

1 IN THE SUPREME COURT OF THE UNITED STATES

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3 THE BOEING COMPANY AND :

4 CONSOLIDATED SUBSIDIARIES, :

5 Petitioner :

6 v. : No. 01-1209

7 UNITED STATES; :

8 and :

9 UNITED STATES, :

10 Petitioner :

11 v. : No. 01-1382

12 BOEING SALES CORPORATION, :

13 ET AL. :

14 - - - - - - - - - - -X

15 Washington, D.C.

16 Monday, December 9, 2002

17 The above-entitled matter came on for oral

18 argument before the Supreme Court of the United States at

19 10:03 a.m.

20 APPEARANCES:

21 KENNETH S. GELLER, ESQ., Washington, D.C.; on behalf of

22 the Petitioner.

23 KENT L. JONES, ESQ., Assistant to the Solicitor General,

24 Department of Justice, Washington, D.C.; on behalf of

25 the Respondent.

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3 JUSTICE STEVENS: We'll now hear argument in our
4 first case, Number 1209, the Boeing Company against the
5 United States.

6 Mr. Geller.

7 ORAL ARGUMENT OF KENNETH S. GELLER

8 ON BEHALF OF THE PETITIONER

9 MR. GELLER: Thank you, Justice Stevens, and may
10 it please the Court:

11 The Internal Revenue Code generally requires
12 every corporation to pay an annual tax measured by its
13 entire net income, but Congress decided 30 years ago in
14 the DISC and FSC statutes that it wished to encourage
15 exports by giving favorable tax treatment to the portion
16 of a company's net income that's attributable to export
17 sales.

18 In order to determine the extent of this income
19 tax benefit, it's obviously critically important to
20 determine precisely how much net income is generated by a
21 company's export sales in any particular year.

22 In enacting the DISC statute, Congress said
23 quite specifically how it expected this export net income
24 calculation to be made. Gross revenues from export sales
25 were to be reduced only by those costs that were directly

1 and factually related to the export income. Export sales
2 revenues were not to be burdened with unrelated expenses
3 which would distort the true amount of export income, and
4 thereby reduce the intended incentive.

5 The DISC regulations, which were promulgated
6 shortly after the statute was passed, reiterate that there
7 must be a direct factual relationship between export sales
8 and expenses.

9 QUESTION: Where do you -- do you get that
10 proposition in the statute, Mr. Geller?

11 MR. GELLER: Justice Scalia, we get it out of
12 two separate statutory provisions. One is section 994.

13 QUESTION: Where are these to be found?

14 MR. GELLER: These are -- this is found on
15 page 27a of the appendix to the petition.

16 And specifically, the reference in 994(a) and
17 994(a)(2) to the requirement that a determination must be
18 made of the net income, quote, attributable to export
19 receipts. We think that the common sense nature of the
20 word attributable, which this Court in the tax context has
21 construed to mean generated by, or caused by, is that you
22 have to take the export -- the revenues from exports and
23 reduce them only by the costs or deductions that are
24 related to those exports, or else you can't possibly come
25 up with a true figure of export -- net export income

1 that's attributable to those -- to those sales.

2 QUESTION: I -- I suppose that -- that R&D
3 expenses have to be attributed in a lot of other instances
4 under the code, don't they? And -- and doesn't the
5 Government use this same procedure that it's been using
6 here in other -- in other areas where it has to
7 attribute -- where -- where R&D expense has to be
8 attributed?

9 MR. GELLER: Yes. It relies on a provision,
10 which we'll talk about in a few minutes, that has many,
11 many applications, and it may well be that in a number of
12 those other applications, it's perfectly valid. Our
13 position is --

14 QUESTION: Well, why is that? I mean, why is
15 it attributable --

16 MR. GELLER: Well, as I hope to --

17 QUESTION: -- okay elsewhere to -- to produce
18 this result, but not okay here to produce this result?

19 MR. GELLER: Because it -- the DISC provisions
20 are unique in a number of respects, one of which is it
21 allows the taxpayer to engage in a particular grouping of
22 transactions, and the -- the -- as we'll talk about in a
23 few minutes, the R&D regulations insist that R&D be
24 attributed in a way that disregards the particular
25 groupings that the taxpayer has selected.

1 But there's another statutory provision that I'd
2 like to call your attention to, Your Honor, and that's
3 section 861. 861 is a section of the code that has been
4 in the code, was in the code for more than 50 years at the
5 time the DISC statute was passed, and it provides for how
6 deductions are to be allocated to gross income. This --
7 this appears at page 26a of the appendix.

8 Now Congress, in passing the DISC statute, said
9 quite specifically that it wanted deductions under the
10 DISC statute to be allocated in a way generally in
11 accordance with the principles of section 861, which were
12 well-established at that time.

13 QUESTION: Where -- where did Congress say that?

14 MR. GELLER: Congress said that in the reports
15 of the House, of the tax-writing committee.

16 QUESTION: Just for my benefit, when it's in the
17 statute, would you say Congress said it. When it's in
18 legislative history, would you tell me who said it?

19 MR. GELLER: Yes, Your Honor.

20 QUESTION: Because when you say Congress said
21 it, I thought you mean it's in the statute.

22 MR. GELLER: Well, it's not in the statute.
23 It's in the reports of the tax-writing committees. But,
24 Your Honor, these were not idle statements. These were
25 not statements of individual Congressmen, or statements on

1 the floor. These were deliberate statements put in the
2 reports of both the House and Senate tax-writing
3 committees which focused specifically -- specifically --
4 on how Congress expected these deductions to be allocated.
5 And I would refer the Court to page --

6 QUESTION: And I'm sure everybody who voted for
7 that knew about those statements.

8 MR. GELLER: Your Honor, these were specific
9 statements that went to the heart of the issue that's
10 before the Court today, and we've quoted them at page 22
11 of our brief, the blue brief. Congress said that
12 these 861 rules --

13 QUESTION: The committee said. Please, please.

14 MR. GELLER: The committee reports said --
15 excuse me, Justice Scalia. The committee reports said
16 that -- that the 861 rules, which are important because
17 later the regulations themselves under DISC reference the
18 861 rules, so it's -- and that's the heart of the
19 Government's argument in this case, so it's important to
20 understand what people thought at the time these 861 rules
21 meant.

22 QUESTION: But -- but why does 861 get you out
23 of the general allocation provisions any more than 994
24 does? In other words, the question was, why do we ignore
25 the usual rule for apportionment of R&D? And you said,

1 well, because 994 is -- is specific and -- and has some
2 policies of its own. And then you said -- and to further
3 that argument, you show us 861.

4 MR. GELLER: Yes.

5 QUESTION: But the regs that we're talking
6 about, which the Government relies on, are under 861.

7 MR. GELLER: Yes, but the -- the regulation,
8 Justice Kennedy, that the Government relies on was added
9 to 861 after the DISC regulations were finalized. It was
10 added in 1977. The DISC statute was passed in 1971. The
11 DISC regulations were finalized in 1975. So our position
12 is it's important to understand what Congress in 1971
13 thought it was doing in the DISC statute, and therefore it
14 seems to us extremely important that it said that it
15 expected deductions, including presumably any deduction,
16 including R&D, to be allocated in accordance generally
17 with the principles of section 861, which were described
18 quite clearly in the Senate and House reports of the
19 tax-writing committees to --

20 QUESTION: Mr. Geller, there's one problem.
21 Perhaps you can cast some light on it. The word is
22 attributable that you pointed to in 994. And the R&D you
23 have divided into Blue Sky and program- or product-
24 specific.

25 MR. GELLER: Yes.

1 QUESTION: That -- that's Boeing's creation.
2 The R&D -- that division is eminently manipulable, it
3 seems to me, if it -- it's the distinction whether it's
4 allocated across the board because of Blue Sky or
5 particular program or project depends on some official act
6 by a corporate board which could be yesterday, could be
7 next month. It's in the control of the corporation.

