No. 01-1209

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF FOR THE PETITIONERS

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QUESTION PRESENTED

Whether Treas. Reg. § 1.861-8(e)(3), which prescribes a general rule for the allocation of research and development expenses in the computation of taxable income, may be applied in the context of export sales entitled to special tax treatment under the Internal Revenue Code.

RULES 24.1 AND 29.6 STATEMENT

The parties to this proceeding are The Boeing Company and Consolidated Subsidiaries and Boeing Sales Corporation. Boeing Sales Corporation is a wholly owned subsidiary of The Boeing Company. No publicly held company owns 10 percent or more of The Boeing Company's stock.

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BRIEF FOR THE PETITIONERS

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 258 F.3d 958. The opinion of the district court (Pet. App. 15a-24a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001, and a timely petition for rehearing was denied on November 19, 2001 (Pet. App. 25a). The petition for a writ of certiorari was filed on February 15, 2002, and was granted on May 28, 2002. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. ("IRC") § 994, 26 U.S.C. § 861, 26 C.F.R. ("Treas. Reg.") § 1.994-1, and 26 C.F.R. § 1.861-8 are reprinted at Pet. App. 26a-53a.

STATEMENT

This case concerns successive sets of tax provisions enacted by Congress to encourage exports by providing preferential tax treatment to income from export sales. The issue here implicates two of the fundamental principles upon which all of these statutory regimes have been premised. First, in determining how to calculate the income that qualifies for tax benefits, expenses are to be deducted from the gross income to which those expenses are *factually related*. Second, taxpayers have wide latitude to maximize the tax benefits with the least disruption of their business practices, and to that end each taxpayer may choose to calculate its income and related expenses on the basis of either specific transactions or transaction groupings along product lines.

The decision below departs sharply from both of these principles. Under the rule announced by the Ninth Circuit, every taxpayer must allocate research and development ("R&D") expenses according to mandatory and extraordinarily broad product groupings that may bear no relation to the product groupings the taxpayer has chosen, resulting in the deduction of product-specific R&D expenses from export sales income that is attributable to other products and *not* factually related to those expenses. In this case, the court of appeals' holding resulted in a reallocation of some $2 billion of petitioner Boeing's R&D costs, thereby increasing Boeing's tax liability by more than $400 million. This decision is inconsistent with the Internal Revenue Code and frustrates the congressional intent underlying a significant economic stimulus measure.

1. In 1971, Congress enacted a set of provisions that were designed "to provide tax incentives for U.S. firms to increase their exports," a program that was thought important both for its "stimulative effect" and "to remove a * * * disadvantage of U.S. companies engaged in export activities." H.R. REP. NO. 92-533, at 58 (1971). See *Caterpillar Tractor Co.* v. *United States*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). Under this program, corporations were permitted to create special subsidiaries known as "Domestic International Sales Corporations" ("DISCs"). Qualifying income from export sales made through DISCs received favorable tax treatment in the form of partial tax deferral. IRC §§ 991-997.[1] As a

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[1] To obtain the tax deferral, a parent corporation sold its export goods to its DISC subsidiary at a discount price, thereby assigning a portion of its otherwise taxable export income to the DISC. The parent then was taxed only on the income it retained and a specified portion of the DISC's income. Tax was deferred on the

consequence, "[t]he greater the DISC profit, the larger the amount of tax-deferred income * * *. Thus, a [corporation creating a DISC] had an incentive to maximize DISC profit." *St. Jude Medical, Inc.* v. *Comm'r*, 34 F.3d 1394, 1397 (8th Cir. 1994).

In 1984, in response to complaints from some of our country's trading partners, the DISC regime was replaced by one making use of Foreign Sales Corporations ("FSCs"). See Deficit Reduction Act of 1984, §§ 801-805, Pub. L. No. 98-369, 98 Stat. 494 (July 18, 1984). After FSC also was held to violate global trade rules, Congress responded by enacting the Extraterritorial Income Exclusion Act of 2000 ("ETI"), Pub. L. No. 106-519, § 3, 114 Stat. 2423 (Nov. 15, 2000). Each of these programs differs slightly from its predecessor, but none of the differences is relevant to the issue presented in this case. In all three of the statutory regimes, the mechanics of determining tax-favored income are substantially identical; in particular, each regime requires the allocation of expenses to factually-related export income and affords taxpayers broad flexibility to make these calculations based either on individual transactions or on various types of product lines.[2]

DISC's remaining income. See IRC §§ 991, 995. In 1984, Congress granted complete exemption from taxation to all DISC income that had not yet been taxed at that time. See Deficit Reduction Act of 1984, § 805(b)(2), Pub. L. No. 98-369, 98 Stat. 494 (July 18, 1984).

[2] The years at issue in this case involve the DISC and FSC provisions. Because the parties have agreed that there are no differences between DISC and FSC that are relevant to this case, we limit our discussion to DISC and refer to the Internal Revenue Code (26 U.S.C.) as in effect in 1979, unless otherwise indicated. The court below did this as well. See Pet. App. 6a n.3.

All three statutes give taxpayers alternative means of determining the portion of export income that qualifies for the favorable tax treatment. Section 994(a) of the DISC statute, which is representative in this respect of the FSC and ETI statutes as well, "permitted a taxpayer to use one of three methods for determining the amount of deemed profit allocated to the DISC and its parent as a result of export sales. The taxpayer/parent could choose the method resulting in the greatest amount of profit [for the DISC]." *St. Jude Medical*, 34 F.3d at 1397 (citations and footnote omitted). See H.R. REP. NO. 92-533, at 59 ("[s]pecial pricing rules in the bill permit a DISC to earn a larger relative amount of the profits arising on sales by the DISC of its parent company's export products").[3] One of these methods, which was used by petitioner Boeing in this case, is known as the "combined taxable income" (or "CTI") method. IRC § 994(a)(2). The CTI method permitted a DISC to retain 50 percent of "the combined taxable income of [the] DISC and [its parent corporation] which is attributable to" export sales. *Ibid*.[4]

The manner in which expenses are to be attributed to (and thus deducted from) export sales to determine combined taxable income is addressed in detail in the legislative history of the DISC statute and in regulations prescribed by the Secretary of the Treasury to implement the statute. Both congressional committee reports accompanying the DISC statute explain that, for purposes of determining CTI, Congress envisioned two types of expenses: expenses directly related to a particular transaction or product (or group of products), and

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[3] See also IRC § 925(a) (FSC); IRC § 941(a) (ETI).

[4] The other two pricing methods assigned taxable income to the DISC equal to 4 percent of export gross receipts (IRC § 994(a)(1)) or in an amount based upon an arm's-length transfer price (IRC § 994(a)(3)).

expenses not directly related to any transaction or product. CTI was to be calculated by deducting from export gross receipts [1] "*all* expenses *directly related*" to the transaction or product and [2] "*a portion* of the * * * expenses *not allocable to any specific item of income*, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the [parent corporation] and the DISC." H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107-08 (1971) (emphasis added). Congress thus intended that, in determining CTI for purposes of export tax benefits, expenses that were specifically related to certain items of income would be allocated only to those items, and expenses not related to *any* particular item of income would be apportioned among all items of income.

