

Manufacturing Tax Break Gone Wild

By David Cay Johnston



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A federal judge has held that putting wrapped candy bars and wine bottles into gift baskets qualifies for a 2004 tax break for manufacturing. Johnston argues that the decision is too broad an interpretation of manufacturing for the purposes of the section 199 deduction.

Putting wrapped candy bars and wine bottles into gift baskets constitutes manufacturing and qualifies for a reduced corporate income tax rate, a federal district court judge has held in what he called a case of first impression.¹

While the 20-page opinion dismissing an IRS lawsuit seeking to recover \$326,000 of refunds and interest has no precedential value, it is sure to be cited by any company seeking the section 199 deduction. The IRS's recovery action was dismissed in May, and it did not appeal. The judgment was entered July 23. Kenneth Silverberg, a tax partner in Nixon Peabody's Washington office who represented the plaintiffs, said neither he nor the three clients would comment. The case was first reported in a post at *OC Weekly*, an alternative online newspaper.²

Making hamburgers would qualify for a lowered tax rate on "manufacturing, production, growth or extraction" profits in section 199, under the reasoning applied by Judge James V. Selna. He held that arranging candy bars, wrapped cheese, wine

bottles, and other items "creates a new product with a different demand" than grocery items have individually.

The IRS sued Timothy J. Dean and his wife, Michelle, who own 75 percent of the gift basket company Houdini Inc., and their minority partner, John K. O'Brien. The Deans filed amended returns for 2005 and 2006, and O'Brien filed an amended 2006 return claiming the section 199 tax deduction, which was 3 percent then and is now 9 percent. This year the deduction lowers the corporate income tax rate from 35 percent to 31.85 percent.

Section 199 created a "domestic manufacturing deduction" that, as Ernst & Young put it in a letter to Treasury, was "intended to be a measure of income derived from the conduct of manufacturing in the U.S." Uncertainty about what constitutes manufacturing was a potential problem cited in the president's economic report for 2004. N. Gregory Mankiw, the Harvard economist who was then President George W. Bush's chief economist,³ thought the issue of "blurry" definitions of manufacturing so significant that he gave it a full page, with a box around it:

When a fast-food restaurant sells a hamburger, for example, is it providing a "service" or is it combining inputs to "manufacture" a product?

Suppose it was decided to offer tax relief to manufacturing firms. Because the manufacturing category is not well defined, firms would have an incentive to characterize themselves as in manufacturing. Administering the tax relief could be difficult, and the tax relief may not extend to the firms for which it was enacted.

In *Dean*, Selna agreed with the three taxpayers that the gift baskets qualified for the tax break because their company "changes the form of an article" within the meaning of section 199, producing something that is "distinct in form and purpose from the individual items inside. The individual items would typically be purchased by customers

¹*United States v. Dean*, No. 11-01977 (C.D. Cal. 2013).

²R. Scott Moxley, "Fullerton Gift Basket Business Defeats IRS Lawsuit in Tax Deduction Dispute," *OC Weekly*, July 24, 2013.

³David Cay Johnston, "In the New Economics: Fast-Food Factories?" *The New York Times*, Feb. 20, 2004, available at <http://www.nytimes.com/2004/02/20/business/in-the-new-economics-fast-food-factories.html>.

as ordinary groceries. But they are transformed into a gift that is usually given during the holiday season."

Transformed? Really? I think Selna's analysis is deeply flawed and demonstrates a lack of independent inquiry — not to mention common sense.

Section 199 did not define the words manufacturing, producing, growing, extracting, installing, developing, improving, or creating. And Treasury has not issued regulations defining those terms either, Selna noted. So he turned to a college dictionary, writing that absent a statutory or regulatory definition of terms, the court must give words their "ordinary, contemporary, common meaning." The court then cited the first definition of the verb manufacture: "to make into a product suitable for use." That was more than enough to qualify for the section 199 tax break, Selna wrote.

Selna said considerable weight should be given to Notice 2005-14, 2005-1 C.B. 498, which stated that the IRS "and Treasury believe Congress intended for the deduction under section 199 to be available for a wide variety of production activities." But in a footnote, he said that he ignored an IRS chief counsel legal memorandum (ILM 201246030) that seems precisely on point. The November 2012 memorandum advised that a company that buys pills in bulk and then packages them in blister packs does not qualify for the manufacturing break. Lawyers for that firm should be seeking refunds based on Selna's reasoning.