8 MR. GELLER: Not -- not quite, Justice Ginsburg.
9 It's not manipulable. It has to satisfy the regulations
10 promulgated under DISC. The DISC regulations -- and here
11 I would refer the Court to page 33a of the appendix to the
12 petition, and specifically the grouping regulations --
13 provide that a taxpayer can only group -- can only group
14 transactions if they fall within a recognized industry
15 product line. So, in other words, you`can't -- you can't
16 allocate expenses to any sorts of transactions you want.
17 They have to be grouped in a way that's consistent with
18 the DISC statute.

19 And that's exactly what Boeing did here. The
20 Blue Sky R&D was attributable to all of their airplane
21 products, and therefore it was allocated to the groupings
22 of all of the different airplane programs. These
23 program-specific R&D -- and I don't think there's any
24 factual dispute about this. The program-specific R&D was
25 factually and directly related only to a specific program.

1 The 747 R&D, for example, was -- was factually and
2 directly related only to the 747 program. And that's why
3 Boeing allocated that R&D only to the 747 program.

4 QUESTION: Mr. Geller, can I ask you a factual
5 question that will help me understand? Does the -- is
6 there just one DISC involved here, or do you have several
7 DISCs for different product lines?

8 MR. GELLER: No. It's one -- it's one DISC.

9 QUESTION: So that what difference would it make
10 whether it was the 747 program, or the 727 program if the
11 DISC sells them both anyway?

12 MR. GELLER: Because, Justice Stevens, under the
13 statute, combined taxable income or export income is -- is
14 to be determined on the basis of product groupings, or at
15 least, the taxpayer has the option of choosing to group by
16 different products rather than by all the sales of the
17 DISC. So, therefore, here, we determine what the export
18 income is for the 747 program, which takes the revenues
19 from the 747 program and reduces them by the deductions,
20 including R&D that's factually and directly related to the
21 747 program, and you -- you come up with the CTI for the
22 747 program. Under -- it's not all mixed together as one
23 group of export income. Under -- under the statute and
24 regulations Boeing was entitled to group transactions.
25 The -- the problem here is that the regulation

1 that the Government relies on takes huge amounts of R&D
2 that are directly related to a specific program and
3 allocates them among all of the programs.

4 QUESTION: But, of course, the converse, I
5 suppose under your view, all of the R&D would go to the
6 domestic corporation because it all takes place before the
7 product is put on the market.

8 MR. GELLER: No. It doesn't really matter
9 whether the product is on the market or not, Your Honor.
10 It has to be allocated to a class of gross income. Now,
11 that class of gross income may well include, as it does in
12 this case, products or programs that aren't yet on the
13 market that are being developed.

14 QUESTION: Right.

15 MR. GELLER: And nonetheless, the regulations
16 are quite clear that the deductions have to be allocated
17 to that class of gross income.

18 So, for example, in the 757 program, which was
19 in -- which was being developed in 1982, there were no
20 sales of the 757 in 1982, and yet there were hundreds of
21 millions of dollars of R&D expended in that year. In our
22 view, the regulations make it quite clear that Boeing had
23 to allocate those deductions, that R&D and other
24 deductions, to the 757 program.

25 QUESTION: Well, what -- what do you say to at

1 least this argument of the Government? I -- I guess the
2 Government would probably say, sure, there's -- there's a
3 kind of factual sense in which there is the kind of
4 relationship that you're talking about. But if you want
5 the closest relationship -- the most perfect
6 relationship -- you would capitalize your R&D and you
7 would start amortizing it when you actually have a product
8 that is generating income that you're selling. That would
9 be the closest match you could get.

10 That match, in effect, has -- has been -- has
11 been set aside. Instead of forcing you to do that, the
12 law now allows you to -- to use your R&D as -- as a
13 current expense.

14 Once you start using it, once you start treating
15 it as a current expense, that very close relationship that
16 you have, if you had capitalized it, is gone. And what
17 the Government is saying is, it's a judgment call how
18 close it's got to be now, now that you have broken the
19 link and have allowed current expense. And that kind of a
20 judgment call is quintessentially the judgment call that
21 the -- that the Treasury makes when it's write -- when it
22 writes regulations.

23 And why isn't that a pretty powerful argument?
24 And if it is, how do you get over the point of
25 reasonableness or -- or Chevron deference as the

1 Government would see it?

2 MR. GELLER: Well, Justice Souter, you've
3 described the Government's position. Let me see if I can
4 respond to it.

5 But generally, just -- as to the last point --
6 this is not a legislative regulation. There really is no
7 Chevron deference that's in play here.

8 QUESTION: Well, there's -- there's -- certainly
9 there is some degree of deference here.

10 MR. GELLER: There is some degree of
11 reasonableness.

12 QUESTION: We can argue whether it's Chevron or
13 not.

14 QUESTION: It was a notice and comment
15 regulation.

16 MR. GELLER: It was, but it was promulgated
17 under section 7805. There's no specific provision in the
18 code that allows the Treasury to issue legislative regs
19 here, but I don't want to get off on that because it --

20 QUESTION: But you -- if it's -- whether you
21 call it -- if you call it an interpretive regulation --

22 MR. GELLER: Yes.

23 QUESTION: -- it still deserves some respect
24 from a court --

25 MR. GELLER: Yes.

1 QUESTION: -- does it not?

2 MR. GELLER: Yes, it does but it has to be
3 consistent, obviously, with the legislative scheme that
4 it's interpreting.

5 Justice Souter, let me answer your question a
6 number of different ways.

7 First, it is not at all unique for expenses to
8 give rise to future year income. In fact, most expenses
9 give rise to future year income. The fact that an expense
10 may occur in year 1, and the income may be generated in
11 year 2, is a commonplace. It doesn't in any way --

12 QUESTION: Sure they do.

13 MR. GELLER: It --

14 QUESTION: But the most precise way to match it,
15 I -- I would suppose, is the capitalization way. And the
16 Government says once you -- once you lose the
17 quintessentially perfect way of doing it, then how you're
18 going to recognize it is a judgment call.

19 MR. GELLER: Well, I don't accept -- they can't
20 capitalize it, Your Honor, because Congress made a
21 judgment in section 174 of the code in order to encourage
22 R&D to allow it to be immediately deducted in the year in
23 which it's incurred.

24 QUESTION: Absolutely. And they say when
25 Congress made that judgment, there's a further judgment

1 left and that is the judgment how close has it got to be.

2 MR. GELLER: Yes, but the Government's
3 regulation here is not close at all. The Government
4 concedes that -- that expenses for R&D give rise to future
5 year income. They can't -- because of section 174, they
6 can't --

7 QUESTION: Well, sometimes -- sometimes they do
8 and sometimes they don't. I mean, if things work out
9 fine, the answer is yes. If they don't work out fine, the
10 answer is no. And that's -- that's one of the -- that's
11 one of the problems that the Government raises.

12 MR. GELLER: Well, look at what the 8(e)(3)
13 regulation does, Your Honor. It doesn't make any attempt
14 to match current year R&D expenses with some future income
15 that might be generated from that R&D. What it, instead,
16 does, it allocates all of that income to current year
17 expenses -- to current year revenues for products that
18 have no relation whatsoever to that R&D.

19 For example, let me say -- come back again to
20 the 757 program.

21 QUESTION: Well, here -- may -- may I interrupt
22 you with this question?

23 MR. GELLER: Sure.

24 QUESTION: You say it has no relation
25 whatsoever. I take it then you are saying that the

1 Government is simply factually wrong when it makes the
2 statement that R&D, which may have a closer relation to
3 one product line than another, nonetheless tends, as a
4 general rule, to have benefits that go beyond product
5 lines. We -- they -- they, in effect, say, look, you
6 learn useful things, and you use them all over the place.

