DISC statute." *Ante*, at 11–12. But the "disappearance" of Boeing's R&D expenses is the direct result of Congress' decision to encourage such expenditures by making them immediately deductible under 26 U.S.C. Sec. 174(a)(1). Moreover, the approach adopted in the regulations, and approved by the Court, does not remedy the alleged problem of disappearing R&D expenses. A company that decides to enter the export market with a product unrelated to its existing business remains free to deduct in the current tax period all R&D expenses incurred in connection with the new product, even though those expenses would not be used to offset DISC income resulting from the sale of existing products.[4] Finally, neither the Court nor the Government provide a satisfactory explanation for why Sec. 861 can be read to permit the "disappearance" of most expenses, see, *e.g.*, 26 CFR Sec. 1.861–8(d)(1) (1979) ("Each deduction which bears a definite relationship to a class of gross income shall be allocated to that class . . . even though, for the taxable year, no gross income in such class is received or accrued. . . . In apportioning deductions, it may be that, for the taxable year, there is no gross income in the statutory grouping (or residual grouping), or that deductions exceed the amount of gross income in the statutory grouping (or residual grouping)"); see also 1 J. Isenbergh, International Taxation: U.S. Taxation of Foreign Persons and Foreign Income ¶21.10 (3d ed. 2003) ("[I]f an expense incurred in one year is properly allocable to income arising in another, the expense will be allocated to the class to which the income belongs and may therefore produce a loss in that class for the year"), but to disallow the "disappearance" of R&D expenses.

Because I believe that Sec. 1.861–8(e)(3) does not apply to a DISC, I need not decide here whether Sec. 1.861–8(e)(3) is consistent with the text of Sec. 861(b) and may be properly applied in other contexts. I am puzzled, however, by the Court's assertion that the Secretary is free to determine that certain expenses "can be properly apportioned on a categorical basis," *ante*, at 13, and the implication that the Secretary has authority to require "ratable apportionment of expenses that could be, but perhaps in fairness should not be, treated as direct costs." *Ibid*. By its terms, Sec. 861(b) appears to contemplate two types of expenses: (1) those that can definitely be allocated to some item or class of gross income and (2) those that *cannot*. 26 U.S.C. Sec. 861(b) (providing for the deduction of "*the* expenses, losses, and other deductions properly apportioned or allocated thereto *and a ratable part* of any expenses, losses, or other deductions *which cannot definitely be allocated to some item or class of gross income*" (emphasis added)). Moreover, on its face, the statute does not appear to permit expenses to be "deemed" related to an item or class of gross income, even though in actual fact they are not so related. Yet, Sec. 1.861–8(e)(3) relies on the notion of "deemed relationships." The regulation states that the methods of allocation and apportionment established there "recognize that research and development is an inherently speculative activity, that findings may contribute unexpected benefits, and that the gross income derived from successful research and development must bear the cost of unsuccessful research and development. 26 CFR Sec. 1.861–8(e)(3)(i)(A) (1979). The regulation then proceeds to require the allocation of R&D expenses based on 2-digit SIC groups. But neither the regulation nor the Court attempt to reconcile the statutory text with the regulation's determination to allocate certain R&D expenses to items or classes of gross income that admittedly did not benefit from that research.

* * * *

In short, I conclude that Boeing properly computed its tax liability for the years at issue here. I would therefore reverse the judgment of the Court of Appeals. Because the Court concludes otherwise, I respectfully dissent.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for May 2003.

Rev. Rul. 2003–45

This revenue ruling provides various prescribed rates for federal income tax purposes for May 2003 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

---

[4] Boeing illustrates this point with the following example: Suppose a company that produces and exports athletic clothing (SIC Code 23) decides to invest the proceeds of its clothing sales in research to develop a line of athletic equipment (SIC Code 39). The company has current DISC sales of $1 million from the athletic clothing, no current sales of athletic equipment, and $500,000 in athletic equipment R&D expenses. Under the regulations, the $500,000 of equipment-related R&D will be allocated to the athletic equipment SIC Code, which has no income. It will not be allocated to the athletic clothing SIC Code to reduce the income eligible for the DISC benefit related to the clothing. Thus, in the words of the Court, the expense will simply "disappear." Brief for Petitioners 37, n. 17.

