No. 01-1209

In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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QUESTIONS PRESENTED

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.

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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 (Pet App. 25a). The petition for a writ of certiorari was filed on February 15, 2002. The jurisdiction of this Court is invoked under 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 Section 925 of the Internal Revenue Code, 26 U.S.C. 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-11a.

STATEMENT

1. This case concerns the proper allocation of research and development expenses in the calculation of income from foreign sales of goods during the years from 1979 to 1987. This question arose under two separate sets of statutory and regulatory provisions, all of 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).

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 of that international challenge, Congress replaced the DISC provisions in 1984 with the "foreign sales corporation" (FSC) provisions of the Code. 26

U.S.C. 921-927 (1988 & Supp. V 1993). See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 805(b), 98 Stat. 1001-1002. When the FSC provisions were enacted in 1984, 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). By thus imposing an interest charge on any deferred taxes under the post-1984 DISC provisions, the asserted export subsidy was removed (see R. Doernberg, *supra*, at 412), as was the economic incentive even for small corporations to employ the post-1984 DISC regime. As a consequence, taxpayers engaged in export operations after 1984 routinely did so under the FSC provisions.

b. The FSC provisions contemplate that a U.S. parent will establish a foreign corporation with a genuine foreign presence to conduct export sales. "If a corporation qualifies as a FSC, a portion of its foreign trade income is exempt from the U.S. corporate income tax [and] [t]hat portion can be distributed as a dividend tax-free to the U.S. parent corporation * * *." R. Doernberg, *supra*, at 397. Because the FSC may be subject to taxes abroad for its foreign sales income, "many U.S. corporations organize FSCs in foreign countries imposing relatively low, or no, corporate and dividend withholding taxes on that income." *Ibid.* Separate regulations were adopted to implement the new requirements of the FSC regime. See, *e.g*, 26 C.F.R. 1.925(a)-1T (1989).

c. In February 2000, the World Trade Organization determined that the FSC provisions that had superseded the DISC provisions provided a prohibited export subsidy in violation of the WTO Agreement on Subsidies and Countervailing Measures and the Agreement on Agriculture. Appellate Body, World Trade Organizations, *United States—Tax Treatment for "Foreign Sales Corporations,"* AB-1999-9 (Feb. 24, 2000).[1] Following that decision, Congress repealed the FSC provisions as of September 30, 2000. With the exception of a narrow, transitional rule for certain transactions commenced under the FSC regime, Congress repealed and replaced the FSC provisions with the new "extraterritorial income exclusion" (ETI) of Section 114 of the Internal Revenue Code. 26 U.S.C. 114. See FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, § 5, 114 Stat. 2433. These new ETI provisions contain a degree of complexity that even the DISC and FSC provisions cannot rival.[2] The ETI provisions were again challenged in proceedings before the WTO, which led to the opinion of the WTO Appellate Body issued in January of 2002. Appellate Body, World Trade Organization, *United States—Tax Treatment for "Foreign Sales Corporations," Recourse to Article 21.5 of the DSU by the European Communities*, AB-2001-8, at 9-12 (Jan. 14, 2002).[3] In that opinion, the WTO Appellate Body concluded that the ETI provisions—like the FSC and DISC provisions

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[1] <http://www.wto.org/english/tratop_e/dispu_e/distabase_e.htm>

[2] Professors Bittker and Eustice noted that the original DISC 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). When the FSC provisions were enacted to replace the DISC provisions in 1984, these same commentators remarked that the new provisions replaced the old with an "equally complex" statutory scheme that "def[ies] concise explanation." *Id.* ¶ 17.14, at 17-55 (5th ed. 1987).

[3] See note 1, *supra*.

that preceded them—constitute prohibited export subsidies under the WTO agreements. *Id.* at 91-93. The WTO Appellate Body further concluded that the narrow transitional rules that had left the FSC provisions temporarily in place for certain transactions were also in violation of the WTO agreements. *Id.* at 84.

