

Publisher's pre-production development activities held not Section 199 manufacturing activities

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In brief

In a recently released Chief Counsel Advice that was issued in response to an IRS Appeals Division (Appeals) request, the IRS concluded that planning and development activities undertaken by a publisher of books and other printed materials (collectively, books) did not constitute a qualifying manufacture, production, growth, or extraction (MPGE) activity for purposes of the Section 199 deduction. Taxpayers that engage in such activities, and rely on such activities to qualify for Section 199 purposes the gross receipts derived from the disposition of their books, should consider the potential impact of this CCA.

In detail

According to the CCA, the publisher performed market research, resource planning, content and layout development, and editing activities that facilitated the creation of an electronic version of a book. The publisher also developed print specifications, including paper type, page size, printing process, ink type, and binding.

To mass-produce its books, the publisher provided a contract manufacturer with the electronic version of the book and its print specifications. The contract manufacturer used its own employees, machinery, and plant to print and assemble the books. The contract

manufacturer would either ship the books directly to customers or ship them to the publisher for packaging and distribution.

The publisher claimed that its activities -- including design, development, creation, content and layout development, materials analysis and selection, editing, and packaging of its books -- qualified under Section 199. Appeals asked the IRS National Office whether those activities are MPGE activities for Section 199 purposes.

Observation: The CCA noted that the taxpayer also claimed to have the benefits and burdens of ownership under Federal income tax principles of the mass-produced books during the period the contract

manufacturer's printing activities took place. In considering the publisher's activities, the CCA did not attribute any of the contract manufacturer's activities to the taxpayer. At the request of Appeals, the IRS National Office did not address in the CCA the benefits and burdens of ownership issue, i.e., whether the publisher or the contract manufacturer had the benefits and burdens of ownership during the contractor's printing process.

Publisher's activities were not MPGE activities

The IRS concluded in the CCA that the publisher's activities related to the production of an

electronic version of a book and thus did not result in qualifying production property (QPP). According to the IRS, an electronic book is not considered tangible personal property under Section 199 and does not fall within the types of qualifying intangible property. Because the publisher's activities created non-qualifying intangible assets and not QPP, the IRS concluded that the publisher's activities were not considered MPGE activities. The IRS also questioned how the publisher's pre-production activities could be considered MPGE because no QPP existed before the contract manufacturer manufactures the books.

The IRS analyzed Example 5 of Reg. sec. 1.199-3(e)(5), which illustrates how a taxpayer's non-MPGE activities may be treated as part of the MPGE of QPP if the taxpayer also MPGEs the QPP. The CCA stated that the contract manufacturer's activities were the activities that constituted the MPGE of QPP; the publisher's activities were not treated as part of the MPGE of QPP because it was the contract manufacturer that manufactures the QPP, not the publisher.

Observation: The Section 199 regulations require that domestic production gross receipts (DPGR) be determined on an item-by-item basis. The term 'item' means the property offered for sale in the normal course of the taxpayer's business, if the gross receipts from the disposition of such property qualify as DPGR. Here the item that was offered for sale by the publisher was the finished book and not an electronic book. Accordingly, it is unclear why the IRS concluded that the taxpayer's activities gave rise to intangible property, i.e., an electronic book, when the taxpayer did not offer an electronic book for sale in the normal course of its business. Rather, the taxpayer offered tangible books for sale, which are QPP.

Observation: In applying Example 5 to the facts in the CCA, the IRS stated that its conclusion that the publisher's activities were non-MPGE activities would change if the publisher was determined to have the benefits and burdens of ownership of the books under Federal income tax principles during the period in which the contractor manufacturer mass-produced the books. That is, if the publisher has the benefits and burdens of ownership during the period in which the contractor manufacturer printed the books, the IRS would conclude that the publisher's activities would be MPGE activities.

Section 263A consistency requirement

The Section 199 regulations provide that, in general, a taxpayer that MPGEs QPP for the tax year should treat itself as a producer under Section 263A (the consistency requirement). The publisher in the CCA appeared to rely on the consistency requirement in asserting that because it was treated as a manufacturer under Section 263A, it should be treated as a manufacturer for purposes of Section 199. The IRS stated that in some cases a taxpayer treated as a producer under Section 263A should not be considered a manufacturer for purposes of Section 199, and that the consistency requirement should not be read to require that a taxpayer that is a producer under Section 263A also is a producer for Section 199 purposes in all cases.

