utilities such as water, electricity, and natural gas used in the building in which qualified research is performed are treated as expenditures for general and administrative expenses.

(ii) *Extraordinary expenditures.* To the extent the taxpayer can establish that the special character of the qualified research required additional extraordinary expenditures for utilities, the additional expenditures shall be treated as amounts paid or incurred for supplies used in the conduct of qualified research. For example, amounts paid for electricity used for general laboratory lighting are treated as general and administrative expenses, but amounts paid for electricity used in operating high energy equipment for qualified research (such as laser or nuclear research) may be treated as expenditures for supplies used in the conduct of qualified research to the extent the taxpayer can establish that the special character of the research required an extraordinary additional expenditure for electricity.

(3) *Right to use personal property.* The determination of whether an amount is paid to or incurred for another person for the right to use personal property in the conduct of qualified research shall be made without regard to the characterization of the transaction as a lease under section 168(f)(8) (as that section read before it was repealed by the Tax Reform Act of 1986). See § 5c.168(f)(8)-1(b).

(4) *Use of personal property in taxable years beginning after December 31, 1985.* For taxable years beginning after December 31, 1985, amounts paid or incurred for the use of personal property are not qualified research expenses, except for any amount paid or incurred to another person for the right to use (time-sharing) computers in the conduct of qualified research. The computer must be owned and operated by someone other than the taxpayer, located off the taxpayer's premises, and the taxpayer must not be the primary user of the computer.

(c) *Qualified services -- (1) Engaging in qualified research.* The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) *Direct supervision.* The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) *Direct support.* The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either --

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

(d) *Wages paid for qualified services -- (1) In general.* Wages paid to or incurred for an employee constitute inhouse research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable

year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) "*Substantially all.*" Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(e) *Contract research expenses -- (1) In general.* A contract research expense is 65 percent of any expense paid or incurred in carrying on a trade or business to any person other than an employee of the taxpayer for the performance on behalf of the taxpayer of --

(i) Qualified research as defined in § 1.41-5, or

(ii) Services which, if performed by employees of the taxpayer, would constitute qualified services within the meaning of section 41(b)(2)(B).

Where the contract calls for services other than services described in this paragraph (e)(1), only 65 percent of the portion of the amount paid or incurred that is attributable to the services described in this paragraph (e) (1) is a contract research expense.

(2) *Performance of qualified research.* An expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that --

(i) Is entered into prior to the performance of the qualified research,

(ii) Provides that research be performed on behalf of the taxpayer, and

(iii) Requires the taxpayer to bear the expense even if the research is not successful.

If an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a contract research expense. The previous sentence applies only to that portion of a payment which is contingent on the success of the research.

(3) "*On behalf of.*" Qualified research is performed on behalf of the taxpayer if the taxpayer has a right to the research results. Qualified research can be performed on behalf of the taxpayer notwithstanding the fact that the taxpayer does not have exclusive rights to the results.

(4) *Prepaid amounts.* Notwithstanding paragraph (e)(1) of this section, if any contract research expense paid or incurred during any taxable year is attributable to qualified research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 41(b)(1)(B) as paid or incurred during the period during which the qualified research is conducted.

(5) *Examples.* The following examples illustrate provisions contained in paragraphs (e) (1) through (4) of this section.

Example (1). A, a cash-method taxpayer using the calendar year as the taxable year, enters into a contract with B Corporation under which B is to perform qualified research on behalf of A. The contract requires A to pay B \$300x, regardless of the success of the research. In 1982, B performs all of the research, and A makes full payment of \$300x under the contract. Accordingly, during the taxable year 1982, \$195x (65 percent of the payment of \$300x) constitutes a contract research expense of A.

Example (2). The facts are the same as in example (1), except that B performs 50 percent of the research in 1983. Of the \$195x of contract research expense paid in 1982, paragraph (e)(4) of this section provides that \$97.5x (50 percent of \$195x) is a contract research expense for 1982 and the remaining \$97.5x is contract research expense for 1983.

Example (3). The facts are the same as in example (1), except that instead of calling for a flat payment of \$300x, the contract requires A to reimburse B for all expenses plus pay B 00x. B incurs expenses attributable to the research as follows:

Labor	\$90x
Supplies	20x
Depreciation on equipment	50x
Overhead	40x
Total	200x

Under this agreement A pays B \$300x during 1982. Accordingly, during taxable year 1982, \$195x (65 percent of \$300x) of the payment constitutes a contract research expense of A.

