Nos. 01-1209 and 01-1382

In the Supreme Court of the United States

THE BOEING COMPANY AND
CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

UNITED STATES OF AMERICA, CROSS-PETITIONER

v.

BOEING SALES CORPORATION, ET AL.

*ON PETITIONS FOR WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT*

BRIEF FOR THE UNITED STATES

THEODORE B. OLSON
Solicitor General
Counsel of Record

EILEEN J. O'CONNOR
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

DAVID ENGLISH CARMACK
FRANK P. CIHLAR
Attorneys

Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTIONS PRESENTED

No. 01-1209

1. Whether, in computing their combined taxable income from the export sales of aircraft during the period from 1979-1984 under the provisions of the Internal Revenue Code pertaining to "domestic international sales corporations" (26 U.S.C. 991-997 (1976 & Supp. III 1979)), petitioners must take into account expenses incurred for aircraft research and development in the manner required by the then-applicable Treasury Regulations.

2. Whether, in computing their combined taxable income from the export sales of aircraft during the period from 1985-1987 under the provisions of the Internal Revenue Code pertaining to "foreign sales corporations" (26 U.S.C. 921-927 (1988)), petitioners must take into account expenses incurred for aircraft research and development in the manner required by the then-applicable Treasury Regulations.

No. 01-1382

3. Whether, if the judgment in No. 01-1209 is reversed, the judgment in favor of cross-respondent in No. 01-1382 should then also be reversed.

TABLE OF CONTENTS

Table of Contents—continued: Page

Table of Contents—Continued: Page

TABLE OF AUTHORITIES

Cases:

In the Supreme Court of the United States

No. 01-1209

THE BOEING COMPANY AND
CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

No. 01-1382

UNITED STATES OF AMERICA, CROSS-PETITIONER

v.

BOEING SALES CORPORATION, ET AL.

ON PETITIONS FOR WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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. A petition for rehearing was denied on November 19, 2001. The petition for a writ of certiorari was filed on February 15, 2002, and a conditional cross-petition was filed on March 20, 2002. Both were granted on May 28, 2002. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Sections 861 and 994 of the Internal Revenue Code, 26 U.S.C. 861 and 994 (1976 & Supp. III 1979), and of 26 C.F.R. 1.861-8 and 1.994-1 (1979), as they were in effect in the years relevant to this case, are set forth at Pet. App. 26a-53a. In addition to those provisions, the relevant portions of Sections 174 and 925 of the Internal Revenue Code, 26 U.S.C. 174, 925 (1988), of 26 C.F.R. 1.925(a)-1T (1989), and of 26 C.F.R. 1.861-17 are set forth at App., *infra*, 1a-12a.

STATEMENT

1. Congress has authorized the Secretary of the Treasury to prescribe regulations "to properly apportion[]" expenses in calculating income resulting from foreign sales of goods. 26 U.S.C. 863(a). This case concerns a challenge to the regulations adopted by the Secretary to properly allocate research and development costs under that statute. The question presented in this case arose under two separate sets of statutory and regulatory provisions, which have since been modified or repealed.

a. In 1971, Congress enacted provisions that established a separate tax status for "domestic international sales corporations" (DISCs). 26 U.S.C. 991-997 (1976 & Supp. III 1979). The DISC provisions sought to "provide substantial stimulus to exports and at the same time to avoid granting undue tax advantages." S. Rep. No. 437, 92d Cong., 1st Sess. 13 (1971). Under these provisions, a domestic manufacturer could form a DISC in the United States "the income of which is not taxed at the DISC level. Instead, the corporate shareholder was taxed directly on a portion of the DISC's income deemed distributed. The portion of the income not deemed distributed was not subject to any U.S. taxation until actually distributed." R. Doernberg, *International Taxation* 395-396 (4th ed. 1999).[1]

b. Soon after their enactment, the DISC provisions were challenged by other Nations as impermissible export subsidies under the General Agreement on Tariffs and Trade. See R. Doernberg, *supra*, at 396. As a consequence, Congress replaced the DISC provisions in 1984 with the "foreign sales corporation" (FSC) provisions of the Code. 26 U.S.C. 921-927 (1988). See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(b), 98 Stat. 1000-1001.[2]

Under the FSC provisions, a U.S. parent would establish a foreign subsidiary to conduct export sales.[3] "If a corporation qualifies as a FSC, a portion of its foreign trade income is exempt from the U.S. corporate income tax. That portion can be distributed as a dividend tax-free to the U.S. parent corporation * * * ." R. Doernberg, *supra*, at 397. To escape taxation entirely on the portion of the income allocated to the FSC, "many U.S. corporations organize FSCs in

---

[1] This, at least, was the theory when the DISC provisions were enacted. When the DISC provisions were replaced in 1984, however, previously accumulated and undistributed DISC income was effectively exempted from tax in many cases. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(b)(2)(A), 98 Stat. 1001.

[2] The DISC provisions were left in effect only "for small corporations" (with export receipts less than $10 million) and were revised to require the payment of interest on any deferred tax liability. 26 U.S.C. 995(b)(1)(E), 995(f) (1988).

[3] Unlike the DISC, the FSC is a foreign corporation, and a portion of its foreign trade income is subject to United States tax. 26 U.S.C. 921, 923. For this reason, Boeing Sales Corporation (petitioner's FSC) is a party to this case.

foreign countries imposing relatively low, or no, corporate and dividend withholding taxes on that income." *Ibid.*[4]

2. a. The DISC and FSC provisions "quickly reach, and rarely leave, a plateau of statutory intricacy seldom rivaled in other sections of the Code." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.14, at 17-43 (4th ed. 1979); *id.* ¶ 17.14, at 17-55 (5th ed. 1987). The central feature of each regime is the allocation of the income resulting from export transactions between the parent and its sales subsidiary. In general, under these provisions, the parent has an incentive to maximize the portion of the profits from export sales allocated to its sales subsidiary, rather than to the parent, in order to defer (under the DISC) or exempt (under the FSC) that income from tax.

b. Under the DISC regime, the portion of the export income attributed to the DISC is based on an assumed "transfer price"[5] for the exported good that would allow the DISC to derive net income that does not exceed the

---

[4] After the World Trade Organization concluded that the FSC provisions provided a prohibited export subsidy (World Trade Organization, Appellate Body, *United States—Tax Treatment for "Foreign Sales Corporations," Recourse to Article 21.5 of the DSU by the European Communities*, AB-2001-8, at 91-93 (Jan. 14, 2002)), Congress repealed and replaced the FSC provisions with the "extraterritorial income exclusion" of Section 114 of the Internal Revenue Code. 26 U.S.C. 114.

[5] The "transfer price" is the hypothetical price at which the good is assumed to have been transferred from the U.S. parent to its DISC or FSC. Once calculated under the DISC and FSC provisions, this price is used in allocating the net income from the transaction between the parent and its sales subsidiary. 26 U.S.C. 994(a); 26 U.S.C. 925(a).

greatest of (i) 4% of the export receipts, (ii) 50% of the "combined taxable income" of the parent and the sales subsidiary, or (iii) the income that would result from an arm's length sale price. 26 U.S.C. 994(a). The FSC regime has a similar profit allocation procedure. 26 U.S.C. 925(a) (1988). The DISC and FSC regulations permit the taxpayer to apply one transfer price method for one group of sales while applying a different transfer price method for another group of sales made during the same year. 26 C.F.R. 1.994-1(c)(7)(i) (DISCs); 26 C.F.R. 1.925(a)-1T(c)(8) (FSCs).

c. Petitioner elected to use the "transfer price" method that is based on the "combined taxable income" of the parent and the sale subsidiary for all of its groups of DISC and FSC export sales.[6] The specific questions addressed in this case concern the proper method for calculating "combined taxable income" under the governing regulations.

Congress did not define the term "combined taxable income" in either the DISC (26 U.S.C. 994(a)(2)) or the FSC (26 U.S.C. 925(a)(2) statutes. In enacting these provisions, however, Congress made clear that it intended that the term "combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable

[6] As used in this brief, the singular "petitioner" refers to the parent corporation, The Boeing Company. Under the method used by petitioner, the transfer price is the price that would allow the DISC to derive income attributable to the sale of the property in an amount that does not exceed "50 percent of the combined taxable income of such DISC and [the parent] which is attributable to the qualified export receipts on such property derived as the result of a sale by the DISC." 26 U.S.C. 994(a)(2). The cognate rule for a FSC is found in Section 925(a)(2), which sets the limit at 23% of "combined taxable income." 26 U.S.C. 925(a)(2).

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. 533, 92d Cong., 1st Sess. 74 (1971).

Section 861, to which the DISC committee reports refer, distinguishes between United States and foreign source income for various income tax purposes.[7] Section 861(a) specifies a number of broad categories of gross income (such as interest from United States payers) that are treated as United States source income. 26 U.S.C. 861(a). Section 861(b) provides, in turn, that expenses "properly apportioned or allocated" to the items of United States source income specified in Section 861(a), along with a ratable portion of any expense that "cannot definitely be allocated" to an item of gross income, are to be deducted to arrive at United States source taxable income. 26 U.S.C. 861(b). Congress specified that the determination whether an expense is "properly apportioned or allocated" to an item of gross income for this purpose is to be made "under regulations prescribed by the Secretary [of the Treasury]." 26 U.S.C. 863(a), (b).

d. The regulations adopted by the Secretary to implement the DISC provisions track the legislative reports. 26 C.F.R. 1.994-1(c)(6) provides that the "combined taxable income" from a sale of export property "is the excess of the gross receipts * * * of the DISC from such sale over the total costs of the DISC and

[7] Whether income has a domestic or foreign source has importance for several purposes. The primary role of this determination is in the calculation of permissible foreign tax credits and the avoidance of double taxation of foreign source income. See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶¶ 17.10, 17.11, 17.30 (5th ed. 1987).

related supplier which relate to such gross receipts." Section 1.994-1(c)(6)(iii), in turn, defines the costs that are treated as relating to those gross receipts as:

> (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, *determined in a manner consistent with the rules set forth in § 1.861-8*.

