Skadden

Skadden, Arps, Slate, Meagher & Flom LLP
& Affiliates

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Jody J. Brewster
Washington, D.C.
202.371.7280
jody.brewster@skadden.com

Emily M. Lam
Palo Alto
650.470.4680
emily.lam@skadden.com

Julia M. Kazaks
Palo Alto
650.470.4640
julia.kazaks@skadden.com

Judith A. Mather
Washington, D.C.
202.371.7203
judith.mather@skadden.com

David A. Schneider
Washington, D.C.
202.371.7830
david.schneider@skadden.com

Vikram Agarwal
Washington, D.C.
202.371.7569
vikram.agarwal@skadden.com

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws. Licensed as Foreign Legal Consultants in Ontario. Jurisdiction of primary qualification: New York.

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

November 4, 2013

US Tax Court Issues Key Section 199 Decision for Contract Manufacturing Arrangements

In a case of first impression, the United States Tax Court has applied the Section 199 domestic production rules in a contract manufacturing context. In *Advo, Inc. & Subsidiaries v. Commissioner,* the court rejected the view advocated by many taxpayers that the Section 199 regulations should be read consistently with contract manufacturing cases, including *Suzy's Zoo v. Commissioner,* decided under Section 263A. The *Advo* decision raises the bar for taxpayers who seek to claim Section 199 deductions for costs incurred in contract manufacturing arrangements. The court, however, also offered encouraging support for the announced administrative practice of the IRS's Large Business & International Division (LB&I) to accept taxpayers' certified allocations of the Section 199 deduction, which would avoid many factually intensive inquiries.

Section 199 permits an annual deduction of 9 percent of the taxpayer's net income from certain U.S. manufacturing activity. In contract manufacturing arrangements, Congress specified that only one of the parties — the contracting corporation or the contract manufacturer — will be entitled to the deduction. The relevant Treasury Regulations finalized in 2006 provide that the party with the benefits and burdens of ownership of the property during the production activity is entitled to the deduction.

On October 24, 2013, the Tax Court issued *Advo, Inc. & Subsidiaries v. Commissioner*, 141 T.C. 9 (2013), concerning a direct mail advertiser that contracted out the printing of the ads it delivered for its customers. Advo had substantial involvement with respect to both the content and production of the ads, which unrelated parties printed. Notwithstanding that under those circumstances Advo likely would be considered a producer of the ads under other provisions of the Internal Revenue Code, including the uniform capitalization rules of Section 263A, the court held that the printer, not Advo, was the producer of the property for Section 199 purposes with respect to the activity of printing the ads. The court found that the printer had more of the benefits and burdens of ownership of the direct advertising materials during printing (such as title, control and risk of loss) than did Advo. Therefore, Advo could not claim a Section 199 deduction.

The taxpayer argued that the analysis in *Suzy's Zoo v. Commissioner*, 114 T.C. 1 (2000), should apply. The *Suzy's Zoo* facts were very similar to Advo's, but *Suzy's Zoo* was a Section 263A case. The court explicitly stated that it was giving "deference" to the preamble to the proposed Section 199 regulations stating that the benefits and burdens of ownership standards under Section 263A and Section 199 are different, and therefore case precedent under Section 263A is not determinative for Section 199 purposes. The Tax Court rejected Advo's argument, finding that "although the factors used to determine ownership under section 263A are helpful in determining ownership under section 199, we are not bound in applying section 199 by the holding in *Suzy's Zoo*. ... Congress did not intend for section 199 to be broadly inclusive in determining the owner of property."

As an administrative law sidenote to the Section 199 analysis in *Advo*, this judicial deference to a preamble to proposed regulations is outside the norm. The *Advo* court noted that preambles are not binding, citing other Tax Court authority to that effect, but

nevertheless deemed this preamble to be "an agency's interpretation of its statute" entitled to "at least the lowest level of deference." Observers of the *Advo* litigation should monitor whether the taxpayer challenges this reasoning on eventual appeal.

Despite its ruling for the IRS in the *Advo* litigation, the Tax Court also signaled that many Section 199 issues, which it noted are "factually intensive," should be able to be resolved more harmoniously. Historically, many taxpayers in contract manufacturing situations have faced challenges by the IRS to their claimed Section 199 deductions similar to the challenge faced by Advo. In an effort to reduce these disputes, LB&I issued a directive in 2013 (LB&I-04-0713-0006) effectively permitting the contracting corporation and the contractor to agree as to which of them will take the deduction. If the allocation is properly certified, the directive instructs IRS employees not to challenge the parties' agreement. The Tax Court noted that the directive shows that "in contract manufacturing relationships, each party, as in this case, will often have some of the benefits and burdens of ownership," and that the directive "can resolve in advance cases like this one." This is a notable judicial endorsement of an administrative effort to streamline and minimize disputes while simultaneously protecting the fisc.

The directive, however, is not likely to eliminate all controversy. Where both the contracting corporation and the contractor claim Section 199 deductions for the same property, or where the taxpayer cannot produce the certifications required under the LB&I directive, the "factually intensive" inquiry will proceed. The *Advo* decision is certain to have a significant impact on those cases at both the IRS administrative controversy and judicial stages.