7 Are you saying that that is factually wrong?

8 MR. GELLER: Yes. I'm saying that -- that --
9 I'm saying clearly in this case it's factually wrong. For
10 example, this case went off on cross motions for summary
11 judgment. There was really no dispute that Boeing had --
12 as a factual matter -- allocated the R&D expenses
13 correctly. As a factual matter. The Government said they
14 had to be reallocated because of this conclusive
15 presumption in section 8(e)(3).

16 But, yes, I'm telling you, Justice --
17 Justice Souter, that that's incorrect as a factual matter,
18 that in fact, under section 174, in order to take a
19 deduction for R&D at all in any circumstance, DISC or no
20 DISC, the taxpayer has to be able to factually relate that
21 R&D expense to a particular product.

22 QUESTION: Oh, you've got to show the
23 relationship --

24 MR. GELLER: Yes, factual relationship.

25 QUESTION: -- but it doesn't follow from that

1 that there is no benefit to product lines outside of that
2 relationship.

3 MR. GELLER: Yes, but if there -- there could
4 well be a spill-over benefit to future product lines, but
5 that doesn't, A, mean that it's not directly and factually
6 related a specific current program.

7 And also, look at the oddity and anomaly of the
8 Government's position here, Justice Souter. Even if it
9 is -- there is some spill-over effect for future product
10 lines, when the Government -- when the -- when Boeing was
11 developing the 757, it's conceivable that they were
12 learning things that would benefit future products. But
13 what the Government does is take all that R&D and allocate
14 it to existing products, sales of existing products that
15 couldn't possibly have benefitted from that R&D.

16 QUESTION: That's so. But could -- I'd like
17 very much to hear your response to Justice Kennedy's
18 question. Was it -- and where we started was with Justice
19 Scalia and Justice Kennedy. And as I understand where
20 they were driving, there is a statute, and the statute is
21 DISC. And under this statute, there's either some
22 language, or there's some history anyway, which is of
23 interest to me, which says when you work out the
24 allocation rules, follow section 881 -- or 861.

25 MR. GELLER: 861.

1 QUESTION: 861, which is for allocation of all
2 kinds of things --

3 MR. GELLER: Well --

4 QUESTION: -- for Puerto Rico, to abroad,
5 et cetera.

6 So now we look to 861.

7 MR. GELLER: But --

8 QUESTION: And lo and behold, what they did in
9 861, after DISC was passed, is they changed the 861 rules,
10 and in those changed rules, it says you're going to
11 allocate everything to a SIC category called
12 transportation services. And then it has a little
13 sentence here. The taxpayer may not subdivide the
14 categories in this list.

15 MR. GELLER: Yes.

16 QUESTION: All right? So that's their 861 rule.

17 MR. GELLER: That's -- that is the --

18 QUESTION: All right. Now, what legally is
19 wrong with that --

20 MR. GELLER: What's legally --

21 QUESTION: -- since Congress told them to use
22 861, and here they're using it.

23 MR. GELLER: Well -- well, there are a number of
24 things wrong with that, Justice Breyer. The first is, as
25 you yourself pointed out. At the time Congress made this

1 cross-reference, at the time the legislative history said
2 that the rules under 861 would be followed, and at the
3 time the regs were issued in 1975 that cross-referenced
4 861, this 8(e)(3) rule, which is an aberrational rule,
5 doesn't follow the general guidelines of the 861 rules.
6 It was not even in the regulation.

7 QUESTION: That's right. In respect to that,
8 for you to win on that, we'd have to say that Congress
9 intended that the rules be different for DISC's than for
10 Puerto Rico, for Europe, for Saudi Arabia --

11 MR. GELLER: Oh, absolutely. Absolutely.

12 QUESTION: -- for everything. Or we'd have to
13 say that we're throwing out this reg for everything.

14 MR. GELLER: No, no, no. The reg has many other
15 applications, and we're not suggesting that it be --

16 QUESTION: So you're saying DISC has to be
17 different.

18 MR. GELLER: I'm saying DISC is different,
19 Justice Breyer.

20 QUESTION: Okay, what in --

21 MR. GELLER: And let me explain, if I could --

22 QUESTION: Yes. That's what I wanted to --

23 MR. GELLER: -- why DISC is different.

24 QUESTION: That's -- we are. I -- all right.

25 MR. GELLER: DISC is different because -- for

1 two reasons. One is, DISC provides preferential tax
2 benefits to a -- to a subclass of net income, export net
3 income. It is critically important to have an accurate
4 calculation of what the export net income is. You cannot
5 have an accurate calculation of the net income from sales
6 of 747s if you're going to start with the gross revenues
7 from the sale of 747s, and then you're going to deduct
8 from it expenses that have no factual relationship to
9 747s. You inevitably are going to be left with an
10 erroneous net income calculation.

11 Now, I want to also add that this was focused on
12 in 1973 and 1975 when the Treasury was issuing its DISC
13 regulations. In 1973, Treasury issued proposed
14 regulations under 861 that specifically said how R&D was
15 going to be -- was going to be allocated in the context of
16 a DISC. They gave an example, which is identical to the
17 example of this case. It was an example involving a
18 manufacturer that manufactured four-, six-, and eight-
19 cylinder engines. Each was grouped as a separate product
20 line, as it was entitled to be --

21 QUESTION: I'll assume the example was
22 identical.

23 MR. GELLER: It is identical.

24 QUESTION: And I will take your words that you
25 have just said.

1 MR. GELLER: Yes.

2 QUESTION: And I will ask you why a different

3 person quoting those words couldn't make the identical

4 argument in respect to the tremendous tax advantages given

5 to Puerto Rico --

6 MR. GELLER: Because --

7 QUESTION: -- or in respect to the supreme

8 importance of having allocation between Europe and the

9 United States among subsidiaries --

10 MR. GELLER: You'd have to look -- you'd have to

11 look --

12 QUESTION: -- and principal corporations be

13 accurate.

14 MR. GELLER: You'd have to look at those

15 statutes. It may well be that 8(e)(3) couldn't be applied

16 there at all if it would lead inevitably to an incorrect

17 calculation of -- of that net income.

18 But there's something in addition here, Your

19 Honor. Two things in addition. First, Justice Breyer,

20 the 994 regulations do not incorporate verbatim all of

21 these 861 rules. They don't incorporate 8(e)(3). They

22 don't incorporate -- they say that the allocations to be

23 made under section 994 are to be done generally in

24 accordance with the rules under 861.

25 At the time that that was put in the

1 regulations, the rules under 861 unequivocally provided
2 that there had to be, for every allocation, a direct
3 factual relationship between the expenditure --

4 QUESTION: Yes, but that doesn't mean when --
5 you say in accordance with 861. Does -- does that mean as
6 it now exists, or --

7 MR. GELLER: Yes.

8 QUESTION: -- 861 as it may be amended from --
9 or, you know --

10 MR. GELLER: I --

11 QUESTION: -- as it may be interpreted from time
12 to time by -- by --

13 MR. GELLER: Not -- not --

14 QUESTION: -- by Treasury?

15 MR. GELLER: I believe, Justice Scalia, not if
16 an aberrational -- not if a rule could be put in several
17 years later that's inconsistent with the rules that the
18 tax-writing committees and that the Treasury Department
19 assumed --

20 QUESTION: But that --

21 MR. GELLER: -- would be the 861 rules.

22 QUESTION: That's a different argument. That --

23 MR. GELLER: That excepts --

24 QUESTION: What I'm saying is it doesn't seem to
25 me, even if you believed in -- in legislative history, you

1 can't rely on the fact that they say it's going to be done
2 pursuant to 861. The Government says, we are doing it
3 pursuant to 861.