26 C.F.R. 1.994-1(c)(6)(iii) (emphasis added). As Congress contemplated, the DISC regulations thus specifically incorporate the cost allocation regulations adopted by the Secretary under Section 861.

In 1977, following public notice and comment, the Secretary adopted final regulations under Section 861 that specifically address cost allocation for DISCs and other purposes. In general, under these regulations, expenses and other deductions are allocated and apportioned to the item or class of gross income to which they are "definitely related." 26 C.F.R. 1.861-8(b)(1). Deductions that are related to all of a taxpayer's gross income, or that are not "definitely related" to any specific class of gross income, are ratably apportioned to all gross income. 26 C.F.R. 1.861-8(b)(5), (c)(1), (c)(2).

In adopting this general cost allocation rule, the Secretary determined that special provision was required for the proper treatment of research expenditures. The regulations note "that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development." 26 C.F.R. 1.861-8(e)(3)(i)(A) (1979). In light of these facts, the Secretary determined that research and development expenses are properly to be "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)." *Ibid.* The regulations adopted in 1977 used the two-digit categories in the Standard Industrial Classification Manual published by the Office of Management and Budget (SIC codes) as the relevant product categories. *Ibid.* When the regulations were revised in 1995, however, the narrower three-digit standard industrial classification codes were adopted as the appropriate product categories for this purpose. 26 C.F.R. 1.861-17(a)(2)(ii). See T.D. 8646, 1996-1 C.B. 145.

3. a. Petitioner elected to group its export sales according to petitioner's internally designated "Airplane Programs" and to use the "combined taxable income" method for determining the transfer price applicable to each grouping. Petitioner therefore computed the "combined taxable income" separately for each program. Pet. App. 2a-3a. In doing so, however, petitioner failed to follow the requirement of the governing regulations that research and development expenses be allocated on the basis of the (then) two-digit industrial classification codes specified in 26 C.F.R. 1.861-8(e)(3)(i)(A). Instead, petitioner allocated the majority of its research and development expenses along narrower, airplane-by-airplane product lines. Pet. App. 3a. The result of the narrower allocation method followed by petitioner was to reduce the research and development expenses allocated to its

export sales, thereby increasing the "combined taxable income" from those sales and decreasing the resulting United States taxes owed by petitioner during the relevant years. *Id.* at 3a-4a.

b. Petitioner's principal business division is its Commercial Airplane Division, which is divided for management and accounting purposes into programs dealing with specific airplane models or with spares, sundry or other activities. Pet. App. 2a. For internal accounting purposes, petitioner divided its research expenditures into two categories: "Blue Sky R&D" and "Company Sponsored Product Development." Of the approximately $4.6 billion in research costs incurred by petitioner during the relevant years, approximately $1.0 billion was classified as "Blue Sky" and $3.6 billion was classified as "Company Sponsored" research. *Id.* at 2a-3a; C.A. E.R. 4-5.

Blue Sky research involved both basic airplane technology and the development of new airplane models prior to the Board's approval of those models as "programs" for production. A large portion of petitioner's Blue Sky research expenses were incurred in "projects" that were the precursors to specific formally identified "programs." For example, during the years involved in this case, petitioner incurred substantial Blue Sky research costs related to what petitioner referred to as the "7X7" project, which eventually became the 767 Program when petitioner's Board of Directors later authorized the production phase of the program. Pet. App. 3a, 17a; C.A. E.R. 62-63, 102.[8]

[8] The commitment of the Board of Directors to authorize production of a particular airplane model was contingent on petitioner's having received significant firm customer orders for that airplane model. Pet. App. 3a, 17a; C.A. E.R. 105-106, 115-116.

"Company Sponsored" research costs were, by contrast, the research costs that petitioner's accounting system identified with particular airplane programs *after* those programs were approved for production by the Board. The difference between "Blue Sky" and "Company Sponsored" research is thus solely a function of the way petitioner chose to divide its commercial airplane business for internal cost accounting and management purposes. Pet. App. 16a-18a; C.A. E.R. 4.[9]

c. During the years at issue, petitioner had commercial sales of airplanes and services of approximately $64 billion, of which $43 billion (67%) were export sales. C.A. E.R. 2-3, 6, 152. In computing "combined taxable income" for these export sales, petitioner followed the requirements of the governing regulations in part, by allocating its "Blue Sky" research costs among *all* of its airplane programs (although petitioner incorrectly did so on the basis of the number of direct labor hours incurred in each program rather than on the basis of sales). Pet. App. 3a; C.A. E.R. 157. With respect to "Company Sponsored" research, however, petitioner declined to follow the regulations and instead sought to allocate those research costs to the particular programs for which they were ostensibly incurred. Applying that method, petitioner routinely made substantial allocations of "Company Sponsored" research costs to specific airplane programs in years before *any* sales were made by those programs. Of the $3.6 billion classified as "Company Sponsored" research during the years relevant to this case, petitioner allocated

[9] During the tax years at issue in this case, petitioner established or maintained separate management and accounting systems for each of the following airplane models: 707, 727, 737, 737-300, 747, 757 and 767. Pet. App. 16a.

approximately half ($1.75 billion) to programs that had no sales in the year the research was conducted. Although *all* of this $1.75 billion was deducted by petitioner (under 26 U.S.C. 174) in calculating its "taxable income" for the years at issue, petitioner asserts that *none* of that amount should be deducted in determining the "combined taxable income" for the export sales made under the DISC and FSC provisions. Pet. App. 3a; C.A. E.R. 152-153.

d. On audit, the Commissioner determined that petitioner's failure to follow the requirements of the regulation unrealistically inflated the amount of income deferred or exempted under the DISC and FSC provisions. Applying the text of the governing regulation (26 C.F.R. 1.861-8(e)(3) (1979)), the Commissioner allocated all of petitioner's research expenses (both "Blue Sky" and "Company Sponsored") to *all* of petitioner's income from sales of commercial airplanes (since all such airplanes are within the two-digit Standard Industrial Classification Code 37 for transportation equipment) and apportioned those expenses among petitioner's programs on the basis of the sales income in each program. This resulted in a higher allocation of research expenses to petitioner's qualified export sales, a lower "combined taxable income" for those sales under the DISC and FSC provisions, and therefore a greater tax liability for petitioner for each of the years in question. Pet. App. 3a-4a, 18a.

4. Petitioner paid the additional tax and brought this timely suit for refund in the United States District Court for the Western District of Washington. Pet. App. 4a. Petitioner claimed that the regulation adopted by the Secretary to allocate research expenditures in the calculation of "combined taxable income" under 26

C.F.R. 1.861-8(e)(3) is invalid as applied to DISC and FSC transactions.

The district court agreed with petitioner. The court held that there is a "conflict" between the two-digit Standard Industrial Classification Code product categories mandated by 26 C.F.R. 1.861-8(e)(3) and the statement in the DISC regulation that a taxpayer's choice in the grouping of transactions is "controlling" (26 C.F.R. 1.994-1(c)(6)(iv) (1979)). Pet. App. 21a. Adopting the reasoning of the Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (1994), rev'g 97 T.C. 457 (1991), the district court held that this conflict should be "resolved in Boeing's favor." Pet. App. 21a. Having concluded that the research cost-allocation rule of 26 C.F.R. 1.861-8(e)(3) is invalid for DISC computations, the court awarded a refund of tax and interest to petitioner in the amount of $419,110,539. Pet. App. 4a.[10]

5. a. The court of appeals reversed. Pet. App. 1a-14a. The court emphasized at the outset that Congress has given the Secretary wide latitude to adopt "legislative regulations" to implement these complex statutory provisions. *Id.* at 5a. In view of the considerable deference owed to the Secretary's exercise of these "explicit grants" of rulemaking authority, the court

---

[10] Because the decision of the district court resulted in a correlative increase in the taxable income of petitioner's FSC, the court also awarded the government a judgment of $481,149 against Boeing Sales Corporation. See *United States* v. *Boeing Sales Corp.*, Cond. Cross Pet. 01-1382 (March 20, 2002) at 3. Petitioners have agreed with the submission of our cross petition that, if the judgment of the court of appeals in favor of the government is reversed in No. 01-1209, the judgment of the court of appeals in favor of Boeing Sales Corporation should be reversed in No. 01-1382 as a purely computational matter. See Pet. Br. 15 n.10.

concluded that the challenged regulations reflect a "permissible interpretation" of the statutes and should therefore be sustained. *Id.* at 5a-6a.

In particular, the court of appeals upheld the Secretary's determination that 26 C.F.R. 1.861-8(e)(3) provides an appropriate method for allocating research expenses in calculating "combined taxable income" under the DISC and FSC provisions. Pet. App. 10a-11a. The court noted that, under the plain text of Section 994(a)(2), "[combined taxable income] is to be calculated based on revenue and costs 'attributable to' sales in the applicable year * * * [and the statute] does not confine the relevant costs to those 'definitely related' to sales of a particular product." *Id.* at 11a. Instead, as the legislative history of the statute makes clear, "Congress recognized some of the costs incurred in a given tax year would not be 'directly related' to specific income items * * * [and] that those costs not 'directly related' would be allocated to export-related sales on a pro rata basis." *Ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74). The court explained that the challenged regulation "is a permissible interpretation" of the statute and "effectuates this Congressional intent" to ensure that the "total costs" related to export sales—including a pro rata share of research costs—are deducted in calculating the "combined taxable income" from the sale of exported goods. Pet. App. 6a, 11a.