Example (4). The facts are the same as in example (3), except that A agrees to reimburse B for all expenses and agrees to pay B an additional amount of \$100x, but the additional \$100x is payable only if the research is successful. The research is successful and A pays B \$300x during 1982. Paragraph (e)(2) of this section provides that the contingent portion of the payment is not an expense incurred for the performance of qualified research. Thus, for taxable year 1982, \$130x (65 percent of the payment of \$200x) constitutes a contract research expense of A.

Example (5). C conducts in-house qualified research in carrying on a trade or business. In addition, C pays D Corporation, a provider of computer services, \$100x to develop software to be used in analyzing the results C derives from its research. Because the software services, if performed by an employee of C, would constitute qualified services, \$65x of the \$100x constitutes a contract research expense of C.

Example (6). C conducts in-house qualified research in carrying on C's trade or business. In addition, C contracts with E Corporation, a provider of temporary secretarial services, for the services of a secretary for a week. The secretary spends the entire week typing reports describing laboratory results derived from C's qualified research. C pays E \$400 for the secretarial service, none of which constitutes wages within the meaning of section 41(b)(2)(D). These services, if performed by employees of C, would constitute qualified services within the meaning of section 41(b)(2)(B). Thus, pursuant to paragraph (e)(1) of this section, \$260 (65 percent of \$400) constitutes a contract research expense of C.

Example (7). C conducts in-house qualified research in carrying on C's trade or business. In addition, C pays F, an outside accountant, \$100x to keep C's books and records pertaining to the research project. The activity carried on by the accountant does not constitute qualified research as defined in section 41(d). The services performed by the accountant, if performed by an employee of C, would not constitute qualified services (as defined in section 41(b)(2)(B)). Thus, under paragraph (e)(1) of this section, no portion of the \$100x constitutes a contract research expense.

§ 1.41-3 Base period research expense.

(a) *Number of years in base period.* The term "base period" generally means the 3 taxable years immediately preceding the year for which a credit is being determined ("determination year"). However, if the first taxable year of the taxpayer ending after June 30, 1981, ends in 1981 or 1982, then with respect to that taxable year the term "base period" means the immediately preceding taxable year. If the second taxable year of the taxpayer ending after June 30, 1981, ends in 1982 or 1983, then with respect to that taxable year the term "base period" means the 2 immediately preceding taxable years.

(b) *New taxpayers.* If, with respect to any determination year, the taxpayer has not been in existence for the number of preceding taxable years that are included under paragraph (a) of this section in the base period for that year, then for purposes of paragraph (c)(1) of this section (relating to the determination of average qualified research expenses during the base period), the taxpayer shall be treated as --

(1) Having been in existence for that number of additional 12-month taxable years that is necessary to complete the base period specified in paragraph (a) of this section, and

(2) Having had qualified research expenses of zero in each of those additional years.

(c) *Definition of base period research expenses.* For any determination year, the term "base period research expenses" means the greater of --

(1) The average qualified research expenses for taxable years during the base period, or

(2) Fifty percent of the qualified research expenses for the determination year.

(d) *Special rules for short taxable years -- (1) Short determination year.* If the determination year for which a research credit is being taken is a short taxable year, the amount taken into account under paragraph (c)(1) of this section shall be modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12.

(2) *Short base period year.* For purposes of paragraph (c)(1) of this section, if a year in the base period is a short taxable year, the qualified research expenses paid or incurred in the short taxable year are deemed to be equal to the qualified research expenses actually paid or incurred in that year multiplied by 12 and divided by the number of months in that year.

(3) *Years overlapping the effective dates of section 41 (section 44F) -- (i) Determination years.* If a determination year includes months before July 1981, the determination year is deemed to be a short taxable year including only the months after June 1981. Accordingly, paragraph (d)(1) of this section is applied for purposes of determining the base period expenses for such year. See section 221(d)(2) of the Economic Recovery Tax Act of 1981.

(ii) *Base period years.* No adjustment is required in the case of a base period year merely because it overlaps June 30, 1981.