In a brief for the case, Andrew T. Pribe, an assistant U.S. attorney, agreed that "section 199 provides no definitions for manufactured, produced, grown or extracted." However, qualifying production material is defined, he said. It can be made from "new or raw material by processing, manipulating, refining, or changing the valve in the article, or by somebody assembling two or more articles" under reg. section 1.199-3(e)(1).

The language "or assembling two or more articles" might suggest that putting wrapped foods and wine bottles in gift baskets qualifies, except that the regulations then add a per se rule in reg. section 1.199-3(e)(2). It provides that "if a taxpayer packages, repackages, labels, or performs minor assembly of [qualifying personal property] and the taxpayer engages in no other" manufacturing or production, then "the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify" for the tax break.

That, too, seems quite clear — repackaging is not manufacturing. But then Selna looked closely at Example 6 in the regulations, which says the tax break is not available for a firm that buys automobiles and "customizes them by adding ground effects, spoilers, custom wheels, specialized paint

and decals, sunroofs, roof racks, and similar accessories." That is "minor assembly" that does not qualify for the tax break, the example states. Selna then came up with what strikes me as bizarre reasoning.

Selna wrote that while the custom auto company "does not change the form or function of the car by adding accessories to it, Houdini changes the form and function of the individual items by creating distinct gifts. Furthermore, the court considers Houdini's complex production process as more similar to purchasing various automobile parts from suppliers — such as the frame, engine, wheels, etc. — and assembling them to create the car itself, which is undoubtably manufacturing."

Selna acknowledged that it is a stretch. "Nevertheless, the Court finds that the combination of products to create a new product — a gift — is not defeated by Example 6. In the end, the additions in Example 6 enhance but do not change the nature of the product. By contrast, Houdini creates a new product with a different demand," he said.

Really? Putting a wrapped candy bar in a basket "changes the form and function of the individual items"? Does the candy bar look different, as is the case with a customized automobile? Does it taste different, the way a spoiler or roof rack changes the dynamics of driving, especially at high speeds or in high winds? Indeed, the gift basket company does not even change the appearance of the candy bar wrappers or wine bottle labels, while the car customizing firm's decals and paint designs can radically alter the appearance and value of an automobile.

Further indications that there is no factual basis for Selna's decision come from the deposition of Daniel Maguire, who prepared the tax returns. He testified that "the standard phrase to describe the business is that it designs, assembles, and sells gift baskets to both wholesale and retailer" buyers, including Costco and Sam's Club. Timothy Dean testified that "gift basket is a kind of generic term that we use for anything we're putting into a container."

Selna referred several times to cardboard and Styrofoam inserts used to fill the basket's void, around which the food and wine are placed. When asked about these inserts in the baskets, Dean testified that the company did not manufacture them, although vendors did using Houdini's design.

Government lawyers argued that Houdini's operations are properly considered packaging and repackaging and that they are within the per se rule prohibiting application of the section 199 deduction. The deduction "is for a taxpayer who, in whole

or significant part, manufactures or produces tangible personal property" primarily in the United States, they said.

Selna wrote that "Houdini's Packaging Department takes food items that are in small, food-safe containers and places them in other packaging, such as a small, colorful box. Houdini is not a 'food-safe' facility, which means that it does not handle unwrapped food items; Houdini uses only food items that are already in a sealed container."

Despite that reasoning, Selna concluded that Houdini transformed the product from grocery items to gifts. Had Selna spent a few minutes researching the issue, he might have come across the Census Bureau's North American Industry Classification System, which defines manufacturing enterprises as being "engaged in the mechanical, physical or chemical transformation of materials, substances or components into new products." There is exactly zero "mechanical, physical or chemical transformation of materials" in the assembly of gift baskets, the record shows.

As for Selna's emphasis on the complexity of packing wrapped foods in baskets, consider the complex operations that Census classifies as retail or wholesale trade, but not manufacturing: "customized assembly of computers; sorting scrap; mixing paints to customer order and cutting metals to customer order." Under Selna's specious reasoning, a flower shop that creates bouquets in vases should qualify for the manufacturing tax break because mere flowers "are transformed into a gift that is usually given during the holiday season." Then again, maybe they qualify only if they do so during the holiday season but not for wedding anniversaries, Valentine's Day, and other occasions that are just as extraneous to the tax law as Selna's defective reasoning.

Maybe as a columnist I can claim the section 199 deduction. After all, I just "transformed" the opinion of Selna into a column, which, to cite the judge, is "a new product with a different demand."

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