TABLE 2.—MATERIAL INCORPORATED BY REFERENCE

Snow Engineering Co. service information	Date
Process Specification #197.	Revised June 4, 2002.
Drawing 20776, Sheet 2, Revision A.	August 30, 2004.
Service Letter #204 ...	Revised March 26, 2001.
Service Letter #240 ...	September 30, 2004.
Drawing 20998, Revision B.	September 28, 2004.
Service Letter #244 ...	April 25, 2005.

Issued in Kansas City, Missouri, on October 26, 2006.

James E. Jackson,

Acting Manager, Small Airplane Directorate, Aircraft Certification Service.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9296]

RIN 1545–BD60

Credit for Increasing Research Activities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final 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 final regulations reflect changes made to section 41 by the Revenue Reconciliation Act of 1989, 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.

DATES: *Effective Date:* These regulations are effective November 9, 2006.

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

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

SUPPLEMENTARY INFORMATION:

Background

This document amends 26 CFR part 1 to provide revised rules for the research credit under section 41, specifically section 41(f). On May 24, 2005, the Treasury Department and the IRS published in the **Federal Register** (70 FR 29662) proposed amendments to the regulations under section 41(f) by cross-reference to temporary regulations (REG–134030–04) and temporary regulations (70 FR 29596) (TD 9205) (collectively, the 2005 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 2005 notice of proposed rulemaking withdrew the proposed regulations published in the **Federal Register** on July 29, 2003 (68 FR 44499) (REG–133791–02) (the 2003 proposed regulations). A public hearing was held on October 19, 2005. After considering the comments received and the statements made at the public hearing regarding the 2005 regulations, the 2005 regulations are adopted as revised by this Treasury decision. These final regulations generally retain the provisions of the 2005 regulations with the modifications discussed below.

Summary of Comments and Explanation of Provisions

Allocation of the Group Credit

The 2005 regulations required that the group credit that did not exceed the sum of the stand-alone entity credits of all the members of the group be allocated among the members of a controlled group in proportion to the relative amounts of each individual member's stand-alone entity credit, computed for each member using the method that would have yielded the largest stand-alone entity credit for that member. Any excess of the group credit over the sum of the stand-alone entity credits of all the members of the group was allocated among all the members of the group based on the ratio of an individual member's qualified research expenditures (QREs) to the sum of all the members' QREs.

Although commentators generally agreed that the 2005 regulations fixed the anomalous results (for example, none of the group credit would be allocated to the members of the controlled group if no member had stand-alone entity credits) created by the method in the 2003 proposed regulations, some commentators continued to disagree with the stand-alone entity credit method. Commentators again suggested that the members of a controlled group should be permitted to use any reasonable method to allocate the group credit as long as the group's members collectively do not claim more than 100 percent of the group credit, or that if one method must be prescribed for all situations, a method that allocates the group credit based on the relative amounts of each member's total QREs (gross QREs method) is more appropriate than any other method.

The Treasury Department and the IRS continue to believe that the allocation method under section 41(f) should be based on a group member's QREs in excess of a base amount, and that the stand-alone entity credit method reflects the incremental nature of the credit. The Treasury Department and the IRS believe that the stand-alone entity credit method of the 2005 regulations is consistent with the purpose of section 41(f) and its underlying legislative history. Further, a single, prescribed method is necessary to ensure the group's members collectively do not claim more than 100 percent of the group credit. For the reasons stated above and in the preamble to the 2005 regulations, the final regulations do not adopt the changes suggested by the commentators, and retain the allocation method contained in the 2005 regulations.

Special Allocation Rule for Consolidated Groups

The 2005 regulations provide that, for purposes of allocating the group credit among the members of a controlled group (first-tier allocation), a consolidated group (whose members are members of the 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 (second-tier allocation) in proportion to the stand-alone entity credits of the members of the consolidated group. Under the 2005 regulations, this rule applied only to taxable years ending on or after May 24, 2005.

One commentator argued that the treatment of a consolidated group as a single member of a controlled group is contrary to the statutory language of sections 41(f)(5) and 1563. The

Secretary is granted broad authority under section 1502 to provide rules regarding the determination of the tax liability of an affiliated group of corporations filing a consolidated return. The Treasury Department and the IRS believe that the treatment of a consolidated group as a single member of a controlled group of corporations for purposes of section 41(f) is within the broad authority of section 1502. Moreover, this treatment is consistent with the single entity treatment of a consolidated group under certain other provisions of the Code.