2. a. The substantive question presented by the petition addresses one element of the complex requirements for computing what is known as the "combined taxable income" (CTI) of the parent and its sales subsidiary under the separate DISC (26 U.S.C. 994(a)) and FSC (26 U.S.C. 925(a)) tax regimes. The taxes imposed under these separate regimes vary depending on the amount of CTI that results from the covered export transactions. In general, under these tax provisions, the parent has an incentive to maximize the portion of its profits that are encompassed within its export-related CTI rather than within the parent's non-export related income, for this tends to reduce its overall tax burden. The taxpayer therefore seeks to minimize the portion of its overall costs that are allocated to its covered export transactions, which has the consequence of maximizing the portion of its overall profits that are allocated to the export-related CTI, and thereby reducing its overall tax burden.

b. While there are numerous differences between a DISC and a FSC, the principal one for the purposes of this case is that income tax on a portion of the export income attributed to a DISC is deferred, while a portion of the export income attributed to a FSC is exempt from income tax. Under both regimes, the combined taxable income of the parent and the sales subsidiary is an ingredient in the determination of the portion of that income that is allocated to the subsidiary and thus available for tax deferral or exemption. In the DISC regime, the combined taxable income resulting from the sale is allocated based on an assumed transfer price for the exported good that would allow the DISC to derive income that does not exceed the greatest of (i) 4% of the export receipts, (ii) 50% of the combined taxable income of the parent and the DISC, or (iii) the income resulting from an arm's length sale price. 26 U.S.C. 994(a). The FSC regime has a similar, but different, allocation procedure that also, in some circumstances, requires or permits consideration of the combined taxable income of the parent and the sales subsidiary. 26 U.S.C. 925(a) (1988).[4]

Although these pricing rules are generally to be applied on a transaction-by-transaction basis, a taxpayer may choose instead to apply them to groups of exported goods consisting of products or product lines selected to determine the allowable transfer price. Different grouping regulations were adopted for this purpose under the DISC and FSC regimes. Compare 26 C.F.R. 1.994-1(a)(1), (c)(7)(i) (DISC), with 26 C.F.R. 1.925(a)-1T(a)(1), (c)(8) (FSC). The grouping rules make it unnecessary for the taxpayer to file a separate schedule for each and every sale, and they provide a limited flexibility in the choice of the pricing rule to apply. For example, the grouping rules would generally permit a taxpayer to elect the "4 percent of the qualified export receipts" pricing rule of Section 994(a)(1) for DISCs or the "1.83 percent of the foreign trading gross receipts" pricing rule of Section 925(a)(1) for FSCs to determine the allowable transfer price for

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[4] 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. See note 9, *infra*.

one group of products, while employing the "50 percent of the combined taxable income" rule of Section 994(a)(2) for DISCs and the "23 percent of the combined taxable income" rule of Section 925(a)(2) for FSCs on another group of products.

c. Petitioner chose to use the "50 percent of the combined taxable income" price rule set forth in Section 994(a)(2) and the "23 percent of the combined taxable income" price rule set forth in Section 925(a)(2) for all of its groups of DISC and FSC export sales.[5] Although Congress never defined the term "combined taxable income" in either the DISC or the FSC statutes, Congress contemplated that "the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country." H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971). The rules established under Section 861 of the Internal Revenue Code, 26 U.S.C. 861, "generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross

[5] As used hereafter 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 taxable 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 related supplier] which is attributable to the qualified export receipts on such property derived as a result of the sale by the DISC." 26 U.S.C. 994(a)(2). See H.R. Rep. No. 533, 92d Cong., 1st Sess. 74 (1971); S. Rep. No. 437, *supra*, at 107. The cognate rule for a FSC is found in Section 925(a)(2), which sets the limit at 23 percent of CTI.

income on a ratable basis." H.R. Rep. No. 533, *supra*, at 74; S. Rep. No. 437, *supra*, at 107-108.

Section 861, to which the DISC committee reports refer, serves to distinguish between domestic and foreign source income for income tax purposes. The determination of the domestic or foreign source of the income has importance for many purposes. See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 17.02, at 17-4 to 17-27 (5th ed. 1987). 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 sources income. Section 861(b) provides, in turn, that expenses "properly apportioned or allocated" to the items of gross 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, shall be deducted to arrive at taxable income. 26 U.S.C. 861(b). The key determination made under Section 861(b) is thus whether an expense is "properly apportioned or allocated" to an item of gross income. Congress did not define the statutory phrase that provides for expenses "properly apportioned or allocated" against various types of income, and taxpayers therefore look to Treasury regulations for guidance.

d. The Treasury regulations adopted to implement the DISC provisions tracked the congressional committee reports. 26 C.F.R. 1.994-1(c)(6) provides that CTI from a sale of export property "is the excess of the gross receipts (as defined in Section 993(f)) of the DISC from such sale over the total costs of the DISC and related supplier which relate to such receipts." Section 1.994-1(c)(6)(iii), in turn, defines the costs that are treated as relating to those gross receipts as (emphasis added):

> (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*.