(4) *Number of months in a short taxable year.* The number of months in a short taxable year is equal to the number of whole calendar months contained in the year plus fractions for any partially included months. The fraction for a partially included month is equal to the number of days in the month that are included in the short taxable year divided by the total number of days in that month. Thus, if a short taxable year begins on January 1, 1982, and ends on June 9, 1982, it consists of 5 and 9/30 months.

(e) *Examples.* The following examples illustrate the application of this section.

Example (1). X Corp., an accrual-method taxpayer using the calendar year as its taxable year, is organized and begins carrying on a trade or business during 1979 and subsequently incurs qualified research expenses as follows:

1979 . . . \$10x

1980 . . . 150x

1/1/81-6/30/81 . . . 90x

7/1/81-12/31/81 . . . 110x

1982 . . . 250x

1983 . . . 450x

(i) *Determination year 1981.* For determination year 1981, the base period consists of the immediately preceding taxable year, calendar year 1980. Because the determination year includes months before July 1981, paragraph (d)(3)(i) requires that the determination year be treated as a short taxable year. Thus, for purposes of paragraph (c)(1), as modified by paragraph (d)(1), the average qualified research expenses for taxable years during the base period are \$75x (\$150x, the average qualified research expenses for the base period, multiplied by 6, the number of months in the determination year after June 30, 1981, and divided by 12). Because this amount is greater than the amount determined under paragraph (c)(2) (50 percent of the determination year's qualified research expense of \$110x, or \$55x), the amount of base period research expenses is \$75x. The credit for determination year 1981 is equal to 25 percent of the excess of \$110x (the qualified research expenditures incurred during the determination year including only expenditures accrued on or after July 1, 1981, through the end of the determination year) over \$75x (the base period research expenses).

(ii) *Determination year 1982.* For determination year 1982, the base period consists of the 2 immediately preceding taxable years, 1980 and 1981. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is \$175x $((\$150x + \$90x + \$110x)/2)$. This amount is greater than the amount determined under paragraph (c)(2) (50 percent of \$250x, or \$125x). Accordingly, the amount of base period research expenses is \$175x. The credit for determination year 1982 is equal to 25 percent of the excess of \$250x (the qualified research expenses incurred during the determination year) over \$175x (the base period research expenses).

(iii) *Determination year 1983.* For determination year 1983, the base period consists of the 3 immediately preceding taxable years 1980, 1981 and 1982. The amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is \$200x $((\$150x + \$200x + \$250x)/3)$. The amount determined under paragraph (c)(2) is \$225x (50 percent of the \$450x of qualified research expenses in 1983). Accordingly, the amount of base period research expenses is \$225x. The credit for determination year 1983 is equal to 25 percent of the excess of \$450x (the qualified research expenses incurred during the determination year) over \$225x (the base period research expenses).

Example (2). Y, an accrual-basis corporation using the calendar year as its taxable year comes into existence and begins carrying on a trade or business on July 1, 1983. Y incurs qualified research expenses as follows:

7/1/83 -- 12/31/83 . . . \$80x

1984 . . . 200x

1985 . . . 200x

(i) *Determination year 1983.* For determination year 1983, the base period consists of the 3 immediately preceding taxable years: 1980, 1981 and 1982. Although Y was not in existence during 1980, 1981 and 1982, Y is treated under paragraph (b) of this section as having been in existence during those years with qualified research expenses of zero. Thus, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is \$0x $((\$0x + \$0x + \$0x)/3)$. The amount determined under paragraph (c)(2) of this section is \$40x (50 percent of \$80x). Accordingly, the amount of base period research expenses is \$40x. The credit for determination year 1983 is equal to 25 percent of the excess of \$80x (the qualified research expenses incurred during the determination year) over \$40x (the base period research expenses).

(ii) *Determination year 1984.* For determination year 1984, the base period consists of the 3 immediately preceding taxable years: 1981, 1982, and 1983. Under paragraph (b) of this section, Y is treated as having been in existence during years 1981 and 1982 with qualified research expenses of zero. Because July 1 through December 31, 1983 is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expenses for that year be adjusted to \$160x for purposes of determining the average qualified research expenses during the base period. The \$160x results from the actual qualified research expenses for that year (\$80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is $\$53 \frac{1}{3}x$ $((\$0x + \$0x + \$160x)/3)$. The amount determined under paragraph (c)(2) of this section is \$100x (50 percent of \$200x). The amount of base period research expenses is \$100x. The credit for determination year 1984 is equal to 25 percent of the excess of \$200x (the qualified research expenses incurred during the determination year) over \$100x (the base period research expenses).