The court of appeals rejected the conclusion of the Eighth Circuit in *St. Jude* that the allocation requirements of 26 C.F.R. 1.861-8(e)(3) are inconsistent with the statement in the DISC regulations (26 C.F.R. 1.994-1(c)(6)(iii)) that expenses "definitely related" to a transaction are to be allocated to that sale. The court emphasized that the DISC regulations cited in *St. Jude* do not define what costs are "definitely related" to a transaction "other than by reference to § 1.861-8." Pet. App. 9a. And, while the Section 861 regulations themselves contain the same general requirement that costs "definitely related" to a particular product are to be apportioned to that product (26 C.F.R. 1.861-8(b)(2)), these regulations further provide that, in view of the inherently speculative and broad nature of research activities, research costs are to be treated as "definitely related" to "relevant broad product categor[ies]" rather than to particular products. Pet. App. 12a (quoting 26 U.S.C. 1.861-8(e)(3)). No "conflict" could exist between these regulations because the research allocation rule is merely a specific application of the general principles of the regulation in which it is contained, and "[i]t is a cardinal principle of construction that . . . [w]hen there are two acts upon the same subject," courts are "to give effect to both if possible." Pet. App. 12a (quoting *United States* v. *Borden Co.*, 308 U.S. 188, 198 (1939)).

SUMMARY OF ARGUMENT

I. A. The court of appeals correctly concluded that the regulations adopted by the Secretary to determine the proper allocation of research costs in calculating the "combined taxable income" from export sales represent a "permissible interpretation" of the governing statutes and should therefore be sustained. Congress did not define the term "combined taxable income" in the DISC or FSC statutes. Instead, Congress directed the Secretary to promulgate regulations to determine the "proper" allocation and apportionment of various expenses to items of income (26 U.S.C. 863(a)) and to apply those rules in determining the "combined taxable income" from export sales. Because Congress directed the agency to fill a statutory gap in determining how expenses are to be "properly allocated" for this purpose, the ensuing legislative regulations are "binding in the courts" unless they are arbitrary or capricious or "manifestly contrary to the statute." *United States* v. *Mead Corp.*, 533 U.S. 218, 227 (2001).

B. The cost allocation regulations adopted by the Secretary generally specify (i) that costs are to be assigned to items of gross income to which they are "definitely related" and (ii) that costs that are related to all of a taxpayer's income, or that are not definitely related to any specific item of income, are to be apportioned ratably to all income. In adopting these regulations, the Secretary determined that special provision was required for the apportionment of research expenses for two separate but related reasons. First, research costs that are currently deducted under Section 174—and are not capitalized and amortized over time—lack a "definite" relationship to any discrete item of income for they are properly attributable to the income of several years, not of a single year. Second, the relationship of research costs to any discrete product is inherently tenuous and difficult to determine, especially when (as in this case) the taxpayer produces more than one product of a related general type. In view of the characteristically broad and speculative nature of research activities, the Secretary reasonably determined in the final regulations that research costs that are currently deducted under Section 174 should be allocated to the "broad product category" to which the research relates and not be allocated simply on the basis of the taxpayer's internal accounting choices. 26 C.F.R. 1.861- 8(e)(3)(i)(A).

The use of the 2-digit (and later 3-digit) SIC product codes in defining the relevant "broad product categories" for this purpose was a reasonable choice among the alternatives. In adopting a regulation that applies for *all* taxpayers, the Secretary appropriately adopted a general standard and was not required to leave this determination to the maze of conflicting management and accounting practices of individual taxpayers.

C. In enacting the FSC provisions in 1984, Congress reviewed the agency's cost allocation regulations and concluded that those rules should continue to apply in "the computation of combined taxable income of a DISC (or FSC) and its related supplier." H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1263 (1984). Congress thereby ratified the past application of those regulations and approved their future use. When, as in this case, Congress enacts "a new law incorporating sections of a prior law" and, in doing so, approves the administrative interpretation of those terms, Congress should be understood to have "adopt[ed] that interpretation." *Lorillard* v. *Pons*, 434 U.S. 575, 580-581 (1978).

II. A. Petitioner incorrectly claims that the challenged regulation violates a "fundamental principle" of the governing statutes that costs be allocated based on their "factual relationship" with a product. These statutes contain no such requirement. Instead, they state only that if the Secretary determines that an expense cannot "definitely" be allocated to some item of income, a "ratable part" of that expense is then to be charged to all items of income. 26 U.S.C. 863(a). The challenged regulation, which allocates research costs ratably among the "broad product category" to which the research relates, is consistent with that statutory principle. The regulation falls directly within the broad authority conferred on the Secretary to determine how various expenses are to be "properly apportioned or allocated" to specific items of income. 26 U.S.C. 863(a).

B. The use of the 2-digit SIC code to designate the "broad product group" to which research costs are allocated under the challenged regulation does not, as petitioner asserts, "conflict" with the "grouping" rule of the DISC and FSC regulations. The cost-allocation rules specify the manner in which expenses are allocated in determining "combined taxable income" for DISCs and FSCs. The "grouping" rule has an entirely unrelated function: it allows the taxpayer to select the "groups" of sales that are to be evaluated under the various alternative transfer pricing methods. 26 C.F.R. 1.994-1(c)(7). Whatever "group" of sales is selected by the taxpayer for that purpose, however, the calculation of "combined taxable income" for that group must be made in accordance with the procedures specified in the challenged cost-allocation regulations. The cross-references contained in these two sets of regulations make clear that these coordinated provisions work in tandem and are not "in conflict."

Petitioner's contrary assertion would make the research cost allocation regulation a nullity for the very purpose for which it was adopted. As the court of appeals emphasized, any suggestion that such expressly interrelated regulatory provisions are "in conflict" ignores the "cardinal principle" that, when "there are two acts upon the same subject," courts are "to give effect to both if possible." Pet. App. 12a.

ARGUMENT

I. IN COMPUTING THE "COMBINED TAXABLE INCOME" FROM EXPORT SALES FOR THE PURPOSES OF THE DISC AND FSC PROVISIONS OF THE INTERNAL REVENUE CODE, PETITIONERS MUST TAKE RESEARCH AND DEVELOPMENT EXPENSES INTO ACCOUNT IN THE MANNER REQUIRED BY 26 C.F.R. 1.861-8(e)(3)

In 1977, the Secretary of the Treasury issued regulations to determine how expenditures are to be "properly apportioned or allocated" in computing combined taxable income for purposes of the DISC provisions. 26 U.S.C. 861(b); see 26 U.S.C. 863(a). The regulations adopted by the Secretary generally require that all expenses "definitely related" to the "income" from sales of an exported product, and a pro rata share of expenses "definitely related" to all or no items of "income" of the taxpayer, be allocated to the export sales in determining the "combined taxable income" of the U.S. supplier and its export subsidiary from those sales. 26 C.F.R. 1.861-8(c)(1), (c)(2). The regulations further specify that, in view of the characteristically broad and speculative nature of research activities, costs related to research are to be "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category [to which the research relates] * * * and therefore allocable to all items of gross income * * * related to such product category * * * ." 26 C.F.R. 1.861-8(e)(3)(i)(A). The court of appeals correctly concluded that these regulations establish a permissible interpretation of the statute and should therefore be sustained.

A. Congress Directed The Secretary Of The Treasury To Issue Regulations To Determine The Manner In Which Expenses Are To Be Taken Into Account In Computing The "Combined Taxable Income" From Export Sales Under The Disc And FSC Provisions Of The Internal Revenue Code

The regulations challenged by petitioners in this case "are legislative regulations because they were promulgated pursuant to [26 U.S.C.] 863(a) and 994(b), which contain explicit grants of authority from Congress." Pet. App. 5a. In enacting the DISC and the FSC provisions, Congress did not attempt to define the statutory construct of "combined taxable income."[11] The history of the DISC provisions, however, reveals that Congress intended that, in implementing this provision, the Treasury would apply "the principles applicable under section 861 for determining" the domestic or foreign source of income. H.R. Rep. No. 533, *supra*, at 74.

Section 861, in turn, has long provided a mechanism for dividing the "source" of income between United States and foreign activities.[12] Under that statute, expenses that are "properly apportioned" to United States source income, and a "ratable part" of expenses that "cannot definitely be allocated" to an item of gross

---

[11] The role that the statutory concept of "combined taxable income" plays in determining petitioner's tax liability is set forth in detail at pages 4-5, *supra*.

[12] The geographic "sourcing" of income has been a feature of income tax law since the enactment of Sections 1(a) and 10 of the Revenue Act of 1916, ch. 463, 39 Stat. 756, 765-766, which imposed a tax on income from sources within the United States received by nonresident aliens and foreign corporations. These "sourcing" rules have relevance for several different tax calculation purposes. See note 7, *supra*.

income, are deducted from United States source income in arriving at United States source "taxable income." 26 U.S.C. 861(b). In the 86 years since the first enactment of Section 861, Congress has not attempted to prescribe detailed rules for implementing this provision. Instead, Congress has specified that the determination *whether* an expense *is* "properly apportioned" to an item of gross income is to be made "under regulations prescribed by the Secretary." 26 U.S.C. 863(a).

In enacting these interrelated statutory provisions, Congress thus authorized the Secretary to adopt regulations to determine the "proper" allocation and apportionment of deductions to items of income and to apply those rules in determining the "combined taxable income" from export sales.[13] Because Congress "explicitly left a gap for [the] agency to fill" and made "an express delegation of authority to the agency to elucidate [the] specific provision[s] of the statute by regulation," the "ensuing regulation" adopted by the Secretary to implement that authority is "binding in the courts" unless it is "procedurally defective," "arbitrary or capricious" or "manifestly contrary to the statute." *United States* v. *Mead Corp.*, 533 U.S. at 227 (quoting *Chevron U.S.A. Inc.* v. *Natural Res. Def. Council, Inc.*,

---

[13] As the court of appeals noted (Pet. App. 5a), in addition to the broad authority conferred on the Secretary of the Treasury to prescribe general regulations for the proper allocation of costs and to use those rules in determining "combined taxable income" for export sales, Congress also authorized the Secretary to "prescribe regulations" for determining the proper "allocation of expenditures in computing combined taxable income" in related contexts involving other distinct types of DISC and FSC transactions. 26 U.S.C. 994(b)(2) (marginal costing rules). See 26 U.S.C. 994(b)(1) (rules for commissions, rentals and other income); see 26 U.S.C. 925(b)(2) (1988) (same under FSC).