The DISC regulations thus specifically incorporate the regulations issued under Section 861. Those regulations were promulgated in 1977 "principally to ensure that foreign operations of domestic corporations are charged with a proper share of deductions." B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 70.10.1, at S70-26 (Supp. 1999). Expenses, losses and other deductions are to be allocated to the class of gross income to which they are definitely related (26 C.F.R. 1.861-8(b)(1)) and then apportioned, if necessary, between so-called "statutory groupings" and "residual groupings" (26 C.F.R. 1.861-8(c)(1)).[6] The deductions that are related to all of a taxpayer's gross income or that are not definitely related to any class of gross income are ratably apportioned to all gross income. 26 C.F.R. 1.861-8(b)(5) and (c)(2).

The regulations under Section 861 recognized "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.

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[6] The computation of DISC taxable income was treated as a "statutory grouping" for these purposes. 26 C.F.R. 1.861-8(f)(1)(iii). The same is true of FSC taxable income. *Ibid.*

1.861-8(e)(3)(i)(A) (1979).[7] Consequently, research and development expenses were "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.* These regulations originally used the two-digit categories found in the Standard Industrial Classification Manual published by the Office of Management and Budget as the relevant product categories. *Ibid.* When these regulations were revised in 1995, however, the narrower three-digit standard industrial classification codes were adopted as the relevant 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, along with its DISC (Boeing International Sales Corporation) and its FSC (Boeing Sales Corporation), chose to group its export sales according to petitioner's internally designated "Airplane Programs" and to use the combined taxable income method for each grouping. Invoking 26 C.F.R. 1.994-1(c)(7) (DISC) and 26 C.F.R. 1.925(a)-1T(c)(8)(ii) (FSC), petitioner treated each of its programs as a product line and computed the CTI for each program. Pet. App. 2a-3a. In doing so, however, petitioner declined to follow the requirement of the regulations that research and development expenses be allocated on the basis of the (then) two-digit industrial classification codes required by 26 C.F.R. 1.861-8(e)(3)(i)(A) (1979). Instead, petitioner sought to allocate most of its research and devel-

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[7] In December 1995, the research and development provisions previously published as 26 C.F.R. 1.861-8(e)(3) (1979) were amended and renumbered as 26 C.F.R. 1.861-17.

opment expenses along narrower, airplane-by-airplane product lines. Pet. App. 3a. The result of the narrower allocation method followed by petitioner would be to reduce the research and development expenses allocated to its export sales and thereby increase the "combined taxable income" from those sales and decrease the resulting United States taxes owed by petitioner during the relevant years. *Id.* at 3a-4a.

b. Petitioner organized its operations in defined operating divisions that dealt with specific products or services and operated largely autonomously. Petitioner's largest division was its Commercial Airplane Division, which produced different models of commercial airplanes and related products and provided related services. The Commercial Airplane Division was, in turn, divided for purposes of organization and accounting into programs dealing with a specific airplane model or with spares, sundry or other activities. Petitioner's financial statements generally did not break down revenues or profits by programs. Instead, they were reported in total for the Commercial Airplane Division. Pet. App. 2a.

Petitioner divided its R&D expenditures into two categories: "Blue Sky R&D" and "Company Sponsored Product Development." Of the approximately $4.6 billion in R&D expenditures incurred by petitioner during the relevant years, approximately $1.0 billion was classified as Blue Sky R&D and $3.6 billion was classified as Company Sponsored Product Development. Pet. App. 2a-3a; C.A. E.R. 4-5.