One commentator argued that treating a consolidated group as a single member of the controlled group adds unnecessary complexity and is administratively burdensome because it requires additional rounds of allocations of each consolidated group's credit among its members and additional computations of each consolidated group member's stand-alone entity credit. One commentator urged that, if the consolidated group rule is retained, then the final regulations should not provide specific rules for how the second-tier allocation is to be made.

The Treasury Department and the IRS continue to believe that computing a stand-alone entity credit for each member of a consolidated group does not impose a greater burden than computing a stand-alone entity credit for a corporation that is not a member of a consolidated group. The Treasury Department and the IRS also believe that specific allocation rules are necessary with respect to the second-tier allocation in order to prevent distortions and provide certainty concerning each consolidated group member's share of the credit, for example, if a member ceases to be a member of the consolidated group or if a member's share of credits becomes subject to section 383. Accordingly, the final regulations retain the rules contained in the 2005 regulations. The final regulations make clear, however, that the special allocation rule for consolidated groups applies prospectively only. Accordingly, the consolidated group rule contained in these final regulations applies only to taxable years ending on or after the date these final regulations are published in the **Federal Register**. For taxable years ending on or after May 24, 2005, and before the date these final regulations are published in the **Federal Register**, taxpayers must use the special allocation rule for consolidated groups contained in the 2005 regulations. However, taxpayers may choose to apply the rule retroactively to taxable years ending before May 24, 2005, provided that all the members of the controlled group treat the consolidated group as a single member of the controlled group.

One commentator stated that the 2005 regulations are unclear whether, for purposes of the second-tier allocation, each consolidated group member's stand-alone entity credit is to be computed in the same manner as a controlled group member's stand-alone entity credit is computed for purposes of a first-tier allocation (that is, using the method that would have yielded the largest stand-alone entity credit for that consolidated group member). The Treasury Department and the IRS believe that the final regulations are clear that this is the rule, as they provide that ''the principles of paragraph (c)'' (which contains the rule) apply for purposes of the second-tier allocation. In addition, this rule is illustrated in *Example 3* of § 1.41–6(e).

Start-Up Companies

For purposes of computing the group credit, § 1.41–6T(b)(2) of the 2005 regulations treated a controlled group as a start-up company if 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 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. One commentator suggested that the rule was not clear in a situation in which one member of the group has both gross receipts and QREs in a taxable year beginning before January 1, 1984. Although the Treasury Department and IRS believe that the temporary regulations are clear that the start-up rules do not apply if the group had QREs and gross receipts in a year beginning before January 1, 1984, no matter which member(s) of the group had the QREs and gross receipts, the final regulations clarify the start-up company rule of § 1.41–6(b)(2) to make it explicit.

Alternative Incremental Research Credit

Section 41(c)(4) provides an election to determine the research credit using the alternative incremental research credit (AIRC) computation. Section 41(c)(4)(B) provides that the election to use the AIRC method applies to all succeeding taxable years unless revoked with the consent of the Secretary. The 2005 regulations generally provide that elections (or revocations) of the AIRC method are made by completing the portion of Form 6765, ''Credit for Increasing Research Activities,'' relating to the AIRC method (in the case of an election of the AIRC method) or to the regular method (in the case of a revocation of the AIRC method), and attaching the completed form to the taxpayer's timely filed original Federal income tax return for the year to which the election (or revocation) applies. Once an election (or revocation) is made for a taxable year, the taxpayer may not change the election (or revocation) on an amended return. The 2005 regulations provide that the provisions relating to AIRC elections and revocations apply to taxable years ending on or after May 24, 2005.

The 2005 regulations provide special rules for making (or revoking) an election for controlled groups under section 41(f)(1) (in which one or more of the members do not join in filing a consolidated return). In such cases, the designated member must make (or revoke) the AIRC election on behalf of the group's members. The election (or revocation) by the designated member is binding on all the members of the group for the taxable year to which the election (or revocation) relates. The 2005 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. If all the members of a controlled group are members of a single consolidated group, the AIRC election (or revocation) is made by the agent of the consolidated group, determined pursuant to the rules of § 1.1502–77.