(iii) *Determination year 1985.* For determination year 1985, the base period consists of the 3 immediately preceding taxable years: 1982, 1983, and 1984. Pursuant to paragraph (b) of this section, Y is treated as having been in existence during 1982 with qualified research expenses of zero. Because July 1 through December 31, 1982, is a short taxable year, paragraph (d)(2) of this section requires that the qualified research expense for that year be adjusted to \$160x for purposes of determining the average qualified research expenses for taxable years during the base period. This \$160x is the actual qualified research expense for that year (\$80x) multiplied by 12 and divided by 6 (the number of months in the short taxable year). Accordingly, the amount determined under paragraph (c)(1) of this section (the average qualified research expenses for taxable years during the base period) is \$120x $((\$0x + \$160x + \$200x)/3)$. The amount determined under paragraph (c)(2) of this section is \$100x (50 percent of \$200x). The amount of base period research expenses is \$120x. The credit for determination year 1985 is equal to 25 percent of the excess of \$200x (the qualified research expenses incurred during the determination year) over \$120x (the base period research expenses).

§ 1.41-4 Qualified research for taxable years beginning after December 31, 1985. [Reserved]

§ 1.41-5 Qualified research for taxable years beginning before January 1, 1986.

(a) *General rule.* Except as otherwise provided in section 30(d) (as that section read before amendment by the Tax Reform Act of 1986) and in this section, the term "qualified research" means research, expenditures for which would be research and experimental expenditures within the meaning of section 174. Expenditures that are ineligible for the section 174 deduction elections are not expenditures for qualified research. For example, expenditures for the acquisition of land or depreciable property used in research, and mineral exploration costs described in section 174(d), are not expenditures for qualified research.

(b) *Activities outside the United States -- (1) In-house research.* In-house research conducted outside the United States (as defined in section 7701(a)(9)) cannot constitute qualified research. Thus, wages paid to an employee scientist for services performed in a laboratory in the United States and in a test station in Antarctica must be apportioned between the services performed within the United States and the services performed outside the United States, and only the wages apportioned to the services conducted within the United States are qualified research expenses unless the 80 percent rule of § 1.41-2(d)(2) applies.

(2) *Contract research.* If contract research is performed partly within the United States and partly without, only 65 percent of the portion of the contract amount that is attributable to the research performed within the United States can qualify as contract research expense (even if 80 percent or more of the contract amount was for research performed in the United States).

(c) *Social sciences or humanities.* Qualified research does not include research in the social sciences or humanities. For purposes of section 30(d)(2) (as that section read before amendment by the Tax Reform Act of 1986) and of this section, the phrase "research in the social sciences or humanities" encompasses all areas of research other than research in a field of laboratory science (such as physics or biochemistry), engineering or technology. Examples of research in the social sciences or humanities include the development of a new life insurance contract, a new economic model or theory, a new accounting procedure or a new cookbook.

(d) *Research funded by any grant, contract, or otherwise -- (1) In general.* Research does not constitute qualified research to the extent it is funded by any grant, contract, or otherwise by another person (including any governmental entity). All agreements (not only research contracts) entered into between the taxpayer performing the research and other persons shall be considered in determining the extent to which the research is funded. Amounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research (see § 1.41-2(e)(2)) are not treated as funding. For special rules regarding funding between commonly controlled businesses, see § 1.41-8(e).

(2) *Research in which taxpayer retains no rights.* If a taxpayer performing research for another person retains no substantial rights in research under the agreement providing for the research, the research is treated as fully funded for purposes of section 41(d)(4)(H), and no expenses paid or incurred by the taxpayer in performing the research are qualified research expenses. For example, if the taxpayer performs research under an agreement that confers on another person the exclusive right to exploit the results of the research, the taxpayer is not performing qualified research because the research is treated as fully funded under this paragraph (d)(2). Incidental benefits to the taxpayer from performance of the research (for example, increased experience in a field of research) do not constitute substantial rights in the research. If a taxpayer performing research for another person retains no substantial rights in the research and if the payments to the researcher are contingent upon the success of the research, neither the performer nor the person paying for the research is entitled to treat any portion of the expenditures as qualified research expenditures.