Blue Sky R&D involved basic airplane technology, as well as the development of new airplanes prior to the initiation of specific airplane programs. A large amount of petitioner's Blue Sky R&D expenses were incurred in "informal programs" or "projects" that were the precursors to specific formally identified programs. For example, petitioner incurred significant Blue Sky R&D expenditures related to what petitioner referred to as the 7X7 "Program" or "Project" and which eventually became the 767 Program when petitioner's Board of Directors authorized the "program go-ahead." Pet. App. 3a, 17a; C.A. E.R. 62-63, 102.[8]

Company Sponsored Product Development represented research and development expenditures that petitioner identified with particular airplane programs. The difference between Blue Sky R&D and Company Sponsored Product Development was a function of the way petitioner divided its commercial airplane business for cost accounting and management purposes. Under petitioner's system, an "airplane program" designated the organizational component that developed and manufactured a specific airplane model after that model had achieved "program go-ahead" status. See note 8, *supra*. During the tax years at issue in this case, petitioner established or maintained a separate program for each of the following airplane models: 707, 727, 737, 737-300, 747, 757 and 767. Pet. App. 16a; C.A. E.R. 4.

c. In computing CTI, petitioner annually allocated its Blue Sky R&D costs among all of its airplane programs primarily on the basis of the number of direct labor hours incurred in each program. Pet. App. 3a; C.A. E.R. 157. Petitioner allocated Company Sponsored Product Development research to the particular program for which it was incurred. Each year peti-

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[8] Program go-ahead was the point at which petitioner's Board of Directors made a firm commitment to produce a particular airplane model. That decision was contingent, in part, on the existence of a significant number of firm customer orders for that airplane model. Pet. App. 3a, 17a; C.A. E.R. 105-106, 115-116.

tioner made these allocations to a particular airplane program even though there might be no sales in that program for that year. As a result, under petitioner's method of allocating R&D expenses, approximately $1.9 billion dollars of R&D expenditures during the years in question—expenditures that were deducted from the income earned by petitioner's Commercial Airplane Division in determining its taxable income generally—were *not* deducted in computing the CTI for sales through Boeing International Sales Corporation and Boeing Sales Corporation for purposes of the DISC and FSC provisions. Pet. App. 3a; C.A. E.R. 152-153. The result was to increase the amount of tax exempt or tax deferred income treated favorably under the DISC and FSC provisions.

d. On audit, the Internal Revenue Service rejected petitioner's methods of allocating R&D expenses in computing the CTI from DISC and FSC sales of its commercial airplanes and related products and services and recomputed the CTI from those sales by allocating the R&D expenses in accordance with 26 C.F.R. 1.861-8(e)(3) (1979). The Service thus allocated petitioner's R&D expenses (both Blue Sky R&D and Company Sponsored Product Development R&D) to all of petitioner's income from sales of commercial airplanes and related products and services in a single category under the two-digit Standard Industrial Classification Code 37 (Transportation Equipment) and apportioned those R&D expenses among petitioner's programs on the basis of sales in each program. This reallocation of R&D expenses resulted in more expenses being allocated to petitioner's qualified export sales, thereby decreasing the CTI for those sales under the DISC and FSC provisions, and thereby yielding a greater tax liability for each of the years in question. Pet. App. 3a-4a, 18a.

4. Petitioners paid the additional tax and filed timely claims for refund. After those claims were not granted, petitioners filed this suit for refund in the United States District Court for the Western District of Washington. Pet. App. 4a. Petitioners contended that the application of 26 C.F.R. 1.861-8(e)(3) (1979) to CTI calculations was "arbitrary, capricious, and invalid under the Code sections and regulations governing DISC and FSC export transactions." C.A. E.R. 8.

The district court upheld petitioner's contention. Pet. App. 24a. The court concluded 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) (1979) and the statement in the DISC regulation that a taxpayer's grouping of transactions is "controlling" (26 C.F.R. 1.994-1(c)(6)(iv)) in the allocation of deductions against the gross income resulting from such grouping. Pet. App. 21a. In so ruling, the court followed the decision of the Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394 (1994), which had concluded that 26 C.F.R. 1.861-8(e)(3) is invalid as applied to DISC computations. The district court stated that the court in *St. Jude* had identified three "defects" in the application of 26 C.F.R. 1.861-8(e)(3) to DISC transactions, two of which were present here. Pet. App. 21a. First, the court stated that the two-digit Standard Industrial Classification Code grouping of 26 C.F.R. 1.861-8(e)(3) departs from the legislative intent to allow costs "to be allocated on a product-by-product basis or on the basis of product lines" when computing CTI. Pet. App. 21a-22a. Second, the court stated that the two-digit industrial code grouping required by 26 C.F.R. 1.861-8(e)(3) is inconsistent with a legislative intent to allocate to each product group "all expenses *directly related*" to the exported goods. Pet. App. 22a (quoting *St. Jude*, 34 F.3d at 1401). The district court therefore concluded that the regulatory requirements of 26 C.F.R. 1.861-8(e)(3)(ii) (1979) are inapplicable to the calculation of CTI and entered judgment in favor of petitioners and against the government for $419,110,539 in tax and assessed interest. Pet. App. 4a.[9]

