

No. 12-684

In the Supreme Court of the United States

UNION CARBIDE CORPORATION AND SUBSIDIARIES,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT*

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

Section 41 of the Internal Revenue Code of 1986 provides a tax credit for increased spending on “qualified research expenses.” 26 U.S.C. 41 (2006 & Supp. IV 2010). Petitioner conducted qualified research on aspects of its commercial production processes at its manufacturing plants, during which time it produced goods for sale in the ordinary course of its manufacturing business. The questions presented are as follows:

1. Whether supplies that petitioner used to produce goods for sale—the costs of which petitioner would have incurred whether or not it conducted any qualified research activities—were “used in the conduct of qualified research,” 26 U.S.C. 41(b)(2)(A)(ii), and therefore were eligible for the research credit.

2. Whether the court of appeals should have refused to defer to the Treasury Department’s interpretation of its own regulation implementing the research credit because the government has a financial interest in the outcome of this case.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-12a) is reported at 697 F.3d 104. The opinion of the Tax Court (Pet. App. 15a-275a) is reported at 97 T.C.M. (CCH) 1207.

JURISDICTION

The judgment of the court of appeals was entered on September 7, 2012. The petition for a writ of certiorari was filed on December 4, 2012. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 41 of the Internal Revenue Code of 1986, 26 U.S.C. 41 (2006 & Supp. IV 2010), provides a tax credit to encourage taxpayers to increase their research spending. Section 41 reflects Congress's view that "a

substantive tax credit for incremental research and experimental expenditures will overcome the resistance of many businesses to bear the significant costs of staffing, supplies, and certain computer charges which must be incurred in initiating or expanding research programs.” H.R. Rep. No. 201, 97th Cong., 1st Sess. 111 (1981). The credit is allowed for 20% of the increase in “qualified research expenses” over the “base amount.” 26 U.S.C. 41(a)(1).¹

“Qualified research expenses” include both the cost of qualified research conducted by a taxpayer in-house, and the cost of contract research paid by a taxpayer to another party for qualified research. 26 U.S.C. 41(b). At issue in this case is the first category of research expenses.

The term “[i]n-house research expenses” is defined in relevant part to include “any wages paid or incurred to an employee for qualified services,” *i.e.*, the performance or direct supervision of qualified research, and “any amount paid or incurred for supplies used in the conduct of qualified research.” 26 U.S.C. 41(b)(2)(A) and (B).² With respect to the amount paid for “supplies,” the applicable Treasury regulation provides that “[e]xpenditures for supplies * * * that are indirect research expenditures or general and administrative

¹ A taxpayer’s “base amount” is generally its average annual gross receipts for the four preceding tax years multiplied by its “fixed-base percentage,” which is the lesser of 16% or the fraction of the taxpayer’s aggregate “qualified research expenses” over its aggregate gross receipts for the 1984 through 1988 tax years. 26 U.S.C. 41(c)(1)-(3).

² “Supplies” are tangible property other than real property and property of a character that may be depreciated. 26 U.S.C. 41(b)(2)(C).

expenses do not qualify as [qualified] research expenses.” Treas. Reg. 1.41-2(b)(1).

“Qualified research” is research that satisfies each of four tests³ and does not fall within the categories of activities for which the research credit is unavailable. 26 U.S.C. 41(d)(1) and (4). The qualified research tests apply separately with respect to each “business component” of the taxpayer, which is a “product” or “process” that is offered for sale, lease, or license to third parties, or that is used by the taxpayer in its trade or business. 26 U.S.C. 41(d)(2)(A) and (B).

In general, the “qualified research” tests are first applied to the entire product or process. If not all of the tests are satisfied, the tests are then applied to increasingly narrow subsets of elements of the product or process. “This shrinking back of the product [or process] is to continue until either a subset of elements of the product that satisfies the requirements is reached, or the most basic element of the product is reached and such element fails to satisfy the test.” Treas. Reg. 1.41-4(b)(2); see H. Conf. Rep. No. 841, 99th Cong., 2d Sess., Pt. 2, at II-73 (1986) (describing the “shrinking-back” rule). In addition, there is a “special rule” that a “plant process * * * for commercial production of a business

³ The four tests used to identify qualified research are as follows: First, the expenses incurred in the research must be treatable as expenses under 26 U.S.C. 174, which governs the tax accounting treatment of research and experimental expenditures. 26 U.S.C. 41(d)(1)(A). Second, the research must have been undertaken for the purpose of discovering information that is technological in nature. 26 U.S.C. 41(d)(1)(B)(i). Third, the application of that information must be intended to be useful in the development of a new or improved business component of the taxpayer. 26 U.S.C. 41(d)(1)(B)(ii). Fourth, substantially all of the research activities must have constituted elements of a process of experimentation. 26 U.S.C. 41(d)(1)(C).

component shall be treated as a separate business component (and not as part of the business component being produced).” 26 U.S.C. 41(d)(2)(C). In other words, plant-based process research may not include the product being produced.