(3) *Research in which the taxpayer retains substantial rights -- (i) In general.* If a taxpayer performing research for another person retains substantial rights in the research under the agreement providing for the research, the research is funded to the extent of the payments (and fair market value of any property) to which the taxpayer becomes entitled by performing the research. A taxpayer does not retain substantial rights in the research if the taxpayer must pay for the right to use the results of the research. Except as otherwise provided in paragraph (d)(3)(ii) of this section, the taxpayer shall reduce the amount paid or incurred by the taxpayer for the research that would, but for section 41(d)(4)(H), constitute qualified research expenses of the taxpayer by the amount of funding determined under the preceding sentence.

(ii) *Pro rata allocation.* If the taxpayer can establish to the satisfaction of the district director --

(A) The total amount of research expenses,

(B) That the total amount of research expenses exceed the funding, and

(C) That the otherwise qualified research expenses (that is, the expenses which would be qualified research expenses if there were no funding) exceed 65 percent of the funding, then the taxpayer may allocate the funding pro rata to nonqualified and otherwise qualified research expenses, rather than allocating it 100 percent to otherwise qualified research expenses (as provided in paragraph (d)(3)(i) of this section). In no event, however, shall less than 65 percent of the funding be applied against the otherwise qualified research expenses.

(iii) *Project-by-project determination.* The provisions of this paragraph (d)(3) shall be applied separately to each research project undertaken by the taxpayer.

(4) *Independent research and development under the Federal Acquisition Regulations System and similar provisions.* The Federal Acquisition Regulations System and similar rules and regulations relating to contracts (fixed price, cost plus, etc.) with government entities provide for allocation of certain "independent research and development costs" and "bid and proposal costs" of a contractor to contracts entered into with that contractor. In general, any "independent research and development costs" and "bid and proposal costs" paid to a taxpayer by reason of such a contract shall not be treated as funding the underlying research activities except to the extent the "independent research and development costs" and "bid and proposal costs" are properly severable from the contract. See § 1.451-3(e); see also section 804(d)(2) of the Tax Reform Act of 1986.

(5) *Funding determinable only in subsequent taxable year.* If at the time the taxpayer files its return for a taxable year, it is impossible to determine to what extent particular research performed by the taxpayer during that year may be funded, then the taxpayer shall treat the research as completely funded for purposes of completing that return. When the amount of funding is finally determined, the taxpayer should amend the return and any interim returns to reflect the proper amount of funding.

(6) *Examples.* The following examples illustrate the application of the principles contained in this paragraph.

Example (1). A enters into a contract with B Corporation, a cash-method taxpayer using the calendar year as its taxable year, under which B is to perform research that would, but for section 41(d)(3)(H), be qualified research of B. The agreement calls for A to pay B \$120x, regardless of the outcome of the research. In 1982, A makes full payment of \$120x under the contract, B performs all the research, and B pays all the expenses connected with the research, as follows:

In-house research expenses	\$100x
Outside research:	
(Amount B paid to third parties for research, 65 percent of which (\$26x) is treated as a contract research expense of B)	40x
Overhead and other expenses	10x
Total	150x

If B has no rights to the research, B is fully funded. Alternatively, assume that B retains the right to use the results of the research in carrying on B's business. Of B's otherwise qualified research expenses of \$126x + \$26x, \$120x is treated as funded by A. Thus \$6x (\$126x - \$120x) is treated as a qualified research expense of B. However, if B establishes the facts required under paragraph (d)(3) of this section, B can allocate the funding pro rata to nonqualified and otherwise qualified research expenses. Thus \$100.8x ($\$120x \times (\$126x / \$150x)$) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be \$25.2x ($\$126x - \$100.8x$). For purposes of the following examples (2), (3) and (4) assume that B retains substantial rights to use the results of the research in carrying on B's business.

Example (2). The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although A makes full payment of \$120x during 1982, B does not perform the research or pay the associated expenses until 1983. The computations are unchanged. However, B's qualified research expenses determined in example (1) are qualified research expenses during 1983.