5. The court of appeals reversed. Pet. App. 1a-14a. Declining to follow the reasoning or holding of *St. Jude*, the court of appeals agreed with the government that 26 C.F.R. 1.861-8(e)(3) provides the appropriate method for allocating R&D expenses in calculating CTI under the DISC and FSC provisions. Pet. App. 10a-11a. The court noted that, under the plain text of Section 994(a)(2), "CTI 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. The court concluded that the legislative history of the statute requires the same conclusion (*ibid.* (quoting H.R. Rep. No. 533, *supra*, at 74)):

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[9] 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.*, No. 01-1382 (Mar. 20, 2000), Cond. Cross Pet. at 3. Boeing Sales Corporation therefore filed a conditional cross-appeal. Because both sides agreed that the judgment against Boeing Sales Corporation was a computational function of the judgment in favor of petitioner and should be reversed if the principal judgment were reversed, the conditional cross-appeal was not separately briefed. Appellee's Br. 17 n.8; Appellant's Reply Br. 1 n.1.

> This House Report reflects that Congress recognized some of the costs incurred in a given tax year would not be "directly related" to specific income items. The Report further reflects Congress's intention that those costs not "directly related" would be allocated to export-related sales on a pro rata basis. The Commissioner's interpretation of [26 C.F.R.] 1.861-8(e)(3) effectuates this Congressional intent.

The court of appeals disagreed with the district court on whether there was a conflict between the requirements of 26 C.F.R. 1.861-8(e)(3) and 26 C.F.R. 1.994-1(c)(6). The court of appeals emphasized that the DISC statute and its legislative history contemplate that the "total costs" allocable to export sales were to include both "definitely" and "indefinitely" related costs, which the court equated with "direct" and "indirect" costs. Pet. App. 12a. Noting that no actual conflict exists in the text of 26 C.F.R. 1.861-8(e)(3) and 26 C.F.R. 1.994-1(c)(7), the court concluded that these regulations "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 [26 C.F.R.] 1.861-8(e)(3)." Pet. App. 12a. The court concluded that petitioner's alternative method of allocating R&D costs for purposes of the DISC and FSC provisions was invalid because it fails to allocate the "total costs" of export sales in computing CTI. *Id.* at 6a.

ARGUMENT

1. As a consequence of the various revisions and repeals of the pertinent statutory provisions, the specific issues presented in this case under the separate DISC and FSC tax regimes lack meaningful prospective importance. For the reasons set forth in detail at pages 2-3, *supra*, the interpretation of the DISC statute and regulations has no prospective importance (i) because that statute is not available for large exporters (such as petitioner) and (ii) because the features of the DISC that were determined to represent a prohibited export subsidy under the GATT were removed by Congress in 1984 and the statute thus no longer provides significant tax relief even for small exporters. Similarly, the proper construction of the separate FSC statute and regulations lacks prospective importance because it has relevance only for the few taxpayers who, following enactment of the ETI, claim reliance on the narrow transitional FSC rules. See pages 3-5, *supra*. And, regulations under the ETI have not yet been formalized and issued for public comment.[10] The questions presented in the petition therefore lack recurring importance and do not warrant review by this Court.

2. a. For the reasons carefully detailed in the decision below (Pet. App. 10a-13a), the court of appeals

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[10] In the legislative history of the ETI, Congress emphasized its intention that, for the common case involving foreign trade transactions, both related direct expenses and overhead expenses apportioned in a reasonable manner are to be taken into account. See H.R. Conf. Rep. No. 1004, 106th Cong., 2d Sess. 199-202 (2000). Rules promulgated under the ETI could therefore reasonably address, and remove, the asserted "conflict" in the regulations that was the premise for the decision of the court of appeals in the *St. Jude* case. See page 14, *infra*.