2. Petitioner is a manufacturer and marketer of basic chemicals and plastics, as well as specialty and intermediate chemicals. Pet. App. 27a. At issue here is research petitioner performed on its process to produce olefins (a fuel and raw material used in the production of chemicals and plastics) and polyethylene, “which is used for high-volume applications such as food containers, milk and water bottles, grocery and trash bags, pipes, and tubing.” *Id.* at 28a.

Petitioner’s olefins production involved the thermal “cracking” of raw hydrocarbon feedstock by exposing it to extreme temperatures in the range of 1400 to 1650 degrees Fahrenheit in a furnace fitted with cracking coils. Pet. App. 33a-34a. Coke, a byproduct of the cracking process, adversely affects furnace performance and clogs cracking coils and downstream equipment. *Id.* at 36a-37a. Petitioner tested a proprietary compound developed by Amoco Chemical Corporation to prevent coke formation by twice pretreating cracking coils. *Id.* at 40a-44a. It then ran the production facility normally, yielded a normal amount of olefins, and sold the materials in the normal course of its business. *Id.* at 42a.

Petitioner also tested a catalyst, UCAT-J, to produce polyethylene resin. UCAT-J was four times more “active” than petitioner’s long-standing M-1 catalyst, meaning that the same amount of UCAT-J could produce four times the amount of resin, and it required smaller quantities of other ingredients in the production process.

Pet. App. 75a-76a. Petitioner conducted 19 production runs using UCAT-J during the relevant time frame and used the resulting resin to fulfill existing customer orders. *Id.* at 82a, 84a, 86a. In the course of these runs, petitioner encountered operating problems that required reactor shutdowns and/or produced off-grade resin. Petitioner had experienced the same issues with M-1, however, and it sold all “aim-grade” resin and apparently all off-grade resin produced with UCAT-J. *Id.* at 72a-73a, 84a.

3. On its income tax returns for the tax years at issue, petitioner claimed research credits based on the cost of research conducted at its laboratories and pilot-plants and on wages paid to its research and development scientists and engineers for research conducted at the manufacturing plants. Pet. App. 262a. With respect to the production costs at issue here, however, petitioner did not claim the research credit on its tax returns. See *id.* at 260a. Instead, petitioner filed a petition with the Tax Court in which it claimed additional research credits based on those normal production costs—*i.e.*, the cost of supplies used to produce goods for sale and the wages paid to the plant operators—on the theory that normal operations were necessary to conduct research at the manufacturing-plant level. *Id.* at 31a; see *id.* at 260a (Tax Court’s observation that “the fact that petitioner first sought the research credit for the claimed costs in its [Tax Court] petition is strong evidence that petitioner did not view these costs as research costs and that [petitioner] would have incurred these costs without the incentive of the research credit”). Petitioner did not include these production costs in its research and development budget, see *id.* at 112a, nor did it include them as research and development costs for financial account-

ing purposes in its annual reports, see C.A. J.A. A209 para. 1085, A245 para. 2854.

Petitioner nonetheless identified in its Tax Court petition 106 projects conducted at its manufacturing plants that it claimed met the requirements of the research tax credit. Pet. App. 31a. The parties agreed to try five of the largest projects as a representative sample. *Ibid.*

4. The Tax Court disallowed nearly all of the claimed qualified research expenses. Of the five projects at issue, the court found that only the Amoco anti-coking project and the UCAT-J project constituted qualified research. Pet. App. 255a. The court also found, however, that petitioner was not entitled to treat its normal production costs in those areas as qualified research expenses. *Id.* at 257a-258a.