Example (3). The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, although B performs the research and pays the associated expenses during 1982, A does not pay the \$120x until 1983. The computations are unchanged and the amount determined in example (1) is a qualified research expense of B during 1982.

Example (4). The facts are the same as in example (1) (assuming that B retains the right to use the results of the research in carrying on B's business) except that, instead of agreeing to pay B \$120x, A agrees to pay \$100x regardless of the outcome and an additional \$20x only if B's research produces a useful product. B's research produces a useful product and A pays B \$120x during 1982. The \$20x payment that is conditional on the success of the research is not treated as funding. Assuming that B establishes to the satisfaction of the district director the actual research expenses, B can al-

locate the funding to nonqualified and otherwise qualified research expenses. Thus \$84x (\$100x (\$126x/\$150x)) would be allocated to otherwise qualified research expenses. B's qualified research expenses would be \$42x (\$126x - \$84x).

Example (5). C enters into a contract with D, a cash-method taxpayer using the calendar year as its taxable year, under which D is to perform research in which both C and D will have substantial rights. C agrees to reimburse D for 80 percent of D's expenses for the research. D performs part of the research in 1982 and the rest in 1983. At the time that D files its return for 1982, D is unable to determine the extent to which the research is funded under the provisions of this paragraph. Under these circumstances, D may not treat any of the expenses paid by D for this research during 1982 as qualified research expenses on its 1982 return. When the project is complete and D can determine the extent of funding, D should file an amended return for 1982 to take into account any qualified research expense for 1982.

§ 1.41-6 Basic research for taxable years beginning after December 31, 1985.

[Reserved]

§ 1.41-7 Basic research for taxable years beginning before January 1, 1986.

(a) *In general.* The amount expended for basic research within the meaning of section 30(e) (before amended by the Tax Reform Act of 1986) equals the sum of money plus the taxpayer's basis in tangible property (other than land) transferred for use in the performance of basic research.

(b) *Trade or business requirement.* Any amount treated as a contract research expense under section 30(e) (before amendment by the Tax Reform Act of 1986) shall be deemed to have been paid or incurred in carrying on a trade or business, if the corporation that paid or incurred the expenses is actually engaged in carrying on some trade or business.

(c) *Prepaid amounts --* (1) *In general.* If any basic research expense paid or incurred during any taxable year is attributable to research to be conducted after the close of such taxable year, the expense so attributable shall be treated for purposes of section 30(b)(1)(B) (before amendment by the Tax Reform Act of 1986) as paid or incurred during the period in which the basic research is conducted.

(2) *Transfers of property.* In the case of transfers of property to be used in the performance of basic research, the research in which that property is to be used shall be considered to be conducted ratably over a period beginning on the day the property is first so used and continuing for the number of years provided with respect to property of that class under section 168(c)(2) (before amendment by the Tax Reform Act of 1986). For example, if an item of property which is 3-year property under section 168(c) is transferred to a university for basic research on January 12, 1983, and is first so used by the university on March 1, 1983, then the research in which that property is used is considered to be conducted ratably from March 1, 1983, through February 28, 1986.

(d) *Written research agreement --* (1) *In general.* A written research agreement must be entered into prior to the performance of the basic research.

(2) *Agreement between a corporation and a qualified organization after June 30, 1983 --* (i) *In general.* A written research agreement between a corporation and a qualified organization (including a qualified fund) entered into after June 30, 1983, shall provide that the organization shall inform the corporation within 60 days after the close of each taxable year of the corporation what amount of funds provided by the corporation pursuant to the agreement was expended on basic research during the taxable year of the corporation. In determining amounts expended on basic research, the qualified organization shall take into account the exclusions specified in section 30(e)(3) (before amendment by the Tax Reform Act of 1986) and in paragraph (e) of this section.

(ii) *Transfers of property.* In the case of transfers of property to be used in basic research, the agreement shall provide that substantially all use of the property is to be for basic research, as defined in section 30(e)(3) (before amendment by the Tax Reform Act of 1986).

(3) *Agreement between a qualified fund and a qualified educational organization after June 30, 1983.* A written research agreement between a qualified fund and a qualified educational organization (see section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986)) entered into after June 30, 1983, shall provide that the qualified educational organization shall furnish sufficient information to the qualified fund to enable the qualified fund to comply with the written research agreements it has entered into with grantor corporations, including the requirement set forth in paragraph (d)(2) of this section.