467 U.S. 837, 843-844 (1984); see *United States* v. *Morton*, 467 U.S. 822, 834 (1984).

A regulation issued under such an express authority to "prescribe standards" has "legislative effect" (*Batterton* v. *Francis*, 432 U.S. 416, 425 (1977)) and is entitled to the highest degree of deference accorded administrative actions. When Congress has made an "explicit delegation of substantive authority" to the agency, the agency's legislative regulation is entitled "to more than mere deference or weight." *Schweiker* v. *Gray Panthers*, 453 U.S. 34, 44 (1981) (cited in *Chevron*, 467 U.S. at 844 n.12). While the Court has made clear that it "do[es] not abdicate review in these circumstances," it has emphasized that its "task is the limited one of ensuring that the Secretary did not 'excee[d] his statutory authority' and that the regulation is not arbitrary or capricious." *Schweiker* v. *Gray Panthers*, 453 U.S. at 44 (quoting *Batterton* v. *Francis*, 432 U.S. at 426).

As the court of appeals noted (Pet. App. 6a), even if the challenged regulations were regarded as interpretive, rather than legislative, the standard of deference owed to the agency's regulations would remain extremely high. As this Court explained in *United States* v. *Correll*, 389 U.S. 299, 307 (1967):

> Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). * * * The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.

B. The Challenged Regulations Establish A Permissible Implementation Of The Governing Statutes And Should Therefore Be Sustained

Recognizing the high degree of deference that applies to both legislative and interpretive regulations under the Internal Revenue Code, the court of appeals correctly concluded that 26 C.F.R. 1.861-8(e)(3) establishes a "permissible interpretation" of the statutes and is therefore valid whether reviewed "under an 'arbitrary or capricious' standard, or under the arguably less deferential 'reasonableness' standard." Pet. App. 5a-6a.

1. *The Basic Framework for Cost Allocation Under 26 C.F.R. 1.861-8 Directly Implements The General Provisions of the Statute*

In 1977, following public notice and comment, the Secretary adopted regulations under Section 861 that specifically address cost allocation in computing "combined taxable income" for DISCs.[14] These regulations are designed "principally to ensure that foreign operations of domestic corporations are charged with a proper share of deductions." B. Bittker & L. Lokken,

---

[14] The cost-allocation regulations adopted in 1977 state specifically that they govern the allocation and apportionment of research and development deductions in the calculation of "the combined taxable income of the DISC and the related supplier." 26 C.F.R. 1.861-8(f)(1)(iii). Petitioner's assertion that "it would be best to interpret Treas. Reg. § 1.861-8(e)(3) not to apply at all to the computation of CTI" (Pet. Br. 29) is therefore frivolous. Moreover, the DISC regulations *expressly* incorporate the cost-allocation procedures of the challenged regulations in the calculation of "combined taxable income" for the DISC and its supplier. 26 C.F.R. 1.994-1(c)(6). And, following enactment of the FSC provisions in 1984, these same cost-allocation rules were expressly made applicable to FSCs by 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(D).

Federal Taxation of Income, Estates and Gifts ¶ 70.10.1, at S70-26 (Supp. 1999). The general provisions of these regulations specify that expenses, losses and other deductions are to be allocated and apportioned to the item or class of gross income to which they are "definitely related." 26 C.F.R. 1.861-8(b)(1), (c)(1). Deductions that are related to all of a taxpayer's gross income, or that are not "definitely related" to any specific item of income, are to be apportioned ratably to all gross income. 26 C.F.R. 1.861-8(b)(5), (c)(2). This general framework of the regulations directly follows the statutory pattern of 26 U.S.C. 861(b) (see pages 19-20, *supra*), and the validity of this general framework is not in question.

2. *Within This Basic Framework, the Secretary Determined That Special Provision Was Required To Ensure That Research Expenses Are Properly Apportioned in Calculating "Combined Taxable Income"*

Congress directed the Secretary to determine, within this general framework, how various expenses are to be "properly apportioned or allocated" to items of income (26 U.S.C. 863(a)), and to apply those rules in calculating "combined taxable income" for DISCs and FSCs. In adopting the cost allocation regulations in 1977, the Secretary concluded that special provision was required for the apportionment of research expenses for two separate, but related reasons.

a. *Research costs that are deducted currently under Section 174 of the Internal Revenue Code are not "definitely related" to specific items of income.* The Internal Revenue Code generally defines "taxable income" as the gross income of the taxpayer less allowable deductions. 26 U.S.C. 63(a). Although taxpayers may deduct ordinary business expenses in the year they are incurred, "capital" expenses that are related to the production of income in several periods are instead to be "amortized and depreciated" over their useful life. *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79, 83-85 (1992). In this manner, "the Code endeavors to match [capital] expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *Id.* at 84. See also *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 16 (1974).

Research and development expenses are a quintessential example of the type of business expenditures that give rise to income, if ever, in a later year. By their very nature, such expenses are logically to be capitalized and recovered over time as a component of the costs of goods sold. See *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84. In 1954, however, Congress authorized taxpayers to elect to treat research expenses "as expenses which are not chargeable to capital account" and are, instead, "allowed as a deduction" in the year they are incurred. 26 U.S.C. 174(a)(1). When (as in the present case) the taxpayer elects to treat its research expenses as current deductions under Section 174, rather than as capital expenditures, the logical or "factual" link between such costs and the income that they generate is thereby severed. If the taxpayer elects to deduct such expenses immediately—before the results of the research bear fruit in the generation of income—a "direct" or "definite" relationship between the research expense and the associated future income disappears.[15] As this Court pointed out in *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84, capital costs are "properly attributable" to the income of several years, not of a single year. Because *research costs deducted currently under Section 174 thus lack a "definite" relationship to items of income*, the Secretary *could* have concluded that the deductions resulting from those expenses should, under the general framework of the statute, be "properly apportioned" (26 U.S.C. 863a)) among *all* items of income during the year the deductions are taken.[16] See 26 C.F.R. 1.861-8(c)(2); page 23, *supra*.

---

[15] As Amicus Tax Executives emphasizes (Br. 24 n.17), an expense that is "definitely related" to an item of income may be deducted in determining "combined taxable income" whether or not there is any item of income which is received or accrued during the taxable year (26 C.F.R. 1.861-8(b)(2)) and even if "no gross income in such class is received" in that year (26 C.F.R. 1.861-8(d)(1)). Under the regulations, the taxpayer may thus have a negative "combined taxable income" when "there is an excess of deductions" over the income received in that year. 26 C.F.R. 1.861-8(b)(2). In every case, however, the regulations permit expenses allocated in their entirety (rather than pro rata) against an item of income only if the expense "bears a definite relationship to" the item of income. 26 C.F.R. 1.861-8(d)(1). The regulations further specify that, for this purpose, research expenses are treated as "definitely related" to the broad class of products to which the research relates. 26 C.F.R. 1.861-8(e)(3)(i)(A).

[16] When research costs are deducted currently under Section 174, and are not amortized over the period of the product sales, there is no "definite" relationship between those deductions and the income from any associated product or activity. In this case, for example, petitioner attempted to "allocate" $1.75 billion of the research costs that it deducted currently under Section 174 to programs that had no sales in the years the research was conducted. See page 11, *supra*. When ordinary principles of capital cost accounting are not followed, and research costs are not

b. *Research costs inherently benefit a broad class of products for any manufacturer.* The Secretary determined, however, that one additional characteristic of research expenses required further refinement in the treatment of such expenses in the final regulations. The relationship of a research cost to any discrete product is inherently tenuous and difficult to determine, especially when (as in this case) the taxpayer produces more than one product of a related general type. The mere fact that a taxpayer, in its internal accounting, may allocate such costs to a single product obviously does not mean that the research does not in fact benefit the production of other related products of the same type. For example, in this very case, petitioner's officers acknowledged (as common sense suggests) that its research activities are not hermetically sealed and that knowledge and expertise garnered in the development and construction of one airplane model carries over to the production of others. C.A. E.R. 103, 127-128.[17]

In the final regulations, the Secretary determined that, in view of the characteristically broad and specu-

---

deducted against the income to which those expenses are logically and properly attributable, the "definite" relationship that otherwise generally exists between an expense and the "activity" or "property" to which it is "incident" (26 C.F.R. 1.861-8(b)(2)) is severed. Special provision for allocating research costs that are currently deducted under Section 174 was therefore required within the general framework of the regulations.

[17] Petitioner has also acknowledged that a large portion of its research expenses (denominated as "Blue Sky" research) are properly to be allocated among *all* of its aircraft programs. "Blue Sky" costs differ from the research costs involved in this case primarily in that they were incurred before a specific aircraft model was authorized for production under petitioner's internal accounting and management practices. See page 9, *supra*.

lative nature of research activities, research costs that are deducted currently under Section 174 should not be allocated based on the taxpayer's internal accounting choices but should instead be treated as "definitely related" to the "broad product category" to which the research relates.[18] The final regulations initially specified that the applicable "broad product category" is to be determined by reference to the two-digit SIC codes established by the Office of Management and Budget. 26 C.F.R. 1.861-8(e)(3)(i)(A). After further experience with the regulation, the Secretary refined the relevant "broad product category" for this purpose by reference to the narrower, three-digit SIC codes. 26 C.F.R. 1.861-17(a)(2)(ii) (1996).[19]

The product categories established in the Standard Industrial Classification Manual published by the Office

---

[18] In determining its "taxable income" for the current period, the taxpayer who elects a current deduction for research costs under Section 174 applies those costs as a deduction against its gross income from *all* sales in the current period. 26 U.S.C. 63(a). The final regulations require that these expenses be treated similarly in determining "combined taxable income" for DISCs and FSCs by providing that research expenses "which a taxpayer deducts under section 174" are to be treated as deductions "definitely related" to income received in the current period. 26 C.F.R. 1.861-8(e)(3)(i)(A).

