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subject: Application of the Domestic Production Activities Deduction to Repackaging

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

A =

B =

ISSUE

For purposes of the domestic production activities deduction under § 199(a) of the Internal Revenue Code, does the exception for repackaging and labeling activities to the definition of manufactured, produced, grown, or extracted (MPGE) under § 1.199-3(e)(2) apply to Taxpayer's activities if Taxpayer repackages and labels pills it did not

manufacture, but manufactures blister packs and sells the blister packs containing the pills in the normal course of its business to customers?

CONCLUSION

No. The exception for repackaging and labeling activities to the definition of MPGE under § 1.199-3(e)(2) does not apply to Taxpayer's activities because Taxpayer engages in other MPGE activities with respect to the blister packs containing the pills by manufacturing the blister packs.

For Taxpayer's gross receipts from the sale of blister packs containing the pills to qualify as domestic production gross receipts (DPGR), Taxpayer must meet the other requirements of § 199, including the "in whole or in significant part" requirement of § 199(c)(4)(A)(i)(I) and § 1.199-3(g)(1). To the extent the gross receipts do not qualify as DPGR, Taxpayer can apply § 1.199-3(d)(1)(ii) to determine whether the gross receipts from the sale of any component of the property (the blister packs containing the pills) qualify as DPGR.

FACTS

Taxpayer is a provider of pharmaceutical products for seniors in nursing, assisted living, and other similar healthcare facilities. In its A taxable year Taxpayer derived gross receipts from providing medications to healthcare facilities, with payments being made by Medicare, Medicaid, and insurance companies.

The medications at issue are those provided in "blister packs." In its business, Taxpayer purchases medicines (pills) in bulk form and places the pills into blister packs before providing the pills to healthcare facilities. Taxpayer does not MPGE the pills. Healthcare facilities can order pills in blister packs or bottles. Some states require certain healthcare facilities to purchase pills in blister packs.

Blister packs are made of plastic PVC and lidding material (an aluminum moisture barrier). The pills (mostly over-the-counter medicine) are normally purchased in bottles with B pills. The plastic PVC and lidding material are in roll form. The blister pack assembly is subject to various Food and Drug Administration (FDA) safety regulations pertaining to the handling and repacking of drugs. Taxpayer's blister packs are produced entirely within the United States.

The steps of the assembly are generally as follows: Taxpayer removes any stuffing from the bottles and empties the pills from the bottles in accordance with FDA safety standards. The pills are then placed on a blister pack assembly line. The assembly equipment heats the plastic, forms depressions in the plastic creating the "blisters" by using a drug-specific metal mold, places the pills into the blisters, and then seals the lidding material to the blister back. A scannable bar code identifying the type of medication, dosage, and expiration date is printed on the lidding material. The blister packs are then perforated, separated, and case packaged in bulk. The process does

not result in any changes to the pills, which retain the same form and pharmaceutical characteristics they had when packaged in bottles. The process transforms the plastic PVC and lidding material into blister packs.

LAW AND ANALYSIS

Under § 199(a)(1), the domestic production activities deduction is an amount equal to 9 percent of the lesser of (A) qualified production activities income (QPAI) of the taxpayer for the taxable year, or (B) taxable income (determined without regard to the § 199 deduction) for the taxable year. Under § 199(a)(2), the percentage is 3 percent for taxable years beginning in 2005 and 2006, and 6 percent for taxable years beginning in 2007 through 2009.

Under § 199(c)(1), QPAI for the taxable year is DPGR less cost of goods sold allocable to such DPGR, less other expenses, losses, or deductions, which are properly allocable to such DPGR.

Section 199(c)(4)(A)(i)(I) provides the term DPGR means the gross receipts of the taxpayer which are derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property (QPP) which was MPGE by the taxpayer in whole or in significant part within the United States. Section 199(c)(5) defines QPP as including tangible personal property.

Section 1.199-3(d)(1) provides that a taxpayer determines, using any reasonable method that is satisfactory to the Secretary based on all of the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis).

Section 1.199-3(d)(1)(i) provides that the term item means the property offered by the taxpayer in the normal course of the taxpayer's business for disposition to customers, if the gross receipts from the disposition of such property qualify as DPGR.