One commentator suggested that the language contained in § 1.41–8T(b)(4)(i) of the 2005 regulations be clarified to avoid any implication that additional requirements (other than completing the appropriate portion of Form 6765 and attaching the form to a timely filed original Federal income tax return) apply to a designated member seeking to elect (or revoke) the AIRC method. The final regulations clarify that a designated member must follow the same procedures for making (or revoking) an AIRC election that apply to other taxpayers.

A commentator also noted that the regulations do not address whether and how changes to a member's research credit information after the original Federal income tax return is timely filed may affect its status as the designated

member. The commentator suggested that the final regulations clarify what happens if the designated member at the time of filing subsequently is determined not to be the designated member. The Treasury Department and the IRS agree that clarification regarding this issue is needed. Accordingly, the final regulations are clarified to provide that the term *designated member* means the member of the group that is allocated the greatest amount of the group credit under paragraph (c) of § 1.41–6 based on the amount of credit reported on the original timely filed Federal income tax return.

A commentator questioned what happens if the designated member fails to timely file an original Federal income tax return. The Treasury Department and the IRS believe that the designated member must timely file a return in order for the group to elect (or revoke) the AIRC method. Accordingly, if the designated member fails to timely file for the current credit year (and thus, fails to elect (or revoke) the AIRC method for that year), then the method used by the group in the immediately preceding credit year remains the method in effect for the current credit year. The final regulations are amended to clarify this rule.

The commentator also suggested that the final regulations allow the members of a controlled group to decide which member of the group will be the designated member. The Treasury Department and the IRS believe that it is necessary to have a bright-line test, applicable to all controlled groups, to provide certainty as to the identity of the designated member, and that to allow the members of a controlled group to decide which member's election (or revocation) will bind all the members of the group would not provide certainty in all situations. Accordingly, this comment has not been adopted.

Another commentator urged the Treasury Department and the IRS to allow taxpayers to elect the AIRC method on an amended return. Alternatively, the commentator argued that if taxpayers cannot elect the AIRC method on an amended return, the final regulations should provide a special rule under which a taxpayer's research credit, computed by the taxpayer under the regular method, may not be adjusted on audit below the amount that would have been allowable under the AIRC method. The Treasury Department and the IRS believe that requiring an election to be made only on a timely filed original Federal income tax return is consistent with the statute and the doctrine of elections, and that the commentator's suggestion would inappropriately limit the authority of the IRS to conduct examinations. Thus, these final regulations retain the rules as contained in the 2005 regulations.

Finally, a commentator suggested that, with respect to the AIRC provisions, the effective date for the 2005 regulations should not be limited to taxable years ending on or after May 24, 2005, but should apply as well to any taxable year ending before that date, provided that the original Federal income tax return for that year has not yet been filed. The Treasury Department and the IRS believe that making this option available retroactively to taxpayers that have not yet filed their returns would treat similarly situated taxpayers differently. For example, taxpayers that already had filed their returns would have been required to request permission for a revocation, while taxpayers that had not filed their returns would be eligible for the automatic revocation procedures set forth in the 2005 regulations. Thus, the Treasury Department and the IRS believe that it is appropriate to limit the application of this rule to prospective use only. The final regulations are effective for taxable years ending on or after the date these final regulations are published in the **Federal Register**. For taxable years ending on or after May 24, 2005, and before the date these final regulations are published in the **Federal Register**, taxpayers must use the rules contained in the 2005 regulations.

Other

Several commentators mentioned that the definition of trade or business in the 2005 regulations was changed from the prior regulations. The change in the 2005 regulations was inadvertent, and the definition has been returned to the language from the regulations existing prior to the issuance of the 2005 regulations. For taxable years prior to the effective date of these final regulations, taxpayers may rely upon the definition of trade or business in these final regulations.

Another commentator requested that the regulations provide guidance as to whether the section 280C(c) election is made member by member or by the entire controlled group. This issue is beyond the scope of these final regulations, as guidance would have to be provided under the authority of section 280C rather than section 41. The Treasury Department and the IRS may consider addressing this issue in separate guidance.

Effective Date

The preamble to the 2005 regulations states that because the Treasury Department and the IRS decided to retain the general rules for the computation and allocation of the group credit contained in the 2003 proposed regulations, with certain modifications, the 2005 regulations were effective for taxable years ending on or after May 24, 2005. For taxable years prior to those covered by the 2005 regulations, a taxpayer generally may use any reasonable method of computing and allocating the group credit. As explained in the preamble to the 2005 regulations, paragraph (b) of the 2005 regulations, relating to the computation of the group credit, and paragraph (c) of the 2005 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).

