No.

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

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

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the Ninth Circuit, in direct conflict with the Eighth Circuit, correctly concluded that Treas. Reg. § 1.861-8(e)(3), which governs the allocation of research and development costs between foreign and domestic income, may be applied to the computation of taxable income for export subsidiaries entitled to special tax treatment under the Internal Revenue Code.

RULES 14.1 AND 29.6 STATEMENT

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

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PETITION FOR A WRIT OF CERTIORARI

OPINIONS BELOW

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

JURISDICTION

The judgment of the court of appeals was entered on August 2, 2001, and a timely petition for rehearing was denied on November 19, 2001 (App., *infra*, 25a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant provisions of 26 U.S.C. § 994, 26 U.S.C. § 861, 26 C.F.R. § 1.994-1, and 26 C.F.R. § 1.861-8 are reprinted in the appendix to this petition at 26a-53a.

STATEMENT

This case concerns successive sets of tax provisions enacted by Congress to encourage exports by partially deferring or exempting taxation of income from export sales. Two principles control the measurement of the export income eligible for this special tax treatment. First, expenses are to be deducted from the export sales income to which those expenses are factually related, rather than from other gross income to which the expenses are not factually related. Second, to maximize tax benefits and thus to enhance the export incentives, taxpayers are permitted to group their income and expenses by recognized industry product line classifications.

The decision below departs from both of these principles. Under the rule announced by the Ninth Circuit, taxpayers are required to allocate or apportion research and development ("R&D") expenses according to broad groupings rather than

product lines, and they must do so in ways that result in substantial R&D costs being deducted from income to which the R&D is *not* factually related. In this case, the court of appeals' holding resulted in the reallocation of some $2 billion of petitioner Boeing's R&D costs, thereby increasing Boeing's tax liability by more than $400 million. This decision frustrates the Nation's trade policy by diluting a significant economic stimulus measure; it also expressly conflicts with a decision of another court of appeals and therefore leaves companies uncertain of the tax benefits they may obtain by expanding their export activities. Further review is plainly warranted.

1. In 1971, Congress enacted a set of provisions that were designed "to provide tax incentives for U.S. firms to increase their exports," a program that was thought important both for its "stimulative effect" and "to remove a * * * disadvantage of U.S. companies engaged in export activities." H.R. Rep. No. 533, 92d Cong., 1st Sess. 58 (1971). See *Caterpillar Tractor Co.* v. *United States*, 589 F.2d 1040, 1044 (Ct. Cl. 1978). The "provisions were designed to neutralize some of the tax advantages for [European] exporters inherent in European territorial-type tax systems, which generally exempt all income earned outside the country from income tax and all exports from value-added and other consumption taxes." *Hearings on Trade Relations with Europe and the New Transatlantic Economic Partnership Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 105th Cong., at 116 (1998) (statement of Jeremy O. Preiss, Chief International Trade Counsel, United Technologies Corporation).

Under the U.S. program, corporations were permitted to create special subsidiaries known as "Domestic International Sales Corporations" ("DISCs"). Income from export sales made through DISCs received partial tax deferral. IRC §§ 991-997.[1]

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[1] In particular, a parent corporation could assign a portion of its otherwise taxable export income to its DISC subsidiary. The parent then was taxed only on the income it retained and a specified portion

As a consequence, "[t]he greater the DISC profit, the larger the amount of tax-deferred income * * * . Thus, a [corporation creating a DISC] had an incentive to *maximize* DISC profit." *St. Jude Medical, Inc.* v. *Commissioner of Internal Revenue*, 34 F.3d 1394, 1397 (8th Cir. 1994) (emphasis added).

In 1984, the DISC regime was replaced by one making use of Foreign Sales Corporation ("FSC") subsidiaries. See Deficit Reduction Act of 1984, §§ 801-805, Pub. L. No. 98-369, 98 Stat. 494. After the FSC regime, like the DISC regime, was declared to violate global trade rules, Congress responded by enacting the Extraterritorial Income Exclusion Act of 2000 ("ETI"). Each of the three regimes differs slightly from its predecessor, but none of the differences is relevant to the issues presented in this case. In each regime the mechanics of determining tax-favored income are substantially identical; in particular, each regime provides for grouping of income and deductions by product or product line.[2]

Under each of the three regimes, it is crucial to determine the income that is attributable to export sales and therefore qualifies for favorable tax treatment. The DISC statute "permitted a taxpayer to use one of three methods for determining the amount of deemed profit allocated to the DISC and its parent as a result of export sales. The taxpayer/parent

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of the DISC's income. Tax was deferred on the DISC's remaining income either until it was distributed to the parent corporation or until the DISC ceased to meet statutory requirements (see IRC § 995(a), (b)). In 1984, Congress granted complete exemption from taxation to all DISC income that had not yet been taxed at that time. See Deficit Reduction Act of 1984, § 805(b)(2), Pub. L. No. 98-369, 98 Stat. 494.

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

could choose the method resulting in the greatest amount of profit [for the DISC]." *St. Jude Medical*, 34 F.3d at 1397. See IRC § 994; H.R. Rep. No. 533, *supra*, at 59 ("special pricing rules in the bill permit a DISC to earn a larger relative amount of the profit on sales by the DISC of its parent company's export products"). One of these methods, which was used by petitioner Boeing in this case, is known as the "combined taxable income" (or "CTI") method. IRC § 994(a)(2).