(e) *Exclusions* -- (1) *Research conducted outside the United States*. If a taxpayer pays or incurs an amount for basic research to be performed partly within the United States and partly without, only 65 percent of the portion of the amount attributable to research performed within the United States can be treated as a contract research expense (even if 80 percent or more of the contract amount was for basic research performed in the United States).

(2) *Research in the social sciences or humanities*. Basic research does not include research in the social sciences or humanities, within the meaning of § 1.41-5(c).

(f) *Procedure for making an election to be treated as a qualified fund*. In order to make an election to be treated as a qualified fund within the meaning of section 30(e)(4)(B)(iii) (before amendment by the Tax Reform Act of 1986) or as an organization described in section 41(e)(6)(D), the organization shall file with the Internal Revenue Service center with which it files its annual return a statement that --

(1) Sets out the name, address, and taxpayer identification number of the electing organization (the "taxpayer") and of the organization that established and maintains the electing organization (the "controlling organization"),

(2) Identifies the election as an election under section 41(e)(6)(D) of the Code,

(3) Affirms that the controlling organization and the taxpayer are section 501(c)(3) organizations,

(4) Provides that the taxpayer elects to be treated as a private foundation for all Code purposes other than section 4940,

(5) Affirms that the taxpayer satisfies the requirement of section 41(e)(6)(D)(iii), and

(6) Specifies the date on which the election is to become effective.

If an election to be treated as a qualified fund is filed before February 1, 1982, the election may be made effective as of any date after June 30, 1981, and before January 1, 1986. If an election is filed on or after February 1, 1982, the election may be made effective as of any date on or after the date on which the election is filed.

§ 1.41-8 Aggregation of expenditures.

(a) *Controlled group of corporations; trades or businesses under common control* -- (1) *In general*. In determining the amount of research credit allowed with respect to a trade or business that at the end of its taxable year is a member of a controlled group of corporations or a member of a group of trades or businesses under common control, all members of the group are treated as a single taxpayer and the credit (if any) allowed to the member is determined on the basis of its proportionate share (if any) of the increase in qualified research expenses of the aggregated group.

(2) *Definition of trade or business*. For purposes of this section, 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). For purposes of this section, any corporation that is a 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.

(3) *Determination of common control*. For rules for determining whether trades or businesses are under common control, see paragraphs (b)-(g) of § 1.52-1 except that the words "singly or" in § 1.52-1(d)(1)(i) shall be treated as deleted.

(4) *Examples*. The following examples illustrate provisions of this paragraph.

Example (1). (i) *Facts*. A controlled group of four corporations (all of which are calendar-year taxpayers) had qualified research expenses ("research expenses") during the base period and taxable year as follows:

Corporation	Base period (average)	Taxable year	Change
A	\$60	\$40	(\$20)
B	10	15	5
C	30	70	40
D	15	25	10

(ii) *Total credit.* Because the research expenses of the four corporations are treated as if made by one taxpayer, the total amount of incremental expenses eligible for the credit is \$35 (\$55 increase attributable to B, C, and D less \$20 decrease attributable to A). The total amount of credit allowable to members of the group is 20% of the incremental amount or \$7.00.

(iii) *Allocation of credit.* No amount of credit is allocated to A since A's research expenses did not increase in the taxable year. The \$7.00 credit is allocated to B, C, and D, the members of the group that increased their research expenses. This allocation is made on the basis of the ratio of each corporation's increase in its research expenses to the sum of increases in those expenses. Inasmuch as the total increase made by those members of the group whose research expenses rose (B, C, and D) was \$55, B's share of the \$7.00 credit is 5/55; C's share is 40/55; and D's share is 10/55.

Example (2). The facts are the same as in example (1) except that A had zero research expenses in the taxable year. Thus, the controlled group had a decrease rather than an increase in aggregate research expenses. Accordingly, no amount of credit is allowable to any member of the group even though B, C, and D actually increased their research expenses in comparison with their own base period expenses.

(b) *Minimum base period research expenses.* For purposes of this section, the rule in section 41(c)(3) (pertaining to minimum base period research expenses) shall be applied only to the aggregate amount of base period research expenses. See the treatment of corporation C in example (1) of paragraph (a)(4) of this section.