[19] In adopting the 3-digit SIC code standard in 1996, the Treasury rejected a proposal to employ instead a 5-digit SIC code standard "because such a rule would too narrowly restrict the necessarily broad scope of the deduction." T.D. 8646, 1996-1 C.B. 144, 145. The agency explained that it "continues to believe that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation." *Ibid.*

of Management and Budget provide a rational and administrable standard for this purpose. Utilization of the two-digit SIC Codes ameliorates the effect of a more general treatment of such costs, which could require a taxpayer to allocate its currently deducted research costs among *all* items of current income. See pages 23-25, *supra*. And, although petitioner objects to the breadth of the two-digit SIC code classifications, it is obvious that some administrable rule is required for this purpose. No alternative classification standard or method (other than petitioner's own internal accounting practices) has been suggested by petitioner for this purpose. In adopting a general regulation that applies for *all* taxpayers, the Secretary properly may establish a general standard and is not required to leave this determination to the vagaries of the management and accounting practices of individual taxpayers.[20] As this Court has emphasized, "[i]n view of the Treasury's markedly different goals and responsibilities, * * * any presumptive equivalency between tax and financial accounting would be unacceptable." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 542-543 (1979). Accord, *United States* v. *Hughes Props., Inc.*, 476 U.S. 593, 603 (1986); *American Automobile Ass'n* v. *United*

[20] In exercising the responsibility to promulgate regulations that specify how costs are to be "properly apportioned" for this purpose (26 U.S.C. 863(a)), the Secretary has adopted specific regulatory standards to govern the allocation of numerous specific items of expense, such as interest costs, attorneys fees and taxes. 26 C.F.R. 1.861-8(e)(1)-(11). The treatment of research costs under 26 C.F.R. 1.861-8(e)(3) is merely one of the several situations in which a general standard—rather than the individual accounting choices and methodologies of individual taxpayers—controls under the regulations.

States, 367 U.S. 687, 693 (1961) (industry accounting practices are not "binding on the Treasury").

3. *The Secretary's Choice Among Alternative Methods of Apportioning Research Expenses in the Calculation of "Combined Taxable Income" is Reasonable and not Arbitrary or Capricious*

a. The court of appeals correctly concluded that the final rules adopted by the Secretary for the allocation and apportionment of research costs represent a reasonable choice among the alternatives. The regulation reveals on its face that, in determining the items of income to which research costs are to be regarded as "definitely related," the Secretary carefully considered (i) the character of the current deduction allowed for such expenses under Section 174 and (ii) the inherently broad and general relationship of research costs to product development. Based on a detailed consideration of these factors, the Secretary concluded that research expenses "which a taxpayer deducts under Section 174" are to be "considered deductions which are definitely related to all income reasonably connected with the relevant broad product category" of the taxpayer because research "is an inherently speculative activity" that routinely provides broad benefits for the taxpayer. 26 C.F.R. 1.861-8(e)(3)(i)(A).

That determination by the Secretary falls within the core of his statutory authority to establish regulations for the proper allocation of expenditures in computing "combined taxable income" for DISC and FSC purposes. See page 20 & note 13, *supra*. Even when the Secretary exercises only the general interpretive authority under 26 U.S.C. 7805 to apply the provisions of the Code to the "limitless factual variations" of commerce, this Court has emphasized that "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *United States* v. *Correll*, 389 U.S. at 307 (quoting *Commissioner* v. *Stidger*, 386 U.S. 287, 296 (1967)). Deference to the Secretary's detailed judgment in the adoption of such regulations "guarantee[s] that the rules will be written by 'masters of the subject,' *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect." *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 477 (1979).

b. Contrary to petitioner's assertion (Pet. Br. 39), the research cost allocation regulations adopted by the Secretary do not "penalize exporters who perform R&D on new products by diminishing the tax advantages related to their current exports." Even without the additional tax benefit of approximately $25 million per year that petitioner seeks in this case, Boeing is reported to have been the largest beneficiary of the FSC regime, with a "total FSC tax benefit" of approximately $1.2 billion during the 1990's. J. Oyola, *A Fresh Look at Foreign Sales Corporation Beneficiaries* (Tax Analysts Reference: 2001 WTD 122-15). See also J. Oyola, *Foreign Sales Corporation Beneficiaries: A Profile*, 88 Tax Notes 933, 936 (2000).

The DISC regime was not intended to provide unlimited or "undue tax advantages" to export activities. S. Rep. No. 437, *supra*, at 13. "[T]he question is whether Congress legislated th[e] degree of encouragement" that petitioner seeks. *Archer-Daniels-Midland Co.* v. *United States*, 37 F.3d 321, 323 (7th Cir. 1994), cert. denied, 514 U.S. 1077 (1995). "Obviously it was necessary to control the amount of export income that the parent could defer by use of a DISC." *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 981 (9th Cir. 1995). The function of the "combined taxable income" determination made under the regulations "is to fix a 'transfer price' between the parent and the DISC which, in turn, limits the amount of income of which the parent can defer realization." *Ibid.*

If the Secretary had adopted the rule that petitioner proposes, and had allowed research costs to be attributed to specific products without regard to a "definite" relationship to the income from such products, the most basic objectives of the statute and regulations would have been defeated. Under petitioner's theory, research costs *routinely* would be ignored in the calculation of "combined taxable income." This is because the bulk of research costs are commonly incurred in years *before* production and sales occur. See note 16, *supra*. By failing to apportion research costs to income to which they are "definitely" related, petitioner's proposed allocation method would vastly overstate the "combined taxable income" from export sales by violating the fundamental requirement that "the *total costs* of the DISC and related supplier *which relate to such gross receipts*" be deducted in computing "combined taxable income." 26 C.F.R. 1.994-1(c)(6) (emphasis added).[21]

---

[21] For example, in the present case alone, petitioner's alternative method of calculating "combined taxable income" overstates the actual net income resulting from its sales by approximately $1.75 billion. That is the amount of research costs that petitioner seeks to (i) charge to specific programs in years when no sales in those programs occurred and (ii) thereafter ignore in the later periods when sales occurred and income was in fact received. See note 16, *supra*.

C. In Enacting The FSC Provisions In 1984, Congress Ratified Application Of The Challenged Research Cost Allocation Regulations To Discs And Expressly Authorized Application Of Those Regulations To FSCs

By the time that Congress enacted the FSC provisions in 1984, the regulations that allocate research expenses in "combined taxable income" calculations (26 C.F.R. 1.861-8(e)(3)) had been in place for seven years. In enacting the FSC provisions, which borrowed heavily from the DISC provisions, Congress stated that it "intends that rules comparable to the rules in regulations issued under th[e DISC] provisions will be appli[cable] to the FSC." 1 Staff of the Senate Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984*, at 636 (Comm. Print 1984). The DISC regulations to which Congress referred expressly incorporate the cost allocation rules of 26 C.F.R. 1.861-8(e)(3). See 26 C.F.R. 1.994-1(c)(6)(iii). The reference in the legislative history of the FSC provisions to the existing DISC regulations demonstrates that Congress intended the cost-allocation rules established in those prior regulations to apply under the FSC provisions as well.

This conclusion was made manifest in another portion of the FSC legislative history. As part of the legislation that enacted the FSC, Congress specifically addressed and extended a moratorium that had been imposed in 1981 on the application of the Section 861 cost allocation regulations for the limited purpose of determining whether income has a United States or foreign source.[22]

[22] Due to concerns relating to the sourcing of income in making foreign tax credit calculations, Congress imposed a temporary

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 126, 98 Stat. 648. In doing so, Congress specified that the moratorium on *that* use of the cost-allocation regulations "*does not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier*." H.R. Conf. Rep. No. 861, *supra*, at 1263 (emphasis added). See *Intel Corp.* v. *Commissioner*, 76 F.3d at 983 (holding that the moratorium does not apply to the computation of DISC "combined taxable income"); *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d at 1403-1405 (same).

In enacting the FSC provisions, Congress thus expressed the clear understanding and intention that the cost-allocation rules of 26 C.F.R. 1.861-8(e)(3) *are* controlling in the calculation of "combined taxable income" not only for DISCs but also for FSCs. Congress thereby ratified the past application of those regulations and approved their future use.