The DISC statute provides generally that, under the CTI method, a DISC is allocated a set portion of "the combined taxable income of [the] DISC and [its parent corporation] which is attributable to" export sales. IRC § 994(a)(2). The statutory language does not define "attributable to" or "combined taxable income" – and, in particular, does not explicitly address how expenditures are to be deducted from gross export receipts when calculating net export income. See *St. Jude Medical*, 34 F.3d at 1398. But that question is addressed in detail both by the legislative history of the DISC statute and by regulations prescribed by the Secretary of the Treasury pursuant to the statute.

The committee reports accompanying the DISC legislation contemplate that all expenses fall into one of two categories that receive differing treatment in the calculation of CTI. CTI is to be "determined by deducting from the DISC's gross receipts" [1] *all* "expenses * * * which are *directly related* to the production or sale of the export property and [2] *a portion* of the * * * *expenses not allocable to any specific item of income*, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the [parent corporation] and the DISC." H.R. Rep. No. 533, *supra*, at 74 (emphasis added). This directive was faithfully implemented by the DISC regulations, which define CTI as "the excess of the gross receipts * * * of the DISC * * * over the total costs of the DISC * * * *which relate to such gross receipts*." Treas. Reg. § 1.994-1(c)(6) (emphasis added). The DISC regulations then provide specific

guidance on how to conduct this calculation, explaining that costs

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

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

This cross-reference in the DISC regulations to Treas. Reg. § 1.861-8 also grew out of the statutory background and harked back to the legislative history of the DISC statute. The committee reports explain that combined taxable income is to be determined "generally in accordance with the principles applicable under [IRC] section 861," one of the statutory provisions that classify income as either U.S. or foreign source income for U.S. income tax purposes. H.R. Rep. No. 533, *supra*, at 74. As the DISC legislative history emphasizes, IRC § 861 includes rules for determining the net income from a given source by "generally allocat[ing] to each item of gross income all expenses directly related thereto, and then apportion[ing] other expenses among all items of gross income on a ratable basis."*Ibid.*[3] Treas. Reg. § 1.861-8, which is cited in the DISC cost allocation regulation, "provided specific guidance for applying the allocation and apportionment rules referred to in IRC §§ 861, 862, and 863." *St. Jude Medical*, 34 F.3d at 1398. At the time the DISC legislation was enacted, Treas. Reg. § 1.861-8 "reiterated [IRC] § 861(b)'s language." *Id*. at 1402. See Treas. Reg. § 1.861-8 (1957).

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[3] IRC § 861(a) identifies income that is United States source gross income. IRC § 861(b) provides for determining net, taxable U.S. source income by subtracting from gross income "the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or deductions which cannot definitely be allocated to some item or class of gross income."

The DISC regulations also address a second issue that is relevant to the calculation of tax-deferred export income. In allocating and apportioning costs so that they may be deducted from revenue, the regulations provide that the determinations may be made either on a transaction-by-transaction basis or, "at the annual choice of the taxpayer[,] * * * on the basis of groups consisting of products or product lines." Treas. Reg. § 1.994-1(c)(7)(i). The taxpayer's choice of a product or product line for these purposes is conclusive so long as it conforms *either* to "recognized industry or trade usage" *or* to "the 2-digit major groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). Thus, "[t]he taxpayer's choice [as to grouping] * * * shall be controlling, and costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year resulting from such grouping." Treas. Reg. § 1.994-1(c)(6)(iv). Accordingly, when a taxpayer chooses to group its export sales by product, costs that definitely relate to each particular product group must be specifically allocated to that group, while costs that do not definitely relate to a particular product group must be apportioned among all relevant classes of income. Costs that relate to a particular product or product group *cannot* be allocated to any other product group, on a pro rata basis or otherwise.[4] These grouping procedures were contemplated by

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[4] To illustrate, suppose that Megacorp, a U.S. conglomerate, makes and sells $100 worth of space shuttles, $100 worth of scooters, and $100 worth of pogo sticks during a particular year. All of the space shuttles are sold domestically to NASA, and all of the scooters and pogo sticks are exported through Megacorp's DISC. During the same year, Megacorp spends $30 to research fuel alternatives for its space shuttles, $10 to research scooter wheel technology, and nothing for pogo stick research. Megacorp also spends another $20 attempting to develop a new automobile that would recycle engine exhaust and $15 to research the impact of solar-generated neutrinos on the motion of all objects. Megacorp anticipates that its neutrino research might lead to improvements in any of its products or to entirely new products.

Congress. See H.R. Rep. No. 533, *supra*, at 74 ("Although * * * the pricing rules provided by the bill generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.").

2. The dispute now before the Court stems from a provision added to the IRC § 861 "sourcing" regulations in 1977, six years after enactment of the DISC statute and two years after issuance of the final DISC regulations in 1975. As a general matter, the 1977 revision of Treas. Reg. § 1.861-8 continued to "emphasize the factual relationship between the deduction and a class of gross income." Treas. Reg. § 1.861-8(b)(1). Revised Treas. Reg. § 1.861-8(e)(3), however, established a special rule for the allocation of research and development expenses, providing that such expenses "shall ordinarily be considered deductions which are definitely related to all income reasonably connected with the relevant broad product category * * * of the taxpayer" set forth in the Office of Management and Budget's Standard Industrial Classification ("SIC") Manual.[5] This regulation thus "deemed a definite relationship [to exist]

Under the DISC regulations, Megacorp can treat each of its four existing or nascent products as a separate group and calculate its total DISC income by adding up the separate net income (*i.e.*, CTI) attributable to its exported scooter and pogo stick groups. It does that by assigning its "definitely related" $10 of scooter R&D exclusively to its scooter group sales and apportioning its $15 of "indefinitely related" neutrino R&D in proportion to all of its current sales – $5 to scooters and $5 to pogo sticks (in each case, $15 x $100/$300). Megacorp's other R&D costs, for space shuttles and automobiles, are not relevant to the CTI calculations, because all of these costs "definitely relate" to existing or future products that Megacorp's DISC does not sell. Ignoring Megacorp's other costs, scooter CTI is thus $85 ($100 minus $10 minus $5), pogo stick CTI is $95 ($100 minus $5), and total CTI is $180.