One commentator argued that the 2005 regulations should not be effective until final regulations are published in the **Federal Register**. The Treasury Department and the IRS continue to believe that the general May 24, 2005, effective date is appropriate, because these final regulations are substantially similar to the 2003 proposed regulations.

Another commentator objected to the use of the December 29, 1999, effective date for the portions of the 2005 regulations that are retroactive, because that is the date that the previous proposed regulations (2000 proposed regulations) were sent to the **Federal Register**, and not the date (January 4, 2000) on which they were published. The Treasury Department and the IRS continue to believe that the December 29, 1999, effective date is the appropriate date, because this is the date the 2000 proposed regulations were filed with the **Federal Register** and, thus, were made available to the public. Additionally, section 7805(b)(3) allows any regulation to take effect or apply retroactively to prevent abuse.

Another commentator criticized the retroactive application of the rule requiring that a member's stand-alone entity credit 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. The

commentator stated that the incentive effect sought can only be achieved prospectively, and that to allow use of the rule retroactively may cause abusive inconsistencies where some members of the group rely on the 2003 proposed regulations, while other members amend to follow the new rule. While the Treasury Department and the IRS do not want to encourage potentially abusive inconsistencies in years that taxpayers believe are settled, the Treasury Department and the IRS believe that one bright line is appropriate and do not want to treat similarly situated taxpayers differently.

Another commentator suggested that the final regulations make clear that the special rule for consolidated groups is to be applied prospectively only. The 2005 regulations required paragraph (b) of those regulations, relating to the computation of the group credit, and paragraph (c) of those regulations, relating to the allocation of the group credit, to be applied retroactively in certain instances of abuse. The 2005 regulations did not require paragraph (d), relating to the special rule for consolidated groups, to be applied retroactively. Thus, the Treasury Department and IRS did not intend that taxpayers be required to apply retroactively the special rule for consolidated groups. Accordingly, the final regulations clarify that the special rule for consolidated groups applies only to taxable years ending on or after the date these final regulations are published in the **Federal Register**. The 2005 regulations apply for taxable years ending on or after May 24, 2005, and before the date these final regulations are published in the **Federal Register**. However, a controlled group may choose to apply the rule in paragraph (d) retroactively if all the members of the group do so, so that the controlled group, as a whole, does not claim more than 100 percent of the group credit.

Special Analyses

It has been determined that this Treasury 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 and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these final regulations were 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 removing the entry for § 1.41–6T and adding an entry in numerical order to read, in part, as follows:

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

Section 1.41–6 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 § 1.41–6T and § 1.41–8T and adding entries for § 1.41–6 and § 1.41–8 to read as follows:

§ 1.41–0 Table of contents.

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§ 1.41–6 Aggregation of expenditures.

(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.

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§ 1.41–8 Special rules for taxable years ending on or after May 24, 2005.

(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.

■ **Par. 3.** Section 1.41–6 is added to read as follows.

§ 1.41–6 Aggregation of expenditures.

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

(ii) *Controlled group* and *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) *Credit year* means the taxable year for which the member is computing the credit.

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

(v) *Trade or business* means 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 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.

(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) There was no taxable year beginning before January 1, 1984, in which a member of the group had gross receipts and either the same member or another member also had qualified research expenditures (QREs); or

(B) There were fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which a member of the group had gross receipts and either the same member or another member also 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. A, B, and C had both QREs and gross receipts in 1985, 1986, 1987, and 1988. 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, and there were not fewer than three taxable years beginning after December 31, 1983, and before January 1, 1989, in which a member of the group had gross receipts and QREs.

(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:

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

(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, no member of the group made any basic research payments or paid or incurred any amounts to an energy research consortium, 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. 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 $0.20 \times (\$330x - \$170x)$, 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: $0.10 \times \$1,700x$, 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 $0.50 \times \$330x$, 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. 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 QREs	$580x	$10x	$70x	$15x	$675x
1984–1988 QREs	500x	25x	100x	25x	650x
1984–1988 Gross Receipts	4,000x	5,000x	2,000x	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 ($527x). The group credit is $0.20 \times (\$675x - \$527x)$, 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 (3.10 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 $527x, which is the greater of: 0.031 × $17,000x, which equals $527x, 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 × $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 ($21.67x), 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 ($8.09x) 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					$29.76x
Minus: Sum of Stand-Alone Entity Credits	$19.46x	$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, each member of the consolidated group is allocated an amount of the group credit allocated to the consolidated group equal to that 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). 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 × $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 × $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 a member of the group had QREs and either the same member or another member also had gross receipts. In that year, each of K, L, and M had both QREs and 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 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 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 × 0.015)—($1,700x × 0.01)]] + [0.032 × [($1,700x × 0.02)—($1,700x × 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