4 MR. GELLER: But not pursuant to the rules.
5 This is -- if you look, in fact, at the 8(e)(3)
6 regulation, Justice Scalia, it begins by explaining why
7 it's deviating from the general rules of 861, why it felt
8 the need for R&D to deviate from the general rules that
9 require a factual connection between expenditures and
10 revenues.

11 Now, there's another -- there's --

12 QUESTION: If you -- if you want me to say that
13 a regulation drawn after a statute was enacted, another
14 statute, is -- is invalid because the intervening statute
15 is -- is applicable instead, what -- what case do I cite,
16 or what rule? Is -- is the rule just that the specific
17 controls over the general? I mean, is that all we're
18 talking about?

19 MR. GELLER: It is. It is certainly the
20 specific controls over the general. It is also the fact
21 that there was a regime here that requires a -- accurate
22 calculation of export income. The rules that were
23 promulgated in 1975 did that. An aberrational rule was
24 put in in 1977 which we say is inconsistent with the
25 accurate calculation of net income and can't be applied,

1 at least in this context.

2 But there's another reason, Justice Kennedy, why
3 the 1977 8(e)(3) regulation is inconsistent with DISC, and
4 that's the grouping regulations, which I want to call your
5 attention to, which is a very, very important part of the
6 DISC statute.

7 If I could call the Court's attention to the
8 grouping regulations which appear at -- at 994(c)(7),
9 which is the bottom of page 33a of the appendix to the
10 petition, you will see that the -- the taxpayer was
11 entitled to group its products, to figure out export
12 income not in gross, but on the basis of each product or
13 recognized product line, which is what Boeing did here.

14 And if the Court would look at (6)(iv) in the
15 middle of page 33a, you'll see that the regulations
16 provide that the taxpayer's choice as to how to group is
17 controlling -- controlling. And the regulations go on to
18 say that costs deductible in a particular year shall be
19 allocated and apportioned to the classes of gross income
20 resulting from such grouping.

21 QUESTION: Now -- now, perhaps you can help me
22 here because this is a complicated statute. Is the
23 Government going to answer that, of -- of course, that
24 is -- is controlling, but that is only for the purpose of
25 one of the three -- of -- of one of the three choices that

1 it makes in -- and -- and it's made the choice to have the
2 combined income?

3 MR. GELLER: Yes, that's the Government's
4 argument. But it's completely inconsistent with the words
5 of the regulations, Justice Kennedy. The regulations say
6 that all of the determinations under (c) have to be made
7 consistent with the grouping, including the allocation of
8 deductions. So --

9 QUESTION: And where -- where does it say that?

10 MR. GELLER: It says it in the language that I
11 just read to you, that the -- all -- that the costs
12 deductible in a taxable year shall be allocated to the
13 items of gross income resulting from such grouping.

14 So, here, Boeing grouped its -- its classes of
15 gross income --

16 QUESTION: Where were you reading from,
17 Mr. Geller? I'd like to follow.

18 MR. GELLER: Excuse me. Yes.

19 QUESTION: What were you reading from?

20 MR. GELLER: I'm reading -- I'm reading in the
21 middle of page 33, Justice Stevens, the (iv), the
22 paragraph --

23 QUESTION: Oh, number iv, okay.

24 MR. GELLER: -- which talks about how costs are
25 to be allocated after the taxpayer has chosen particular

1 groupings.

2 QUESTION: These are the regulations --

3 MR. GELLER: Under DISC.

4 QUESTION: -- under the DISC scheme.

5 MR. GELLER: That's right.

6 QUESTION: Correct?

7 MR. GELLER: That's exactly right, Justice

8 O'Connor.

9 QUESTION: And this is how Treasury initially

10 thought the DISC scheme should be --

11 MR. GELLER: There's -- there's nothing in

12 this --

13 QUESTION: And you're reading under (iii)?

14 Sub (iii)?

15 MR. GELLER: I'm reading -- sub (iv), (iv).

16 QUESTION: Sub (iv).

17 MR. GELLER: (iv), Justice Kennedy. This is

18 crucial.

19 And if you look at the Eighth Circuit's decision

20 in St. Jude, this is one of the provisions that it

21 referred to as -- as showing that 8(e)(3) is completely

22 inconsistent with the --

23 QUESTION: But the problem is then along come

24 regulations under the general 861 provision governing R&D

25 expenses, and they don't track each other. So how is it

1 that we --

2 MR. GELLER: You have inconsistent --

3 QUESTION: -- don't defer to the Treasury
4 Department interpretation? That's the sticking point for
5 me.

6 MR. GELLER: Well, Justice --

7 QUESTION: We owe some kind of deference.

8 MR. GELLER: I appreciate that, Justice
9 O'Connor. You don't defer, I think, for several reasons.

10 First, the language of the statute -- it's
11 critical to determine an accurate calculation of export
12 net income. The 8(e)(3) regulation provides conclusive
13 presumptions in place of factual matching so that it
14 inevitably will lead to an incorrect -- and secondly, as I
15 said, the -- it was the understanding of everyone,
16 including the Treasury Department when it issued the DISC
17 regulations in 1975, that the taxpayer's choice of
18 grouping would be controlling, that -- that allocations of
19 deductions, including R&D deductions, would be -- be made
20 on the -- on the basis of the taxpayer's grouping. And
21 when 8(e)(3) comes in, it says, no, no, no. For R&D --

22 QUESTION: Mr. Geller, on that point doesn't the
23 word grouping, the last word in subparagraph (iv), refer
24 to the three choices in subparagraph (vi) of the -- on --
25 on page 32a?

1 MR. GELLER: No, no, no. I think it refers to
2 the -- to the choices that are to be made in paragraph
3 (vii) at the bottom of page 33a, and the top of 34a.

4 The groupings are -- you can -- you can
5 determine CTI, Justice Stevens, either on the basis of
6 each individual transaction, which would be very, very
7 cumbersome. Congress understood that and therefore
8 expected that there would be grouping. The taxpayer is
9 entitled to choose two different ways to group its
10 transactions. One is by recognized product line -- which
11 is what Boeing did here, the 747s, the 767s, the
12 recognized product lines -- or basis of SIC code. Boeing
13 could have chosen to group its transactions by SIC code.
14 It chose not to do that.

15 And nonetheless, the 8(e)(3) regulation comes in
16 and insists that although all other deductions can be made
17 on the basis of the product groupings chosen by Boeing,
18 which the regulations say are to be controlling, this one
19 class of deductions, R&D, has to be allocated on the basis
20 of SIC code. And that's completely inconsistent with the
21 statement in the middle of page 33a that we were talking
22 about that says that all of the deductions are to be
23 allocated on the basis of the taxpayer's grouping, and
24 that that grouping is, in the words of the regulation,
25 controlling.

1 QUESTION: Mr. Geller, I don't want to eat up
2 your -- your rebuttal time.

3 MR. GELLER: That's all right.

4 QUESTION: But -- but the Government is going to
5 come back and say, look it, if you did it transaction-by-
6 transaction, we would apply our normal rule under 861.

7 MR. GELLER: If you did a --

8 QUESTION: You say it's a lot different.

9 MR. GELLER: I think the -- actually --

10 QUESTION: Would that be correct if they did --

11 MR. GELLER: No, no. It would actually help our
12 argument. If you did it transaction-by-transaction, you
13 took an individual sale of a 747 --

14 QUESTION: Right.

15 MR. GELLER: -- airplane and you tried to figure
16 out what the export net income was from that sale, it
17 seems to me you would start with the cost of the -- of the
18 revenues generated by the sale of that single airplane,
19 and then you would try to figure out what costs were
20 incurred in producing that airplane, including the R&D
21 costs. You would never, I think, take costs that were
22 incurred that year in trying to develop a 787 airplane,
23 which had no relationship whatsoever to the sale of
24 that 747, and attribute those costs to it in order to
25 reduce the net income. That's what the 8(e)(3) regulation

1 does.

