WNTS Insight

A Washington National Tax Services (WNTS) Publication

November 29, 2012

IRS examines whether manufacture of packaging qualifies for section 199 deduction

In brief

In a recently released legal memorandum (CCA 201246030), the IRS Office of Chief Counsel concluded that the exclusion from the section 199 domestic manufacturing deduction for repackaging and labelling activities does not apply to a taxpayer that repackages and labels pills that it did not manufacture because the taxpayer engaged in other eligible manufacturing, production, growing, or extraction (MPGE) activities by virtue of its manufacture of the blister packs containing the pills.

This CCA clarifies that the application of the exclusion does not apply to a taxpayer that performs MPGE activities other than packaging and labelling. The CCA should have equal applicability outside the facts of the CCA to any taxpayer that, in addition to repackaging or labelling property, performs other eligible MPGE activities.

Background

Section 199 provides a deduction for domestic production equal to nine percent of the lesser of (1) qualified production activities income (QPAI) of the taxpayer for the tax year or (2) taxable income (determined without regard to the section 199 deduction) for the tax year. Under section 199(c)(1), QPAI equals domestic production gross receipts (DPGR) less the sum of the cost of goods sold (CGS) and other expenses, losses, and deductions properly allocable to DPGR.

The term DPGR for purposes of section 199 includes gross receipts of the taxpayer derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) that was MPGE by the taxpayer in whole or in significant part within the United States. However, Reg. sec. 1.199-3(e)(2) provides

that if a taxpayer packages, repackages, labels, or performs minor assembly of QPP and engages in no other MPGE activity with respect to that QPP, then the taxpayer's packaging, labelling, or minor assembly does not qualify as an MPGE activity with respect to that QPP (the Repackaging Rule).

Reg. sec. 1.199-3(g)(2) provides that QPP will be treated as MPGE in whole or in significant part by the taxpayer within the United States for purposes of Reg. sec. 1.199-3(g)(1) if the MPGE of the QPP by the taxpayer within the United States is substantial in nature, taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States.

Alternatively, Reg. sec. 1.199-3(g)(3)(i) provides that a taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States if, in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States either (1) account for 20 percent or more of the taxpayer's CGS of the QPP or, (2) in a transaction without CGS (for example, a lease, rental, or license), account for 20 percent or more of the taxpayer's unadjusted depreciable basis in the QPP.

A taxpayer applying section 199 must determine whether the gross receipts derived from the property that it offers in the normal course of its business for sale to customers are DPGR. That is, the taxpayer must determine whether the item it offers for sale satisfies all the requirements of section 199, including whether the property was MPGE by the taxpayer in whole in significant part within the United States. In contrast, if the gross receipts of the property offered by the taxpayer for sale does not qualify as DPGR, then under Reg. sec. 1.199-3(d)(1)(ii) any component of the property is treated as the item, provided that the gross receipts from the disposition of such component property qualify as DPGR (the Shrinkback Rule).

New CCA

Taxpayer's activities

The taxpayer provides pharmaceutical products (pills) to nursing homes, assisted living facilities, and other healthcare facilities. The taxpayer does not MPGE the pills. Instead, the taxpayer purchases the pills in bulk and places the pills into blister packs that the taxpayer manufactures entirely in the United States before selling them to healthcare facilities. The pills are not changed during this process and retain the same form and pharmaceutical characteristics they had prior to the blister pack packaging.

Repackaging Rule

The IRS examined whether the taxpayer's activities -- manufacturing the blister packs --constituted an MPGE activity or whether such activities did not qualify as an MPGE activity under the Repackaging Rule.

The IRS concluded that the Repackaging Rule does not apply to the taxpayer's activities. Although the IRS acknowledged that the taxpayer did not manufacture the pills that were repackaged into the blister packs, the IRS determined that the taxpayer engaged in the MPGE of QPP when it produced the blister packs. The IRS further indicated that if the taxpayer did not MPGE the blister packs, but only repackaged and labelled pills into blister packs manufactured by a third party, then the Repackaging Rule would apply, and no portion of the gross receipts from the sale

of the blister packs would be DPGR. However, the IRS concluded that the Repackaging Rule did not apply in this case because the taxpayer engaged in other MPGE activities with respect to the QPP by manufacturing the blister packs.

Shrinkback Rule

In addition, the IRS stated that to the extent the taxpayer's gross receipts from the sale of the blister packs containing the pills were non-DPGR because the taxpayer did not manufacture the blister packs containing the pills in whole or in significant part, the taxpayer could apply the Shrinkback Rule to determine whether any gross receipts derived from the sale of any component of the property (e.g., the blister packs without the pills) qualify as DPGR.

Therefore, according to the IRS, to the extent the taxpayer met the section 199 requirements with respect to the blister packs, under the Shrinkback Rule the gross receipts derived from the sale of the blister packs should qualify as DPGR. The taxpayer could then allocate the gross receipts attributable to blister packs for purposes of determining the taxpayer's total DPGR, but any gross receipts attributable to the pills without the blister packs (i.e., a nonqualifying component) would be non-DPGR.

"In whole or in significant part" requirement

Even though advice was not sought from the IRS National Office on the application of the "in whole or in significant part" requirement of section 199 to the taxpayer's finished blister packs inclusive of the pills, the National Office nonetheless provided some additional comments on how that requirement may apply to the taxpayer's facts.

The IRS noted that none of the taxpayer's activities resulted in a change to the pills. Accordingly, the IRS stated that to the extent that the pills are part of the value to the property offered for sale, the activities that produced the pills, and value that the pills contribute, would weigh against treating the taxpayer as having MPGE the blister pack containing the pills in whole or in significant part.

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