[5] The provisions of Treas. Reg. § 1-861-8(e)(3) were renumbered in 1996 and, with amendments not relevant to this petition, were republished as Treas. Reg. § 1.861-17. See App., *infra*, 9a n.7.

between an expenditure for R&D and *all* income reasonably connected with a specific *broad product category*" (*St. Jude Medical*, 34 F.3d at 1399 (emphasis added)) – no matter how narrow or product-specific the actual focus of the R&D expense.[6]

3. For over 40 years, petitioner Boeing has been a world leader in commercial aircraft development and a major U.S. exporter of commercial aircraft. During the period at issue in this litigation, DISC-eligible export sales constituted approximately 70% of Boeing's commercial aircraft sales by dollar volume. Boeing exported commercial aircraft through a qualified export subsidiary. Before 1984, that subsidiary was Boeing International Sales Corporation, a qualified DISC; between 1984 and 1987, that subsidiary was Boeing Sales Corporation, a qualified FSC.

Boeing has maintained its leadership position by continuously developing new commercial aircraft. Consistent with industry practice, Boeing organizes its internal operations along product lines (*e.g.*, the 727, 737, and 757), each of which constitutes a separate "Program" within the Boeing organization. Management and staff for each Program are responsible for developing and managing a particular product line, including the line's various models and derivatives (for

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[6] Again consider Megacorp. Because all of Megacorp's diverse R&D pertains to products falling within SIC classification 37, which broadly covers all "transportation equipment," Treas. Reg. § 1.861-8(e)(3) would place the entirety of that R&D into a single pot and allocate the undifferentiated sum among all products in proportion to current sales. Thus, the exported scooters and pogo sticks each would attract $25 of R&D (total R&D of $75 x $100/$300), the CTI deemed attributable to each of those groups would be $75 ($100 minus $25), and total CTI would be $150 – in contrast to the $180 of total CTI that would result from applying the DISC regulations. This difference occurs because Treas. Reg. § 1.861-8(e)(3) mechanically reassigns to all products portions of all of Megacorp's R&D that in fact are "definitely related" to particular products.

example, passenger and cargo versions of the 747). App., *infra*, 16a.

As a leader in aviation technology, Boeing spends billions of dollars on research and development. Boeing allocates its R&D costs both *across* airplane Programs and directly *to* particular Programs, depending on the type of research. Some of Boeing's research is broad-based and aimed at advancing the state of the art for commercial aviation technology, including general avionics and aerodynamics research (such as wind tunnel tests to study wing airfoil designs and engineering analysis seeking ways to improve the weight and strength of airplanes). Boeing also conducts research to create and develop new products. Such research includes, for example, sketching and analyzing alternative fuselages, wings, and engines, as well as other technologies that could eventually be configured into a new commercial aircraft. Boeing refers to both of these types of general research and development as "Blue Sky R&D." App., *infra*, 2a-3a, 16a-17a.

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

Mirroring its internal organizational structure, Boeing's accounting practices track costs and revenues along Program lines. Specifically, Boeing's cost accounting system allocates costs to the activity to which they are most closely related. Each airplane Program is a separate "final cost objective," and the accounting system allocates to each Program those costs directly related to it. The same is true for revenues. So, for example, the costs and sales of the 727 are accounted for separately from the 767, which are accounted for separately from the 777. In keeping with this framework, Boeing's cost accounting system allocates all research and development that is directly associated with a particular product line (the Program R&D) to that Program. However, costs for general research and development that are not directly related to a particular program (the Blue Sky R&D) are apportioned among Programs on a pro rata basis. For financial accounting and federal income tax purposes, Boeing deducts all research and development costs – including costs relating directly to a particular Program and those that must be apportioned among Programs – in the period in which they are incurred. This is true even if there are no corresponding sales in that period. App., *infra*, 3a, 17a-18a.

For DISC and FSC purposes, Boeing elected to treat each of its Programs as a separate product group, as permitted by Treas. Reg. § 1.994-1(c). Boeing used the CTI method to calculate the relevant income of each group. To determine CTI in each case, Boeing started with the product group's gross export receipts and subtracted from them the total combined costs of its export subsidiary and its United States operations that directly related to those export receipts, as well as a portion of its costs that did not directly relate to any Program. See App., *infra*, 3a, 17a. As part of this process, Boeing subtracted research and development costs from the revenues of each product group. Program R&D was attributed directly to the relevant Program; Blue Sky R&D was apportioned across Programs. *Id.* at 3a, 17a-18a.

4. After conducting an audit and reviewing Boeing's taxes for the years at issue (1979-1987), the IRS disallowed Boeing's method of allocating and apportioning its R&D costs and reallocated those expenses pursuant to Treas. Reg. § 1.861-8(e)(3). As noted above, that provision deems *all* of Boeing's R&D in any given year to be related to sales of *all* airplane models in that year, because all of Boeing's various commercial aircraft product lines fall into the single SIC Code 37 (transportation equipment). The IRS treated all R&D costs the same, without regard to their factual relationship to a particular product line. For example, the IRS allocated portions of the Program R&D costs that were attributable solely to aircraft still in the developmental stages (as were the 757 and 767 during some of the years at issue) to export sales generated by other Programs under which aircraft were actually in production and being sold during the years in question (such as the 747). The IRS apportioned costs in this manner even though the R&D expenditures associated with developing a new product line (such as the 767), obtaining FAA certification, and bringing it to market do not in any way contribute to the development of existing product lines (such as the 747). By reallocating $2 billion of research and development costs related to specific Boeing Programs and charging them against the revenues from other Programs, the IRS decreased the CTI upon which Boeing's export tax benefits were based and thereby increased Boeing's overall tax obligation for the years 1979 to 1987 by some $ 419 million. App., *infra*, 3a-4a, 18a.