REV. RUL. 2003–45 TABLE 1

Applicable Federal Rates (AFR) for May 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	1.53%	1.52%	1.52%	1.52%
110% AFR	1.68%	1.67%	1.67%	1.66%
120% AFR	1.83%	1.82%	1.82%	1.81%
130% AFR	1.99%	1.98%	1.98%	1.97%
Mid-Term				
AFR	3.17%	3.15%	3.14%	3.13%
110% AFR	3.50%	3.47%	3.46%	3.45%
120% AFR	3.82%	3.78%	3.76%	3.75%
130% AFR	4.14%	4.10%	4.08%	4.07%
150% AFR	4.79%	4.73%	4.70%	4.68%
175% AFR	5.59%	5.51%	5.47%	5.45%
Long-Term				
AFR	4.79%	4.73%	4.70%	4.68%
110% AFR	5.27%	5.20%	5.17%	5.14%
120% AFR	5.76%	5.68%	5.64%	5.61%
130% AFR	6.24%	6.15%	6.10%	6.07%

REV. RUL. 2003–45 TABLE 2

Adjusted AFR for May 2003

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	1.34%	1.34%	1.34%	1.34%
Mid-term adjusted AFR	2.72%	2.70%	2.69%	2.68%
Long-term adjusted AFR	4.45%	4.40%	4.38%	4.36%

REV. RUL. 2003–45 TABLE 3

Rates Under Section 382 for May 2003

Adjusted federal long-term rate for the current month	4.45%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.58%

REV. RUL. 2003–45 TABLE 4	
Appropriate Percentages Under Section 42(b)(2) for May 2003	
Appropriate percentage for the 70% present value low-income housing credit	7.92%
Appropriate percentage for the 30% present value low-income housing credit	3.40%

REV. RUL. 2003–45 TABLE 5	
Rate Under Section 7520 for May 2003	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	3.8%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of May 2003. See Rev. Rul. 2003–45, page 876.

Section 3121.—Definitions

Federal Insurance Contributions Act (FICA); Medicare. This ruling provides that for the continuing employment exception to the Medicare portion of the Federal Insurance Contributions Act tax to apply to service performed by an employee of a state, political subdivision, or instrumentality thereof, such employee must be a member of a retirement system pursuant to Internal Revenue Code section 3121(b)(7)(F). Rev. Ruls. 86–88 and 88–36 supplemented.

Rev. Rul. 2003–46

The Federal Insurance Contributions Act (FICA) tax consists of an old age, survivors, and disability insurance ("OASDI") portion and a hospital insurance ("Medicare") portion. This revenue ruling provides guidance concerning the applicability of the Medicare portion of FICA tax under Internal Revenue Code § 3121(u)(2) to employees of state and local governments. Specifically, this revenue ruling considers the interaction between §§ 3121(u)(2)(C) and 3121(b)(7)(F) in the context of the continuing employment exception. Section 3121(u)(2) generally extends the Medicare portion of FICA tax to wages for service performed by employees of states, political subdivisions, and wholly owned instrumentalities thereof hired after March 31, 1986. Section 3121(b)(7)(F), enacted by section 11332(b) of the Omnibus Budget Reconciliation Act of 1990 (OBRA '90), Pub. L. 101–508, 104 Stat. 1388, expands the definition of employment for FICA tax purposes to include service performed after July 1, 1991, by state or local government employees who are not members of a retirement system.

This revenue ruling supplements Rev. Rul. 86–88, 1986–2 C.B. 172, and Rev. Rul. 88–36, 1988–1 C.B. 343, both of which provide guidelines concerning the application of § 3121(u)(2) in a question and answer format. This revenue ruling also provides guidelines in a question and answer format. In this revenue ruling, the terms "state," "political subdivision," "state employer," "political subdivision employer," and "continuing employment exception" have the same meanings as in Rev. Rul. 86–88.

SERVICE ELIGIBLE FOR THE CONTINUING EMPLOYMENT EXCEPTION

Q1. Is the continuing employment exception to the Medicare portion of FICA tax available for service performed by an employee for a state employer or political subdivision employer who is not a member of a retirement system within the meaning of § 3121(b)(7)(F)?

A1. No. Under § 3121(u)(2)(C)(i), the continuing employment exception applies only to service that is otherwise excluded from employment under § 3121(b)(7). Section 3121(b)(7) excepts from employment service in the employ of a state employer or political subdivision employer for FICA tax purposes. However, § 3121(b)(7)(F) expands the definition of employment for FICA tax purposes to include service by an employee who is not a member of a retirement system. *See* § 31.3121(b)(7)–2 of the Employment Tax Regulations. The House-Senate Conference Report to OBRA '90 provides that "[t]he conference agreement extends Medicare coverage to, and applies the HI [(Medicare)] tax with respect to wages of, those employees (otherwise not already subject to the HI tax) who become subject to OASDI by reason of this provision." H.R. Rep. No. 101–964, at 1105 (1990). Consequently, wages paid for service performed by an employee who is not a member of a retirement system for the state employer or political subdivision employer are subject to the OASDI and Medicare portions of FICA tax regardless of when the employee became employed.

Q2. Is the continuing employment exception available for service performed by an employee for a state employer or political subdivision employer who is subject to the Medicare portion of FICA tax solely because the employee is not a member of a retirement system (*i.e.*, the employee meets all the requirements of § 3121(u)(2)(C), and the employee's service is not covered by a voluntary agreement with the Secretary of Health and Human Services pursuant to § 218 of the Social Security Act, 42 U.S.C. § 418), but who becomes a member of a retirement system after July 1, 1991?