correctly concluded that, in determining "combined taxable income" for DISC and FSC transactions during the years relevant to this case, R&D expenses were to be grouped under the two-digit SIC codes required by 26 C.F.R. 1.861-8(e)(3) (1979). See also note 11, *infra*. Although the decision of the Eighth Circuit in *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d 1394, 1396-1402 (1994), conflicts with that determination as applied to DISC transactions only, there is no recurring importance to that conflict because the pertinent provisions of the DISC statute have been modified or repealed. See pages 2-3, *supra*.

b. There is no conflict among the circuits concerning the further determination of the court of appeals in this case that the agency's regulations provide a proper allocation of R&D expenses to FSC transactions. Indeed, this is the first appellate decision even to address that issue. The FSC statute and regulations present this expense-allocation question in a distinctly different context than was before the court in *St. Jude*, which addressed only the materially different DISC provisions. See 34 F.3d at 1396-1402.

The DISC regulations involved in *St. Jude* specified "that the *taxpayer's choice regarding the grouping of transactions shall control* as long as it conforms to a recognized industry/trade usage or a SIC group." 34 F.3d at 1402 (emphasis added) (citing 26 C.F.R. 1.994-1(c)(6)(iv), (7)(ii)). The court in *St. Jude* concluded that this regulation required the Treasury to respect the grouping chosen by the taxpayer in allocating R&D expenses in making CTI calculations under the DISC regime, rather than the two-digit SIC classification code grouping specified in the Section 861 regulations. The court emphasized that the Section 861 regulations were not adopted with DISCs specifically in mind and that, "at the time the DISC legislation was enacted, [the Section 861 regulations] did not contain the SIC categories * * * ." 34 F.3d at 1402. The court concluded in *St. Jude* that, because the two-digit SIC classification code allocation procedures of the Section 861 regulations were adopted after the DISC legislation was enacted, they should not be "applied to DISC CTI computations." *Ibid.*[11]

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[11] For reasons similar to those adopted by the court of appeals in this case (see Pet. App. 10a-13a), the Tax Court in *St. Jude* also rejected the assertion that there is a conflict between the DISC regulations and the Section 861 regulations. *St. Jude Medical, Inc.* v. *Commissioner*, 97 T.C. 457, 479-481 (1991), aff'd in part and rev'd in part, 34 F.3d 1394 (8th Cir. 1994). The Tax Court emphasized that the cost allocation methods established in the Section 861 regulations are entitled to substantial judicial deference. 97 T.C. at 483. Section 863 of the Code expressly authorizes the Secretary of the Treasury to prescribe regulations under Section 861 to specify how items of income, expense, and losses and deductions are to be allocated or apportioned to sources within or without the United States (26 U.S.C. 863(a)), and the regulations adopted under this statute are to be upheld when, as here, they provide a reasonable choice among alternative methods of implementing the statute. 97 T.C. at 483. As this Court held in *United States* v. *Correll*, 389 U.S. 299, 307 (1967):

> In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *Commissioner* v. *Stidger*, 386 U.S. 287, 296. 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.

The Tax Court also noted the Section 861 regulations "harmonize[] with the origin and purposes of" the DISC provisions. 97 T.C. at 483. The DISC committee reports state that "the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable

The reasoning of the court of appeals in *St. Jude*, however, has no application to CTI calculations under the separate FSC statute and regulations. In the first place, by the time Congress enacted the FSC provisions in 1984, the Section 861 regulations for R&D expense allocations in CTI calculations had long been in place. 26 C.F.R. 1.861-8(e)(3) (1979). And, when the FSC was enacted, Congress specifically endorsed application of the then-existing Section 861 regulations to the new FSC regime. 1 Staff of the Sen. Comm. on Finance, 98th Cong., 2d Sess, *Deficit Reduction Act of 1984*, at 636 (Comm. Print 1984). See also H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 968-977 (1984).[12]

under section 861 * * * [which] generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis." H.R. No. 533, *supra*, at 74; S. Rep. No. 437, *supra*, at 107-108. Contrary to petitioners' assertion (Pet. 17-19), nothing in the Section 861 regulations conflicts with this legislative description of those regulations. The Section 861 regulations apportion items of expense partially on a direct and partially on a ratable basis. See 26 C.F.R. 1.861-8(a)(2) (1979) ("allocations and apportionments are made on the basis of the factual relationship of deductions to gross income"). The regulations thus recognize a fundamental tenet of cost accounting, which is that "the unit of costing determines whether a cost is direct or indirect: as the unit of costing changes, some indirect costs may be converted to direct costs." D. Keller et al., *Management Accountants' Handbook* ¶ 7.2(b), at 7-8 (4th ed. 1992).

