TAX EXECUTIVES INSTITUTE, INC.

comments on

REG-136459-09

relating to

Amendments to Domestic Production Activities Deduction Regulations; Allocation of W-2 Wages in a Short Taxable Year and in an Acquisition or Disposition

submitted to

The Internal Revenue Service

February 16, 2016

On August 27, 2015, the IRS and Treasury Department proposed, in REG-136459-09, new regulations regarding the Domestic Production Activities Deduction under section 199 of the Internal Revenue Code.[1] These proposed regulations intend to provide guidance to taxpayers on a variety of matters at issue in section 199, which is a significant and complex section of the Code. Tax Executives Institute, Inc. ("TEI") applauds the IRS and Treasury for taking on this effort, and we appreciate the opportunity to comment on these proposed regulations. We specifically address below the effort in the proposed regulations to define and provide examples of minor assembly. Minor assembly does not rise to the level of qualified manufacturing. It is therefore critical to provide objective guidance that not only provides a clear rationale for distinguishing minor assembly from qualifying manufacturing, but also can be applied in a wide variety of commercial settings. To achieve these objectives, we recommend refining the proposed definition of minor assembly and altering proposed Example 9 under Prop. Treas. Reg.

[1] All section references are to the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), and all regulatory references are to the regulations thereunder.

§1.199-3(e)(5). This simplistic example, which appears to be modeled on a factually intensive district court case involving the production of gift baskets, does not provide a rationale for determining what is and is not manufacturing under section 199 and, if adopted, would create confusion across a variety of industries.

Tax Executives Institute

TEI is the preeminent association of in-house tax professionals worldwide. Our approximately 7,000 members represent more than 2,800 of the leading corporations in North and South America, Europe, and Asia. TEI represents a cross-section of the business community and is dedicated to developing and effectively implementing sound tax policy, promoting the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of tax administration and compliance to the benefit of taxpayers and governments alike. TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply in a cost-efficient and predictable manner.

TEI, as a professional association of in-house tax executives, offers a unique perspective. Members of TEI manage the tax affairs of their companies and must contend daily with provisions of the tax law impacting business enterprises, including the section 199 domestic production activities deduction. Our members work for companies involved in a wide variety of industries. Their collective perspectives are broad-based and not tied to any particular special interest group. The diversity, background, and professional training of TEI's members place the organization in a uniquely qualified position from which to comment on these proposed regulations.

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The Proposed Definition of Minor Assembly

Section 199 generally provides a deduction to manufacturers equal to nine percent of their domestic qualified production activities income or taxable income, whichever is lower. Qualified production activities include producing property manufactured, produced, grown, or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States. Existing regulations further define MPGE to include "manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP [qualified production property]; 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…." Treas. Reg. §1.199-3(e)(1). The regulations also state, "[i]f 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." Treas. Reg. §1.199-3(e)(2). Together these two regulation subsections, 1.199-3(e)(1) and (e)(2), imply a two-step process. First, one would have to look at the particular process in question under section 1.199-3(e)(1) to determine whether it constitutes "manufacturing, producing, growing, extracting, [etc.]," thus making it MPGE or not. After doing that analysis, if a reasonable question remains as to whether that process is MPGE, one would then look to section 1.199-3(e)(2) to determine if the process is packaging, repackaging, or minor assembly.

The preamble to the proposed regulations explains that Treas. Reg. §1.199-3(g) does not provide a definition of minor assembly, and it is difficult to identify an objective test that would be widely applicable. The proposed regulations identify two options for determining such an objective test. The first option focuses "on whether the taxpayer's activity is only a single

process that does not transform an article into a materially different QPP" and offers examples that include mixing paint to achieve a custom color or a making a copy of a customer's key. The second option focuses "on whether an end user could reasonably engage in the same assembly activity of the taxpayer" and provides an example of a particular item sold by a taxpayer in either assembled or disassembled form, the idea being that if the taxpayer's customer could reasonably assemble the item without the taxpayer, then the taxpayer's assembly of the item would not be MPGE.

As a general proposition:

> What constitutes manufacturing or who is a manufacturer within the meaning of a tax statute will ultimately depend upon the nature and terms of the statute and the circumstances of each case. And the term "manufacturing" or "manufacturer" as used in tax statutes is not susceptible of a definition that is exact and all-embracing.