	N	O	P	Total
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*—(1) *In general.* Except for paragraph (d) of this section, these 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 (including use of the consolidated group rule contained in paragraph (d) of this section) for taxable years ending before May 24, 2005. However, paragraph (b) of this section, relating to the computation of the group credit, and paragraph (c) of this section, relating to the allocation of the group credit, (applied without regard to paragraph (d) of this section) 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) of this section. 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) of this section.

(2) *Consolidated group rule.* Paragraph (d) of this section is applicable for taxable years ending on or after November 9, 2006. For taxable years ending on or after May 24, 2005, and before November 9, 2006, see § 1.41–6(d) as contained in 26 CFR part 1, revised April 1, 2006.

§ 1.41–6T [Removed]

■ **Par. 4.** Section 1.41–6T is removed.

■ **Par. 5.** Section 1.41–8 is added to read as follows.

§ 1.41–8 Special rules for taxable years ending on or after November 9, 2006.

(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, an election (or revocation) must be made by the designated member by satisfying the requirements of paragraph (b)(2) or (b)(3) of this section (whichever applies), and such election (or revocation) by the designated member shall be binding on all the members of the group for the credit year to which the election (or revocation) relates. If the designated member fails to timely make (or revoke) an election, each member of the group must compute the group credit using the method used to compute the group credit for the immediately preceding credit year.

(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 this section based on the amount of credit reported on the original timely filed Federal income tax return (even if that member subsequently is determined not to be the designated member). 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 regulations are applicable for taxable years ending on or after November 9, 2006. For taxable years ending on or after May 24, 2005, and before November 9, 2006, see § 1.41–6T(b)(5) as contained in 26 CFR part 1, revised April 1, 2006.

§ 1.41–8T [Removed]

■ **Par. 6.** Section 1.41–8T is removed.

Steven T. Miller,

Acting Deputy Commissioner for Services and Enforcement.

Approved: October 18, 2006.

Eric Solomon,

Acting Deputy Assistant Secretary of the Treasury.

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POSTAL SERVICE

39 CFR Part 501

Requirements for Authority To Manufacture and Distribute Postage Evidencing Systems

AGENCY: Postal Service.

ACTION: Final rule.

SUMMARY: This final rule revises the requirements for authority to manufacture and distribute postage evidencing systems. This final rule includes updating the regulations, removing obsolete text, and incorporating pertinent portions of the rules for postage meters (Postage Evidencing Systems) formerly contained in section P030 of the *Mailing Standards of the United States Postal Service*, Domestic Mail Manual (DMM) (Issue 58). This rule integrates the requirements that apply to the distribution and manufacture of PC Postage® products, a type of Postage Evidencing System. In addition, obsolete references to requirements for manually reset and mechanical meters are eliminated.

DATES: This rule is effective December 11, 2006.

FOR FURTHER INFORMATION CONTACT: Daniel J. Lord, Manager, Postage Technology Management, U.S. Postal Service, at 202–268–4281.

SUPPLEMENTARY INFORMATION: Postage Evidencing Systems are devices or systems of components that a customer uses to print evidence that the prepaid postage required for mailing has been paid. They include, but are not limited to, postage meters and PC Postage® systems. The Postal Service™ regulates these systems and their use in order to protect postal revenue. Only Postal Service-authorized product service providers may design, produce, and distribute Postage Evidencing Systems.

As a result of changes in technology, proposed revisions were published in the **Federal Register** on June 27, 2006 [Vol. 71, No. 123, Pages 36498–36506], with a request for submission of comments by July 27, 2006. We received three submissions from postage evidencing system providers in response to our solicitation for public comments. The Postal Service gave thorough consideration to the comments it received, modified the proposed rule as appropriate, determined that some comments were outside the scope of this rulemaking, and now announces the adoption of the final rule.

List of Subjects in 39 CFR Part 501

Postal Service.