1999-005
August 30, 1999
Attachment 1

CC:INTL:Br3:DBergkuist
PUB-120694-98

ACTION ON DECISION

Subject: St. Jude Medical, Inc. v. Commissioner,
34 F.3d 1394 (8th Cir. 1994),
rev'g in part, 97 T.C. 457 (1991).
Tax Ct. Dkt. No. 5274-89

Issue:

Whether section 1.861-8(e)(3) of the Income Tax Regulations is invalid as applied to DISC combined taxable income (CTI) calculations.

Discussion:

The taxpayer chose to determine DISC commissions due from the sales of export property under the CTI method permitted by section 994(a)(2) of the Code. Section 1.994-1(c)(6)(iii) of the regulations provides that costs (other than cost of goods sold) are to be used to reduce the gross receipts from the sales of export property in order to determine CTI. The expenses that are treated as relating to the gross receipts from sales of export property are (a) the expenses, losses, and other deductions definitely related, and therefore allocated and apportioned, thereto, and (b) a ratable part of 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 rule set forth in section 1.861-8.

CTI is a pricing mechanism used to reach the amount of income that will be subject to the benefits of the DISC rules. The amount of research and development expenses allocated and apportioned to a product or product lines under section 1.861-8 is a reasonable expense to be utilized in the calculation of CTI. The Service believes that the allocation of research and development expenses attributable to unsuccessful insulin pumps and pacemakers to St Jude's income from the sale of heart valves pursuant to section 1.861-8(e)(3) is consistent with the rules set forth in section 1.861-8, and that there is a definite relationship between an expenditure for research and development and all income reasonably connected with a specific broad product category (i.e., a two digit Standard Industrial Classification (SIC) category). The Taxpayer excluded these expenses and did not follow section 1.861-8.

Reversing the Tax Court, the Eighth Circuit concluded that, for purposes of calculating the CTI of a DISC, mandating the use of SIC categories to allocate R&D expenses is inconsistent with Congress's intent in enacting the DISC statute to allow costs to be allocated on a product-by-product basis or on the basis of product lines. The Court also stated that the mandated use of section 1.861-8 by section 1.994-1(c)(6)(iii) is inconsistent with Congress's intent generally to allocate to each item of gross income all expenses directly related thereto. The Court went on to say that requiring the products within the SIC category having gross income derived from successful research and development to bear the cost of unsuccessful research and development within the category (see section 1.861-3(e)(3)(i)) is inconsistent with Congress's stated intent to deduct from the DISC's gross receipts the costs of goods sold with respect to the property, including the selling, overhead, and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property.

We disagree with the Eighth Circuit's reasoning and conclusion. We believe that the Tax Court was correct when it noted that "the petitioner misinterprets the purpose and application of the grouping provisions. The grouping rules do not supersede the section 1.861-8, Income Tax Regs., allocation and apportionment provisions because the provisions are not in conflict."

In addition, we agree with the Tax Court's rejection of taxpayer's contention that section 1.861-8(e)(3) is an invalid interpretation of Congressional intent to the extent it requires allocation of research and development expenses according to SIC product categories in computing the CTI of a DISC and its related supplier. The Tax Court based this position on the length of time that the final regulations under section 1.861-8(e)(3) have been in effect, the close and repeated review of the challenged regulations by Congress and the Treasury, Congress's decision not to suspend the application of the allocation and apportionment provisions with respect to a DISC, and the lack of legislative history indicating Congressional disapproval of the regulations or a lack of harmony with the origin and purpose of the DISC provisions.

Since there is no conflict among the circuits, the Service did not file a petition for a writ of certiorari. We believe that this issue should continue to be litigated and/or defended since it also arises in the context of Foreign Sales Corporations (section 1.925-1T(c)(6)(iii)(D)).

Although we disagree with the decision of the court, we recognize the precedential effect of the decision to cases appealable to the Eighth Circuit, and therefore will follow it with respect to cases within that circuit, if the opinion cannot be meaningfully distinguished. We do not, however, acquiesce to the opinion and will continue to litigate our position in cases in other circuits.

Recommendation:

Nonacquiescence.

Reviewers:

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