As this Court has frequently observed, when Congress enacts "a new law incorporating sections of a prior law" and, in doing so, approves the administrative interpretation of those terms, Congress should be understood to have "adopt[ed] that interpretation." *Lorillard* v. *Pons*, 434 U.S. 575, 580-581 (1978). See *Albemarle Paper Co.* v. *Moody*, 422 U.S. 405, 414 n.8 (1975) (Congress has thereby "ratified this construction"). In particular, this Court has "held in many

---

moratorium on the application of the cost allocation rules of 26 C.F.R. 1.861-8(e)(3) solely for the *sourcing* of income. See Section 223 of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 249; Section 126 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 648; Section 13211 of the Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, 100 Stat. 324. That moratorium was lifted in 1986. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1216, 100 Stat. 2549.

cases" that a "long-standing administrative interpretation" set forth in a Treasury regulation that interprets the predecessor of "a substantially reenacted statute, is deemed to have received congressional approval and has the effect of law." *Commissioner* v. *Estate of Noel*, 380 U.S. 678, 682 (1965) (citing cases). See also *Heard* v. *Commissioner*, 326 F.2d 962, 966 (8th Cir.), cert. denied, 377 U.S. 978 (1964); N. Singer, *Sutherland Statutory Construction* § 22:33, at 399 & n.11 (6th ed. 2002).[23]

II. THE CHALLENGED RESEARCH COST-ALLOCATION RULES DO NOT CONFLICT WITH ANY PROVISION OF THE DISC AND FSC STATUTES OR REGULATIONS

Petitioner argues that the Secretary's treatment of research costs under the regulations is invalid for two reasons. First, petitioner asserts that the regulations violate a "rule * * * established by the plain language of the DISC statute" that "costs that are factually

---

[23] Petitioner suggests that the FSC provisions need not be addressed in this case because the parties "agreed that there are no differences between DISC and FSC that are relevant to this case" (Pet. Br. 3 n.2). Although the parties agreed that "differences between the DISC and FSC rules" are not material to this case (Stip. ¶ 28), the parties have *not* agreed that the history of the enactment of the FSC is irrelevant. To the contrary, the government pointed out in the court of appeals that this history reflects an express approval by Congress of the regulation involved in this case and, indeed, that "it is difficult to make a stronger case for the application of the legislative reenactment doctrine." Gov't C.A. Br. 40. See Gov't C.A. Reply Br. 24. Petitioners also addressed the reenactment doctrine in their brief in the court of appeals. Pet. C.A. Br. 55-59. The court found it unnecessary to reach the issue, however, because it upheld the regulation on the merits as a permissible interpretation of the statute. See Pet. App. 5a-6a.

related to one product (or product group) may not be deducted from revenue arising from the sale of a different product (or product group)." Pet. Br. 15. Second, petitioner claims that the requirement of the regulations that research costs be allocated to the broad product group to which those costs relate violates the "grouping" rules of the DISC and FSC regulations that allow the taxpayer to group its export sales within narrower product categories in applying the transfer price rules of those statutes. Pet. Br. 16-17. Neither of these objections to the challenged regulations is valid.

A. The Research Cost Allocation Regulations Properly Implement, And Do Not Conflict With, The Governing Statutes

1. *The Challenged Regulations Properly Implement the Governing Statutes*

Petitioner errs in claiming (Pet. 15) that it is a "fundamental principle" of the governing statutes that costs are to be allocated based on their "factual relationship" with a "product" or "product group." The applicable statutes do not contain any such requirement.[24]

---

[24] Amicus Tax Executives Institute errs in suggesting (Br. 25) that any ambiguity in the statutes that govern this case should be construed against the government. In *White* v. *United States*, 305 U.S. 281, 292 (1938), this Court expressly rejected the proposition that "doubts should be resolved in favor of the taxpayer." The Court has instead long applied "the 'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84 (quoting *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 593 (1943)). This rule applies with special force to the DISC and FSC, for "[i]t has been said many times that provisions granting

a. Section 863(a) directs the Secretary to determine, by regulations, which expenses are to be "properly apportioned and allocated" to specific items of "income." 26 U.S.C. 863(a). This statute does not state whether a "factual relationship" or a "logical relationship" or some other type of "relationship" is sufficient. The statute states only that, if the Secretary determines that an expense "cannot definitely be allocated to some item * * * of gross income," then a "ratable part" of that expense is to be charged to all items of income. *Ibid.* As we have explained above, the challenged regulation is based on, and conforms with, these broad statutory principles. See pages 19-29, *supra*.

b. The DISC and the FSC statutes and their legislative histories also do not define how the Secretary is to determine which costs are, or are not, "definitely related" to items of income. The "statutory text does not confine the relevant costs to those 'definitely related' to sales of a particular product." Pet. App. 11a. As the Tax Court stated in upholding the challenged regulations, "[a] requirement that an expense be 'definitely related' to gross income from export receipts in order to be allocated to the item does not exist in the text of sections 994(a) or (b) or 861(b) [or 925(a)]." *St. Jude Medical, Inc.* v. *Commissioner*, 97 T.C. at 478.

c. The phrase that is the centerpiece of petitioner's argument appears only in the Secretary's regulations, and not in the statutes. It is the DISC and FSC regulations—and not the statutes—that specify that "costs that are 'definitely related' to gross receipts from the sales of export property and costs that are 'not

special tax exemptions are to be strictly construed." *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46, 49 (1940) (citing cases).

definitely related' to a class of gross income * * * are treated as costs 'relating' to gross receipts from sales of export property and therefore enter into the combined taxable income computation." *St. Jude Medical, Inc.* v. *Commissioner*, 97 T.C. at 478 (citing 26 C.F.R. 1.994-1(c)(6)(iii)); see also 26 C.F.R. 1.861-8(c)(1), (c)(2)).

The portion of the regulation challenged in this case —which defines research expenses currently deducted under Section 174 to be "definitely related" to income generated by a broad class of similar products—is simply an elaboration by the Secretary of the general standard established in the agency's own regulations. As we describe above (pages 23-29, *supra*), this fact-specific elaboration of this *regulatory* standard falls directly within the broad authority of the Secretary to "promulgate regulations" to determine how various expenses are to be "properly apportioned or allocated" to specific items of income. 26 U.S.C. 863(a).

2. ***The "Principles Applicable Under Section 861" do not Require a "Factual Relationship" Between Income and Expense in Allocating and Apportioning Current Expense to Current Income***

a. Ignoring the text of the governing statutes, petitioner nonetheless argues that the "fundamental principles" of these statutes require that expenses be assigned only to products to which they are "factually related." The "factually related" standard on which petitioner rests its argument, however, appears only in the portion of the Treasury's regulations that describes, in general terms, how expenses are allocated *under the regulations*. After setting forth the general rule of the regulations that expenses are allocated to the income to which they are "definitely related" (26 C.F.R. 1.861-8(a)(2)), the sentence of the regulation on which petitioner relies states that, "*[a]s further detailed below*, allocations and apportionments are made on the basis of the factual relationship of deductions to gross income." 26 C.F.R. 1.861-8(a)(2) (emphasis added). Of course, it was in adopting these very regulations that the Secretary clearly specified in the provisions "further detailed below" that a sufficient factual and logical relationship exists for this purpose between research expenses currently deducted under Section 174 and the income earned during that period from sales of products within the related broad product groups. 26 C.F.R. 1.861-8(e)(3)(i)(A). The *full* text of the regulation thus refutes petitioner's reliance on the small portion of the regulation that it chose to quote.

b. Petitioner asserts (Pet. 24-26) that the Secretary should not be permitted to adopt the research cost allocation rule of the final regulation because the 1973 proposed regulations contained no such provision. Petitioner is unquestionably wrong, however, in suggesting that the Secretary is bound by each and every phrase in a proposed regulation. A proposed regulation is nothing more than a "suggestion[] made for comment." *LeCroy Research Systems Corp.* v. *Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984). "If the Commissioner wanted [the proposed] regulation to have binding effect, it could have been issued as a temporary regulation." *Ibid.* Furthermore, in adopting the *final* regulations, the Secretary plainly was not required to give each phrase of the proposed regulations the meaning that petitioner now seeks.[25]

---

[25] For example, while petitioner makes much of the supposed need for a "factual relationship" between income and expenses—a phrase that is nowhere to be found in the governing statutes—it

In claiming that the 1973 proposed regulation should govern this case, petitioner errs in relying on a selected portion of the Technical Memorandum that accompanied the proposed DISC regulations (Pet. Br. 23). In quoting that Memorandum, petitioner has omitted the sentences that underscore that the regulations had *not* been cast in concrete at the time they were first proposed. The omitted sentences state (1972 T.M. Lexis 14, at *8-*9 (June 29, 1972) (emphasis added)):

> In determining deductible expenses attributable to the property and transaction, the rules of section 861(b) and 1.861-8 are to be applied *in whatever form they ultimately take in a new notice to be prepared.* * * * *It is anticipated that rules will be later developed under 1.861-8 or the Treasury decision containing 1.994-1 to allocate expenses incurred in one year to items of gross income received in another year.*

This Technical Memorandum reflects the agency's understanding, at the time that the proposed regulations were issued, that timing problems in the apportionment of costs incurred in one year to revenues earned in other periods needed to be further addressed in the final rules.

The challenged research cost allocation rules ultimately adopted in the final regulations, of course, respond directly to this timing concern. See pages 23-29, *supra*. And, prior to the final adoption of these regulations in 1977, the research cost-allocation rules were issued as *amended* proposed rules for public comment in 1976. 41 Fed. Reg. 49,160 (1976).

---

studiously avoids explaining why aircraft research is not "factually related" to the income from aircraft sales.

Petitioner incorrectly suggests (Pet. Br. 24) that the provisions of the 1973 *proposed* regulations, rather than the provisions of the 1977 *final* regulations, should be understood as the cost allocation "rules set forth in §1.861-8" (26 C.F.R. 1.861-8(c)(6)(iii)) that were incorporated by the DISC regulations in 1975. In issuing the DISC regulations in 1975, the agency clearly stated that the 1973 "proposed regulations" under Section 861 had relevance only "for informational purposes." T.D. 7364, 1975-2 C.B. 315, 316. The agency also made clear that a cross reference in the DISC regulations to other regulations that were, at that time, only proposed is "intended to refer to such regulations as will be finally adopted." *Ibid.*

c. Petitioner also errs in claiming (Pet. Br. 19) that the Secretary may not allocate deductions "partly to the particular sale in question and partly to completely unrelated sales." The text of the governing statute clearly provides that "a ratable part of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*" shall be deducted in arriving at taxable income. 26 U.S.C. 861(b) (emphasis added). As the Ninth Circuit (Pet. App. 11a) and the Tax Court in *St. Jude* (97 T.C. at 478) have correctly recognized, the governing statutes and regulations explicitly require that a ratable part of expenses that are *not* definitely related to any specific item of income are to be charged against *all* items of income.

Even though research expenses deducted currently under Section 174 are not "definitely" or "directly" related to the "income" earned from specific products in *any* specific period (see pages 23-25, *supra*), petitioner suggests that the mere existence of *some* relationship between its research and *future* income should suffice.