Boeing paid the additional tax demanded by the IRS and filed suit seeking a refund. The district court ruled for Boeing, relying heavily on the Eighth Circuit's decision in *St. Jude Medical* and holding that Treas. Reg. § 1.861-8(e)(3) is invalid as applied to CTI computations. App., *infra*, 15a-24a. The district court pointed to three considerations supporting this conclusion. First, the court explained that, by mandating that export sales be grouped according to the broad SIC classifications, Treas. Reg. § 1.861-8(e)(3) conflicts with Treas.

Reg. §§ 1.994-1(c)(6)(iv) and (7), which provide that taxpayers may group income and allocate costs by product or product line. App., *infra*, 21a-22a. Second, the court reasoned that Treas. Reg. § 1.861-8(e)(3) creates an artificial "deemed" relationship between sales and R&D that conflicts with Congress's intent to "'generally allocate to each item of gross income all expenses *directly related thereto.*'" App., *infra*, 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H. Rep. No. 533, *supra*, at 74)) (emphasis in *St. Jude Medical*). And third, the court determined that Congress intended DISCs to deduct only those costs "'directly related to the production or sale of the export property'"; charging unsuccessful R&D that is never actualized as a successful product to current export sales of successful products through an artificial "deemed" relationship is "inconsistent" with that expressed intent. App., *infra*, 22a (quoting *St. Jude Medical*, 34 F.3d at 1401 (quoting H. Rep. No. 533, *supra*, at 74)). The district court thus concluded that the IRS erred in applying Treas. Reg. § 1.861-8(e)(3) to Boeing's CTI calculation, holding that Boeing was entitled to group its export sales by product line and allocate research and development expenditures accordingly.

On appeal, the Ninth Circuit reversed. App., *infra*, 1a-14a. The court of appeals opined that Treas. Reg. §§ 1.861-8(e)(3) and 1.994-1(c)(7) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income. The taxpayer is required, nonetheless, to apportion these costs to broader categories of income and allocate them between the taxpayer's export and domestic sales by the proportional method set forth in Treas. Reg. § 1.861-8(e)(3)." App., *infra*, 12a. The Ninth Circuit also suggested that application of Treas. Reg. § 1.861-8(e)(3) in this context is supportable because, at the time of the enactment of the DISC statute, "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." App., *infra*, 11a. The court therefore held that,

as applied in this case, "Treas. Reg. § 1.861-8(e)(3) * * * is a reasonable interpretation of the applicable statutes and regulations." App., *infra*, 13a. In reaching this conclusion, the Ninth Circuit expressly "decline[d] to follow the reasoning of *St. Jude Medical*." App., *infra*, 10a.

REASONS FOR GRANTING THE PETITION

The decision below creates an express conflict with the holding of the Eighth Circuit on an important and recurring issue of federal law. This conflict plainly warrants the Court's attention. The existence of contrasting standards governing the treatment of R&D expenses in different circuits results in identically situated taxpayers being treated differently on the basis of geography; will generate a substantial volume of litigation; and creates considerable confusion in the operation of a tax incentive statute, an area where predictability and certainty are essential. The issue, moreover, is one of enormous practical importance: this case alone involves more than $400 million in tax liability, with billions of dollars potentially at stake across the Nation. Finally, the Ninth Circuit's decision frustrates the manifest intent underlying the DISC and related tax regimes, which Congress established to effectuate a vital international trade policy. Review by this Court therefore is imperative.

A. There Is An Express Conflict In The Circuits On Whether Treas. Reg. § 1.861-8(e)(3) May Be Applied To The Computation Of CTI

Review by this Court is necessary because there is a clear and irreconcilable conflict in the courts of appeals on a significant issue of federal law. The conflict is indisputable: the Ninth Circuit expressly, and candidly, "decline[d] to follow the reasoning of *St. Jude Medical*." App., *infra*, 10a.

On this point, the Ninth Circuit was correct: *St. Jude Medical* is indistinguishable from this case. In *St. Jude Medical*, as here, the taxpayer produced a number of devices

that were stipulated to be "separate products or product lines under recognized industry or trade usage." *St. Jude Medical*, 34 F.3d at 1401. In that case, as in this one, these separate products all fell into a single SIC classification. See *ibid*. In *St. Jude Medical*, as here, the taxpayer separately allocated R&D costs to each of the products with which they were actually associated, instead of apportioning them generally across the SIC category. See *id*. at 1396, 1400. And in that case, as in this one, the IRS disapproved the taxpayer's allocation of the R&D, contending that, under Treas. Reg. § 1.861-8(e)(3), *all* of the R&D costs relating to *all* products within the SIC classification had to be spread across the export receipts from *all* products within the classification. *Id*. at 1396, 1400.