Section 1.199-3(d)(1)(ii) provides if § 1.199-3(d)(1)(i) does not apply to the property, then any component of the property described in § 1.199-3(d)(1)(i) is treated as the item, provided that the gross receipts from the disposition of the property in § 1.199-3(d)(1)(i) that are attributable to such component qualify as DPGR. Each component that meets the requirements under § 1.199-3(d)(1)(ii) must be treated as a separate item and a component that meets the requirements under § 1.199-3(d)(1)(ii) may not be combined with a component that does not meet these requirements.

Section 1.199-3(d)(4), Example 3, provides that R manufactures toy cars in the United States. R also purchases cars that were manufactured by unrelated persons. R offers the cars for sale to customers, in the normal course of R's business, in sets of three, and requires no minimum quantity order. R sells the three-car toy sets to toy stores. A

three-car set may contain some cars manufactured by R and some cars purchased by R. If the gross receipts derived from the sale of the three-car sets do not qualify as DPGR under § 1.199-3, then under § 1.199-3(d)(1)(ii), R must treat a toy car in the three-car set as the item, provided the gross receipts derived from the sale of the toy car qualify as DPGR under § 1.199-3.

Section 1.199-3(e)(1) provides the term MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP; making QPP out of scrap, salvage, or junk material as well as from new or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, fishing, and mining minerals.

Section 1.199-3(e)(2) provides if a taxpayer packages, repackages, labels, or performs minor assembly of QPP and the taxpayer engages in no other MPGE activity with respect to that QPP, the taxpayer's packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP.

Section 1.199-3(g)(1) provides that in general QPP must be MPGE in whole or in significant part by the taxpayer and in whole or in significant part within the United States to qualify under § 199(c)(4)(A)(i)(I).

Section 1.199-3(g)(2) provides that QPP will be treated as MPGE in significant part by the taxpayer within the United States for purposes of § 1.199-3(g)(1) if the MPGE of the QPP by the taxpayer within the United States is substantial in nature taking into account all of the facts and circumstances, including the relative value added by, and relative cost of, the taxpayer's MPGE activity within the United States, the nature of the QPP, and the nature of the MPGE activity that the taxpayer performs within the United States.

Section 1.199-3(g)(3)(i) provides a taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States for purposes of § 1.199-3(g)(1) if, in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States account for 20 percent or more of the taxpayer's CGS of the QPP, or in a transaction without CGS (for example, a lease, rental, or license) account for 20 percent or more of the taxpayer's unadjusted depreciable basis (as defined in § 1.199-3(g)(3)(ii)) in the QPP.

Section 1.199-3(g)(5), Example 2, provides that X purchases gemstones and precious metal from outside the United States and then uses these materials to produce jewelry within the United States by cutting and polishing the gemstones, melting and shaping the metal, and combining the finished materials. X's MPGE activities are substantial in nature under § 1.199-3(g)(2). Therefore, X has MPGE the jewelry in significant part within the United States.

Section 1.199-3(d)(1)(i) requires Taxpayer to determine whether the gross receipts derived from the property that Taxpayer offers in the normal course of its business for sale to customers are DPGR. To the extent the gross receipts are DPGR, then the property offered in the normal course of its business for sale to customers is Taxpayer's item for purposes of § 199. In this case, the property that Taxpayer offers in the normal course of its business for sale to customers is the blister packs containing the pills. While Taxpayer did not MPGE the pills, treating this as the property offered is consistent with Example 3 of § 1.199-3(d)(4) because Taxpayer offers the blister packs and pills as a set in the normal course of its business for sale to customers.

For gross receipts from the sale of blister packs containing the pills to be DPGR, Taxpayer must meet the requirements of § 199(c)(4)(i)(1). To meet these requirements, the blister packs containing the pills must be QPP that was MPGE by the Taxpayer in whole or in significant part within the United States. If the gross receipts from the blister packs containing the pills are non-DPGR, then Taxpayer can determine whether gross receipts from the sale of any of the components (e.g. the blister packs) qualify as DPGR by applying § 1.199-3(d)(1)(ii). To qualify as DPGR, gross receipts from the sale of a component must meet the requirements under § 199(c)(4)(A)(i)(I).

In this case there is no issue in determining that the blister packs containing the pills are QPP. Also, if Taxpayer applies § 1.199-3(d)(1)(ii), there is no issue in determining the individual blister packs without pills (and vice versa, i.e. pills without blister packs) qualify as QPP.

The issue for this advice is whether any of Taxpayer's activities relating to the sale of blister packs containing the pills relate to the MPGE of the blister packs containing the pills or whether all of Taxpayer's activities fall within the exception for repackaging and labeling activities to the definition of MPGE under § 1.199-3(e)(2).

