Perkin-Elmer Corp. v. Commissioner, 103 T. C. 464 (1994)

The IRS's sales method for allocating research and development expenses under section 1. 861-8(e)(3)(ii) of the Income Tax Regulations is a valid interpretation of the statute for computing foreign tax credits.

Summary

The Perkin-Elmer Corporation challenged the IRS's method of allocating its research and development (R&D) expenses for calculating its foreign tax credit. The IRS used a sales-based approach under section 1. 861-8(e)(3)(ii), which Perkin-Elmer argued was invalid because it did not consider R&D expenses of its foreign subsidiaries, resulting in an unfair allocation to foreign income. The Tax Court upheld the regulation, finding it a reasonable interpretation of the statute. The decision highlights the complexities of allocating expenses for multinational corporations and the balance between preventing double taxation and ensuring fair tax treatment.

Facts

Perkin-Elmer Corporation (P-E) and its subsidiaries engaged in R&D activities across the U. S. , U. K. , and Germany. For the tax years 1978-1981, P-E's R&D expenses were allocated using the IRS's sales method under section 1. 861-8(e)(3)(ii), which did not account for the R&D expenses of P-E's foreign subsidiaries. P-E proposed an alternative 'worldwide' method that included these foreign expenses, arguing it better reflected the actual benefits of R&D across its global operations. The IRS's method resulted in a larger allocation of P-E's R&D expenses to foreign income, thus reducing P-E's foreign tax credit and exposing it to potential double taxation.

Procedural History

P-E challenged the IRS's allocation method in the U. S. Tax Court. Prior to this case, the IRS had issued regulations in 1977 under section 1. 861-8(e)(3)(ii), and Congress had temporarily modified these rules several times between 1981 and 1993. The Tax Court's decision in this case was the first to directly address the validity of the IRS's sales method for R&D expense allocation in the context of foreign tax credits.

Issue(s)

1. Whether section 1. 861-8(e)(3)(ii) of the Income Tax Regulations, which uses a sales-based method for allocating R&D expenses, is a valid interpretation of the statute for computing foreign tax credits?

Holding

1. Yes, because the regulation is a reasonable interpretation of the statutory provisions governing the allocation of deductions for foreign tax credit purposes,

despite criticisms and alternative methods proposed by taxpayers.

Court’s Reasoning

The Tax Court assessed the validity of the regulation using standards established by the Supreme Court, focusing on whether the regulation harmonized with the statute’s language, origin, and purpose. The court found that the regulation was consistent with the statutory requirement to allocate expenses between U. S. and foreign income sources. It rejected P-E’s argument that the regulation ignored the factual relationship between deductions and income, emphasizing that the regulation allowed for adjustments, such as exclusive allocations to U. S. income and cost-sharing agreements, to better reflect actual benefits. The court also noted that Congress had repeatedly considered but not altered the regulation, suggesting its acceptance of the IRS’s approach. The decision acknowledged the imperfections of the sales method but concluded it was not unreasonable given the complexities of R&D expense allocation.

Practical Implications

This decision affirms the use of the IRS’s sales method for allocating R&D expenses in computing foreign tax credits, impacting how multinational corporations allocate expenses across their global operations. It underscores the importance of understanding and potentially utilizing the flexibility within the regulations, such as seeking larger exclusive allocations or entering into cost-sharing agreements. The ruling may influence future legislative and regulatory efforts to refine R&D expense allocation rules, especially as global business practices evolve. It also serves as a precedent for assessing the validity of IRS regulations in areas where statutory guidance is ambiguous, affecting how similar cases are analyzed and potentially influencing business decisions regarding R&D investments and tax planning.