This directive was implemented by the Treasury Department's DISC regulations, which define CTI as "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC and [its parent corporation] * * * *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations provide specific guidance on how to conduct this calculation, explaining that costs

> which shall be treated as relating to gross receipts from sales of export property are *(a)* the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and *(b)* a ratable part of other expenses, losses, or other deductions which are *not definitely related to a class of gross income*, determined in a manner consistent with the rules set forth in § 1.861-8.

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added).

The cross-reference in the DISC regulations to Treas. Reg. § 1.861-8 also grew out of the statutory background.

The congressional committee reports explain that CTI is to be determined "generally in accordance with the principles applicable under [IRC] section 861," a statutory provision that sets out general rules for classifying revenue as either U.S. or foreign source income for U.S. income tax purposes. H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107.[5] As the reports emphasize, these "sourcing" rules determine the net income from a given source by "generally allocat[ing] to each item of gross income all expenses *directly related* thereto, and then apportion[ing] other expenses among all items of gross income on a ratable basis." H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added). Treas. Reg. § 1.861-8, which is cited in the DISC cost allocation regulation, "provided specific guidance for applying the allocation and apportionment rules referred to in IRC §§ 861, 862, and 863." *St. Jude Medical*, 34 F.3d at 1398. At the time the DISC legislation was enacted, Treas. Reg. § 1.861-8 "reiterated [IRC] § 861(b)'s language." *Id*. at 1402. See Treas. Reg. § 1.861-8 (1957).

The DISC regulations also establish the procedures by which taxpayers may make DISC income determinations, including the calculation of CTI, on either a transaction-by-transaction basis or, "at the annual choice of the taxpayer[,] * * * on the basis of groups consisting of products or product lines." Treas. Reg. §1.994-1(c)(7)(i). If a taxpayer chooses to

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[5] IRC § 861(a) identifies income that is United States source gross income, while IRC § 861(b) provides for determining net, taxable U.S. source income by subtracting from gross income "the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income." The language of IRC § 861(b) has remained substantively unchanged since it was enacted as § 217(b) of the Revenue Act of 1921, ch. 136, 42 Stat. 227, 244 (1921).

group transactions, its choice of a "product or a product line *will be accepted*" by the IRS so long as it conforms *either* to "recognized industry or trade usage" or to "the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification [SIC] * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii) (emphasis added).[6] Thus, "[t]he taxpayer's choice [as to grouping] * * * shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv).

Accordingly, when a taxpayer chooses to group its export sales by product line, costs that definitely relate to any particular product group must be specifically allocated to the sales income of that group, while costs that do not definitely relate to any particular product group must be apportioned among all relevant classes of income. Costs that relate to a particular product group may *not* be allocated to any other product group, on a pro rata basis or otherwise. These grouping procedures were specifically contemplated by Congress. See H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 108 ("Although * * * the pricing rules provided by the bill gener-

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[6] The Standard Industrial Classification is a system "used to categorize industries. Facilities may be categorized into major groups (2-digit SIC Code), industry groups (3-digit SIC Code), or industry codes (4-digit SIC Code), depending on the level of detail appropriate." *Nat'l Mining Ass'n* v. *U.S. E.P.A*, 59 F.3d 1351, 1355 n.6 (D.C. Cir. 1995) (citing EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, STANDARD INDUSTRIAL CLASSIFICATION MANUAL 12 (1987)).

ally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.").[7]

2. The dispute now before the Court stems from a provision added to the IRC § 861 sourcing regulations in 1977, six years after enactment of the DISC statute and two years after issuance of the final DISC regulations in 1975. As a general matter, the 1977 revision of Treas. Reg. § 1.861-8 continued to "emphasize the factual relationship between the deduction and a class of gross income." Treas. Reg. § 1.861-8(b)(1). In

[7] To illustrate, suppose that Megacorp, a U.S. conglomerate, makes and sells $100 worth of space shuttles, $100 worth of motor scooters, and $100 worth of blimps during a particular year. All of the space shuttles are sold domestically to NASA, and all of the motor scooters and blimps are exported through Megacorp's DISC. During the same year, Megacorp spends $30 to research fuel alternatives for its space shuttles, $10 to research scooter wheel technology, nothing for blimp research, and $20 attempting to develop a new automobile that would recycle engine exhaust. Megacorp also has $15 in deductible charitable contributions. Under the DISC regulations, Megacorp can treat each of its four existing or nascent products as a separate group and calculate its total DISC income by adding up the separate net income (*i.e.*, CTI) attributable to its exported scooter and blimp groups. It does that by allocating its "definitely related" $10 of scooter R&D exclusively to its scooter group sales. Megacorp's other R&D costs, for space shuttles and automobiles, are not relevant to the CTI calculations, because all of these costs "definitely relate" to existing or future products that Megacorp's DISC does not sell. Its charitable deductions, which are not definitely related to any particular category of income, are apportioned among *all* categories of income pro rata based on sales. Therefore, the CTI amounts from scooters and blimps are each reduced by $5 ($15 x $100/$300). Ignoring Megacorp's other costs, scooter CTI is thus $85 ($100 minus $10 minus $5), blimp CTI is $95 ($100 minus $5), and total CTI is $180.

a significant departure from this principle, however, Treas. Reg. § 1.861-8(e)(3) announced a special and inconsistent rule for the allocation of research and development expenses.

The 1977 regulation provides that R&D expenses, even if directly related to *one particular product or product line*,

> shall ordinarily be considered deductions which are definitely related to *all* income reasonably connected with the relevant broad [two-digit SIC Code] product *category* * * * of the taxpayer and therefore allocable to *all* items of gross income * * * related to such product category[.]

Treas. Reg. § 1.861-8(e)(3) (1977) (emphasis added).[8] This regulation thus "deemed a definite relationship [to exist] between an expenditure for R&D and *all* income reasonably connected with a specific *broad product category"* (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D expense. To offer an example, under this new approach to allocation, income from the export of cotton balls would be reduced by R&D expenses related to the development of cardiac pacemakers and space suits, because all of those products are listed in SIC Code 38.[9]

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[8] The provisions of Treas. Reg. § 1.861-8(e)(3) were renumbered in 1996 and, with amendments not relevant to this case, were republished as Treas. Reg. § 1.861-17. See Pet. App. 9a n.7.

[9] Again consider Megacorp. Because all of Megacorp's diverse R&D pertains to products falling within SIC classification 37, which broadly covers all "transportation equipment," Treas. Reg. § 1.861-8(e)(3) would place the entirety of that R&D into a single pot and apportion the undifferentiated sum among all products in proportion to current sales. Thus, the exported scooters and blimps each would attract $20 of R&D (total R&D of $60 x $100/$300), the CTI deemed attributable to each of those product groups would

3. For over 40 years, petitioner Boeing has been a world leader in commercial aircraft development and a major U.S. exporter of commercial aircraft. During the period at issue in this litigation, DISC-eligible export sales constituted approximately 70 percent of Boeing's commercial-aircraft sales by dollar volume. Boeing exported commercial aircraft through a qualified export subsidiary. Before 1985, that subsidiary was Boeing International Sales Corporation, a DISC; during the remaining years involved in this case, that subsidiary was Boeing Sales Corporation, a FSC.

