

In A New Bottle: Repackaging, Manufacturing and Qualified Production Activities.

Section 199 of the Internal Revenue Code provides a deduction for domestic production activities. I.R.C. § 199. The deduction provides an incentive to undertake certain types of business activities within the United States, such as manufacturing and film production.

A key metric for the deduction is “qualified production activities income,” which represents the taxpayer’s “domestic production gross receipts” less cost of goods sold and other related expenses. I.R.C. § 199(c)(1). “Domestic production gross receipts,” in turn, are defined to include transactions involving “qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.” I.R.C. § 199(c)(4)(A)(i)(I). A recent case dealt with the scope of the term “manufacturing” in Section 199. *United States v. Dean*, 2013 U.S. Dist. LEXIS 65357 (C.D. Cal. May 7, 2013).

The taxpayers in *Dean* were owners of an S corporation that was in the gift basket business. 2013 U.S. Dist. LEXIS 65357, slip op. at *2-*4. The gift baskets were put together from a variety of food items in particular configurations, and the basket was then covered in shrink-wrap when completed. *Id.* at *5-*6. The taxpayers filed amended returns for 2005 and 2006, claiming a deduction under Section 199 and receiving substantial refunds.

Subsequently, the government filed suit under Section 7405 of the Code, which authorizes an action for an “erroneous refund.” The government’s theory was that the taxpayers were not entitled to a deduction under Section 199 because they were not involved in manufacturing. Instead, the government argued that the taxpayers’ company was simply repackaging goods.

This theory had some teeth to it: a Treasury Regulation promulgated to explain when property was manufactured within the meaning of Section 199 specifically provided that a “taxpayer’s packaging, repackaging, labeling, or minor assembly does not qualify” unless the taxpayer also engaged in related manufacturing or similar activity. Treas. Reg. § 1.199-3(e)(2).

On the merits, the government lost. The Court was persuaded that the gift baskets that the company produced were “distinct in form and purpose from the individual items inside.” *Dean*, 2013 U.S. Dist. LEXIS 65357, slip op. at *20. In the Court’s view, the company’s production process took ordinary grocery items and transformed them into a gift. *Id.* This is a good result for the taxpayer, but I would expect the government to take an appeal.

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