The outcome in *St. Jude Medical*, however, was quite different from the one here. The Eighth Circuit rejected the IRS's position, "hold[ing] that § 1.861-8(e)(3) is invalid as applied to DISC CTI computations." 34 F.3d at 1396. The court reasoned that "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated on a product-by-product basis or on the basis of product lines." *Id*. at 1401. Moreover, the Eighth Circuit found that "the deemed relationship mandated by § 1.861-8(e)(3)(i) is inconsistent with Congress's intent to 'generally allocate to each item of gross income all expenses *directly related* thereto.'" *Ibid*. (quoting H.R. Rep. No. 533, *supra*, at 74 (emphasis added by the court)). And the court noted that mandatory use of the SIC categories, which had the effect of requiring that income from successful R&D "'bear the cost of unsuccessful research and development'" (*ibid*. (quoting Treas. Reg. § 1.861-8(e)(3)(i)), would be "inconsistent with Congress's stated intent" to deduct from DISC gross receipts those expenses that "'are directly related to the production or sale of * * * property.'" *Ibid*. (quoting H.R. Rep. No. 533, *supra*, at 74).

In reaching that conclusion, the Eighth Circuit acknowledged "a conflict between two Treasury regulations:

§ 1.994-1 and § 1.861-8. Section 1.994-1 allows the taxpayer's choice regarding the manner of grouping transactions to control. Section 1.861-8 mandates a specific method of grouping transactions." *St. Jude Medical*, 34 F.3d at 1402. In resolving this conflict, the court looked to the principles generally applicable under IRC § 861, concluding:

> An examination of § 861(b)'s language does not allow us to infer that Congress intended to impose mandatory SIC transaction grouping in CTI computations related to R & D expenditures. * * * In fact, § 1.861-8, at the time the DISC legislation was enacted, did not contain the SIC categories, but rather reiterated § 861(b)'s language.

St. Jude Medical, 34 F.3d at 1402 (footnote omitted). After examining "the origin and the purpose of the DISC statute," the Eighth Circuit accordingly held "that § 1.861-8 is unreasonable, and thus invalid, as applied to DISC CTI computations. * * * We believe Congress intended in CTI computations to allocate costs, such as R & D expenditures, to definitely related gross export receipts." *Ibid.*

In this case, the Ninth Circuit reached precisely the opposite conclusion. The Ninth Circuit expressly recognized the Eighth Circuit's holding "that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to DISC CTI computations" and "did not control the computation of DISC combined taxable income." App., *infra*, 10a. As we have explained, however, the Ninth Circuit went on to reject the Eighth Circuit's analysis. See *ibid.* The court below reasoned, instead, that "[the] statutory text does *not* confine the relevant costs to those 'definitely related' to sales of a particular product" (*id.* at 11a (emphasis added)); that "[t]here is *no* conflict between Treas. Reg. § 1.861-8(e)(3) and Treas. Reg. § 1.994-1(c)(6)" (*id.* at 12a (emphasis added)); and that Treas. Reg. § 1.861-8(e))(3) "*is* a reasonable interpretation of the applicable statutes and regulations." App., *infra*, 13a (emphasis added).

The Ninth Circuit made no attempt to, and plainly could not, reconcile its holding with that of the Eighth Circuit in *St. Jude Medical*. Deciding cases that in all relevant respects are identical, the Eighth Circuit held that taxpayers are entitled to allocate R&D expenses on the basis of the specific product or product-line groupings that the DISC regulations authorize, while the Ninth Circuit held that same treatment impermissible, concluding that taxpayers instead must apportion R&D expenses on the basis of broad SIC classifications. As a result, identically situated taxpayers located in different parts of the country must bear dramatically different tax burdens. Because of the great need for "uniform application of the Internal Revenue laws" (*Turnbow* v. *Commissioner*, 368 U.S. 337, 339 (1961)), this intolerable situation warrants review by this Court.

B. The Decision Below Is Wrong

The need for review is particularly acute because the decision below is plainly wrong. The background and contemporaneous understanding of the DISC statute unmistakably establish two fundamental principles: (a) expenses that are *directly* related to a particular class of gross income must be allocated to that class and no other; and (b) taxpayers are entitled to select the grouping of products or product categories that they believe to be most advantageous. The court of appeals' decision departs from both of those principles. It thus frustrates the congressional intent and undermines the purposes of a significant federal tax incentive.

1. There is no denying that the Ninth Circuit's approach leads to perverse results. Under the court of appeals' holding, Boeing's R&D that relates exclusively to *one* specific airplane model has to be allocated, in large part, to revenue from the sale of *other*, unrelated models. Thus, if Boeing incurred a research expense in 1987 that was directed solely to improving a component unique to a new 767 model that was not yet in production, the Ninth Circuit would require treating the expense as part of the cost of that year's 747 sales – even

though *that* model of aircraft had been introduced years earlier and did not benefit at all from the R&D relating to 767s. Indeed, the court of appeals' holding would require that research expenses incurred in the development of *scooters or boats* be allocated, in part, to the production of *aircraft or space vehicles* because they all fall within the SIC Code (37) for "transportation equipment."

When it enacted the DISC statute, Congress certainly did not contemplate requiring such an outcome. To the contrary, the DISC regime was premised on the understanding that the income "attributable to" export sales under IRC § 994 would be calculated by allocating expenses to the class of income with which they are factually associated. The statute was enacted against the background of IRC § 861(b), which defines taxable income as gross income less [1] "the expenses * * * properly apportioned or allocated thereto and [2] a ratable part of any expenses * * * which cannot definitely be allocated to some item or class of gross income." Plainly, this scheme postulates that, if an expense *can* "definitely be allocated to some item or class of gross income," it falls into the first of these categories and therefore may *not* be ratably apportioned across all classes of income.