C.P. Jhong, Annotation, *What constitutes manufacturing and who is a manufacturer under tax laws*, 17 A.L.R.3d 7, § 3 (1968). The Subpart F regulations, for example, distinguish between selling manufactured products and simply selling component parts by stating the former "involves activities that are substantial in nature and generally considered to constitute the manufacture, production, or construction of property." Treas. Reg. §1.954-3(a)(4)(iii). Those regulations, however, exclude "packaging, repackaging, labeling, or minor assembly operations [from] the manufacture, production, or construction of property for purposes of section 954(d)(1)." *Id.*[2]

[2] In *Bausch & Lomb, Inc. v. Commissioner*, the Tax Court applied the Subpart F definition of manufacturing to the process of assembling sunglasses. The Court found that the final assembly of sunglasses overseas was substantial in nature, in part, because such operations' employees "required training and experience in sunglass assembly techniques before they became proficient at assembling sunglasses." *Bausch & Lomb, Inc. v. Comm'r*, 71 T.C.M. (CCH) 2031, *30 (1996). The Tax Court also found that the final assembly of sunglasses overseas was more than mere repackaging of the sunglasses' various parts because such operations "purchased sunglass

When a process is not otherwise obviously MPGE under the definitions of section 1.199-3(e)(1), and there is a reasonable question as to whether the process is minor assembly under section 1.199-3(e)(2), we encourage the IRS and Treasury Department to adopt the second option for defining minor assembly, which focuses on whether an end user could reasonably engage in the same assembly activity of the taxpayer. To take this standard out of the abstract and improve its administrability, it should be expanded to provide that an activity constitutes minor assembly when the assembly activity does not add value to the product beyond the convenience of saving the end user the time and resources self-assembly would require, and an end user could reasonably be expected to complete the assembly activity in a relatively brief amount of time using tools and other resources that are ordinarily found in the end user's home[3] or place of business. The number of steps involved in an assembly activity and the complexity of those steps should be independent factors in determining whether an end user could reasonably engage in the assembly activity of the taxpayer. A qualifying MPGE process could employ numerous steps that all seem very simple. Similarly, an MPGE process could have only one step that is substantial. As one or both of these factors increase, the overall value a taxpayer adds to any given product increases, and the assembly activity becomes more like MPGE and less like minor assembly.

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parts that could not be sold to the ultimate consumers no matter how they were repackaged." *Id.* at *37.

[3] The regulations should not adopt a rationale for classifying minor assembly that is tantamount to asking, "Can this process be performed in the home?" Many U.S. companies that obviously create QPP, such as automakers and guitar builders and brewers, make products that can also be made by individuals in their homes as crafts. *See* Build Your Own Car – Roadster, Hot Rod & Supercar, http://www.factoryfive.com; BYO Guitar, http://www.byoguitar.com/; Home Brewing Kits, http://www.homebrewing.com. However, an individual who plans on making a car or a guitar or beer in his or her home is not going to do so over a brief period of time nor without the addition of capital equipment that is not ordinarily found in an end user's home.

The regulations should not adopt the first proposed definition, which focuses on whether MPGE involves only a single-process that does not transform an article into materially different QPP, because this definition lacks a coherent principle for distinguishing a qualifying manufacturing process from non-qualifying minor assembly. The congressional purpose underlying section 199 was straightforward: "[A] reduced tax burden on domestic manufacturers will improve the cash flow of domestic manufacturers and make investments in domestic manufacturing facilities more attractive. Such investment will create and preserve U.S. manufacturing jobs."[4] This promotion of U.S. manufacturing should not turn primarily on how many steps the manufacturing might involve, but rather, whether the process is actually manufacturing. Most people would agree that pressing sheet metal is a manufacturing process, as it involves the transformation of materially different QPP, such as stamping a sheet of galvanized metal into a roof panel. Depending on one's definition of "process," such manufacturing might involve just a single process. The proposed regulations also, however, offer an example of non-qualifying MPGE under the first definition: "a taxpayer using an industrial key cutting machine to custom cut keys for customers using blank keys that taxpayer purchased from unrelated third parties." We see no principled distinction as to why stamping a metal roofing panel from a sheet of steel would be MPGE but cutting a key from a piece of metal would not be MPGE.[5] Both appear to be material transformations, which would qualify as

[4] H.R. Rept. No. 108-548, 115 (2004).