2 If the Court has no further questions, I'd like
3 to reserve the balance of my time for rebuttal. Thank
4 you.

5 QUESTION: Mr. Jones.

6 ORAL ARGUMENT OF KENT L. JONES

7 ON BEHALF OF THE RESPONDENT

8 MR. JONES: Thank you, Justice Stevens, and may
9 it --

10 QUESTION: Mr. Jones, before I lose the thread
11 of -- my thread of thought, is it correct what Mr. Geller
12 just said, that if it was done transaction-by-transaction,
13 you would not use the same -- the same allocation basis
14 that you're using here?

15 MR. JONES: No. If it were done on a
16 transactional basis, which is the -- the base case
17 provision under DISC, 861 regs would tell us how to
18 allocate costs to the income from that transaction.

19 And what -- I mean, really the -- the first
20 point of departure that Mr. Geller made from the statute
21 is that he suggests that only costs -- or that any -- the
22 costs must be factually related to an item of income to be
23 set off against it. But that's not the statutory
24 standard.

25 QUESTION: Well, this is kind of simplistic, but

1 it does seem that in -- in the 1970s, Congress wanted to
2 encourage exports, and to do that, they thought they
3 should make some income tax advantages for companies
4 producing products for export. And that involved allowing
5 grouping of products and favorable income tax treatment
6 which, if you didn't have the -- the 861 regulations on
7 R&D, would allow the taxpayer to do what the petitioner is
8 arguing here.

9 So, it seems to me the argument is that the 861-
10 regs are just so contrary to DISC that they shouldn't
11 govern and don't govern. Is that the thrust of it?

12 MR. JONES: Oh, clearly that's not the case.
13 The 861 regs were -- were formulated for the purpose of
14 determining combined taxable income for DISCs and FSCs.
15 That's what Congress -- that's what the committee said
16 they wanted the Secretary to do under the DISC, and that's
17 what the 861 -- if you look at 861(f)(1)(iii), it says
18 that expressly. So --

19 QUESTION: But 861 applies generally, doesn't
20 it, not just to DISCs?

21 MR. JONES: It -- it applies generally, but it
22 was specifically formulated with the calculation of
23 combined taxable income for DISC in mind. And so it's --
24 it's illogical to suggest, as -- as they do --

25 QUESTION: The statute was, or the reg --

1 QUESTION: You mean the reg?

2 MR. JONES: I'm sorry. I meant the reg. The
3 861-8 reg was -- was formulated with the calculation of
4 combined taxable income expressly in mind, and we know
5 that both by the terms of the reg 861-8(f) --

6 QUESTION: Well, how do we know that?

7 QUESTION: Getting back to Justice Scalia's
8 question, and I think it relates to what Justice O'Connor
9 is asking too, is -- is your answer to the last argument,
10 that a transaction-by-transaction basis -- we would --
11 would clearly not have this problem -- is we clearly would
12 have this problem and we'd look at 861, and you'd lose
13 there too? Or is that not your answer?

14 MR. JONES: Well, that's one way of making the
15 point, but let me -- let me address directly --

16 QUESTION: No, no. I want to know what your
17 position is.

18 MR. JONES: Well, my position is they've totally
19 misdescribed the grouping provision of the DISC regs, and
20 once you understand it, you will appreciate that the 861-8
21 regs apply to all of these transactions. And you can --
22 you can see that by looking at only two pieces of the DISC
23 regs.

24 The DISC regs, at page 29a in the middle of the
25 page, says, grouping of transactions for purposes of

1 applying the pricing method is provided by (c)(7). So,
2 you group to decide what your pricing method is, and if
3 they choose the -- the combined taxable income method,
4 which they've done here, then you go to (c)(6), which is
5 back on page 33a.

6 (c)(6) says here's how you determine combined
7 taxable income. You take the income. You deduct the
8 costs of goods sold, and then you allocate under
9 provisions of -- of section 861 regs. And then the
10 provision that Mr. Geller cites says -- is the (iv)
11 provision, which says you that allocate the costs to the
12 items of income resulting from the group. That's what the
13 grouping does. It groups the income, and then against
14 that income, we apply the costs allocated under the
15 section 861-8 regs. It is --

16 QUESTION: Where is -- where that's last
17 language I'm looking for? It's on --

18 MR. JONES: It's 33 of the petition appendix.

19 QUESTION: 33a, yes.

20 MR. JONES: It's the last phrase of the -- of
21 the item (iv), and it says that we allocate costs to the
22 income resulting from the grouping. Now, that's what the
23 grouping is all about. They're allowed to pick out a
24 series of transactions, group the income, calculate the
25 CTI for the group, so they don't have to file a separate

1 report for a thousand different transactions. That's all
2 that the grouping is about.

3 Now, that's been the Secretary's interpretation
4 of his own regulations for 25 years. And of course, under
5 this Court's precedents, his interpretation of his own
6 regulations is entitled to controlling weight unless it's
7 inconsistent with the provisions of the text of the regs.
8 And as the Tax Court explained in the St. Jude case, and
9 as I have just described, the text of the reg says you
10 allocate under 861 to the income resulting from the
11 grouping.

12 QUESTION: All right, that's fine. But he says
13 that -- and what you're supposed to do is you're supposed
14 to, I guess, subtract the costs which are allocated to the
15 items of gross income in that group. Is that what you're
16 supposed to do? You take the gross receipts in that
17 group --

18 MR. JONES: You take the gross receipts for that
19 group --

20 QUESTION: -- and you subtract the costs.

21 MR. JONES: -- and then you allocate costs --

22 QUESTION: Yes.

23 MR. JONES: -- under 861.

24 QUESTION: Right. Now, you allocate them
25 under 861.

1 MR. JONES: Right.

2 QUESTION: So we go to 861 --

3 MR. JONES: Right.

4 QUESTION: -- and he says, now, if you look at

5 861, and try to allocate according to 861 to the group

6 that they've picked out, it's seriously nuts, basically.

7 I mean, imagine that you had a farmer and the

8 farmer raised roses, and he had some fishes, and -- and

9 what he has is he does research on fish diseases. And he

10 says -- you'd say, well, my goodness, you're going to

11 allocate his whole laboratory costs which does nothing but

12 fish diseases to the growing of roses because both are

13 farming or fisheries.

14 Now, is it -- something like that is really out

15 of whack, it makes so little sense that that isn't a

16 reasonable method of allocation under anybody's theory.

17 MR. JONES: That's -- that's a fair synopsis of

18 their position, and -- and the defects in it --

19 QUESTION: Right.

20 QUESTION: So why is it reasonable to allocate

21 the fish disease research to rose culture?

22 MR. JONES: Well, let me start with what the

23 Secretary was supposed to do in the regs, and get to you

24 the answer to your question.

25 The -- the statute on which the regs are adopted

1 doesn't just say you allocate the costs that are
2 definitely related to the product in determining what
3 costs would be charged against it. It also says you
4 allocate to it a share of costs that cannot definitely be
5 allocated to any particular item of income.

6 Now, when the conundrum for research costs --
7 and the reason that we have a separate regulation for it
8 is that there's more than one way that research costs are
9 treated under the code. When research costs are
10 capitalized and amortized over their useful life, they're
11 then properly attributed -- as this Court said in
12 INDOPCO -- to the revenues as they're received. But when
13 the taxpayer makes the election that section 174 gives it
14 to take a current deduction, it severs any relationship
15 between the costs and the income. There is a mismatching,
16 as we say. There is no proper connection between the
17 costs and the income.