Boeing has maintained its leadership position by continuously developing new commercial aircraft. Consistent with industry practice, Boeing organizes its internal operations along product lines (*e.g.*, aircraft models 727, 737, 747), each of which constitutes a separate "Program" within the Boeing organization. Management and staff for each Program are responsible for developing and managing a particular product line, including the line's various models and derivatives (for example, passenger and cargo versions of the 747). Pet. App. 16a.

As a leader in aviation technology, Boeing spends billions of dollars on research and development. Boeing allocates its R&D costs both *across* airplane Programs and directly *to* particular Programs, depending on the type of research. Some of Boeing's research is broad-based and aimed at generally advancing the state of the art for commercial aviation technology, including avionics and aerodynamics

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be $75 ($100 minus $20 minus $5), and total CTI would be $150 – in contrast to the $180 of total CTI that would result from applying the DISC regulations. This difference occurs because Treas. Reg. § 1.861-8(e)(3) mechanically reassigns to *all* products in SIC Code 37 portions of Megacorp's R&D that in fact are "definitely related" to *particular* products.

research. Boeing also conducts research to create and develop new products. Such research includes, for example, sketching and analyzing alternative fuselages, wings, and engines, as well as other technologies that could eventually be configured into a new commercial aircraft. Boeing refers to both of these types of research and development as "Blue-Sky R&D." Pet. App. 2a-3a, 16a-17a.

In addition to this Blue-Sky R&D, Boeing engages in extensive R&D for each *particular* product line or type of aircraft that the company has decided to produce. Research and development to design, develop, test, and qualify the new aircraft for commercial service is a major component of each Program. For example, because each new aircraft has a unique configuration, Boeing engineers must specially design thousands of parts to fit the new aircraft's configuration and aerodynamic requirements. Similarly, Boeing must conduct extensive research and testing to ensure that a new aircraft will meet national and international safety standards. Finally, Boeing regularly engages in R&D to modify and improve each product line even after aircraft within that product line have entered commercial service. Research directly related to particular Programs constituted over 75 percent of Boeing's total R&D expenditures for the years at issue in this litigation. Boeing refers to the *Program-specific* research and development as "Program R&D" because it is generally not transferable to other Programs or aircraft. Pet. App. 3a, 17a.

Boeing's cost accounting system has operated in essentially the same way since the 1960s, having been designed to comply with the Government Cost Accounting Standards and Federal Acquisition Regulations applicable to federal procurement programs. See CA9 Supp. E.R. 22. Mirroring its internal organizational structure, Boeing's accounting system tracks costs and revenues along Program lines. Each airplane Program is a separate "final cost objective," and the accounting system allocates to each Program those costs directly related to it. The same is true for revenues. So, for example, the costs and sales of the 727 are accounted for separately from those of the 767, which are accounted for separately from those of the 777. In keeping with this framework, Boeing's cost accounting system allocates all Program R&D to the particular product line to which it is related. Blue-Sky R&D, which relates to all Programs, is allocated to, and apportioned among, the Programs. For financial accounting and federal income tax purposes, Boeing deducts all research and development costs in the period in which they are incurred, even if there are no corresponding sales in that period. Pet. App. 3a, 17a; see also IRC § 174.

For DISC purposes, Boeing chose the CTI method to calculate income from export sales. Because the DISC regime permitted CTI to be determined for product groupings based upon recognized industry classifications, Boeing chose to treat each of its Programs as a DISC product grouping and derived the CTI for each grouping under the accounting procedures described above. So, for example, Boeing took the export sales receipts for a particular product line (*e.g.*, 737, 747) in one year and subtracted from that figure the costs associated with that product line in the same year, along with appropriate portions of costs not associated with any particular product line. Pet. App. 3a, 17a.

4. After examining Boeing's tax returns for the years at issue (1979-1987), the IRS disallowed Boeing's method of allocating its R&D costs to the Programs to which they factually related and instead reallocated those expenses pursuant to the special method described in Treas. Reg. § 1.861-8(e)(3), the sourcing R&D regulation that had been promulgated in 1977. Because all of Boeing's various commercial product lines fell into SIC Code 37 (transportation equipment), the IRS's approach deemed *all* of Boeing's R&D in

any given year – including R&D that unquestionably related only to one specific airplane model – to be related fungibly to sales of *all* airplane models in that year. The IRS therefore treated all R&D costs the same, without regard to whether the costs were demonstrably related as a factual matter to a particular product line.

For example, the IRS allocated a portion of the Program R&D costs specifically attributable to aircraft still in the developmental stages (as was the 767 during some of the years at issue) among aircraft produced by other Programs that were actually in production and being sold (such as the 747). The IRS allocated costs in this manner even though the R&D expenditures associated with developing a new product line (such as the 767) and bringing it to market did not in any way contribute to the development of existing product lines (such as the 747). By reallocating $2 billion of research and development costs, the IRS decreased the profits of Boeing's export subsidiaries and thereby increased Boeing's overall tax obligation for the years 1979 to 1987 by some $419 million. Pet. App. 3a-4a, 18a.

5. Boeing paid the additional tax demanded by the IRS and filed suit seeking a refund. The district court ruled for Boeing, holding that Treas. Reg. § 1.861-8(e)(3) is invalid as applied to CTI computations. Pet. App. 15a-24a. Relying on *St. Jude Medical, Inc.* v. *Commissioner*, *supra*, in which the Eighth Circuit rebuffed the IRS's attempt to apply Treas. Reg. § 1.861-8(e)(3) to the calculation of CTI, the district court pointed to two considerations supporting this conclusion.

First, the district court explained that, by mandating that R&D costs be grouped according to broad SIC classifications, Treas. Reg. § 1.861-8(e)(3) conflicts with Treas. Reg. §§ 1.994-1(c)(6)(iv) and (7), which provide that, for DISC purposes, taxpayers may group income and allocate costs by product or product line. Pet. App. 21a-22a. Second, the court reasoned that Treas. Reg. § 1.861-8(e)(3) creates an artificial "deemed" relationship between sales and R&D that conflicts with Congress's intent to "'generally allocate to each item of gross income all expenses *directly related thereto*.'" Pet. App. 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H.R. REP. NO. 92-533, at 74)) (emphasis in *St. Jude Medical*). The district court thus concluded that the IRS erred in applying Treas. Reg. § 1.861-8(e)(3) to Boeing's CTI calculations, holding that Boeing was entitled to group its export sales by product line and allocate research and development expenditures accordingly.

The Ninth Circuit reversed. Pet. App. 1a-14a. The court of appeals opined that Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c)(7)

> can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become "indirectly" or "indefinitely" related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3).

Pet. App. 12a. The court of appeals also reasoned that application of Treas. Reg. § 1.861-8(e)(3) in this context is supportable because, at the time of the enactment of the DISC statute, "Congress recognized that some of the costs incurred in a given tax year would not be 'directly related' to specific income items." Pet. App. 11a. The court therefore held that, as applied in this case, "Treas. Reg. § 1.861-8(e)(3) * * * is a reasonable interpretation of the applicable statutes and regulations." Pet. App. 13a. In reaching this conclusion, the court expressly "decline[d] to follow the reasoning of [the Eighth Circuit in] *St. Jude Medical*." *Id*. at 10a.[10]

SUMMARY OF THE ARGUMENT

A. The Ninth Circuit's decision must be set aside because it is inconsistent with a fundamental principle governing the computation of DISC combined taxable income: costs that are factually related to one product (or product group) may not be deducted from revenue arising from the sale of a different product (or product group). That rule is established by the plain language of the DISC statute, which defines CTI as income that is "attributable to" export receipts. Income from the sale of one product can hardly be "attributable to" expenses relating to the development of an entirely unrelated product.