[5] Our proposed definition of minor assembly does beg the question of whether mixing custom paint or making a custom key are manufacturing, which REG-136459-09 implies they should not be. The proposed regulations offer no principled reason for excluding store-mixed paint or store-made keys from being QPP when their factory-made counterparts are manufacturing for section 199 purposes. However, given the seemingly low margins that these in-store customizations likely garner hardware stores, gross income from such MPGE would likely be small to nil, might not even be worth the administrative effort to capture, and would not likely be a source of abuse. Furthermore, Section 199(c)(4)(B)(i) of the Code excludes the sale of food and beverages made in retail locations from qualifying for the deduction, which leaves the possibility for other qualifying materials being manufactured in retail locations.

MPGE under section 1.199-3(e)(1), thus making the first proposed definition of minor assembly objectively unworkable.

Alternatively, under the definition of minor assembly offered in this comment, stamping a door hinge from a sheet of brass would be MPGE, not just because it may or may not involve a single process, but rather because an end user cannot reasonably be expected to make a door hinge in his or her own home over a brief period of time without significant capital investment. On the other hand, painting an article, which REG-136459-09 indicates should not be considered MPGE, is generally something that an end user could do, especially when the intended outcome is of a simple nature. The average person would not consider painting a bedroom or putting a new layer of paint on a piece of used furniture to be manufacturing. These processes can generally be performed by an end user in his or her home over a relatively brief period of time with materials generally found in the home. Hiring a contractor to perform this work is a matter of convenience to the end user, not a matter of necessity arising from the complexity or capital-intensive nature of the task. Therefore, painting in this context is properly considered either a service or minor assembly, rather than manufacturing, for section 199 purposes.

The same principle would apply to unassembled furniture or a bicycle purchased by an end user. When purchased at retail, these items might involve a couple hours of assembly once brought home, but again these processes can generally be performed by an end user in his or her home over a relatively brief period of time with materials generally found in the home. However, the average individual is not ordinarily going to make his or her own furniture or his or her own bicycle from raw materials over a relatively brief period of time using tools and other resources ordinarily found in the home.

Thus, when a process is not otherwise obviously MPGE under section 1.199-3(e)(1) of the regulations, and there is a need to determine whether a process is minor assembly under Sec.

1.199-3(e)(2) of the regulations, we encourage the adoption of the second concept for defining minor assembly, which focuses on whether an end user could reasonably engage in the same assembly activity of the taxpayer. An activity should constitute minor assembly when the assembly activity does not add value to the product beyond the convenience of saving the end user the time and resources self-assembly would require, and an end user could reasonably be expected to complete the assembly activity in a relatively brief amount of time using tools and other resources that are ordinarily found in the end user's home or place of business. If the end user could not reasonably be expected to perform that process, it is not minor assembly and constitutes MPGE.

Proposed Example 9

Proposed Example 9 provides as follows:

> X is in the business of selling gift baskets containing various products that are packaged together. X purchases the baskets and the products included within the baskets from unrelated third parties. X plans where and how the products should be arranged into the baskets. On an assembly line in a gift basket production facility, X arranges the products into the baskets according to that plan, sometimes relabeling the products before placing them into the baskets. X engages in no other activity besides packaging, repackaging, labeling, or minor assembly with respect to the gift baskets. Therefore, X is not considered to have engaged in the MPGE of QPP under paragraph (e)(2) of this section.

Treas. Reg. §1.199-3, Example 9. The example appears to be modeled on *United States v. Dean*, 945 F. Supp. 2d 1110 (C.D. Cal. 2013), in which the court ruled in favor of a taxpayer that claimed section 199 deductions for its assembly of gift baskets. In that case, the IRS, through the Justice Department, brought suit in the District Court for the return of erroneously issued refunds to the taxpayer for 2005 and 2006, specifically because of the taxpayer's claim to section 199 deductions. The court held the taxpayer's process of creating gift baskets from preexisting consumer items met the threshold requirements of MPGE because the taxpayer "change[d] the

form and function of the individual items by creating distinct gifts" that had a "different demand." *Id*. at 1118.