18 Now, the reason that we need to -- the -- the --
19 in that case where there is no definite relationship
20 between the costs and the income, the default principle of
21 the statute is that the costs are to be allocated over all
22 income of the taxpayer, not just the income from any
23 specific product, but the income from --

24 QUESTION: He'll grant you all that. He grants
25 that.

1 MR. JONES: No --

2 QUESTION: But he says, you know, sometimes it
3 is clear. For example, it is clear that roses don't get
4 fish diseases, and similarly, he says, it is equally clear
5 that -- I don't know the factual details, but he says it's
6 equally clear that a 727 research is not as vague as a --
7 is -- is different from a 757. Just the same -- roses and
8 fish diseases. And he says where it's that clear, it's
9 not reasonable for the Treasury to try to pretend that
10 it's vague or hard to allocate, et cetera.

11 MR. JONES: The -- a reason why the regulation
12 is reasonable is because if, as I have just said, the
13 statutory default cases -- you can apply it against all
14 income. What the Secretary has said is, well, I'm not
15 going to make you apply it against all income. I'm going
16 to make you apply it only against a subcategory of income,
17 in this case, the income associated with sales of a
18 product from which foreign sales income might be derived.

19 QUESTION: Yes, but you use this link -- this
20 severance argument, and you say, oh, well, once you do
21 this, you sever the expense from the future income.
22 I would have thought -- please correct me if I'm wrong --
23 that all expenses are -- are severed in the sense that all
24 expenses can be used for future income.

25 MR. JONES: No. That's a -- that's a fallacy

1 in -- in the suggestion of Mr. Geller that mismatching
2 occurs all the time. It's very rare for mismatching to be
3 tolerated. For example, if a taxpayer spends \$10 building
4 a widget in year 1, and sells the widget in year 2, the
5 \$10 he spent in year 1 isn't mismatched. It's put in the
6 inventory costs. It's charged as a component of the costs
7 of goods sold in year 2, when the item is sold. The code
8 is -- and the Secretary is very thorough about routinely
9 requiring matching of expenses.

10 This is an exceptional situation created by the
11 Congress allowing the current deduction, but as Justice
12 Souter pointed out, allowing the current deduction for
13 research doesn't mean that that's -- that Congress decided
14 it was definitely related when it was taken. It clearly
15 isn't definitely related.

16 And so my -- my point was that if it would have
17 been reasonable for the Secretary to just do what the
18 statute says, which is we'll apply it against all income,
19 it's more reasonable, the Secretary decided, to apply it
20 against a smaller category. And then -- and then 5 or 7
21 years later, the Secretary decided it was even more
22 reasonable to -- to apply it against a somewhat narrower
23 category, and we got down to SIC code 3.

24 Well, these are all alternatives, each of which
25 is reasonable. They're more reasonable than the statutory

1 default case, the Secretary decided.

2 QUESTION: Under code 3, would there be any
3 difference? It was still transportation equipment as a
4 category.

5 MR. JONES: For Boeing, we can go all the way to
6 SIC code category 4, which is planes and parts. I mean,
7 this -- this issue is sort of abstract in this case
8 because whatever, you know, objective test the Secretary
9 had used, it would result in the same in -- in this case.

10 QUESTION: Where does the statute say you could
11 just apply it across the board? By -- the statute in 994
12 that I have just refers to 50 percent of the combined
13 taxable income, and that doesn't define --

14 MR. JONES: I'm talking about section 861, which
15 is at page 26a of the petition appendix.

16 QUESTION: 26a, yes.

17 MR. JONES: And subpart -- part (b) in the
18 middle says that you allocate a ratable part. It says
19 par, but I think that's ratable part of expenses which
20 cannot definitely be allocated to some item or class of
21 gross income. So you -- and you -- you would under the
22 default case make that allocation across all items of
23 income.

24 QUESTION: Well, his argument is that it can --
25 that -- that the research on fish can definitely be

1 allocated to fish.

2 MR. JONES: If -- if it's currently deducted, it
3 cannot be definitely allocated to an item of income. You
4 see, petitioner just takes two words out of the statute
5 and changes them. The statute says you allocate costs
6 that cannot be definitely allocated to an item of income.
7 And he says, well, we allocate costs that are factually
8 related to a product. Well, that's not what the statute
9 either says, or is about. We allocate costs to income not
10 to products.

11 Now, the --

12 QUESTION: It says item or class of gross
13 income.

14 MR. JONES: Right.

15 QUESTION: What is -- what is class of gross
16 income?

17 MR. JONES: Well, for example, if they group
18 products, they -- they group all the sales of Boeing 707s.
19 Then you allocate the costs to that group based on the
20 costs that can be directly allocated.

21 QUESTION: For that year.

22 MR. JONES: -- and they share --

23 QUESTION: You're saying it has to be that year.

24 MR. JONES: Yes, and a share of the costs that
25 cannot be directly allocated to an item -- to any item of

1 income.

2 Now, this -- the reasonableness of this -- of
3 the Secretary's approach is especially clear in light of
4 the alternatives that he faced. If he had adopted the --
5 the position that petitioner prefers, the result would be
6 that petitioner would claim an expense against a product
7 that was going to be built and sold some other time, and
8 never charge that expense against that product when it's
9 sold.

10 Now, the obvious and unimpeachable result of
11 that is they overstate their foreign sales income. And in
12 this case, they do it by \$2 billion over the period that's
13 at stake. They overstate their foreign source income,
14 which has the direct consequence of overstating the -- the
15 DISC and FSC benefits that they calculate based on that
16 amount of combined taxable income.

17 QUESTION: But isn't it true, just going back to
18 Justice O'Connor's thought, that -- that the
19 consequence -- the Government's position is that all
20 research and development cost gets allocated to the DISC
21 when you're in a business like they are?

22 MR. JONES: I think that's -- I don't understand
23 the factual context of that statement, but the -- the
24 answer is all research costs, like every other type of
25 cost gets charged against the income -- against foreign

1 sales income to the extent that --

2 QUESTION: Proportionately.

3 MR. JONES: Proportionally, yes, thank you.

4 Pro rata if it's not current -- you know, if it's
5 currently claimed and not capitalized and amortized.

6 If it's capitalized and amortized -- I should
7 just point out because it's -- it is a factual point that
8 is worth knowing. If it's capitalized and amortized, then
9 the costs are recovered as part of the cost of goods
10 sold --

11 QUESTION: No. I -- I understand the
12 distinction between capitalizing it and -- and taking it
13 in the current year. But it seems to me that -- that
14 the -- the net result of the Government's approach is
15 that -- that all of the -- all of the research and
16 development expense of the company would be attributable
17 to the DISC.

18 MR. JONES: It would just be attributable to
19 the -- to -- well, I mean --

20 QUESTION: If -- if the DISC is 25 percent of
21 its sales --

22 MR. JONES: If all --

23 QUESTION: -- 25 percent of its R&D --

24 MR. JONES: Correct. If all the sales were DISC
25 sales, then -- then you would be right. But if -- if some

1 portion of the sales were domestic, which is certainly the
2 case with Boeing, then that portion would be allocated to
3 that portion of the income. I mean, this pro rata
4 allocation that I've been talking about, that what you're
5 allocating between is the sales that the DISC makes and
6 the sales that the DISC doesn't make.

7 QUESTION: What are the -- just out of
8 curiosity, what are the rough proportions of -- of
9 overseas and domestic sales?

10 MR. JONES: I believe the record says something
11 like two-thirds of Boeing's sales during this whole
12 10-year period were overseas and, therefore, I assume,
13 made through the DISC.

14 QUESTION: But just as a housekeeping matter, if
15 Boeing were to prevail here, would it still be open for
16 the Government to say, well, all right, you can allocate
17 along your product lines, but the Blue Sky portion still
18 has to be greatly increased?

19 MR. JONES: You mean, would it be open at this
20 stage --

21 QUESTION: I think I've got the right color.
22 The Red Sky and the Blue Sky. The Blue Sky is the
23 general. Correct?

24 MR. JONES: Yes. At this stage of --

25 QUESTION: And that was about some 20 percent.

1 If -- if the -- if Boeing prevails, can you still go back
2 and say, okay, you get the product line, but you've got to
3 add another 20, 30 percent to the Blue Sky?

