St. Jude Medical, Inc. v. Commissioner, 97 T. C. 457, 1991 U. S. Tax Ct. LEXIS 93, 97 T. C. No. 33 (U. S. Tax Court, October 31, 1991)

Research and development expenses must be allocated to export sales in computing combined taxable income for a Domestic International Sales Corporation (DISC), even if the expenses relate to products never placed into production or sold.

Summary

St. Jude Medical, Inc. , challenged the IRS's inclusion of research and development (R&D) expenses for products never marketed in the computation of combined taxable income for its DISC. The Tax Court held that R&D expenses are allocable to export sales under the 50/50 combined taxable income method, as per Treasury Regulation 1. 861-8(e)(3). The court rejected the applicability of a moratorium on R&D expense allocation to DISCs and upheld the regulation's requirement to use Standard Industrial Classification (SIC) categories for allocation, despite the taxpayer's argument for using narrower industry or trade usage categories.

Facts

St. Jude Medical, Inc. , a manufacturer of artificial heart valves, established St. Jude International Sales Corporation (International) as a DISC to benefit from tax deferral on export sales. St. Jude attempted to develop a cardiac pacemaker and an insulin pump but abandoned these projects. In computing combined taxable income, St. Jude did not allocate R&D expenses related to the pacemaker and pump, nor did it allocate 30% of R&D expenses related to its heart valves to export sales. The IRS recomputed the income, allocating these expenses, which reduced the amount of income eligible for tax deferral.

Procedural History

St. Jude Medical filed a petition in the U. S. Tax Court challenging the IRS's deficiency determinations for the years 1981-1983. The court addressed the allocation of R&D expenses in the context of DISC combined taxable income, ruling in favor of the IRS's position.

Issue(s)

1. Whether the R&D expense allocation moratorium under section 223 of the Economic Recovery Tax Act of 1981 applies to the computation of combined taxable income for a DISC.
2. Whether R&D expenses attributable to products never placed into production or offered for sale are allocable to export sales in computing combined taxable income under section 1. 861-8(e)(3) of the Income Tax Regulations.
3. Whether section 1. 861-8(e)(3) is a valid regulation for purposes of the DISC transfer pricing rules, specifically regarding the use of SIC product categories, industry and trade usage categories, the wholesale trade category, and the exclusive

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geographic apportionment method.

Holding

1. No, because the moratorium applies only to geographic sourcing, which is not relevant to the computation of combined taxable income for a DISC.
2. Yes, because under section 1. 861-8(e)(3), R&D expenses are considered definitely related to all income within the relevant SIC product category, including export sales.
3. Yes, because the regulation harmonizes with the purpose and origin of the DISC provisions and has been consistently applied and scrutinized by Congress without disapproval.

Court’s Reasoning

The court applied the legal rule from section 1. 994-1(c)(6)(iii) of the Income Tax Regulations, which requires that combined taxable income be computed consistently with section 1. 861-8. The court reasoned that R&D expenses must be allocated to all income within the same SIC product category, including export sales, as these expenses are considered definitely related to the income. The court rejected St. Jude’s argument that only expenses directly related to export sales should be allocated, citing the regulation’s requirement to allocate all R&D expenses within the product category. The court also upheld the validity of the regulation, noting its consistency with the DISC provisions’ purpose and the lack of congressional disapproval despite repeated scrutiny. The court emphasized that the allocation method aims to reflect the speculative nature of R&D and the potential benefits across products within the same category.

Practical Implications

This decision clarifies that R&D expenses, even for unsuccessful products, must be allocated in computing DISC combined taxable income. Practitioners should ensure that all R&D expenses are allocated using SIC categories, not narrower industry or trade usage categories. This ruling may reduce the tax deferral benefits available to DISCs by increasing the expenses allocated to export sales. The decision also reaffirms the inapplicability of the R&D expense allocation moratorium to DISCs, emphasizing the distinction between geographic sourcing and the computation of combined taxable income. Subsequent cases, such as those involving Foreign Sales Corporations (FSCs), have continued to apply similar principles, confirming the enduring impact of this ruling on tax planning involving export sales through domestic entities.

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