The legislative history of the DISC statute makes this point explicit, taking pains to spell out precisely the expense allocation scheme that Congress intended. The committee reports expressed Congress's intent that expense allocations under DISC "be determined generally in accordance with the principles applicable under section 861," observing that those IRC § 861 rules "generally allocate to each item of gross income all expenses directly related thereto." H.R. Rep. No. 533, *supra*, at 74. Applying this principle in the DISC context, the committee reports went on to declare that CTI is to be computed by subtracting from export revenue those "expenses * * * which were *directly related* to the production or sale of the export property and a portion of the * * * expenses *not allocable to any specific item of income*." *Ibid*. (emphasis

added). This system leaves no room for taking a portion of the expenses that *are* in fact related to particular export property and apportioning them to *other*, unrelated property.[7]

This understanding is confirmed by the DISC regulations that were promulgated almost contemporaneously with the enactment of the DISC statute. These rules identify the costs that "shall be treated as relating to gross receipts from sales of export property" as including both expenses that are "*definitely related*, and therefore allocated and apportioned, thereto," and "a ratable part of other expenses * * * which are *not definitely related to a class of gross income*." Treas. Reg. § 1.994-1(c)(6)(iii) (emphasis added). Again, this structure plainly contemplates that costs that *are* definitely related to particular products may not be allocated or apportioned to *other* products.

Moreover, at the time these regulations were promulgated it was clearly understood that a factual relationship had to exist between R&D expenditures and any "definitely related" income-producing activity to which those expenditures might be exclusively allocated. The final DISC allocation and apportionment regulation issued in 1975, Treas. Reg. § 1.994-1(c)(6)(iii), provides that these determinations are to be made "in a manner consistent with the rules set forth in [Treas. Reg.] § 1.861-8." As we have explained (at page 5, *supra*), the

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

version of § 1.861-8 contemporaneously in force simply reiterated IRC § 861(b)'s language, distinguishing between expenses that can and cannot "definitely be allocated" to a class of income. And the proposed § 1.861-8 regulations in place in 1975 unambiguously applied the factual relationship principle to R&D in the DISC context. Those proposed regulations set forth the general rule as follows:

> Expenditures for research and development which a taxpayer deducts * * * shall be considered deductions which are definitely related to the class of gross income to which such research and development activity gives rise or is reasonably expected to give rise and shall be allocated to such class.

Prop. Treas. Reg. § 1.861-8(e)(3)(i) (1973). Example (1) in this proposed regulation illustrated the rule by treating four-, six-, and eight-cylinder gasoline engines as *separate* products, each with separate and directly allocable R&D. Example (2) extended this tracing of R&D to a DISC CTI computation in which four- and six-cylinder engines were grouped separately.[8]

Against this background, the Ninth Circuit plainly erred in holding that Treas. Reg. § 1.861-8(e)(3) could validly be applied in the circumstances of this case. That regulation irrebuttably deems *all* R&D expenses to be definitely related to *all* income within a broad SIC Code, so that the expenses must be spread over *all* products and product groups falling within that Code. This "deemed" relationship ignores the actual

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[8] The Secretary of the Treasury evidently relied on these examples when including the reference to Treas. Reg. § 1.861-8 in the DISC regulations. The Technical Memorandum accompanying the final DISC regulations indicated that they did not include their own examples "for determining the portion of certain expenses of the [parent corporation] to be deducted in determining combined taxable income of the DISC and [the parent corporation]" because the drafters anticipated that the examples in the 1973 proposed § 1.861-8 regulations would apply. 1974 TM Lexis 30, at *20 (Oct. 29, 1974).

relationship between expense and income that Congress explicitly intended to govern CTI calculations under the DISC statute. The rule established by § 1.861-8(e)(3) also is contrary to the undisputed facts in this case, which establish that the research at issue here related to the design of *particular* airplane lines; it implements a regime in which narrowly focused research relating to the details of a new airplane is treated as a cost of selling an airplane that has been in production for 20 years; and it perverts the DISC scheme's central purpose by reducing the incentives that encourage exports. For these reasons, as the Eighth Circuit correctly held, "§1.861-8[(e)(3)] is unreasonable, and thus invalid, as applied to DISC CTI computations." *St. Jude Medical*, 34 F.3d at 1402.

2. The Ninth Circuit's holding that CTI must be calculated by apportioning expenses across all products within a broad SIC Code also is insupportable for a second, closely related reason: the DISC regulations emphatically state that the taxpayer is entitled to *choose* whether or not CTI determinations will be made on a product-by-product basis. The taxpayer is entitled to make this choice annually (see Treas. Reg. §1.994-1(c)(7)(i)) and its "choice [as to grouping] * * * shall be *controlling*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added). Indeed, the regulations specifically provide that the taxpayer's choice "will be accepted by [the IRS]" so long as it conforms *either* to "recognized industry or trade usage" *or* to "the 2-digit major groups * * * of the Standard Industrial Classification * * * of the Office of Management and Budget." Treas. Reg. § 1.994-1(c)(7)(ii). The DISC regulation, moreover, makes clear that the taxpayer's choice in this regard will determine the category of income to which expenses should be allocated in computing CTI: "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year *resulting from such grouping*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added). This grouping rule was sufficiently important that Congress expressly incorporated it into both the FSC and ETI

statutes that succeeded DISC. IRC § 927(d)(2)(B) (1984); IRC § 943(b)(1)(B) (2000).