4 MR. JONES: I hate to make a concession that I'm
5 not 100 percent certain -- certain about, but --
6 especially since, you know, it -- it could be of
7 importance. I do not believe that issue is open, but
8 it -- but if it were, I would reserve our right to address
9 that. But I don't -- I don't know exactly how it would be
10 open.

11 QUESTION: Mr. Jones, I thought -- maybe I'm
12 confused, but I thought the Government's position was Blue
13 Sky, product-specific -- this is R&D and we treat R&D a
14 certain way and we don't buy into that line, which is set
15 by the company.

16 MR. JONES: Oh, I agree completely, but -- but I
17 understood Justice Kennedy to be saying that if the Court
18 adopted Boeing's approach, would there then be a factual
19 question about what part -- whether the Blue Sky amount
20 was accurately described in the record. And I just don't
21 know for certain. My assumption is that that's not still
22 open.

23 QUESTION: Is -- is it open as to -- suppose
24 the -- you were to say the following. Where a taxpayer
25 can show that a particular R&D expense can be definitely

1 allocated to some item or class of gross income, other
2 than the DISC class in this situation or whatever, where
3 they can show that, then the commissioner cannot require
4 them to allocate it to a different item.

5 MR. JONES: Well, it -- I --

6 QUESTION: That would be just taking the words
7 of the statute. Now, suppose you said that.

8 MR. JONES: It sounds -- it sounds like you
9 correctly described the statute, and let me point out that
10 if they, for example, did their fish research or whatever
11 it was --

12 QUESTION: Yes.

13 MR. JONES: -- and they capitalized and
14 amortized it to the -- to the appropriate products and
15 charged it, then -- then they would be entitled to --

16 QUESTION: So -- so that's what -- that's what I
17 find difficult to reconcile with the 861 -- 861-8 -- what
18 is it called? It's 861-8 --

19 MR. JONES: (e) --

20 QUESTION: -- (3) --

21 MR. JONES: (3)(i).

22 QUESTION: -- et cetera -- sentence which says
23 but you have to use two-digit SIC categories because
24 I think they're so broad, those categories, that it should
25 be possible, like my fish example, to find instances where

1 you could. And why aren't they in that category?

2 MR. JONES: First, it only -- that only applies
3 if they're deducted under 174. So -- so we've narrowed
4 the issue that much. And when they're deducted under 174,
5 as I've said, there were a series of reasonable
6 alternatives facing the Secretary based from the statutory
7 default case that you allocated across all income.

8 Now, the reason I keep stressing that point is
9 because this Court's decisions are very clear that the
10 Court, especially in the context of Treasury regulations,
11 doesn't sit here to decide the wisdom of the particular
12 rule chosen. It only -- in the words of Correll -- looks
13 to see whether some reasonable method was applied, not
14 whether this was the best one, or the most logical --

15 QUESTION: Yes, but it seems to me that what
16 you're doing is -- is quarreling with the decision
17 Congress made under 174. Congress said R&D is inherently
18 something that ought to be capitalized, but we think it's
19 so important, it's going to be expensed. And you keep
20 saying that, well, you know, really it can't be expensed.
21 We're going to, in effect, make them capitalize it anyway.
22 That -- that's --

23 MR. JONES: No. We're -- we're not making them
24 capitalize it. I mean, I would cite, really, my
25 explanation of that as Justice Souter's question earlier,

1 that -- which is that the -- the decision to allow this
2 current deduction is effective in determining taxable
3 income for domestic purposes. We don't dispute that
4 there's a deduction, but I'll point out 861 -- the mere
5 fact there's a deduction doesn't tell you how to allocate
6 it. And the -- 861 says that if the deduction is not
7 definitely related to some item of income, then you charge
8 it against all the items of income.

9 QUESTION: Can -- can I come back to the Blue
10 Sky expenses? A question that was asked earlier caused me
11 to question my understanding of the case.

12 As I understand it, Boeing is willing to accept
13 a ratable portion of the Blue -- Blue Sky expenses in its
14 DISC. Right?

15 MR. JONES: Yes. They actually want to --

16 QUESTION: Just a -- what it -- what it's
17 objecting to is -- is those expenses that -- you know,
18 that -- that go to fish research, those expenses that are
19 identifiable to a particular category.

20 MR. JONES: Just to elaborate, that go to fish
21 research that that -- that were deducted currently rather
22 than amortized over the proper future income. That's --
23 that's what this case is really all about is this
24 peculiarity --

25 QUESTION: But that's the whole scheme that

1 Congress passed in the '70s to try to encourage exports.
2 So it just -- the interpretation of 861 in the regs seems
3 to go somewhat contrary to the overall purpose of the
4 scheme for DISCs.

5 MR. JONES: Several -- several courts have
6 correctly said that the purpose of the -- of the combined
7 taxable income calculation is to serve as a limit on the
8 DISC and FSC benefits. Congress didn't intend unlimited
9 benefits. They didn't intend to allow benefits of the
10 type that Boeing is seeking where they inflate their
11 foreign source income by not -- not putting the costs
12 against that income in calculating it.

13 And so, the answer to your question is no. The
14 Secretary's rule is designed to accomplish the correct, in
15 the Secretary's view, determination of combined taxable
16 income for this very purpose.

17 Now, it -- I think that -- that the issue
18 that -- that may actually be the one the Court wants to
19 consider first is that in 1984, when Congress enacted the
20 FSC provision, it -- it in our view ratified and adopted
21 the very cost -- research cost allocation regulation that
22 we have in this case. In -- in the Deficit Reduction Act
23 of 1984, there are two provisions that relate to this
24 case. Congress adopted -- enacted the FSC which, of
25 course, is based on the provisions of the DISC, and -- and

1 it also contains the combined taxable income method of
2 limiting the -- the benefit. And -- and at the same time
3 that they adopted the FSC, they enacted a provision that
4 took one piece of this regulation out and suspended it.
5 That's the piece called geographic sourcing. That, for
6 purposes of citation, is 1.861-8(e)(3)(ii).

7 This case is about 1.861-8(e)(3)(i), which is
8 the rule that calculates combined taxable income. And
9 when Congress took out -- said we're going to suspend this
10 geographic sourcing rule in this regulation, they said,
11 we're not suspending this regulation for application in
12 calculating combined taxable income for DISCs and FSCs.

13 Well, under this Court's decision in
14 *Lorillard v. Pons*, that is a ratification and adoption of
15 the regulation. The Court made the point in *Lorillard*
16 that when a --

17 QUESTION: Can I -- Mr. Jones, can I go back for
18 just a second -- and be sure I understand something
19 right -- to the fish/roes hypothetical? Am I correct in
20 assuming that the fishes -- the research on the fishes
21 would be charged to the DISC only if fishes and roses were
22 in the same SIC grouping?

23 MR. JONES: Under any scenario, that's correct.

24 QUESTION: Oh. So if they're in a different
25 grouping, then the rose farmer wouldn't have to pay for

1 the fish research.

2 MR. JONES: That's correct. I was assuming you

3 carefully constructed your question.

4 QUESTION: But the -- but the grouping can be as

5 broad as -- as transportation equipment.

6 MR. JONES: It can be quite broad.

7 QUESTION: That's a pretty broad group.

8 MR. JONES: It can be quite broad. But the

9 point is that it's not --

10 QUESTION: And it includes, by the way,

11 agriculture, forestry, and fisheries. That's one

12 category.

13 (Laughter.)

14 MR. JONES: It's not -- it's -- the point is

15 it's not as broad as the statutory default rule. The

16 statutory default rule is by definition reasonable, and

17 the -- the narrower rule that the -- that the --

18 QUESTION: You've lost me. The statutory

19 default rule --

20 MR. JONES: Is that you apply these costs

21 against all items of income because they're not definitely

22 related to an item of income. That's the statutory

23 default principle.