Moreover, the DISC statute was enacted against the backdrop of IRC § 861(b), a provision that had long required the factual matching of income and expenses. There is no doubt that Congress intended this longstanding § 861 principle to apply in the DISC context: Congress made that point explicitly in the DISC statute's legislative history. Indeed,

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[10] Unlike a DISC, which is completely exempt from taxation (IRC § 991), a FSC is exempt from taxation only on a specified percentage of its income. IRC §§ 882(a), 921(d), 923(a). Under the FSC statutory mechanism, the district court's holding, which enlarged CTI and thus the income of Boeing's export subsidiaries, automatically caused the tax liability of Boeing's FSC subsidiary to increase. Therefore, consistent with its reversal of the district court's holding for Boeing, the Ninth Circuit also reversed the district court's order increasing the tax obligation of Boeing's FSC. See Pet. App. 2a n.1. The government filed a conditional cross-petition (No. 01-1382), asking that, if the Court rules for Boeing on its petition (No. 01-1209), it require Boeing's FSC to pay this additional amount. Petitioners agree that if they prevail in No. 01-1209, the government should prevail in No. 01-1382.

the tax-writing committees restated the core principle of IRC § 861 in their own words, explaining that expenses that are directly related to particular property should be allocated only to revenues from *that* property. And this requirement is unambiguously confirmed by the DISC regulations that were promulgated by the Treasury Department almost contemporaneously with enactment of the DISC statute; those regulations provide that expenses "directly related" to particular products may not be deducted from receipts generated by the sale of other products.

In these circumstances, the Ninth Circuit erred in holding that, for DISC purposes, Treas. Reg. § 1.861-8(e)(3) could validly be applied to require that R&D expenses related to one product be deemed related to *all* income from *all* products within a broad SIC Code. That requirement attributes such R&D costs to income from the sale of products that had no factual connection to the R&D. It therefore departs from the manifest congressional intent.

B. The conflict between Treas. Reg. § 1.861-8(e)(3) and the intent of Congress underlying the DISC legislation is all the more apparent in light of a second important feature of the DISC regime: taxpayers may choose whether income determinations, including the computation of CTI, are to be made on a SIC Code product-grouping basis, on a recognized industry product-grouping basis, or on a transaction-by-transaction basis. The DISC regulations promulgated shortly after enactment of the DISC statute are unambiguous in giving taxpayers the virtually unrestricted right to decide whether and how to group their products.

Accordingly, if a taxpayer exercises its right to perform CTI calculations on a recognized industry product-grouping or specific-transaction basis, the DISC regulations require that all costs factually related to each chosen industry grouping or transaction be assigned to that grouping or transaction alone – and not be reassigned to other groupings or transactions according to SIC Codes. These regulations implement one of numerous choices that Congress offered taxpayers in an effort to make the export incentive easy to use and therefore as effective as possible. The Ninth Circuit's holding undercuts this vital ingredient of the statute's design by compelling allocation of R&D on the basis of unbending product classifications defined by SIC Codes.

ARGUMENT

The statutory background here is complex, but the issue before the Court is simple and straightforward. May the IRS require allocation of product-specific R&D expenses to DISC income derived from product lines that are wholly unrelated to the underlying R&D activity? In our view, the answer to this question is clear. Every indicium of congressional intent – the plain language of the DISC statute, the background of existing legislation against which that statute was enacted, the DISC statute's explicit legislative history, the contemporaneous regulations interpreting the statute, and the unmistakable statutory policy – points in a single direction: in the computation of DISC income, product-specific costs must bear a factual relationship to the revenues from which they are deducted, and taxpayers are entitled to choose the method by which they group income and expenses.

The decision below is wholly inconsistent with both of these principles. Under the Ninth Circuit's holding, R&D costs related to the development of an improved cotton ball *must* be deducted from DISC income derived from the sale of space suits because both products happen to be listed in the same broad SIC Code. Needless to say, this requirement makes product-specific costs deductible from factually unrelated income, while also impinging on taxpayer flexibility in the grouping of transactions. Congress manifestly did not contemplate such an outcome when it enacted the DISC statute for the purpose of encouraging U.S. exports. As a consequence, application of the Ninth Circuit's approach "thwart[s] Congress's intent when it promulgated" the DISC regime and "is unreasonable, and thus invalid, as applied to DISC CTI computations." *St. Jude Medical*, 34 F.3d at 1402-1403.

A. Under The DISC Regime, Costs That Are Directly Related To Particular Income Must Be Allocated Exclusively To That Income

1. The plain language of the DISC statute precludes the allocation of product-specific costs to unrelated income.

At the outset, the Ninth Circuit's approach, which assigns costs that are factually associated with specific products to revenues from *other* products, simply cannot be reconciled with the controlling statutory language. The Code specifies that a DISC's net income, under each of the three methods of determining income permitted by the statute, is to be that "attributable to [a] sale" of export goods. IRC § 994(a). Speaking to the CTI method in particular, the statute, using similar language, goes on to provide that the income qualifying for export incentives is a specified portion of combined taxable income "attributable to the qualified export receipts." IRC § 994(a)(2).

The taxable income "attributable to" any sale necessarily consists of the gross revenue attributable to the sale less the expenses attributable to that revenue. As this Court has explained, in the tax context the "ordinary meaning [of] the phrase 'attributable to' [is] caused or generated by." *Braunstein* v. *Comm'r*, 374 U.S. 65, 70 (1963).[11] Therefore, the

[11] See also 1 OXFORD ENGLISH DICTIONARY 774-775 (2d ed. 1989) ("attributable" defined as "[c]apable of being attributed or ascribed, *esp*. as owing to, produced by"; verb "attribute" defined

language of IRC § 994(a) necessarily means that combined taxable income is the revenue generated by a sale minus the expenses that made that revenue possible – that is, the expenses that are factually related to the sale. In contrast, it is impossible to see how income from the sale of one product (*e.g.*, a Boeing 747) is, within the common usage of the words, "attributable to" factually unrelated expenses (*e.g.*, research costs relating to blimps).

Indeed, although Congress intended taxpayers to have discretion to calculate CTI for aggregations of transactions (see pages 6-8, *supra*), the default case described in the statute calls for CTI to be determined separately for each *individual* "sale of export property." See IRC § 994(a); H.R. REP. NO. 92-533, at 74. The CTI from any particular sale plainly was to be the revenue from that sale less the combined deductions of the DISC and its parent corporation attributable to the sale. Given the statutory text, it would be nonsensical to suggest that CTI was to be the revenue from the individual sale less some contrived quantum of deductions attributable partly to the particular sale in question and partly to completely unrelated sales.