In particular, petitioner contended that the costs of supplies for production were qualified research expenses under 26 U.S.C. 41(b)(2)(A)(ii), on the theory that the supplies were “used in the conduct of qualified research.” Pet. App. 255a. The Tax Court rejected that argument, explaining that petitioner’s interpretation of the statute would inappropriately extend the definition of qualified research expenses to include “amounts incurred during the production process * * *, not during the conduct of qualified research itself.” *Id.* at 256a. “Here,” the court observed, “the disputed supplies were raw materials used in the commercial production and sale of finished products. They were used to make products for sale, not for experimentation.” *Ibid.*

Similarly, the Tax Court found that petitioner’s claimed wage expenses from the UCAT-J project were not qualified research expenses. It explained that “[s]ervices performed by employees for activities that would occur regardless of whether the taxpayer was

engaged in qualified research are not qualified services.” Pet. App. 257a. Accordingly, the court held that petitioner could not claim the research credit for wages paid to plant operators during the UCAT-J runs. *Id.* at 263a-264a.

5. The court of appeals affirmed. Pet. App. 1a-12a. Like the Tax Court, the court of appeals rejected petitioner’s “plain language” reading of 26 U.S.C. 41(b)(2)(A)(ii), *i.e.*, that petitioner could claim the credit for any supplies “used” in the ordinary production of goods for sale, so long as that production was the subject of research. The court explained that, “[w]hile [petitioner] chooses to focus on the word ‘used’ in isolation,” the court would instead “look to the meaning of the phrase as a whole.” Pet. App. 7a. In the court’s view, “[t]he critical part of [the statutory] phrase is ‘*in the conduct of qualified research*,’ which specifies the type of use creditable supply costs may be put towards.” *Ibid.* (emphasis by court of appeals). “At first blush,” the court explained, “this suggests that the statute only covers costs for supplies purchased for the purpose of conducting qualified research.” *Ibid.*

The court of appeals also agreed with the Tax Court that the costs for which petitioner sought a research credit were “at best, indirect research costs excluded from the definition of [qualified research expenses] under section 1.41-2(b)(2) [of the Treasury Regulations].” Pet. App. 8a (quoting *id.* at 256a) (alterations in court of appeals’ decision). The court stated that the regulation does not clearly identify the standard used to distinguish for this purpose between direct and indirect research expenses. *Id.* at 8a-9a. The court observed, however, that the government’s brief had argued that “[s]upply costs are ‘indirect research expenditures’ if

they would have been incurred regardless of any research activities.” *Id.* at 9a (brackets in original).

The court of appeals noted that courts “ordinarily give deference to an agency’s interpretation of its own ambiguous regulations, even if that interpretation appears in a legal brief.” Pet. App. 9a (citing *Auer v. Robbins*, 519 U.S. 452, 461-462 (1997)). The court concluded that the Commissioner’s interpretation of the Treasury regulation was “entirely consistent with the purpose of the research tax credit, which is to provide a credit for the cost that a taxpayer incurs in conducting qualified research that he would not otherwise incur.” *Ibid.*; see *id.* at 10a (“[T]he Commissioner reached a result that is rational, prudent, and consistent with the legislative history and congressional purpose.”). The court further explained that petitioner’s contrary interpretation, which would “[a]fford[] a credit for the costs of supplies that the taxpayer would have incurred regardless of any qualified research it was conducting,” would “simply create[] an unintended windfall” for the taxpayer. *Ibid.*

ARGUMENT

Petitioner contends that it should be able to claim the research tax credit for the ordinary supply costs that it would have incurred even if it had performed no research. The court of appeals correctly rejected that argument, and petitioner cites no other court of appeals decision that has addressed the application of the tax credit to expenses like those at issue here. Petitioner further contends that the court of appeals should not have deferred to the Commissioner’s interpretation of the applicable Treasury regulation because the government is “financially interested” in this case. Pet. i. Petitioner did not raise that argument in the court below, however, and it cites no case in which any court has

adopted that exception to usual deference principles. In any event, there is no reason to suppose that the court of appeals would have reached a different outcome if it had construed the pertinent regulation de novo. Further review is not warranted.

