

THOMAS, J., dissenting

SUPREME COURT OF THE UNITED STATES

Nos. 01–1209 and 01–1382

THE BOEING COMPANY AND CONSOLIDATED
SUBSIDIARIES, PETITIONERS
01–1209 *v.*
UNITED STATES

UNITED STATES, PETITIONER
01–1382 *v.*
BOEING SALES CORPORATION ET AL.

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

[March 4, 2003]

JUSTICE THOMAS, with whom JUSTICE SCALIA joins,
dissenting.

Before placing its hand in the taxpayer’s pocket, the Government must place its finger on the law authorizing its action. *United Dominion Industries, Inc. v. United States*, 532 U. S. 822, 839 (2001) (THOMAS, J., concurring) (citing *Leavell v. Blades*, 237 Mo. 695, 700–701, 141 S. W. 893, 894 (1911)). Despite the Government’s failure to do so here, the Court holds in its favor; I respectfully dissent.

To read the majority opinion, one would think that the Court has before it a perfectly clear statutory and regulatory scheme and that the position of petitioners/cross-respondents (hereinafter Boeing) is utterly without support. Nothing could be further from the facts of this suit. Indeed, the Internal Revenue Service (IRS) itself initially read the statutory and regulatory provisions at issue here to permit precisely what Boeing asserts it is allowed to

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do.¹

When regulations governing DISCs were first proposed in 1972, the IRS received public comments recommending that the regulations be amplified to include rules and examples on how expenses should be treated for purposes of determining the combined taxable income of the DISC and a related supplier. The IRS, however, declined to incorporate the recommendations in the final regulations, explaining that proposed regulation §1.861–8, which had been published in 1973, provided ample guidance on the subject. Technical Memorandum accompanying T. D. 7364, 1974 T. M. Lexis 30, pp. *20–21 (Oct. 29, 1974).

Proposed regulation §1.861–8(e)(3), in turn, explained that where “research and development . . . is intended or is reasonably expected to result in the improvement of specific properties or processes, deductions in connection with such research and development shall be considered definitely related and therefore allocable to the class of gross income to which the properties or processes give rise or are reasonably *expected* to give rise.” 38 Fed. Reg. 15843 (1973). The regulations went on to note that in “other cases, as in the case of most basic research, research and development shall generally be considered definitely related and therefore allocable to all gross income of the current taxable year which is likely to benefit from the research and development.” *Ibid.* Example 1 in §1.861–8(g) illustrated this principle by considering the research and development (R&D) expenditures of a corporation manufacturing four-, six-, and eight-cylinder gasoline engines. The corporation conducted both general and engine-specific research. The example made clear that,

¹ Because, as the Court notes, *ante*, at 4, differences in the rules governing domestic international sales corporations (DISCs) and foreign sales corporations do not affect the outcome of this suit, I too focus only on the relevant DISC provisions.

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while general R&D expenses were “definitely related” to gross income resulting from sales of all three types of engines, R&D expenses in connection with a specific type of engine were to be allocated only to gross income arising from sales of that type of engine. *Id.*, at 15846 (“X’s deductions for its research and development expenses in connection with the 4 cylinder engine are definitely related to the gross income to which the 4 cylinder engine gives rise, i.e., gross income from the sales of 4 cylinder engines . . .”).

Indeed, the IRS’ 1974 position on the proper allocation of R&D expenses incurred in connection with separate lines of products is the only one that makes sense under the relevant DISC regulations. See, *e.g.*, 26 CFR §§1.994–1(c)(6), (7) (1979). As the Court explains, *ante*, at 2, 26 U. S. C. §994 was designed to provide special tax treatment for American companies engaged in export activities. To that end, §994 permits a DISC and its related supplier to compute their relevant transfer price (and, relatedly, their income tax liability) based on one of three methods. See §994 (providing that the transfer price for sales between a DISC and a related supplier can be computed based on (1) the gross income method, (2) the combined taxable income method, and (3) the usual transfer-pricing rules set forth in §482).

The Treasury Department has promulgated regulations explaining how the statutory framework must be applied. Section 1.994–1(c)(7) of those regulations explains that, as a general rule, a determination of the transfer price under §994 is to be made on a transaction-by-transaction basis. Section 1.994–1(c)(7), however, provides that, instead of following the transaction-by-transaction rule, taxpayers may make §994 transfer price determinations based on groups consisting of products or product lines. §1.994–1(c)(7)(i). Specifically, the regulation states that

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“A determination by a taxpayer as to a product or a product line will be accepted by a district director if such determination conforms to any one of the following standards: (a) A recognized industry or trade usage, or (b) the 2-digit major groups (or any inferior classifications or combinations thereof, within a major group) of the Standard Industrial Classification [SIC] as prepared by the [Office of Management and Budget].” §1.994–1(c)(7)(ii).

Section 1.994–1(c)(6)(iv), in turn, provides that, in connection with the computation of combined taxable income, “[t]he taxpayer’s choice in accordance with [§1.994–1(c)(7)] as to the grouping of transactions 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.*” (Emphasis added.) Thus, in tandem, §§1.994–1(c)(6)(iv) and 1.994–1(c)(7) give a taxpayer the choice of allocating and apportioning costs to items or classes of gross income resulting from (1) case-by-case transactions, (2) products or product lines grouped together based on industry or trade usage, and (3) products or product lines grouped together based on 2-digit SIC codes or lesser included subgroups.