Against this background, the Ninth Circuit plainly erred in holding that Treas. Reg. § 1.861-8(e)(3) could validly be applied in the circumstances of this case. Needless to say, the interpretation of a statute begins with the ordinary or natural meaning of the words used. *Federal Deposit Ins. Corp.* v. *Meyer*, 510 U.S. 471, 476 (1994); *Comm'r* v. *Soliman*, 506

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as "[t]o ascribe *to* as belonging or proper; to consider or view as belonging or appropriate *to*"); WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 141-142 (1993) ("attributable" defined as "capable of being attributed"; verb "attribute" defined as "to explain as caused or brought about by: regard as occurring in consequence of or on account of").

U.S. 168, 174 (1993). If that meaning is clear, there is no need to look further. *Gitlitz* v. *Comm'r*, 531 U.S. 206, 220 (2001); *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 254 (1992). And here, the Ninth's Circuit's approach is precluded by the plain statutory language: subtraction of product-specific research and development costs from income generated by the sale of an *unrelated* product or group of products will result in a sum that cannot be said, in any ordinary sense, to be "attributable to" that sale.

2. The statutory background and legislative history confirm the plain meaning of the statute.

This common sense reading of the DISC statute's text is confirmed by an examination of the legislative context and history. As we have noted (at page 6, *supra*), IRC § 994 was enacted against the background of existing IRC § 861, a provision that determines the geographic source of several common types of income. IRC § 861(a) establishes source rules for various items of gross income, while § 861(b) dictates how deductible costs are to be assigned to those items of gross income to permit computation of net income. The latter provision, which had been in effect without substantive change for 50 years at the time the DISC statute was enacted, provided:

> From the items of gross income specified * * * there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto *and a ratable part* of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*.

IRC § 861(b) (emphasis added). Plainly, this regime postulates that, if an expense *can* "definitely be allocated to some item or class of gross income," it falls into the first of these categories and therefore may *not* be ratably apportioned across all classes of income.

Consistent with this principle, the § 1.861-8 regulations issued by the Treasury Department in 1957 (and in effect when the DISC statute was enacted in 1971) "reiterated § 861(b)'s language." *St. Jude Medical*, 34 F3d at 1402. Subsequent proposed regulations applying IRC § 861 that were published in 1966 spelled out the necessary implication of IRC § 861(b)'s text, explicitly providing that a "deduction which is definitely related to a single item or class of gross income *shall be allocated thereto*." Prop. Treas. Reg. § 1.861-8(a)(2)(i) (1966), 31 Fed. Reg. 10,394, 10,405 (Aug. 2, 1966) (emphasis added). This proposed regulation confirmed that a deduction was "definitely related" to gross income if it was "incurred in whole or in material part as a result of, or incident to, the activities from which such gross income is derived." *Id.* at § 1.861-8(a)(3)(i). Thus, the 1966 proposed regulation articulated the established § 861 principle that expenses incurred in connection with particular income must be traced and allocated exclusively to that definitely related income.

Congress unquestionably was aware of this longstanding principle in 1971 and intended it to apply in the DISC context. In their reports accompanying the DISC legislation, both of the congressional tax-writing committees specified:

> [T]he combined taxable income from the sale of the export property is to be determined generally *in accordance with the principles applicable under section 861* for determining the source (within or without the United States) of the income of a single entity with operations in more than one country.

H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added). In addition, the committees clearly stated their understanding of the § 861 principles they were incorporating:

> These [§ 861] rules generally allocate to each item of gross income *all* expenses *directly related thereto*, and then apportion *other* expenses among all items of gross income on a ratable basis.

H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added).

To make certain that there could be no misunderstanding of their intentions, the drafters went on to explain how these § 861 principles would apply to the determination of CTI:

> [T]he combined taxable income of a DISC and [its parent company] with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the * * * expenses of both the DISC and the [parent company] *which are directly related* to the production or sale of the export property and *a portion* of the * * * expenses not allocable to *any* specific item of income[.]

H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 107 (emphasis added). This system plainly leaves no room for taking expenses that are in fact related to particular export property and apportioning them to income from the sale of other, unrelated property.

3. The DISC regulations implemented Congress's expense-tracing mandate.

This understanding also is confirmed by the DISC regulations that the Treasury Department promulgated shortly after enactment of the DISC statute – regulations that "have particular force" because they were "a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent." *Nat'l Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979). These regulations provide that CTI is "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC and [its parent corporation] *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations then spell out expressly that the costs "relating to gross receipts" are:

> (a) the expenses, losses, and other deductions *definitely related*, and therefore allocated and apportioned, thereto, and (b) *a ratable part* of any other expenses, losses, or other deductions *which are not definitely related to a class of gross income*[.]

Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added).

In fact, this was the Treasury Department's view of the proper interpretation of the DISC statute virtually from the moment of enactment. In the Technical Memorandum accompanying issuance of the proposed DISC regulations in 1972,[12] the Treasury Department explained:

> Under these rules, generally, expenses which are definitely related to particular items of income are taken into account only with respect to such items. * * * Rules are also provided to make clear that only

[12] The 1972 proposal was, for all purposes relevant to this case, virtually identical to the final regulations adopted in 1975. The only difference of note is that, while the 1972 proposed regulations referred to expenses attributable to specific income items as costs "properly apportioned and allocated" to gross receipts, the 1975 final regulations cemented the intended concept by referring to such expenses as costs "*definitely related*, and therefore allocated and apportioned," to gross receipts. Prop. Treas. Reg. § 1.994-1(c)(6)(iii) (1972), 37 Fed. Reg. 19,265, 19,266 (Sept. 21, 1972); Treas. Reg. § 1.994-1(c)(6)(iii) (1975).

> items attributable to the transaction are taken into account in computing "taxable income" of the DISC. *Thus, loss items cannot be netted against gain items unless they are from the same transaction, or in the case of a grouping election under paragraph (c)(7), are part of the same product or product line.*

1972 T.M. Lexis 14, *9 (June 29, 1972) (emphasis added). It thus was clearly understood that expenses related to particular products may *not* be offset against income from the sale of other products.

To be sure, the final DISC regulation issued in 1975 provides that costs are to be allocated to CTI "in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii). As we have explained (at page 6, *supra*), however, the version of Treas. Reg. § 1.861-8 contemporaneously in force when the DISC regulations were promulgated simply reiterated IRC § 861(b)'s language, distinguishing between expenses that may and may not "definitely be allocated" to a class of income. And a proposed revision to the § 1.861-8 regulations that was published in 1973[13] – and was still pending in 1975, when the DISC regulations became final – unambiguously applied this factual relationship principle to R&D in the DISC context.

Those 1973 proposed § 861 regulations set forth the general rule as follows:

> Expenditures for research and development which a taxpayer deducts * * * shall be considered deductions which are *definitely related* to the class of gross income to which such research and develop-

[13] The 1973 proposed regulation expanded upon and replaced the 1966 proposed regulation described at page 21, *supra*.

> ment activity gives rise or is reasonably expected to give rise and shall be allocated to such class.

Prop. Treas. Reg. § 1.861-8(e)(3)(i) (1973), 38 Fed. Reg. 15,840, 15,843 (June 18, 1973) (emphasis added). Example 1 in § 1.861-8(g) of this proposed regulation illustrated the rule by treating four-, six-, and eight-cylinder gasoline engines as separate products, each with separate and directly allocable R&D. Example 2 expressly applied this specific tracing of R&D in a DISC setting where the taxpayer had elected to treat four- and six-cylinder engines as separate product groups, necessitating separate CTI calculations for each group. R&D related to the eight-cylinder engines (a product line not sold through the taxpayer's DISC) was *not* used to offset income from sales of the four- and six-cylinder engines. The 1973 proposed regulations under IRC § 861 therefore reiterated the principle that taxpayers were "required to allocate deductions," including R&D deductions, "on the basis of the factual relationship of deductions to gross income." Prop. Treas. Reg. § 1.861-8(a)(2) (1973).

