

Gift basket company ruled engaged in manufacturing eligible for Section 199 deduction

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In brief

The US District Court for the Central District of California recently concluded in *United States v. Dean*, 2013 WL 2255254 (C.D. Cal., May 7, 2013), that the activities of a gift basket company qualified as manufacturing activities eligible for the Section 199 domestic manufacturing deduction. The gift basket company's activities involved purchasing various items — such as chocolates, cookies, candy, cheeses, crackers, wine, and alcohol — from third parties, and combining these items together in gift baskets or towers.

The court concluded that the company's activities were not merely the packaging and repackaging of goods, but changed the form and function of the individual items into a new product with a different demand, namely a gift. Taxpayers that engage in this activity or similar activities — for example, by combining two or more purchased raw materials and using those, and perhaps other raw materials, to form a new item -- should consider the potential impact of this case on eligibility for the Section 199 deduction.

In detail

The taxpayer's activity

In *Dean*, the taxpayer designed, assembled, and sold gift baskets and gift towers through both wholesale and retail channels. The taxpayer would select a basket, determine the contents of the basket, and design a cardboard form or Styrofoam base to be placed inside the basket to keep contents from shifting. The baskets consisted of food items that were purchased in individually wrapped packages or in bulk and then placed into other

packaging, such as a small, colorful box.

Assembly of the basket, which the court described as a "complex production process," involved machines and assembly-line workers who would insert and secure different items into the basket by gluing, stacking, tying, or attaching them to the basket. Once all items were included in the basket, the assembly line workers would encase the basket in shrink wrap and place a bow on the basket if needed. Gift box towers went through a

similar assembly process in which boxes were connected through cardboard tabs or sticky-dot adhesive.

Section 199 requirement

To be eligible for the Section 199 deduction, a taxpayer must derive gross receipts from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that was manufactured, produced, grown, or extracted (MPGE) by the taxpayer in whole or in significant part within the United States. Section 3.04(3)

of Notice 2005-14, the original guidance issued by the IRS and Treasury under Section 199, states that “the IRS and Treasury believe that Congress intended for the deduction under section 199 to be available to taxpayers for a wide variety of production activities,” and therefore “defines MPGE broadly.”

Consistent with this belief, MPGE is defined broadly in Reg. sec. 1.199-3(e)(1) to include manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article; or by combining or assembling two or more articles.

However, the Section 199 regulations provide that if a taxpayer packages, repackages, labels, or performs minor assembly of QPP, and the taxpayer engages in no other MPGE activity with respect to that QPP, then the taxpayer’s activities do not qualify as MPGE with respect to that QPP.

District court analysis

The taxpayer argued that it was eligible for the Section 199 deduction because it MPGE the gift baskets and gift towers. The government contended that the taxpayer’s activities merely consisted of packaging and repackaging the items in gifts baskets and gift towers and therefore did not qualify as MPGE activities.

In its analysis, the court first noted that the taxpayer’s activities could fall within the dictionary terms of manufacturing, production, packaging, or repackaging. In finding that the taxpayer “changed the form of an article,” the court concluded that the taxpayer’s production process created gift baskets and gift towers

that were “distinct in form and purpose from the individual items.” According to the court, the taxpayer’s activities “transformed into a gift” individual items that typically would have been purchased by consumers as ordinary groceries.

As part of its analysis, the court examined Example 6 of Reg. sec. 1.199-3(e)(5), describing the activities of a company that purchases automobiles from an unrelated person and customizes them by adding ground effects, spoilers, custom wheels, specialized paint and decals, sunroofs, roof racks, and similar accessories that the company does not manufacture. The regulation views them as minor assembly activities that do not meet the definition of MPGE.

In the court’s view, Example 6 illustrates a situation in which the form or function of an item (an automobile) was not changed by the company’s customization activities. By contrast, the court concluded the gift basket activities did change the actual form and function of the individual items. In rejecting the government’s assertion that the taxpayer merely performed a service—packaging and repackaging—that added value to the final product, the court analogized the taxpayer’s production process to the activities of an automobile manufacturer that purchased various automobile parts from suppliers—such as the frame, engine, wheels, etc.—and assembled them to create the car itself.

Conclusion

The court’s decision in *Dean* is consistent with the broad definition of MPGE in the Section 199 regulations. Prior to *Dean*, the IRS National Office had issued CCA 201246030, in which the IRS concluded that the exclusion from the Section 199 deduction for repackaging and labeling activities did not apply to a taxpayer that

repackaged and labelled pills that it did not manufacture, because the taxpayer engaged in MPGE activities to create the packaging. *Dean* further clarifies whether a taxpayer’s activities rise to the level of an eligible MPGE activity or instead are packaging, repackaging, labeling, or minor assembly that is ineligible for Section 199.

Based on this case and the CCA, the determination of whether a packaging activity constitutes MPGE requires an analysis of the extent and types of activities performed by the taxpayer. If a taxpayer’s activities combine two or more articles and change the form and function of an item and result in a new product with a different demand, then those activities would appear to satisfy the MPGE definition in Reg. sec. 1.199-3(e)(1).

The takeaway

The issues addressed by *Dean* affect any taxpayer that may conduct similar business activities, for example, by combining two or more purchased raw materials and using those, and perhaps other raw materials, to form a new item. For those taxpayers, *Dean* provides insight into how a court might analyze particular business activities for Section 199 eligibility. Taxpayers should assess whether their business activities meet the criteria of MPGE as defined in Reg. sec. 1.199-3(e)(1) in light of the new guidance provided by the district court in *Dean*.

Let's talk

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