In our view, § 1.199-3(e)(2) does not apply to Taxpayer's activities in this case. Section 1.199-3(e)(2) applies to repackaging and labeling when a taxpayer engages in no other MPGE activities with respect to the QPP. Taxpayer is engaging in the MPGE of QPP when Taxpayer produces the blister pack from the plastic PVC and lidding material. Taxpayer heats the plastic, depresses the plastic (molds), and seals each pack. We also consider the MPGE of the blister packs to be a part of the MPGE of the blister packs containing the pills (the blister packs are a component of the blister packs containing the pills for purposes of § 199). At the same time, we also recognize Taxpayer is repackaging the pills into the blister packs. Taxpayer's activity is removing the pills from one package (the bottle) and placing them into another (the blister pack). The form and characteristics of the pills do not change. The fact that the repackaging is done concurrently with the MPGE of the blister packs does not change that conclusion. Taxpayer also labels the blister packs identifying the type of medication, dosage, and expiration date. If Taxpayer did not MPGE the blister packs, but only repackaged and labeled pills into blister packs manufactured by a third party, then the exception under § 1.199-3(e)(2) would apply. However, the exception to the definition of MPGE under

§ 1.199-3(e)(2) does not apply to Taxpayer because Taxpayer engages in other MPGE activities with respect to the QPP (blister packs containing the pills) by manufacturing the blister packs.

While the above analysis answers the request for advice, we are providing some additional comments as to the how the "in whole or in significant part" requirement of § 199(c)(4)(A)(i)(I) and § 1.199-3(g)(1) may apply to Taxpayer.

For Taxpayer's gross receipts from the blister packs and pills to qualify as DPGR, Taxpayer must show that the MPGE of the blister packs and pills was done in whole or in significant part by Taxpayer within the United States under § 1.199-3(g)(1). The QPP will be treated as MPGE in significant part by Taxpayer within the United States if the MPGE of the QPP by Taxpayer within the United States is substantial in nature as described in § 1.199-3(g)(2). Alternatively, Taxpayer will be treated to have met the "in whole or in significant part" requirement if it meets the safe harbor in § 1.199-3(g)(3). In determining whether Taxpayer's activities with respect to the entire product are substantial in nature, all relevant facts and circumstances should be taken into account as described in § 1.199-3(g)(2).

Taxpayer's facts are distinguishable from the facts in § 1.199-3(g)(5), Example 2. In that example, X manipulated the gemstones (cutting and polishing) and the metal (melting and shaping), and combined the gemstones and metal to produce the jewelry. In Taxpayer's situation, none of Taxpayer's activities result in a change to the pills. Its activities with respect to the pills are repackaging, as the MPGE of the pills was not completed by Taxpayer. Thus, to the extent that the pills are part of the value to the property offered, the activities that produced the pills, and value that the pills contribute, weigh against treating Taxpayer as having MPGE the blister pack containing the pills in whole or in significant part.

To the extent that Taxpayer's gross receipts derived from the sale of blister packs containing the pills are non-DPGR because Taxpayer did not MPGE the blister packs containing the pills in whole or in significant part under § 1.199-3(g)(2) or (3), Taxpayer can apply the provisions of § 1.199-3(d)(1)(ii) to the components of the blister packs containing the pills. Under the provisions of § 1.199-3(d)(1)(ii), Taxpayer must determine whether any gross receipts derived from the sale of individual components qualify as DPGR. To qualify as DPGR, gross receipts from the sale of a component must meet the requirements under § 199(c)(4)(A)(i)(I). For example, the blister packs and the pills are both separate components of the blister pack containing the pills. Taxpayer does not meet the requirements of § 199(c)(4)(A)(i)(1) with respect to the pills because Taxpayer did not MPGE the pills. However, Taxpayer may meet the requirements with respect to the blister packs. If Taxpayer did MPGE the blister packs in whole or in significant part within the United States, then the gross receipts derived from the sale of the blister packs should qualify as DPGR. The blister packs without the pills would be treated as a separate "item" for purposes of § 1.199-3(d)(1). Taxpayer could then allocate the gross receipts attributable to that item for purposes of

determining Taxpayer's total DPGR, but any gross receipts attributable to the pills without the blister packs (i.e. a non-qualifying component) would be non-DPGR.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call James Holmes 202-622-3040 if you have any further questions.