1. Like a tax deduction, a tax credit “is a matter of legislative grace,” and “the burden of clearly showing the right to the claimed [credit] is on the taxpayer.” *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943)); see Tax Ct. R. 142(a)(1). The court of appeals correctly held that petitioner had failed to carry that burden.

a. Petitioner argued in the court of appeals that all of its ordinary production supplies were “used” in research, and thus eligible for the tax credit, so long as research was conducted during the production process. Pet. App. 5a-6a. The court explained, however, that “[w]hile [petitioner] chooses to focus on the word ‘used’ in isolation,” it is necessary to “look to the meaning of the phrase as a whole,” including in “critical part * * * ‘in the conduct of qualified research,’ which specifies the type of use creditable supply costs may be put towards.” *Id.* at 7a (quoting 26 U.S.C. 41(b)) (emphasis by court of appeals). The court noted as well that the title of Section 41 (“Credit for increasing research activities”) confirms that the credit is “for increasing research activities,” not for the production of goods for sale. *Id.* at 7a-8a (quoting 26 U.S.C. 41 (2006 & Supp. IV 2010)). The court of appeals also pointed to the “[s]pecial rule” under 26 U.S.C. 41(d)(2)(C), which requires taxpayers to treat a plant process for commercial production as a distinct business component separate from the product being produced. Pet. App. 8a. The court quoted with

apparent approval the Tax Court’s conclusion that “Congress did not intend for all of the activities that were associated with the production process to be eligible for the research credit if the taxpayer was performing research only with respect to the process, not the product.” *Ibid.* (quoting *id.* at 256a).

The court of appeals agreed with the Tax Court that the costs for which petitioner seeks a research credit are “at best” indirect research expenses excluded from the definition of qualified research expenses under Treasury Regulation 1.41-2(b)(1). See Pet. App. 8a. The court explained that the Commissioner’s interpretation of that regulation—under which “[s]upply costs are ‘indirect research expenditures’ [and thus not eligible for the research tax credit] if they would have been incurred regardless of any research activities”—was “entirely consistent with the purpose of the research tax credit.” *Id.* at 9a. The court further explained that, given Congress’s intent to encourage outlays for qualified research, affording a credit for the cost of supplies that the taxpayer would have incurred regardless of any qualified research would generate a “windfall” that Congress did not intend. *Id.* at 10a.

b. Petitioner does not contend that the court of appeals’ interpretation of Section 41 or the applicable Treasury regulation conflicts with that of any other circuit. Indeed, this appears to be the first case since the enactment of the research credit in 1981 that has presented the question of what supply costs are eligible for the credit when a taxpayer simultaneously performs research on a production process and produces products for sale in the ordinary course of its business. In the absence of a conflict in the circuits, there is no reason

for this Court to address the application of the research tax credit to these circumstances.

2. Petitioner contends that the court of appeals should not have deferred to the Commissioner's interpretation of Treasury Regulation 1.41-2(b)(1) because the government "advanced that position as a financially interested party." Pet i. For several independent reasons, that argument likewise does not warrant this Court's review.

a. Petitioner did not raise its current objection to deference in the court of appeals, and the court therefore did not address the argument. The government's brief in the Second Circuit did not argue that the interpretation of the Treasury regulation reflected in that brief was entitled to *Auer* deference. In its reply brief, petitioner argued that the government had thereby waived any claim to deference, but petitioner did not contend that the government's financial interest in the case rendered deference inappropriate. "It is only in exceptional cases coming here from the federal courts that questions not pressed or passed upon below are reviewed," *Youakim v. Miller*, 425 U.S. 231, 234 (1976) (per curiam) (quoting *Duignan v. United States*, 274 U.S. 195, 200 (1927)), and petitioner makes no showing that this case is exceptional.

b. Petitioner does not contend that any court of appeals has adopted its position that an agency interpretation of its own regulation is not entitled to judicial deference if the government is a "financially interested party" in the case before the court. Pet i. Indeed, petitioner does not assert that any court of appeals has expressly addressed that question.

c. The court of appeals' invocation of *Auer* deference, see Pet. App. 9a, does not appear to have been neces-

sary to the court's decision. Before considering the regulation, the court suggested that petitioner's contention was inconsistent with the statute, based on the court's analysis of the relevant provision "as a whole," its statutory title, and the statutorily required division between the production process and the product. See *id.* at 7a-8a. As a straightforward matter of statutory construction, the court of appeals thus concluded that "Congress did not intend for all of the activities that were associated with the production process to be eligible for the research credit if the taxpayer was performing research only with respect to the process, not the product." *Id.* at 8a (quoting *id.* at 256a).