24 QUESTION: Where is that?

25 MR. JONES: That's in 861(b) at page 26a of the

1 petition appendix. It says that --

2 QUESTION: Got you.

3 MR. JONES: Okay.

4 Now, on the ratification point, *Lorillard v.*
5 *Pons* makes the point that when Congress enacts a statute
6 that's based upon a -- a prior -- the provisions of a
7 prior act, it is assumed to have adopted the -- the
8 administrative interpretation. Now, that's not a -- by
9 itself an overpowering presumption, but what *Lorillard*
10 pointed out was that when Congress, in doing that, looks
11 at the agency's interpretation and excised a portion of
12 it, the inference that it approved the remaining part is
13 very strong.

14 Now, here, it's strong not only because of that
15 inference, but because Congress said -- I'm sorry -- the
16 committee that made this amendment said that they --
17 although they were excising this part about geographic
18 sourcing, that the part about combined taxable income
19 calculations for DISCs and FSCs would remain in effect.

20 Now, petitioner says, but 2 years later Congress
21 did something that somehow negates at that ratification.
22 Well, of course, the sub -- Congress can't change the law
23 as ratified, but that's not what happened in '86 in any
24 event. What happened in '86 was that the -- the committee
25 what was -- that was removing the suspension of the -- on

1 the geographic sourcing rule said that we're not saying
2 whether the regulation is valid or not. Well, the
3 regulation that they were talking about was the geographic
4 sourcing rule. Petitioner says, well, they were talking
5 about the whole rule. No. They were talking about the
6 geographic sourcing rule as we know from the last part of
7 that same report which says that nothing in this act has
8 anything to do with the use of these -- of the -- of the
9 research cost allocation regulations for calculating
10 CTI -- combined taxable income -- for DISC and FSC
11 purposes.

12 QUESTION: Correct me if I'm wrong. In the
13 court of appeals opinion -- and it's the paragraph at
14 12(a). I think you'll be familiar with this one, where
15 the court of appeals said, the more narrowly a taxpayer
16 chooses to define incomes, the more costs become
17 indirectly or indefinitely related. Can I be excused from
18 trying to understand that, or --

19 (Laughter.)

20 MR. JONES: Well, I can try to help, but I'm --
21 I can't promise results. It -- it looked to me like what
22 they had in mind was the thought that this -- that a
23 taxpayer who says my research only relates to wing nuts
24 on -- on this plane is -- is defining it so narrowly that
25 it's not realistic. And -- and indeed, the record of this

1 case reflects that -- that research on one type of plane
2 has applications on other types of planes. And -- and I
3 think what the court was addressing there was his view
4 that -- that this was an appropriate accommodation. This
5 was one of the choices that the Secretary had. It was a
6 reasonable choice.

7 QUESTION: It really was restating the problem
8 rather than offering a specific solution.

9 MR. JONES: I think it was restating the problem
10 in a way that indicated it felt that the Secretary's
11 choice was a reasonable one.

12 QUESTION: Mr. Jones, can you tell us this
13 continuing significance of this arrangement? I -- we're
14 now past the successor of the FSC. Is that true?

15 MR. JONES: Yes. The FSC is no longer with us.
16 It was replaced by the extraterritorial income
17 provisions -- maybe in '98. I'm not sure.

18 QUESTION: What about the two-digit SIC? Is
19 that still with --

20 MR. JONES: Two-digit is -- it was replaced by
21 the -- the narrower three-digit band in '94, I believe.

22 QUESTION: So if we thought the two-digit was a
23 little bit going too far, would that throw open all kinds
24 of claims on the -- on the -- from all kinds of people?

25 MR. JONES: Well, I mean, again, if the Court

1 wanted -- felt it needed to look at the two-digit versus
2 three-digit, although to me they're just, you know,
3 spectrums along the --

4 QUESTION: The degree of specificity -- well, at
5 least three-digit would separate the roses from the fish.

6 MR. JONES: This case really doesn't present the
7 question --

8 QUESTION: It doesn't.

9 MR. JONES: -- because, as I said, there's
10 just -- is -- there's no question that Boeing goes all the
11 way to SIC 4. And so if the standard is are the products
12 reasonably related, which -- which is --

13 QUESTION: So we don't have to consider it. All
14 we'd have to --

15 MR. JONES: I don't think you have to consider
16 it, but if you did, I think you would do it in the context
17 of realizing these are reasonable alternatives, and that
18 the Secretary didn't have to pick the best one. He just
19 had to pick one of them. And I -- if you thought that
20 none of these were reasonable, then -- then, you know, it
21 wouldn't matter which one he picked.

22 QUESTION: At some point they certainly --

23 MR. JONES: If there are no further questions,
24 thank you.

25 QUESTION: Thank you, Mr. Jones.

1 Mr. Geller, you have a little over 2 minutes
2 left.

3 REBUTTAL ARGUMENT OF KENNETH S. GELLER

4 ON BEHALF OF THE PETITIONER

5 MR. GELLER: So much to say.

6 Justice Kennedy, I think you put your heart on
7 the -- on the Government's -- the -- the problem with the
8 Government's position here. It's simply an unwillingness
9 to accept the fact that Congress created a number of
10 incentives here that were not designed simply to raise
11 revenue. They had other purposes such as the export --
12 the -- the beneficial treatment of export income and also
13 the immediate deductibility of -- of R&D.

14 Now, the Government tries to defend this
15 regulation here on the -- on the basis that there's this
16 temporal mismatch and it's all the result of not
17 capitalizing. I should say a number of things about that.

18 First, this was not the basis for the regulation
19 at the time the regulation was issued. It was not the
20 basis for defending this regulation in the lower courts.
21 And it -- and the Government's position is not even
22 consistent with that regulation because if the whole
23 problem here is the lack of a temporal mismatch, you would
24 think that if you had a class of gross income in which in
25 a particular year there was both revenues and R&D

1 expenses, well, in that situation there's no temporal
2 mismatch. They would at least allow you to allocate those
3 R&D expenses to that revenue in that year. No. Even if
4 there's revenue in a class of gross income in a particular
5 year, they still insist that those R&D expenses be spread
6 across all of the income in that SIC code.

7 Now, I want to mention St. Jude, because in this
8 case we're dealing with airplanes and airplanes, and while
9 the -- the costs are specifically allocated only to
10 particular programs, it gets a little more complicated.

11 But look at St. Jude. In St. Jude, you had a
12 manufacturer who was exporting artificial heart valves.
13 That's all it was doing, is manufacturing and exporting
14 artificial heart valves. In the same year, it was
15 engaging in R&D for insulin pumps, and for pacemakers.
16 The Government insisted that the export income from the
17 sale of those heart valves be reduced, and that the DISC
18 benefit be reduced because of the R&D spent on these other
19 products that obviously had no basis or relevance to the
20 sale of the heart valve simply because they were all
21 within the broad -- same broad SIC code.

22 And I should say, Justice Kennedy, the Ninth
23 Circuit's opinion I think is somewhat unintelligible.
24 The -- the part that you -- you referred to, we all
25 stumbled over because it makes no sense. The more

1 narrowly -- the more narrowly you define your classes of
2 gross income, the more that -- that costs will be directly
3 allocated to more than one class of income. It's not a
4 question of anything being indirectly allocated.

5 And there's no default rule at issue here either
6 because all of our costs are directly allocable to
7 specific programs. That's all we ask that we be allowed
8 to do.

9 We ask that the judgment in the Ninth Circuit be
10 reversed. Thank you.

11 JUSTICE STEVENS: Thank you, Mr. Geller.

12 The case is submitted.

13 (Whereupon, at 11:03 a.m., the case in the
14 above-entitled matter was submitted.)

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