If petitioner had capitalized its research costs, the annual amortization of such costs would then have had a logical or "factual" relationship to its future income and could then be said to be "properly attributable" to that income as it is earned. *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. at 84. But when, as in this case, the taxpayer elects currently to deduct its research costs (as Section 174 allows), the taxpayer thereby destroys any "definite" or "factual" relationship between those expenses and the income earned. See note 16, *supra*.

The improper treatment of research costs that petitioner advocates in this case would vastly overstate the benefits to which petitioner is entitled under the DISC and the FSC regimes. Petitioner seeks to exclude approximately $1.75 billion in research expense deductions in calculating its "combined taxable income" even though those expenses were in fact deducted in determining its "taxable income" under the general provisions of the Code. See note 16, *supra*. Through this inconsistent treatment, petitioner seeks to treat a substantial portion of its aggregate taxable income as if it were export-related, when in fact it is not.

B. The Research Cost Allocation Rules In 26 C.F.R. 1.861-8(e)(3) Do Not Conflict With The "Grouping" Rules In The DISC And FSC Regulations

1. Under the DISC and FSC provisions, the taxpayer has three options for calculating the "transfer price" that is used in determining the amount of income that is deferred under DISC or exempted under FSC. 26 U.S.C. 994(a); 26 U.S.C. 925(a). Only one of these options requires a calculation of the "combined taxable income" of the taxpayer and its sales subsidiary. The others are based on a percentage of export sales

revenues or on an assumed "arms length price" for the transfer. See page 5, *supra*.

In the ordinary case, the "transfer price" is to be determined on a transaction-by-transaction basis for each individual "sale of export property." 26 U.S.C. 944(a); 26 U.S.C. 925(a). The DISC and FSC regulations, however, allow a taxpayer to elect to apply the "transfer price" rules on the basis of "groups" of exported products or product lines. Different "grouping" regulations were adopted for this purpose under the DISC and FSC regimes. 26 C.F.R. 1.994-(c)(7)(i) (DISC); 26 C.F.R. 1.925(a)-1T(c)(8) (FSC). These "grouping" rules are administratively efficient, for they make it unnecessary for the taxpayer to file a separate transfer price schedule for each and every sale. The "grouping" rules also provide flexibility, for they permit a taxpayer to elect one of the three "transfer price" rules for one group of products and a different "transfer price" option for another group.

The regulations generally give taxpayers a wide discretion in determining which group of products to select for separate transfer price determinations. The regulations specify that the taxpayer's choice to group a "product or product line will be accepted" if it conforms either to "a recognized industry or trade usage" or the "two-digit major groups * * * of the [SIC codes]." 26 C.F.R. 1.994-1(c)(7). The DISC regulations further state that a grouping choice made by the taxpayer "in accordance with" these criteria will be "controlling." 26 C.F.R. 1.994-1(c)(6)(iv).[26]

2. Petitioner claims (Pet. Br. 30) that the statement in these regulations that the taxpayer may "group" its

---

[26] The FSC regulations do not contain a similar statement. See 26 C.F.R. 1.925(a)-1T(c)(8).

sales for transfer price determinations by reference to "recognized industry or trade usage" (26 C.F.R. 1.994-1(c)(7)) conflicts with the requirement in the cost-allocation regulation that, in calculating "combined taxable income," research costs are to be allocated among all related products within the two-digit SIC code (26 C.F.R. 1.861-8(e)(3)(i)(A)). As the Tax Court explained in rejecting this assertion in the *St. Jude* case, however, "[t]he grouping provisions do not supersede the * * * allocation and apportionment provisions because the provisions are not in conflict." 97 T.C. at 480.

a. The cost-allocation regulations specify the manner in which expenses and other deductions are allocated and apportioned in determining "combined taxable income" for DISCs and FSCs. 26 C.F.R. 1.861-8(f)(1)(iii). It is, of course, for this very reason that the cost-allocation rules of 26 C.F.R. 1.861-8 are expressly cited and specifically incorporated in the DISC and FSC regulations. 26 C.F.R. 1.994-1(c)(6)(iii); 26 C.F.R. 1.925(a)-1T(c)(6)(iii)(D). A calculation of "combined taxable income" has relevance, however, only if the taxpayer elects that option from among the three available choices for determining the "transfer price" for the transactions.

b. The "grouping" rules of 26 C.F.R. 1.994-1(c)(7) have an entirely different and separate function. The grouping rules do not purport to prescribe rules for allocating or apportioning expenses. They instead merely allow the taxpayer to elect *which groups of sales* will be evaluated under one, or another, of the three alternative transfer pricing methods. See 26 C.F.R. 1.994-1(a)(1). As the Tax Court explained in *St. Jude* (97 T.C. at 480):

> The grouping provisions permit taxpayers to group transactions for purposes of applying the three DISC transfer pricing methods allowed by section 994(a). That is, a taxpayer may use the 4-percent gross receipts method, the 50-50 combined taxable income method, or the [arm's length pricing] method for different product-line groups during the same year. However, regardless of the product-line groups a taxpayer uses, and whether based on recognized industry trade usage or otherwise, if the taxpayer uses the 50-50 combined taxable income method, research and development expenses are allocable and apportionable, with respect to export receipts attributable to that product-line group, consistent with [the cost-allocation requirements of 26 C.F.R. 1.861-8].

In view of the coordination intended between (and specified within) the provisions of these related regulations, it makes no sense to assert that there is a fatal "conflict" in their application. The research expense allocation requirements of the Section 861 regulations *expressly* state that *they* apply in determining "combined taxable income" for DISC and FSC purposes. 26 C.F.R. 1.861-8(f)(1)(iii), (8)(g) (Examples 22-23). The DISC and FSC regulations *also* expressly state that cost allocations for DISC and FSC purposes "are to be determined in a manner consistent with the rules set forth in [the Section 861 regulations]." 26 C.F.R. 1.994-1(c)(6)(iii).[27]

[27] In *St. Jude*, the Eighth Circuit reversed the Tax Court and accepted petitioner's assertion that these two regulations are in "conflict." 34 F.3d at 1402. In doing so, however, the court of appeals did not address or respond to the Tax Court's explanation of the separate and limited purpose served by the "grouping"

c. In arguing that these regulations should be viewed as in "conflict," petitioner ignores not only their plain text but also the applicable legal principles. Under petitioner's theory that the research expense allocation rules are inapplicable for the determination of "combined taxable income" for exported products, the allocation rule would be made a nullity for the *express* purpose for which it was adopted. See 26 C.F.R. 1.861-8(f)(1)(iii). As the court of appeals emphasized in this case, petitioner's suggestion that such interrelated regulatory provisions are "in conflict" ignores the "cardinal principle of construction that . . . [w]hen there are two acts upon the same subject," courts are "to give effect to both if possible." Pet. App. 9a (quoting *United States* v. *Borden Co.*, 308 U.S. at 198).

Similarly, petitioner's assertion that a "conflict" exists between these regulations ignores the settled rule that the agency's interpretation of its own regulations is "entitled to controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Udall* v. *Tallman*, 380 U.S. 1, 16 (1965) (quoting *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-414 (1945)). The Secretary's consistent and reasoned explanation of the way in which these provisions cooperate, rather than "conflict," is entitled to special weight in this case because, in enacting the FSC, Congress ratified application of the challenged regulations for "the computation of combined taxable income of a DISC

---

regulations. The court instead simply assumed (as petitioner does in its brief here) that, once an election is made under the "grouping" regulations, "costs should be allocated and apportioned accordingly." *Id.* at 1401. As we describe in the text, however, the plain text of the regulations refutes that assumption.

(or FSC) and its related supplier." H.R. Rep. No. 861, *supra*, at 1333. See page 33, *supra*.

CONCLUSION

The judgment of the court of appeals should be affirmed.[28]

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

EILEEN J. O'CONNOR
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

KENT L. JONES
Assistant to the Solicitor General

DAVID ENGLISH CARMACK
FRANK P. CIHLAR
Attorneys

OCTOBER 2002

---

[28] For the reasons acknowledged by petitioners (Pet. Br. 15 n.10), if the portion of the judgment of the court of appeals in favor of the government is reversed, the portion of the judgment of the court of appeals in favor of cross-respondent should then also be reversed.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

In addition to the statutes and regulations set forth in the appendix to the petition, the following statutes and regulations are involved in this case.

1. Section 174 of the Internal Revenue Code, 26 U.S.C. 174, provides in relevant part:

(a) Treatment as Expenses.—

(1) In general.—

A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction.

* * * * *

(b) Amortization of Certain Research and Experimental Expenditures.—

(1) In general.—

At the election of the taxpayer, * * * research or experimental expenditures * * * may be treated as deferred expenses. In computing taxable income, such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer * * * .

* * * * *

2. During the years relevant to this case, 26 U.S.C. 925 (1985) (added by Pub. L. No. 98-369, Div. A, Tit.

VIII, § 801(a), 98 Stat. 990) (July 18, 1984), provided, in relevant part:

(a) In general.—

In the case of a sale of export property to a FSC by a person described in section 482, the taxable income of such FSC and such person shall be based upon a transfer price which would allow such FSC to derive taxable income attributable to such sale (regardless of the sales price actually charged) in an amount which does not exceed the greatest of—

(1) 1.83 percent of the foreign trading gross receipts derived from the sale of such property by such FSC,

(2) 23 percent of the combined taxable income of such FSC and such person which is attributable to the foreign trading gross receipts derived from the sale of such property by such FSC, or

(3) taxable income based upon the sale price actually charged (but subject to the rules provided in section 482).

Paragraphs (1) and (2) shall apply only if the FSC meets the requirements of subsection (c) with respect to the sale.