Turning to the regulation, the court of appeals stated that the rule did not "clear[ly]" "distinguish[]" between direct and indirect research expenses." Pet. App. 9a. The court then stated that the Commissioner's resolution of that interpretive question was entitled to deference, see *ibid.*, but the court's subsequent analysis indicates that the court found the Commissioner's interpretation to be superior to petitioner's. The court stated that the Commissioner's interpretation was "entirely consistent with the purpose of the research tax credit" and was supported by the legislative history. *Id.* at 9a-10a. Indeed, the court observed that petitioner's contrary interpretation would create "an unintended windfall." *Id.* at 10a. There is consequently no reason to suppose that the court of appeals would have adopted petitioner's interpretation of the regulation if it had construed the rule de novo.

d. Petitioner is wrong in arguing that deference to an agency's interpretation of its own rule is inappropriate when the government has a financial interest in the outcome of the case. As a general matter, this Court has

long deferred to an agency's interpretation of its own regulations. In *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410 (1945) (*Seminole Rock*), for example, the Court stated that "a court must necessarily look to the administrative construction of the regulation if the meaning of the words used is in doubt," and that the administrative interpretation has "controlling weight unless it is plainly erroneous or inconsistent with the regulation." *Id.* at 413-414. In *Auer v. Robbins*, 519 U.S. 452 (1997), the Court reaffirmed that approach, even when the agency's interpretation came "in the form of a legal brief," provided there is "no reason to suspect that the interpretation does not reflect the agency's fair and considered judgment on the matter in question." *Id.* at 462. The Court has noted that such "deference is all the more warranted" when, as in this case, the regulation is part of a complex scheme "in which the identification and classification of relevant 'criteria necessarily require significant expertise and entail the exercise of judgment grounded in policy concerns.'" *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994) (quoting *Pauley v. BethEnergy Mines, Inc.*, 501 U.S. 680, 697 (1991)).

The Court repeatedly has deferred to agencies' interpretations of their own regulations advanced in administrative proceedings and subsequently challenged in federal court. See, e.g., *Thomas Jefferson Univ.*, 512 U.S. at 512-513; *Robertson v. Methow Valley Citizens Council*, 490 U.S. 332, 358-359 (1989); *Northern Ind. Pub. Serv. Co. v. Porter Cnty. Chapter of the Izaak Walton League of Am., Inc.*, 423 U.S. 12, 14-15 (1975) (per curiam). The agency in each of those cases was a party to the suit in which the agency's interpretation was challenged. In *Thomas Jefferson University*, for exam-

ple, the Secretary of Health and Human Services faced a challenge under the Administrative Procedure Act, 5 U.S.C. 551 *et seq.*, to the denial of Medicare reimbursement claims based on the Secretary's interpretation of her own regulation. The Court concluded that "the Secretary's construction is, at the very least, a reasonable one, and we are required to afford it 'controlling weight.'" *Thomas Jefferson Univ.*, 512 U.S. at 515 (quoting *Seminole Rock*, 325 U.S. at 414). The Court did not afford the Secretary's interpretation any less deference because of her role in the litigation.

There is likewise no support in this Court's precedent for petitioner's argument that an agency's interpretation is not entitled to deference "[w]here an agency is a litigant with a strong financial interest in the outcome." Pet. 24-25. *Thomas Jefferson University*, for example, involved a dispute between a hospital and the Secretary of Health and Human Services over millions of dollars in Medicare reimbursements, see 512 U.S. at 510-511, but the Court nonetheless deferred to the Secretary's interpretation of her regulation, see *id.* at 512-514. The Court has also made clear that the Treasury Department's interpretations of ambiguous tax *statutes* are entitled to deference, see, *e.g.*, *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011), even though those interpretations affect private tax liability (and thus the financial interests of the United States) in the same manner as the regulatory interpretation at issue here.

e. Because petitioner did not claim the research credit for the production costs at issue here on its tax returns (which would have precipitated an administrative disallowance), but instead filed a petition in the Tax Court claiming additional research credits, the agency's

first opportunity to apply its regulation to those production costs came after the litigation had commenced. Petitioner suggests in passing (Pet. 21-22, 23) that deference might be unwarranted here because the relevant agency interpretation was set forth in the government's litigation briefs, rather than announced before the suit began. The pertinent question presented in the petition for a writ of certiorari, however, contains no reference to that distinction, but instead focuses on the government's status as "a financially interested party." Pet. i. Petitioner's failure to claim the research credit for its production costs on its tax returns also suggests that petitioner viewed the agency as unlikely to treat those costs as creditable. See Pet. App. 260a. That inference further undermines petitioner's contention that, if the court of appeals had construed the agency's regulation de novo, it would have treated the research credit as applicable to the costs at issue here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 2013