Indeed, the Treasury Department explicitly declined to include any expense allocation examples in the final 1975 DISC regulations precisely because it thought that these examples in the 1973 proposed IRC § 861 sourcing regulations were sufficient illustrations of how expenses were to be allocated for CTI purposes. According to the Technical Memorandum concerning the final DISC regulations, the Treasury Department had received complaints that the proposed CTI computation provisions lacked examples of how to allocate expenses. But

> [s]ubsequent to receipt of these comments, a notice was published under § 1.861-8 on June 18, 1973 (38 F.R. 15840) [*i.e.*, the 1973 proposed § 1.861-8 regulations] which provides rules and examples for allocation and apportionment of expenses in determin-

> ing combined taxable income of the DISC and related supplier. Hence, this suggestion [to add examples to the DISC regulations themselves] was not adopted.

1974 T.M. Lexis 30, *20-21 (Oct. 29, 1974). In the period immediately following enactment of the DISC statute, the Treasury Department thus expected that product-specific R&D would *not* be allocated to income from other products. As a consequence, the R&D allocation method used by Boeing is precisely the method anticipated both by Congress and by the drafters of the contemporaneous DISC regulations. [14]

> *4. Application of Treas. Reg. § 1.861-8(e)(3) to the determination of CTI conflicts with the DISC statute.*

In this setting, the Ninth Circuit plainly erred in holding that the ultimate version of Treas. Reg. § 1.861-8(e)(3) – adopted years *after* the DISC statute and regulations were firmly in place – could validly be applied in the circumstances of this case. That regulation deems *all* R&D expenses to be definitely related to *all* income within a broad SIC

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[14] In fact, aside from Treas. Reg. § 1.861-8(e)(3), the aberrational R&D provision at issue here, the § 861 Treasury regulations have themselves consistently recognized that the IRC § 861 regime contemplates a factual relationship between an expense and the class of income to which it is allocated. Treas. Reg. § 1.861-8(b) specifically notes that the allocation "rules emphasize the factual relationship between the deduction and a class of gross income." The preamble accompanying the proposal of the § 861 regulations on which the government relies in this case states: "If a proper allocation and apportionment of deductions *on the basis of factual relationships* is not accomplished, taxable income attributable to various sources will not be properly reflected under the applicable operative provisions of the Code." 41 Fed. Reg. 49,160, 49,161 (Nov. 8, 1976) (emphasis added).

Code, so that product-specific expenses must be spread over revenue from *other* products and product groups falling within that Code. By providing that "[e]xpenditures for research and development which a taxpayer deducts * * * shall ordinarily be *considered* deductions which are definitely related to *all* income reasonably connected with the relevant *broad product category*" (Treas. Reg. § 1.861-8(e)(3)(i)(A) (emphasis added)), the regulation eliminates any necessity for a factual connection between expenses and the income from which they are deducted.[15] Indeed, Treas. Reg. § 1.861-8 itself acknowledges that it departs from the "factual relation" principle with respect to R&D expenses, stating:

> The methods of allocation and apportionment of research and development set forth in this paragraph (e)(3) recognize that * * * the gross income derived from successful research and development must bear the cost of unsuccessful research and development.

Treas. Reg. § 1.861-8(e)(3)(i)(A).

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[15] The abrupt about-face in the regulations' R&D allocation method is brought into sharp relief through a comparison of Example 2 in § 1.861-8 of the 1973 proposed regulations and Example 4 in § 1.861-8(g) of the 1977 final regulations. Example 2, it will be recalled, did not allocate the R&D expenses related to developing 8-cylinder engines to the revenues from the sales of 4- and 6-cylinder engines. See page 25, *supra*. In Example 4 of the 1977 regulations, on the other hand, R&D expenses related to bulldozer development were used to offset the revenues from both bulldozers *and* lawn mower engines because both fall within the same SIC Code. The 1977 Example 4 therefore ignores the factual connection between expenses and revenues that was central to the outcome in the 1973 proposed regulation's Example 2.

As the Eighth Circuit noted in striking down this regulation as applied to CTI calculations, this approach "*deem[s]* a definite relationship" to exist between an expenditure for R&D and *all* income associated with a broad product category (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D or how broad the product category. And these SIC Code product categories are very broad indeed; the regulation lists a scant 20 product categories for manufactured goods, into which all of the vast multitude of discrete products generated by the American economy must fall. See Treas. Reg. § 1.861-8(e)(3)(i)(A).

Not surprisingly, application of this regulation in the computation of CTI can lead to perverse results, as this case strikingly demonstrates. Under the court of appeals' holding, Boeing R&D that relates exclusively to *one* specific airplane model has to be allocated, in large part, to revenue from the sale of *other*, unrelated models. If Boeing incurred a research expense in 1987 that was directed solely to improving a component unique to a new 767 model that was not yet in production, the Ninth Circuit would require treating the expense as part of the cost of that year's sales of model 747 airplanes – even though the 747 had been introduced years earlier and did not benefit at all from R&D relating to the 767. By the same token, the court of appeals' holding would require that research costs from the development of hang gliders, blimps, or the recently announced "Sonic Cruiser" all be allocated, in part, to the revenue from the sale of 747s because they all fall within the SIC Code 37 ("transportation equipment").

For the reasons discussed above, application of this methodology in the DISC context is insupportable. The "deemed" relationship ignores the *actual* connection between expense and income, which Congress manifestly intended to guide CTI calculations under the DISC statute. The Ninth Circuit's approach also cannot be squared with the contemporaneous regulations that the Treasury Department itself issued implementing that statute's terms.

In these circumstances, it would be best to interpret Treas. Reg. § 1.861-8(e)(3) not to apply at all to the computation of CTI. The Treasury Department evidently contemplated that there would be situations in which R&D expenses should not be deemed related to all income within an applicable SIC Code; Treas. Reg. § 1.861-8(e)(3)(A) provides that such treatment "[o]rdinarily" is appropriate, which of course suggests that there are some types of cases in which such treatment is *in*appropriate. This plainly is such a case. Because application of Treas. Reg. § 1.861-8(e)(3) cannot be squared with the DISC statute, that regulation should yield to the specialized DISC regulations that were specifically designed to govern the CTI determination. See *Morales* v. *Trans World Airlines, Inc.*, 504 U.S. 374, 384 (1992) ("it is a commonplace of statutory construction that the specific governs the general"); *Crawford Fitting Co.* v. *J. T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987) ("[w]here there is no *clear* intention otherwise, a specific statute will not be controlled or nullified by a general one") (citation and internal quotation marks omitted; alteration and emphasis supplied). But whether or not the drafters of Treas. Reg. § 1.861-8(e)(3) intended it to apply in cases such as this one, the outcome must be the same: the plain text of and manifest intent behind the DISC statute precludes use of the regulation's "deemed relationship" methodology in calculating CTI.

