Intel Corp. v. Commissioner, 100 T. C. 616, 1993 U. S. Tax Ct. LEXIS 38, 100 T. C. No. 39 (1993)

The Economic Recovery Tax Act of 1981’s moratorium on research and experimental expense allocation does not apply to computing combined taxable income for DISC purposes, and the IRS cannot require the use of Example (1) for sourcing export sales income without a foreign selling branch.

Summary

Intel Corporation challenged the IRS’s determinations regarding the allocation of research and experimental expenses (R&E) for DISC commissions and the sourcing of income from export sales. The Tax Court held that the moratorium on R&E allocation under the Economic Recovery Tax Act of 1981 did not apply to computing combined taxable income under section 994(a), following the precedent set in St. Jude Medical, Inc. v. Commissioner. Additionally, the court ruled that the IRS could not mandate the use of Example (1) from section 1. 863-3(b)(2) of the regulations to source export sales income unless those sales were made through a foreign selling or distributing branch, as Intel did not maintain such a branch.

Facts

Intel Corporation, engaged in designing, manufacturing, and selling semiconductor components and computer systems, operated Intel DISC as a commission Domestic International Sales Corporation (DISC). Intel paid commissions to Intel DISC on sales eligible for DISC treatment, calculated using the combined taxable income method under section 994(a)(2). Intel did not allocate or apportion any R&E expenses incurred in the U. S. to these commissions. Separately, Intel sold products manufactured in the U. S. to unrelated parties, with title passing outside the U. S. , and sourced the income using Example (2) of section 1. 863-3(b)(2). The IRS challenged both the R&E allocation and the sourcing method used for these export sales.

Procedural History

Intel filed a petition in the Tax Court in 1989, seeking to sever and address the R&E allocation moratorium and export source issues separately. The court granted the severance motions in 1990. Intel moved for partial summary judgment on the R&E allocation moratorium issue in 1991, which was stayed pending the outcome of St. Jude Medical, Inc. v. Commissioner. After the St. Jude decision, Intel renewed its motion in 1992, and the IRS filed a cross-motion for partial summary judgment on the same issue. Intel also moved for partial summary judgment on the export source issue in 1992, with the IRS filing a cross-motion. The Tax Court ruled in 1993 on both issues.

Issue(s)

1. Whether the moratorium on the allocation of research and experimental expenses to foreign sources imposed by section 223 of the Economic Recovery Tax Act of 1981 applies to the computation of combined taxable income under section 994(a)(2).
2. Whether the IRS can require the use of Example (1) of section 1. 863-3(b)(2) to source income from export sales when the sales are not made through a foreign selling or distributing branch.

Holding

1. No, because the Economic Recovery Tax Act of 1981's moratorium does not extend to the computation of combined taxable income for DISC purposes as established in St. Jude Medical, Inc. v. Commissioner.
2. No, because the IRS cannot mandate the use of Example (1) for sourcing export sales income without a foreign selling or distributing branch, as Intel did not maintain such a branch.

Court's Reasoning

The court's decision on the R&E allocation moratorium was based on the precedent set in St. Jude Medical, Inc. v. Commissioner, where it was determined that the moratorium did not apply to the computation of combined taxable income under section 994(a)(2). The court found no compelling reason to overrule this precedent, emphasizing the specific language of the statute and the policy considerations that the moratorium was intended to address.

Regarding the export source issue, the court analyzed the statutory and regulatory framework, focusing on the requirements of Example (1) of section 1. 863-3(b)(2). The court held that Example (1) requires both an independent factory price (IFP) and sales through a foreign branch for its application. Intel's sales did not meet the latter requirement, thus Example (1) could not be applied. The court emphasized the plain language of the regulations and the legislative history indicating a mixed-source directive for cross-border sales. The court rejected the IRS's argument that Example (1) could be applied solely based on the existence of an IFP, as this would contradict the statutory intent of mixed-source treatment.

Practical Implications

This decision clarifies that the R&E allocation moratorium does not apply to DISC combined taxable income calculations, impacting how multinational corporations structure their DISC operations and allocate expenses. Taxpayers and practitioners must carefully consider whether their transactions fall under the scope of the moratorium.

On the export source issue, the ruling establishes that the IRS cannot unilaterally impose Example (1) for sourcing export sales income without the presence of a foreign branch. This has significant implications for companies engaged in export sales, as they can choose their sourcing method based on the absence of a foreign branch, potentially affecting their foreign tax credit calculations and overall tax planning strategies.

The decision also underscores the importance of adhering to the specific requirements of tax regulations, reinforcing that the IRS must follow the same rules as taxpayers. This case may influence future regulatory changes or legislative actions aimed at clarifying or modifying the sourcing rules for export sales.

