

Benefits + Burdens = Deduction; Contract Manufacturing and the Domestic Production Deduction.

Section 199 of the Internal Revenue Code provides a deduction that is available to those engaged in certain business activities within the United States, including manufacturing and extracting oil and gas. With certain exceptions, only one taxpayer can claim the deduction. Treas. Reg. 1.199-3(f)(1). For industries in which contract manufacturing is common, this raises the question of which entity is the “manufacturer” entitled to the deduction. The Tax Court addressed this recently in *ADVO, Inc. v. Commissioner*, 2013 U.S. Tax Ct. LEXIS 29 (Oct. 24, 2013).

ADVO is a “direct mail advertiser.” In ordinary English, they generate junk mail. Clients contract with ADVO for advertisements, and it creates advertisements on their behalf. Once the advertisement is approved by the client, it is transferred to one of ADVO’s contract printers in a .pdf format. 2013 U.S. Tax Ct. LEXIS 29, slip op. at *8-*11. The final .pdf file includes the separated printing process colors. *Id.* at*11.

ADVO directed that its contract printers use specified paper that it sourced through a broker, but the printers ordered the paper directly from the broker and it was delivered to them, not ADVO. ADVO only paid for the paper when it paid the printer’s invoice and it did not guarantee that it would cover the cost of it if a purchaser defaulted. *Id.* at*11-*12.

Under its contracts with the printers, ADVO did not assume the risk of loss over the printed advertisement until delivery, and the printers maintained ownership of the film, plates and other materials used in production. *Id.* at*13. Once the printing process was complete, the printer cut or folded the finished mailers and then bundled them for shipment to ADVO. *Id.* at*18. When ADVO received the finished materials it assembled them into shared mail packages and sent them out. *Id.* at*18.

ADVO had sought a deduction based upon its gross receipts relating to direct mail advertising and distribution, and the government countered that it did not qualify for the deduction because it had contracted out its manufacturing.

The Tax Court commenced its analysis by examining the definition of manufacturing in the relevant Treasury Regulation, which indicates that the taxpayer must have the “benefits and burdens of ownership” associated with the relevant property during manufacturing to qualify for the deduction. Treas. See Reg. 1.199-3(e)(1).

In resolving the question whether ADVO had the benefits and burdens of ownership at the relevant time, the Tax Court applied a multi-factor test derived from *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981). The factors that the Court considered to be relevant on the facts before it were as follows:

- When ADVO obtained legal title;
- The parties’ intent;
- The extent of ADVO’s control over the printing process;
- The risk of loss or damage during production;
- Profits from the manufacture and sale of the advertising;
- The extent of ADVO’s participation in the manufacturing process.

2013 U.S. Tax Ct. LEXIS 29, slip op. at *56-*66. On the facts, the court concluded that the risk of loss or damage factor was neutral. *Id.* at *62-*65. All of the other factors weighed in favor of the government's position, leading the court to conclude that ADVO did not enjoy the benefits and burdens of ownership when the advertisements were being manufactured. As a consequence it did not qualify for the deduction.

Businesses that contract out all or a portion of their manufacturing may want to re-examine those arrangements to see if they can qualify for a deduction in either their existing form or with adjustments. Having title pass immediately and using cost plus contract arrangements would appear to make the claim to a deduction more viable.

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