B. The DISC Statute And Regulations Allow Taxpayers To Choose Whether CTI Is Calculated On The Basis Of Industry Usage Rather Than SIC Code

1. The conclusion that product-specific expenses must be deducted from the DISC income to which they are factually related is enough to dispose of this case. But the Ninth Circuit's holding that CTI must be calculated by spreading R&D expenses across all products within a broad SIC Code is erroneous for a second, closely related reason: the DISC regulations emphatically state that the taxpayer is entitled to *choose* whether or not CTI determinations will be made on the basis of particular sales, on the basis of product groups recognized by industry usage, or on the basis of SIC Code product groups. That choice, once made, identifies the universe of sales income to which related expenses must be allocated. And the regulations establishing the primacy of taxpayer choice in this regard implement the clear congressional intent.

As we have noted (page 19, *supra*), the governing statutory provision calls for CTI to be determined separately for *each* "sale of export property." See IRC § 994(a). Needless to say, performing separate calculations of CTI for each individual export sale could severely burden the accounting resources of a large exporter, which may have many thousands of export sales every year. Undoubtedly mindful of this looming administrative hardship, the congressional tax-writing committees specified that, "[a]lthough both of the pricing rules provided by the bill generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines." H.R. REP. NO. 92-533, at 74; S. REP. NO. 92-437, at 108. Indeed, Congress attached such importance to affording taxpayers product-grouping alternatives that it included provisions specifically authorizing grouping in each successive export incentive enactment. IRC § 927(d)(2)(B) (1984) (FSC); IRC § 943(b)(1)(B) (2000) (ETI).

The Treasury Department faithfully implemented this congressional intent in the regulations issued shortly after enactment of the DISC statute. These regulations establish two product-grouping alternatives to transaction-by-transaction computations of CTI: "recognized industry or trade usage" groups *or* the "groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). The regulations then added even greater flexibility by permitting taxpayers to choose grouping selectively. Thus, "the taxpayer may choose a product grouping with respect to one product and use the transaction-by-transaction method for another product within the same taxable year." Treas. Reg. § 1.994-1(c)(7)(iii). Moreover, because grouping was "at the annual choice of the taxpayer" (Treas. Reg. § 1.994-1(c)(7)(i)), taxpayers could change their grouping decisions from year to year.

Because the purpose of grouping was to ease taxpayer burdens while allowing taxpayers to maximize their DISC tax benefits, the DISC regulations make explicit that the taxpayer has the right to select which of these grouping options to use. They state that a product grouping "determination by a taxpayer * * * *will be accepted* [by the IRS]" as long as the taxpayer's choice conforms either to recognized industry usage or to the SIC Code classifications referred to above. Treas. Reg. § 1.994-1(c)(7)(ii) (emphasis added). For good measure, the regulations provide that "[t]he taxpayer's choice [as to grouping] * * * shall be controlling." Treas. Reg. § 1.994-1(c)(6)(iv)(emphasis added).

2. The virtually unrestricted opportunity to choose product groupings is one of a raft of choices that the DISC program made available to taxpayers. Taxpayers were given

substantial leeway to determine for themselves how best to maximize their tax benefits, minimize their compliance burdens, and strike the balance between benefits and burdens. This broad flexibility was essential to making the DISC program effective as an export incentive. Thus, at every turn the congressional design enabled taxpayers free rein to make choices.

For example, although the statute generally contemplated that an exporter would sell its goods to its DISC, which in turn would resell them to the customer, Congress alternatively allowed taxpayers to continue making sales directly to their customers while paying their DISCs a sales commission. IRC § 994(b)(1). The regulations duly specify that an exporter would obtain an equal tax benefit under either export sales structure. See Treas. Reg. § 1.994-1(d)(2).

Similarly, Congress incorporated broad flexibility in a requirement (IRC § 992(a)(2)) that DISCs invest their tax-deferred earnings in assets relating to exports. The statute provides a long menu of qualifying investments, including inventories of goods to be exported, customer accounts receivable arising from export sales, certain loans for use in the parent corporation's export business, securities issued by the Export-Import Bank, and several others. IRC § 993(b); Treas. Reg. § 1.993-2. With all these choices, every taxpayer could comply with the statute's investment requirement in the manner best suited to its particular business.

In addition, as explained above, the statute permits taxpayers to maximize their DISC benefits by choosing from one of three alternative transfer pricing methods. IRC § 994(a). See page 4, *supra*. From among these options, taxpayers were free to "choose the method resulting in the greatest amount of profit" for the DISC. *St. Jude Medical*, 34

F.3d at 1397.[16] Because the various transfer pricing methods were available on a transaction-by-transaction basis (IRC § 994(a)), taxpayers also were free to apply any of the permitted pricing methods to certain sales while applying a different method or methods to other sales. Indeed, because the statute made DISC benefits available for individual transactions, an exporter was free to decline DISC benefits altogether for selected export sales.

This wide array of choices that Congress built into the DISC regime was critical to the achievement of the statute's function as a tax incentive. Congress's overriding goal was to provide a stimulus that would encourage as many companies as possible to increase their export sales, thus keeping domestic jobs from moving overseas. Although the statute promised significant tax benefits to that end, obtaining those benefits could impose a considerable cost: possibly undesirable structural changes to export businesses; greater compliance burdens; the inconvenience of interposing the DISC in the sales channel to the customer; and the enormous administrative difficulty of separately calculating the DISC benefit for potentially thousands of individual export sales every year. Had the statute been designed too inflexibly, these various disadvantages would have discouraged use of the incentive, thereby eroding its intended stimulative effect. But the

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[16] The three pricing methods also provided taxpayers with flexibility in determining to what extent they had to reorganize their business in order to take advantage of the DISC incentive. Normally, transactions between related parties are governed by the arm's length standard of IRC § 482, which assigns profits based on the relative economic functions of the parties. By providing two additional pricing options, Congress created additional flexibilty by relieving taxpayers of the burden of dividing the economic functions between the taxpayer and the DISC to justify the DISC's profit level. See Treas. Reg. § 1.994-1(a)(2).

DISC system's many compliance and benefit-calculation options, which vest wide discretion in the taxpayer, enabled each company to strike its own balance of burdens and benefits, thereby maximizing the nationwide effectiveness of the incentive. The broad range of taxpayer choice, of which the "grouping" regulation was an integral part, therefore was central to the fulfillment of Congress's principal objective.

3. Application of Treas. Reg. § 1.861-8(e)(3) in this setting clashes directly with the critical taxpayer-choice feature of the DISC regime. In this case, Boeing exercised its option to group its transactions by product lines that indisputably conform with recognized industry practice. But rather than allocate R&D costs to the classes of income "resulting from [the taxpayer's] grouping," as the DISC regulation mandates, Treas. Reg. § 1.861-8(e)(3) requires that such costs be allocated according to SIC Code – which is not, of course, the alternative that Boeing, exercising its unfettered discretion, decided to use.