The Ninth Circuit's approach is flatly at odds with this principle. Rather than allocate costs to the classes of income "resulting from [the taxpayer's] grouping," as the DISC regulation mandates, the court of appeals requires that costs be allocated according to SIC Code. As the Eighth Circuit explained, "[m]andating use of the SIC categories is inconsistent with Congress's intent to allow costs to be allocated [either] on a product-by-product basis or on the basis of product lines." *St. Jude Medical*, 34 F.3d at 1401. Indeed, "[Treas. Reg.] § 1.861-8, at the time the DISC legislation was enacted, did not contain the SIC categories, but rather reiterated § 861(b)'s language." 34 F.3d at 1402. The decision below thus works a significant, and unwarranted, change in the incentives provided by the DISC statute and regulations.

The DISC provisions were specifically designed to encourage manufacturers to locate their productive facilities in the United States and to export their goods, rather than to supply their foreign markets from overseas factories. See H.R. Rep. No. 533, *supra*, at 58; S. Rep. No. 437, 92d Cong., 1st Sess. 90 (1971). To accomplish that result, Congress offered relief from taxation for a portion of the manufacturer's income "attributable to" (IRC § 994(a)(2)) sales of the exported goods. But by attributing millions of dollars of R&D expenses to export sales, even though the expenses in fact bore no relationship to those sales, the decision below artificially understates Boeing's true export sales income and reduces the incentive of U.S. companies to expand their domestic manufacturing operations. By contrast, the Eighth Circuit understood that this approach "may improperly decrease the profits allocated to a DISC, thus thwarting Congress's intent when it promulgated the DISC intercompany pricing rules." 34 F.2d at 1402-1403.

3. The rationales advanced by the Ninth Circuit cannot support its holding. *First*, the court of appeals opined that Treas. Reg. § 1.861-8(e)(3) and § 1.994-1(c) "can be harmonized by recognizing that the more narrowly a taxpayer chooses to define income items, the more costs become 'indirectly' or 'indefinitely' related to specific items of income." App., *infra*, 12a. This perplexing statement disregards *both* the controlling facts and the controlling law. The statement is flatly wrong as a factual matter, because it is undisputed that the R&D costs for each Boeing Program were *definitely* related to that Program and that Program alone, and were completely unrelated – "indefinitely" or otherwise – to other Programs. The Ninth Circuit's statement is equally indefensible as a legal proposition, because Treas. Reg. § 1.861-8(e)(3)(i) manifestly did *not* transform any R&D expenses into costs "'indefinitely' related to specific items of income." Instead, the regulation explicitly deems all R&D costs to be "*definitely* related to all income reasonably connected with the relevant [SIC] category" (emphasis added). Either way, the Ninth Circuit's purported "harmonization" of the regulations was nothing but rhetorical alchemy.

Second, the court of appeals may have meant to adopt the government's suggestion (see U.S. 9th Cir. Br. 11) that it was impermissible for Boeing to allocate R&D expenses to Programs that had no current gross income from which those expenses could be deducted. See App., *infra*, 3a (stating that such costs "simply 'disappeared'"). If so, the court plainly was incorrect. There is nothing inherently wrong in having the costs directly related to a particular product line exceed the gross income generated by that line in a given year. To the contrary, Treas. Reg. § 1.861-8(d) explicitly states that "[e]ach deduction which bears a definite relationship to a class of gross income shall be allocated to that class in accordance with paragraph (b)(1) of this section [which emphasizes the "factual relationship between the deduction and a class of gross income"] even though, for the taxable year, *no gross income in*

such class is received" (emphasis added). Indeed, this principle was recognized even by the R&D allocation regulation itself. See Treas. Reg. § 1.861-8(e)(3)(ii)(B) ("[a]mounts apportioned under this paragraph (e)(3) may exceed the amount of gross income related to the product category within the statutory grouping."). See also IRC § 174 (general R&D incentive provision that allows R&D to be deducted in current year even though it may not generate income until future years); Treas. Reg. § 1.861-8(c)(1) ("In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping").

Third, the court of appeals found it significant that "Congress recognized [that] some of the costs incurred in a given tax year would not be 'directly related' to specific income items." App., *infra*, 11a. But that observation, while doubtless correct, is simply beside the point. That certain costs (*i.e.*, overhead) are not directly related to specific products hardly means that the costs that *are* directly related to specific products should be apportioned to *other* products. The Ninth Circuit's sleight-of-hand thus cannot obscure its departure from the fundamental principles underlying the DISC statute and regulations.

C. The Issue Presented Here Is A Recurring One Of Great Practical Importance

The question presented in this case has enormous practical significance. The Ninth Circuit's decision severely undermines the efficacy of an important export tax incentive program that has been used for decades by thousands of major U.S. manufacturers.

In its most recent (year 2000) analysis, the IRS reported that the number of FSC returns had risen to well over 4,000 in 1996, a 42% increase over the 3,073 FSC returns just filed four years

earlier.[9] Not only is the number of these taxpayers on the rise, but the amount of tax benefits is increasing as well. These companies' aggregate annual FSC tax benefits were estimated in February 2000 at approximately $4 billion for the year 2000, with a projected increase to $5.5 billion by the year 2005.[10] Estimates of total annual tax benefits from ETI, which replaced the FSC regime, begin at $4.8 billion for 2003, with the number projected to rise to $6.5 billion by the year 2007.[11]

Nearly 90% of all FSC returns filed for 1996 reported manufactured product exports, with nearly two-thirds of these revenues coming from exports of non-electrical machinery; transportation equipment; electrical machinery, equipment, and supplies; and chemicals and allied products.[12] Thus, thousands of FSCs are in industries with significant R&D expenditures, and the method of allocation of those expenditures can have a substantial effect on the amount of their tax-based export incentive. The resolution of the issue in this case will significantly affect many U.S. exporters that made substantial R&D expenditures during the years for which the FSC regime was in effect; as evidenced by the $419 million at issue in this case, the amounts at stake for any given taxpayer with regard to the R&D allocation issue can be very large. Equally

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[9] Cynthia Belmonte, *Foreign Sales Corporations, 1996*, STATISTICS OF INCOME BULLETIN, Spring 2000 (published by the Internal Revenue Service).