Although under §1.991–1(c)(7) taxpayers are given three choices with respect to the proper grouping of export income (*and* the related allocation of *expenses*), and although §1.994–1(c)(6)(iv) provides that the taxpayer’s selection under §1.991–1(c)(7) shall be “controlling,” §1.861–8(e)(3) takes away the very choices §1.991–1 provides. Under §1.861–8(e)(3), the taxpayer is told that R&D expenses may be allocated *solely* to items or classes of gross income resulting from products that are within the same 2-digit SIC group—which happens to be only one of the three options given under §1.991–1(c)(7). In my view, the rule set forth in §1.861–8(e)(3) entirely eviscer-

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ates the options given in §1.991–1. Thus, despite the Court’s efforts to show that the two regulations complement, rather than contradict, each other, *ante*, at 15–17, the conflict is irreconcilable.² On these facts, a taxpayer should be permitted to compute its tax liability under §1.991–1, rather than under §1.861–8(e)(3), based on the principle that a specific rule governs a general one.³ See *Morales v. Trans World Airlines, Inc.*, 504 U. S. 374, 384 (1992); *Crawford Fitting Co. v. J. T. Gibbons, Inc.*, 482 U. S. 437, 445 (1987); see also *St. Jude Medical, Inc. v. Commissioner*, 34 F. 3d 1394 (CA8 1994).

The Court disapproves of Boeing’s method of allocating R&D because, as the Court sees it, Boeing’s approach results in the “disappear[ance]” of relevant costs, *ante*, at 6, in “the sense that [R&D costs] were not accounted for by Boeing in computing its [combined taxable income],” *ante*, at 7, n. 10. The Court is troubled by the fact that this computation method has enabled Boeing “to deduct some \$1.75 billion of expenditures from its domestic taxable earnings under 26 U. S. C. §174 and never deduct a penny of those expenditures from its ‘combined taxable earnings’ under the DISC statute.” *Ante*, at 11–12. But the “disap-

²A taxpayer wishing to (1) group its sales based on an accepted industry practice, for example based on different models, *and* (2) allocate its R&D expenses with respect to a specific model to the items or classes of gross income resulting from that model is not, on the Government’s view, permitted to do so. Rather, the taxpayer must first allocate R&D expenses incurred in connection with the relevant model to items or classes of gross income resulting from all models falling within the same 2-digit SIC group and only after doing so can the taxpayer deduct a portion of that model’s R&D expenses from the income earned by sales of that model.

³With respect to a DISC, §1.991–1 provides the more specific rules because it applies only to DISCs, while §1.861–8(e)(3) sets forth more general rules because it applies to all taxpayers that have foreign source income.

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pearance” of Boeing’s R&D expenses is the direct result of Congress’ decision to encourage such expenditures by making them immediately deductible under 26 U. S. C. §174(a)(1). Moreover, the approach adopted in the regulations, and approved by the Court, does not remedy the alleged problem of disappearing R&D expenses. A company that decides to enter the export market with a product unrelated to its existing business remains free to deduct in the current tax period all R&D expenses incurred in connection with the new product, even though those expenses would not be used to offset DISC income resulting from the sale of existing products.⁴ Finally, neither the Court nor the Government provide a satisfactory explanation for why §861 can be read to permit the “disappearance” of most expenses, see, *e.g.*, 26 CFR §1.861–8(d)(1) (1979) (“Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class . . . even though, for the taxable year, no gross income in such class is received or accrued In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping)”); see also 1 J. Isenbergh, *International*

⁴Boeing illustrates this point with the following example: Suppose a company that produces and exports athletic clothing (SIC Code 23) decides to invest the proceeds of its clothing sales in research to develop a line of athletic equipment (SIC Code 39). The company has current DISC sales of \$1 million from the athletic clothing, no current sales of athletic equipment, and \$500,000 in athletic equipment R&D expenses. Under the regulations, the \$500,000 of equipment-related R&D will be allocated to the athletic equipment SIC Code, which has no income. It will not be allocated to the athletic clothing SIC Code to reduce the income eligible for the DISC benefit related to the clothing. Thus, in the words of the Court, the expense will simply “disappear.” Brief for Petitioners 37, n. 17.

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Taxation: U. S. Taxation of Foreign Persons and Foreign Income ¶21.10 (3d ed. 2003) (“[I]f an expense incurred in one year is properly allocable to income arising in another, the expense will be allocated to the class to which the income belongs and may therefore produce a loss in that class for the year”), but to disallow the “disappearance” of R&D expenses.

Because I believe that §1.861–8(e)(3) does not apply to a DISC, I need not decide here whether §1.861–8(e)(3) is consistent with the text of §861(b) and may be properly applied in other contexts. I am puzzled, however, by the Court’s assertion that the Secretary is free to determine that certain expenses “can be properly apportioned on a categorical basis,” *ante*, at 13, and the implication that the Secretary has authority to require “ratable apportionment of expenses that could be, but perhaps in fairness should not be, treated as direct costs.” *Ibid.* By its terms, §861(b) appears to contemplate two types of expenses: (1) those that can definitely be allocated to some item or class of gross income and (2) those that *cannot*. 26 U. S. C. §861(b) (providing for the deduction of “*the* expenses, losses, and other deductions properly apportioned or allocated thereto *and a ratable part* of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*” (emphasis added)). Moreover, on its face, the statute does not appear to permit expenses to be “deemed” related to an item or class of gross income, even though in actual fact they are not so related. Yet, §1.861–8(e)(3) relies on the notion of “deemed relationships.” The regulation states that the methods of allocation and apportionment established there “recognize 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 CFR §1.861–

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8(e)(3)(i)(A) (1979). The regulation then proceeds to require the allocation of R&D expenses based on 2-digit SIC groups. But neither the regulation nor the Court attempt to reconcile the statutory text with the regulation's determination to allocate certain R&D expenses to items or classes of gross income that admittedly did not benefit from that research.

* * *

In short, I conclude that Boeing properly computed its tax liability for the years at issue here. I would therefore reverse the judgment of the Court of Appeals. Because the Court concludes otherwise, I respectfully dissent.