The Ninth Circuit went fatally astray in endorsing this approach to the allocation of R&D in the DISC context. When a taxpayer makes a product-grouping choice, *all* of "the determinations under [Treas. Reg. § 1.994-1] are to be made * * * on the basis of" the taxpayer's chosen groupings. Treas. Reg. § 1.994-1(c)(7)(i). That is, *every* aspect of the calculation of CTI must be made in accordance with the groupings that the taxpayer has selected. Of course, the allocation of expenses to sales is one of those aspects and, as we have explained (pages 23-25, *supra*), the regulation expressly dealing with that matter (Treas. Reg. § 1.994-1(c)(6)(iii)) calls for expenses to be allocated to the sales that are factually related to those expenses. Consequently, when a taxpayer has decided to employ product groupings, expenses are to be allocated on the basis of their factual relationship to sales *within each chosen grouping*. The regulations spell out this point as well. Treas. Reg. § 1.994-1(c)(6)(iv) ("costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from [the taxpayer's] grouping.").

As the Eighth Circuit accordingly explained in rejecting application of Treas. Reg. § 1.861-8(e)(3) in the computation of CTI, "*[m]andating* use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated [either] on a product-by-product basis *or* on the basis of product lines." *St. Jude Medical*, 34 F.3d at 1401 (emphasis added). The decision below thus works a significant, and unwarranted, change in Congress's carefully drawn balance of incentives and compliance requirements.

C. The Ninth Circuit's Reasoning Does Not Support Its Judgment

In nevertheless requiring the allocation and apportionment of R&D expenses on the basis of SIC Code when DISC CTI is calculated, the Ninth Circuit entirely failed to address the legislative and regulatory background. And the rationales that the court of appeals did advance cannot support its holding.

1. To begin with, after observing that IRC § 994(a)(2) required CTI "to be calculated based on revenue and costs 'attributable to' sales," the court of appeals noted that "[t]his statutory text does not confine the relevant costs to those 'definitely related' to sales of a particular product." Pet. App. 11a. That statement is unassailable; relevant costs also clearly include "a ratable part of any other [costs] which are not definitely related" to sales of *any* particular product. See Treas. Reg. § 1.994-1(c)(6)(iii). But it is undisputed in this case that the R&D costs that the IRS reallocated to Boeing's export sales *were* definitely related to particular products or product lines – products *that Boeing did not export*. The

court of appeals simply blinded itself to this incontrovertible fact. The court never even tried to explain how CTI amounts could possibly be "attributable to" the products that Boeing did export if those amounts were reduced by costs definitely related to products that Boeing did not export.

Nor did the Ninth Circuit explain why its holding was supported by the comment that "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." Pet. App. 11a. That observation, while also doubtless correct, is simply beside the point. That certain costs (*e.g.*, charitable contributions, see Treas. Reg. § 1.861-8(e)(9)) are not directly related to specific products hardly means that costs that *are* directly related to specific products should be apportioned to revenue from the sale of *other* products. The Ninth Circuit's sleight-of-hand thus cannot obscure its departure from the fundamental principles underlying the DISC statute and regulations.

The court of appeals made a related error in opining that Treas. Reg. § 1.861-8(e)(3) and § 1.994-1(c) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income." Pet. App. 12a. This perplexing statement disregards both the undisputed facts and the controlling law. As we have just explained, the statement is flatly wrong as a factual matter because the R&D costs for each Boeing Program were *definitely* related to that Program and that Program alone, and were completely *unrelated* – "indefinitely" or otherwise – to other Programs. The Ninth Circuit's statement is equally indefensible as a legal proposition, because Treas. Reg. § 1.861-8(e)(3)(i) manifestly did not transform any R&D expenses into costs "'indefinitely' related to specific items of income." To the contrary, the theory of the regulation is that all R&D costs may be deemed "*definitely* related to all income reasonably connected with the relevant [SIC] category" (emphasis added). The Ninth Circuit's justification for its conclusion therefore is unsupported by the very provision it purports to interpret.

In fact, as we have noted, the default method of CTI computation is transaction-by-transaction. IRC § 994(a)(2); Treas. Reg. § 1.994-1(c)(7)(i) ("Generally, the determinations under this section are to be made on a transaction-by-transaction basis."); see also H.R. REP. NO. 92-533, at 74. Congress thus expected that DISC income very often would be calculated on the narrowest possible basis, that of individual sales. There is no indication that Congress expected this method of calculation to require the association of vast, "indefinitely related" costs with the sales revenue.

2. The court of appeals also may have meant to adopt the government's argument below (see U.S. 9th Cir. Br. 11) that it was impermissible for Boeing to allocate R&D expenses to Programs that had no current gross income from which those expenses could be deducted. See Pet. App. 3a (stating that such costs "simply 'disappeared'"). If so, the court plainly erred.[17] The reality is that the U.S. taxation sys-

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[17] We note that the government's own allocation method would not eliminate the phenomenon of "disappearing" R&D expenses. Take, for example, the case of a company currently producing and exporting athletic clothing (SIC Code 23) that decides to invest the proceeds of its clothing sales in research to develop a line of athletic equipment (SIC Code 39). The company has current DISC sales of $1,000,000 from the athletic clothing, no current sales of athletic equipment, and $500,000 in athletic equipment R&D expenses. Under the government's allocation method, the $500,000 of equipment-related R&D will be allocated to the athletic equipment SIC Code, which has no income. It will not be allocated to the athletic clothing SIC Code to reduce the income eligible for the

tem, with few exceptions, is based upon the annual accounting of revenue and deductible costs. See, *e.g.*, IRC § 441(a) ("Taxable income shall be computed on the basis of the taxpayer's taxable year."). See generally *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931); *Healy* v. *Comm'r*, 345 U.S. 278, 285 (1953).

The "disappearance" of R&D costs therefore is the *intended* consequence of another legislative tax incentive: Congress's decision to make R&D expenses currently deductible (see IRC § 174) so as "to encourage expenditure for research and experimentation." *Snow* v. *Comm'r*, 416 U.S. 500, 504 (1974) (citation and internal quotation marks omitted). R&D expenses are likely to exceed any income they generate during the early years in the development cycle of any product. By nonetheless authorizing the current-year deduction – rather than capitalization (see IRC § 263A(c)(2)) – of R&D expenditures, Congress authorized these expenditures to "disappear."

It therefore is not surprising that Treas. Reg. § 1.861-8 itself acknowledges that expenses incurred in one year may exceed the related income (if any) earned in that year. The regulation repeatedly and explicitly acknowledges that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class * * * *even though, for the taxable year, no gross income in such class is received*." Treas. Reg. § 1.861-8(d)(1) (emphasis added); see also *id.* §§ (b)(1), (b)(2), (c)(1). Thus, the regulations under § 861 acknowledge and expressly countenance this temporal mismatch phenomenon.

What is more, the government's "disappearance" argument, if accepted, could greatly reduce the value of tax incen-

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DISC benefit related to the clothing. That expense accordingly will, in the Ninth's Circuit's words, "simply disappear."

tives aimed at increasing exports and encouraging long-term research on new programs. For example, if Boeing undertook development of a new product that would be of significant benefit to the country – such as the Sonic Cruiser – the enormous R&D expenses likely to be related to that product would reduce the export benefit from the unrelated current sales of commercial aircraft. The government's application of Treas. Reg. § 1.861-8(e)(3) therefore stands to penalize exporters who perform R&D on new products by diminishing the tax advantages related to their current exports. That result is clearly contrary to Congress's intention to create incentives for both exports and R&D.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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