(c) *Tax accounting periods used -- (1) In general.* The credit allowable to a member of a controlled group of corporations or of a group of trades or businesses under common control is that member's share of the aggregate credit computed as of the end of such member's taxable year. In computing the aggregate credit in the case of a group whose members have different taxable years, a member shall generally treat the taxable year of another member that ends with or within the determination year of the computing member as the determination year of that other member. The base period research expenses taken into account with respect to a determination year of another member shall be the base period research expenses determined for that year under § 1.41-3, except that § 1.41-3(c)(2) shall be applied only at the aggregate level.

(2) *Special rule where 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, the district director 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.

(d) *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 district director with audit jurisdiction of the return will determine the group in which the business is to be included.

(e) *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 qualified research expenses 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 qualified re-

search expenses. 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.

§ 1.41-9 Special rules.

(a) *Allocations -- (1) Corporation making an election under subchapter S -- (i) Pass-through, for taxable years beginning after December 31, 1982, in the case of an S corporation.* In the case of an S corporation (as defined in section 1361) the amount of research credit computed for the corporation shall be allocated to the shareholders according to the provisions of section 1366 and section 1377.

(ii) *Pass-through, for taxable years beginning before January 1, 1983, in the case of a subchapter S corporation.* In the case of an electing small business corporation (as defined in section 1371 as that section read before the amendments made by the Subchapter S Revision Act of 1982), the amount of the research credit computed for the corporation for any taxable year shall be apportioned pro rata among the persons who are shareholders of the corporation on the last day of the corporation's taxable year.

(2) *Pass-through in the case of an estate or trust.* In the case of an estate or trust, the amount of the research credit computed for the estate or trust for any taxable year shall be apportioned among the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

(3) *Pass-through in the case of a partnership -- (i) In general.* In the case of a partnership, the research credit computed for the partnership for any taxable year shall be apportioned among the persons who are partners during the taxable year in accordance with section 704 and the regulations thereunder. See, for example, § 1.704-1(b)(4)(ii). Because the research credit is an expenditure-based credit, the credit is to be allocated among the partners in the same proportion as section 174 expenditures are allocated for the year.

(ii) *Certain expenditures by joint ventures.* Research expenses to which § 1.41-2(a)(4)(ii) applies shall be apportioned among the persons who are partners during the taxable year in accordance with the provisions of that section. For purposes of section 41, these expenses shall be treated as paid or incurred directly by the partners rather than by the partnership. Thus, the partnership shall disregard these expenses in computing the credit to be apportioned under paragraph (a)(3)(i) of this section, and in making the computations under section 41 each partner shall aggregate its distributive share of these expenses with other research expenses of the partner. The limitation on the amount of the credit set out in section 41(g) and in paragraph (c) of this section shall not apply because the credit is computed by the partner, not the partnership.

(4) *Year in which taken into account.* An amount apportioned to a person under this paragraph shall be taken into account by the person in the taxable year of such person which or within which the taxable year of the corporation, estate, trust, or partnership (as the case may be) ends.

(5) *Credit allowed subject to limitation.* The credit allowable to any person to whom any amount has been apportioned under paragraph (a)(1), (2) or (3)(i) of this section is subject to section 41(g) and sections 38 and 39 of the Code, if applicable.

(b) *Adjustments for certain acquisitions and dispositions -- Meaning of terms.* For the meaning of "acquisition," "separate unit," and "major portion," see paragraph (b) of § 1.52-2. An "acquisition" includes an incorporation or a liquidation.

(c) *Special rule for pass-through of credit.* The special rule contained in section 41(g) for the pass-through of the credit in the case of an individual who owns an interest in an unincorporated trade or business, is a partner in a partnership, is a beneficiary of an estate or trust, or is a shareholder in an S corporation shall be applied in accordance with the principles set forth in § 1.53-3.

(d) *Carryback and carryover of unused credits.* The taxpayer to whom the credit is passed through under paragraph (c) of this section shall not be prevented from applying the unused portion in a carryback or carryover year merely because the entity that earned the credit changes its form of conducting business.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: April 6, 1989.

John G. Wilkins,

Acting Assistant Secretary of the Treasury.

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