(b) Rules for commissions, rentals, and marginal costing.—

The Secretary shall prescribe regulations setting forth—

(1) rules which are consistent with the rules set forth in subsection (a) for the application of this section in the case of commissions, rentals, and other income, and

(2) rules for the allocation of expenditures in computing combined taxable income under subsection (a)(2) in those cases where a FSC is seeking to establish or maintain a market for export property.

(c) Requirements for use of administrative pricing rules.—

A sale by a FSC meets the requirements of this subsection if—

(1) all of the activities described in section 924(e) attributable to such sale, and

(2) all of the activities relating to the solicitation (other than advertising), negotiation, and making of the contract for such sale, have been performed by such FSC (or by another person acting under a contract with such FSC).

(d) Limitation on gross receipts pricing rule.—

The amount determined under subsection (a)(1) with respect to any transaction shall not exceed 2 times the amount which would be determined under subsection (a)(2) with respect to such transaction.

(e) Taxable income.—

For purposes of this section, the taxable income of a FSC shall be determined without regard to section 921.

(f) Special rule for cooperatives.—

In any case in which a qualified cooperative sells export property to a FSC, in computing the combined taxable income of such FSC and such organization for purposes of subsection (a)(2), there shall not be taken into account any deduction allowable under subsection (b) or (c) of section 1382 (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions).

2. 26 C.F.R. 1.925(a)-1T (1989) provided, in relevant part:

Temporary Regulations; Transfer pricing rules for FSCs

* * * * *

(c)(6) *Full costing combined taxable income*—(i) *In general.* For purposes of section 925 and this section, if a FSC is the principal on the sale of export property, the full costing combined taxable income of the FSC and its related supplier from the sale is the excess of the foreign trading gross receipts of the FSC from the sale over the total costs of the FSC and related supplier including the related supplier's cost of goods sold and its and the FSC's noninventoriable costs (see § 1.471-11(c)(2)(ii)) which relate to the foreign trading gross receipts. Interest or carrying charges with respect to the sale are not foreign trading gross receipts.

(ii) *Section 482 applicability.* Combined taxable income under this paragraph shall be determined after taking into account under paragraph (e)(2) of this section all adjustments required by section 482 with respect to transactions to which the section is applicable. If a related supplier performs services under contract with a FSC, the FSC shall compensate the related supplier an arm's length amount under the provisions of § 1.482-2(b)(1) through (6). Section 1.482-2(b)(7), which provides that an arm's length charge shall not be deemed equal to costs or deductions with respect to services which are an integral part of the business activity of either the member rendering the services (i.e., the related supplier) or the member receiving the benefit of the services (i.e., the FSC), shall not apply if the administrative pricing methods of section 925(a) (1) and (2) are used to compute the FSC's profit and if the related supplier is the person rendering the services. Section 1.482-2(b)(7) shall apply, however, if a related person other than the related supplier is the person rendering the services or if the section 482 method of section 925(a)(3) is used to compute the FSC's profit. See § 1.925(a)-1T(a)(3)(ii). For a special rule for computation of combined taxable income where the related supplier is a qualified cooperative shareholder of the FSC, see paragraph (c)(7) of this section.

(iii) *Rules for determination of gross receipts and total costs*. In determining the gross receipts of the FSC and the total costs of the FSC and related supplier which relate to such gross receipts, the rules set forth in subdivisions (iii) (A) through (E) of this paragraph shall apply.

(A) Subject to the provisions of subdivisions (iii) (B) through (E) of this paragraph, the methods of accounting used by the FSC and related supplier to compute their taxable incomes will be accepted for purposes of determining the amounts of items of income and expense (including depreciation) and the taxable year for which those items are taken into account.

(B) A FSC may, generally, choose any method of accounting permissible under section 446(c) and the regulations under that section. However, if a FSC is a member of a controlled group (as defined in section 927(d)(4) and § 1.924(a)-1T(h)), the FSC may not choose a method of accounting which, when applied to transactions between the FSC and other members of the controlled group, will result in a material distortion of the income of the FSC or of any other member of the controlled group. Changes in the method of accounting of a FSC are subject to the requirements of section 446(e) and the regulations under that section.

(C) Cost of goods sold shall be determined in accordance with the provisions of § 1.61-3. See sections 471 and 472 and the regulations thereunder with respect to inventories. With respect to property to which an election under section 631 applies (relating to cutting of timber considered as a sale or exchange), cost of goods sold shall be determined by applying § 1.631-1 (d)(3) and (e) (relating to fair market value as of the beginning of the taxable year of the standing timber cut during the year considered as its cost).

(D) Costs (other than cost of goods sold) which shall be treated as relating to gross receipts from sales of export property are the expenses, losses, and deductions definitely related, and therefore allocated and apportioned thereto, and a ratable part of any other expenses, losses, or deductions which are not definitely related to any class of gross income, determined in a manner consistent with the rules set forth in

§ 1.861-8. The deduction for depletion allowed by section 611 relates to gross receipts from sales of export property and shall be taken into account in computing the combined taxable income of the FSC and its related supplier.

(7) Cooperatives and combined taxable income method. If a qualified cooperative, as defined in section 1381(a), sells export property to a FSC of which it is a shareholder, the combined taxable income of the FSC and the cooperative shall be computed without taking into account deductions allowed under section 1382(b) and (c) for patronage dividends, per-unit retain allocations and non-patronage distributions. The FSC and cooperative must take into account, however, when computing combined taxable income, the cooperative's cost of goods sold, or cost of purchases.

(8) *Grouping transactions.* (i) [Reserved]. For further guidance, see § 1.925(a)-1(c)(8)(i).

(ii) A determination by the related supplier as to a product or a product line will be accepted by a district director if such determination conforms to either of the following standards: Recognized trade or industry usage, or the two-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification as prepared by the Statistical Policy Division of the Office of Management and Budget, Executive Office of the President. A product shall be included in only one product line for purposes of this section if a product otherwise falls within more than one product line classification.

(iii) A choice by the related supplier to group transactions for a taxable year on a product or product line basis shall apply to all transactions with respect to that product or product line consummated during the taxable year. However, the choice of a product or product line grouping applies only to transactions covered by the grouping and, as to transactions not encompassed by the grouping, the determinations are to be made on a transaction-by-transaction basis. For example, the related supplier 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. Sale transactions may not be grouped, however, with lease transactions.

(iv) For purposes of this section, transactions involving military property, as defined in section 923(a)(5) and § 1.923-1T(b)(3)(ii), may be grouped only with other military property included within the same product or product line grouping determined under the standards of subdivision (8)(ii) of this paragraph. Non-military property included within a product or product line grouping which includes military property may be grouped, at the election of the related supplier, under the general grouping rules of subdivisions (i) through (iii) of this paragraph.

(v) A special grouping rule applies to agricultural and horticultural products sold to the FSC by a qualified cooperative if the FSC satisfies the requirements of section 923(a)(4). Section 923 (a)(4) increases the amount of the FSC's exempt foreign trade income with regard to sales of these products, see § 1.923-1T(b)(2). This special grouping rule provides that if the related supplier elects to group those products that no other export property may be included within that group. Export property which would have been grouped under the general grouping rules of subdivisions (i) through (iii) of this paragraph with the export property covered by this special grouping rule may be grouped, however, at the election of the related supplier, under the general grouping rules.

(vi) For rules as to grouping certain related and subsidiary services, see paragraph (d)(3)(ii) of this section.

(vii) If there is more than one FSC (or more than one small FSC) within a controlled group of corporations, the same grouping of transactions, if any, must be used by all FSCs (or small FSCs) within the controlled group. If the same grouping of transactions is required by this subdivision, and if grouping is elected, the same transfer pricing method must be used to determine each FSC's (or small FSC's) taxable income with respect to that grouping.

(viii) The product or product line groups that are established for purposes of determining combined taxable income may be different from the groups that are established with regard to economic processes (see § 1.924(d)-1(e)).

*   *   *   *   *

(g) Effective date. The provisions of this section and § 1.925 (b)-1T apply with respect to taxable year ending after December 31, 1984, except that a corporation may not be a FSC for any taxable year beginning before January 1, 1985.

3. Since December 22, 1995, 26 C.F.R. 1.861-17 has provided (T.D. 8646, 60 Fed. Reg. 66,503 (1995)):

§ 1.861-17 Allocation and apportionment of research and experimental expenditures.

(a) Allocation—(1) In general. The methods of allocation and apportionment of research and experimental expenditures set forth in this section recognize that research and experimentation is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation. Expenditures for research and experimentation that a taxpayer deducts under section 174 ordinarily shall be considered deductions that are definitely related to all income reasonably connected with the relevant broad product category (or categories) of the taxpayer and therefore allocable to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories). For purposes of this allocation, the product category (or categories) that a taxpayer may be considered to have shall be determined in accordance with the provisions of paragraph (a)(2) of this section.

(2) Product categories—(i) Allocation based on product categories. Ordinarily, a taxpayer's re-

search and experimental expenditures may be divided between the relevant product categories. Where research and experimentation is conducted with respect to more than one product category, the taxpayer may aggregate the categories for purposes of allocation and apportionment; however, the taxpayer may not subdivide the categories. Where research and experimentation is not clearly identified with any product category (or categories), it will be considered conducted with respect to all the taxpayer's product categories.

(ii) Use of three digit standard industrial classification codes. A taxpayer shall determine the relevant product categories by reference to the three digit classification of the Standard Industrial Classification Manual (SIC code). A copy may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. The individual products included within each category are enumerated in Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, 1987 (or later edition, as available).

(iii) Consistency. Once a taxpayer selects a product category for the first taxable year for which this section is effective with respect to the taxpayer, it must continue to use that product category in following years, unless the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in the product category is appropriate. For this purpose, a change in the taxpayer's selection of a product category shall include a change from a three digit

SIC code category to a two digit SIC code category, a change from a two digit SIC code category to a three digit SIC code category, or any other aggregation, disaggregation or change of a previously selected SIC code category.

*   *   *   *   *