[10] Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2001, Table 32-4, Tax Expenditures by Function for Fiscal Years 1999-2005, February 7, 2000.

[11] Joint Committee on Taxation, Estimates of Federal Tax Expenditures for Fiscal Years 2002-2006, JCS-1-02, January 17, 2002.

[12] Cynthia Belmonte, *Foreign Sales Corporations, 1996*, STATISTICS OF INCOME BULLETIN, Spring 2000 (published by the Internal Revenue Service).

important, resolution of the issue will affect the behavior of thousands of taxpayers that must decide both whether to make substantial R&D expenditures on exports under the ETI regime and whether the tax incentives are sufficient to warrant an increase in exports.

Congress has long evidenced a concern for the competitiveness of the U.S. economy in the world market and has consistently sought to improve the U.S. balance of payments. Three decades ago, Congress determined that strong export incentives would promote those goals. In enacting the DISC provisions in 1971, Congress deviated from the general residence-based tax system of the U.S. (*i.e.*, taxing U.S. taxpayers on their worldwide income) and adopted a feature of territorial taxation (taxing only income earned in the U.S. and exempting or deferring some income of U.S. taxpayers earned abroad) that was designed to tax export sales more favorably than comparable domestic transactions.[13] These provisions, intended to level the playing field for U.S. exporters and to increase the volume of exports from the U.S., gave taxpayers considerable flexibility to maximize their tax benefits. It was no accident that the statutory scheme permitted taxpayers to

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[13] See General Explanation of Tax Legislation Enacted in the 106th Congress, April 19, 2001, Joint Committee Print, 107th Cong., 1st Session. See also *Hearings on Trade Relations with Europe and the New Transatlantic Economic Partnership Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 105th Cong., at 117 (1998) (statement of Jeremy O. Preiss, Chief International Trade Counsel, United Technologies Corporation) ("Congress enacted both the DISC and the FSC in part to begin leveling the playing field between the U.S. income tax system * * * and more export friendly territorial systems. The FSC is not a provision designed to confer a tax benefit on U.S. exporters that is not enjoyed by their competitors abroad; to the contrary, the FSC is designed to ameliorate – in quite small measure – a significant tax advantage that is enjoyed by companies exporting from countries with territorial tax systems.").

allocate their expenses, including R&D expenses, to product groups.

Congress has steadfastly adhered to this important policy in the face of repeated protests from other countries that these features of U.S. law provide illegal export subsidies. Thus, as noted above (see pages 2-3, *supra*), after the DISC regime was determined to violate international law, Congress enacted the FSC legislation. In that legislation, Congress pointedly codified the principles of the DISC regulations that permit taxpayers to maximize their tax incentive through the allocation of expenses to product groups. The ETI legislation, which was enacted in November 2000 after the FSC regime also was declared inconsistent with international obligations, includes an identical provision.[14] The FSC regulations remain in effect under the ETI regime to fill the gap before new regulations are promulgated.[15]

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[14] The statutory product grouping provisions for FSC (IRC § 927(d)(2)(B)) and ETI (IRC § 943(b)(1)(B)) both state as follows:

> Grouping of transactions. To the extent provided in regulations, any provision of this subpart [the overall FSC or ETI regime] which, but for this subparagraph, would be applied on a transaction-by-transaction basis may be applied by the taxpayer on the basis of groups of transactions based on product lines or recognized industry or trade usage. Such regulations may permit different groupings for different purposes.

[15] General Explanation of Tax Legislation Enacted in the 106th Congress, April 19, 2001, Joint Committee Print, 107th Cong., 1st Session. The importance of the issue presented here is not diminished by the recent decision of the World Trade Organization's Appellate Body that the current ETI regime is inconsistent with WTO rules, which authorizes the European Union to impose retaliatory tariffs against the United States. See WTO Report of the Appellate Body on Complaint of the European Communities Concerning United States Tax Treatment for "Foreign Sales Corporations," Daily Rep. for Executives, No. 10, at L-1 (Jan. 15, 2002). That decision does not displace U.S. law and the ETI system thus remains in effect. The

At bottom, the decision below ignores Congress' continuous support for the grouping rule and undermines a longstanding statutory policy designed to provide tax incentives for exports. Prior to the Ninth Circuit's decision, taxpayers could rely on statutory and regulatory language, the intent of Congress, and the Eighth Circuit's validation of that understanding in *St. Jude Medical* to compute export income in accordance with the DISC/FSC/ETI regulations, including the grouping rule. After the Ninth Circuit's decision, however, that benefit is available with certainty only to taxpayers in the Eighth Circuit. Thousands of taxpayers in other circuits will not be able to predict the magnitude of the export incentives promised to them by ETI (or its successor regime). Nor will those taxpayers be able to take advantage of those incentives as Congress intended without significant risk of an IRS challenge. Moreover, taxpayers outside the Eighth Circuit are now vulnerable to IRS claims for back taxes that would retroactively reduce the incentives upon which those taxpayers already have relied. The Court should resolve this dispute so that a single rule applies to export decision-making and tax liability throughout the United States.

WTO decision may be accessed at <www.wto.org/english/tratop_e/dispu_e/distabase_wto_members4_3.htm>.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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