[12] Beginning with the Economic Recovery Tax Act of 1981, § 223, Pub. L. No. 97-34, 95 Stat. 249, Congress enacted a series of moratoriums on 26 C.F.R. 1.861-8(e)(3) (1979) for geographic source purposes under Section 904 of the Code. Those moratoriums, however, did not apply to CTI calculations under either the DISC or FSC provisions. See *Intel Corp.* v. *Commissioner*, 76 F.3d 976, 983 (9th Cir. 1996); *St. Jude Medical, Inc.* v. *Commissioner*, 34 F.3d at 1403-1405. Congress thus specifically contem-

Secondly, when the FSC regulations were adopted, they did not employ the language from the DISC regulations on which the court relied in the *St. Jude* case. While the DISC regulations had stated that the grouping election of the DISC and its parent would be "controlling" (26 C.F.R. 1.994-1(c)(7) (1979)) and that the "costs deductible in a taxable year [were to] be allocated and apportioned to the items or classes of gross income * * * resulting from such grouping" (26 C.F.R. 1.994-1(c)(6)(iv)), the regulations adopted to implement the FSC regime contained no parallel provision. See 26 C.F.R. 1.925-1T(c)(6) (1989). The regulatory language on which the court of appeals relied in *St. Jude* in concluding that a conflict existed between the grouping directives of the DISC regulations and the Section 861 regulations thus did not exist under the FSC regime. Instead, under the FSC regime, both the Section 861 regulations and the FSC regulations direct the taxpayer to recognized trade usages and the "two-digit major groups * * * of the Standard Industrial Classification" codes in allocating expenses among groups of products. 26 C.F.R. 1.925(a)-1T(c)(8)(ii) (1989); see 26 C.F.R. 1.861-8(e)(3) (1979). Since the *St. Jude* case concerned DISC transactions only, that court did not have the FSC provisions before it. And, since the reasoning of the *St. Jude* court concerning the DISC provisions is inapplicable to the different statutory and regulatory provisions governing the taxation of FSC transactions, there is no conflict between that decision and the holding in this case that the two-digit

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plated that the Section 861 regulations (including the two-digit SIC classification code grouping requirement) were to apply to FSC CTI determinations.

SIC codes properly apply in allocating expenses among FSC product lines.

Moreover, in the course of generally revising the Section 861 regulations in 1995, the Treasury adopted a more specific product grouping provision that now directs the allocation of R&D expenditures on the basis of "the three digit classification of the Standard Industrial Classification Manual (SIC code)." 26 C.F.R. 1.861-17(a)(2)(ii). That more recent regulatory definition of product groups makes the controversy raised by petitioner in this case even more remote for the future.

In any event, the FSC provisions were repealed in 2000 and replaced by the ETI. See pages 3-5, *supra*. Because there is no relevant, current conflict among the circuits concerning the present application of either the FSC or the ETI, and since the DISC has no genuine present application for export transactions, there is no probable future importance to the issues addressed in this case. Further review of the extremely narrow, technical questions presented by the petition is therefore not warranted.

3. Petitioner errs in contending that the straightforward application of the longstanding Treasury regulations adopted by the court of appeals in this case achieves a "perverse result" (Pet. 16). The difference between the R&D expense allocation requirements of the Section 861 regulations and the model-by-model allocation proposal of petitioner is not just one of timing. Although petitioner suggests that "[t]here 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" (Pet. 22), this obscures the fact that, under petitioner's interpretation, such excess costs would *never* be deducted from gross income generated in a later year. Petitioner's

contention is that, in calculating its CTI, it should be allowed to ignore nearly $2 billion in aircraft R&D expenses because the income from some of the applications of that research was not realized in the tax years that the expenses were incurred. Petitioner's interpretation would improperly overstate its "combined taxable income" from export sales of aircraft (and thereby reduce its United States taxes) by violating the requirement that "the *total costs* of the DISC and related supplier which relate to such gross receipts" be deducted in computing CTI. 26 C.F.R. 1.994-1(c)(6) (emphasis added). See also 26 C.F.R. 1.925(a)-1T(c)(6) (1989).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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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. 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), 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 gen eral.* 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 nonpatronage 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 FR 66503 (Dec. 22, 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 research 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.

* * * * *