The IRS stated that Section 199 and Section 263A are not consistent in the treatment of the production of books. Under Section 263A, the costs of the publisher's activities that create the intangible aspects of a book are included as costs related to the production of tangible personal

property. Section 199, however, treats the manuscript and electronic version of a book as intangible property, with the result that the activities that create the intangibles are treated as the production of non-qualifying intangible property. The IRS concluded in the CCA that the publisher may be treated as a producer of tangible personal property under Section 263A, but as a producer of non-qualifying intangible property under Section 199.

The CCA noted that Congress did not provide that the production of a manuscript or electronic book is a qualifying activity under Section 199. The CCA suggested that if the publisher's activities did qualify, then they would be treated similar to costs of producing films and would not be treated as the production of tangible personal property as allowed under Section 263A. The CCA therefore concluded that the rules under Section 263A with respect to books are not applicable for purposes of Section 199.

Observations: Notice 2005-14, the first published guidance under Section 199, defined MPGE broadly to generally include all the activities specifically listed in Sections 263A and 48. Because the Section 199 definition is based on Section 263A, it is apparent why the publisher argued that it should be treated as a manufacturer for Section 199 purposes if its activities were production activities for Section 263A purposes.

The IRS cited *Suzy's Zoo vs. Commissioner*, 114 T.C. 1 (2000), aff'd, 273 F.3d 875 (9th Cir. 2001), as support for its position that the publisher's activities were not MPGE activities for Section 199 purposes. In *Suzy's Zoo*, the IRS successfully argued that the taxpayer at issue, who developed greeting cards but contracted out for the printing of such

cards, was a producer for Section 263A purposes. Because the taxpayer in *Suzy's Zoo* was a producer for Section 263A purposes, and that standard is the origin of the definition of MPGE, it would appear that such a taxpayer should equally be a producer for Section 199 purposes. However, the IRS stated in the CCA its belief that there are cases in which a taxpayer is treated as a producer for purposes of Section 263A and should not be considered a manufacturer for purposes of Section 199.

Other issues

The CCA also addressed IRS Exam's position that a taxpayer must show that it applied some type of physical force to property for the taxpayer to MPGE tangible personal property. Noting that the term 'physical force' has not been defined or established as a standard to determine whether an activity is an MPGE activity, the IRS National Office declined to state that

the MPGE of tangible personal property categorically involves the use of physical force.

Finally, the IRS concluded that activities relating to the development of print specifications were non-MPGE activities because they did not produce QPP. In addition, because the publisher did not engage in any other MPGE activity with respect to the QPP, the IRS determined that any packaging activities would not qualify as MPGE activities.

The takeaway

The issues addressed by the CCA affect any taxpayer that sells printed materials and uses third-party printers to perform the printing activities.

The issues raised in the CCA, and the arguments made by the IRS National Office in the CCA, are similar to arguments the IRS has made in *Advo*,

Inc. & Subsidiaries vs. Commissioner, Docket No. 17247-10, pending before the US Tax Court. According to the Tax Court filings in that case, *Advo, Inc.* is a direct-mail media company that is engaged in soliciting and processing advertising from retailers, manufacturers, and service companies for targeted distribution to consumer households and that uses third-party printers to print its advertisements. The Tax Court case deals with issues similar to those raised in the CCA, e.g., whether *Advo's* activities prior to the third-party printing activities are MPGE activities for Section 199 purposes, as well as what factors are taken into account in determining whether *Advo* or its third-party printers have the benefits and burdens of ownership during the printing process. A decision in *Advo* is expected from the Tax Court in the coming months.

Let's talk

For a deeper discussion, please contact:

George Manousos, *Washington D.C.*
(202) 414-4317
george.manousos@us.pwc.com

Joseph Maselli, *New York*
(646) 471-5156
joseph.f.maselli@us.pwc.com

Wayne Robinson, *New York*
(646) 471-1010
wayne.robinson@us.pwc.com

Colleen Green, *Washington D.C.*
(202) 414-1382
colleen.m.green@us.pwc.com