The proposed regulations should not adopt Exhibit 9 for three reasons. First, the example's concluding language, "X engages in no other activity besides packaging, repackaging, labeling, or minor assembly with respect to the gift baskets," purports to convey facts clarifying the law but really just recites a legal conclusion already found in Treas. Reg. §1.199–3(e)(2) ("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.") By describing much of the example in terms already found in the regulation, the example creates an unhelpful circularity, much like defining a word and then clarifying that definition by using the word in a sentence in which the sentence repeats the definition of the word. It simply does not tell the reader anything new, and no industries, other than possibly the gift-basket industry, would understand how Example 9 may or may not apply to them.

Second, proposed Example 9 uses facts that are much simpler than those in *Dean* and therefore attempts to overrule that case by regulation without addressing the legal reasoning underlying the ultimate decision. The *Dean* court relied, in part, on facts such as "the void fill in [the] gift basket is a cardboard form or Styrofoam base that is placed inside the basket; the other items are in turn placed inside. [The manufacturer] generally designed the cardboard forms, indicating where the cuts and folds should be made…." *Dean*, 945 F. Supp. 2d at 1112. The court also found, "After the items have been placed inside the basket, a plastic wrapping is heated to shrink around the basket." *Id*. at 1113. Example 9 ignores these facts, which undoubtedly have legal significance, and instead describes a simplistic process in which the taxpayer arranges products into a basket according to a plan. Adopting Example 9 would

promote misinterpretation and misapplication by enforcement personnel who would likely view the example as incorporating all of the facts in *Dean* and reaching a contrary conclusion. In *Jacobellis v. Ohio*, Justice Stewart stated in his concurring opinion about the definition of obscenity, "I know it when I see it…." *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964). As written, Example 9 would usher in this notoriously subjective standard for drawing the line between MPGE and minor assembly.

Third, based on the entire record of evidence before it, the *Dean* court correctly found the taxpayer's activity to be MPGE. While the manufacturing of gift baskets at issue in *Dean* would fall on the less complex end of a complexity spectrum for the nation's manufacturers, it nevertheless involves the making of a unique product that is more than just minor assembly. An individual wishing to create a homemade gift basket can do that in his or her home without significant capital expenditures. It is certainly not uncommon. But it would be very uncommon for that individual to design and manufacture a cardboard or Styrofoam base so as to prepare that basket for maximum shipping efficacy and to then shrink-wrap the basket in plastic prior to shipping, as the taxpayer did in *Dean*. Not all gift baskets are created equal, and the regulations should not imply otherwise. This distinction comports with the threshold proposed in this comment for when a process constitutes minor assembly, namely when the assembly activity does not add value to the product beyond the convenience of saving the end user the time and resources self-assembly would require, and an end user could reasonably be expected to complete the assembly activity in a relatively brief amount of time using tools and other resources that are ordinarily found in the end user's home or place of business. In this example, an individual at home is not likely to invest the resources in equipment for making a gift basket's Styrofoam base, nor is he or she likely going to have the proper materials for shrink-wrapping the basket. It may not be the heaviest of industries, but it is manufacturing nevertheless.

We recommend altering proposed Example 9 to the following breakdown of a gift basket/gift packaging that would and would not constitute QPP under the definition of minor assembly offered in this comment:

> X is in the business of selling gift baskets containing various products that are packaged together. X purchases the baskets and the products included within the baskets from unrelated third parties. X plans where and how the products should be arranged into the baskets by creating Styrofoam bases to fill the bottom void in the baskets so that the baskets' products are stabilized for consumer presentation and shipping. On an assembly line in a gift-basket production facility, X arranges the products into the baskets according to that plan and shrink-wraps the baskets in plastic so that they maintain the integrity of their internal assembly during shipping. Under these facts, a reasonable question exists as to whether this process constitutes MPGE under section 1.199-3(e)(1) of the regulations. Therefore, a "minor assembly" analysis under section 1.199-3(e)(2) of the regulations is necessary. Under that analysis, because an end user could not reasonably engage in the same assembly activity of the taxpayer over a brief period of time or without significant capital investment of items that would not ordinarily be found in that end user's home, X is considered to have engaged in the MPGE of QPP under paragraph (e)(2) of this section.
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> Y is in the business of selling a large number of consumer items to retail customers over the Internet. As part of a holiday promotion, Y offers its customers the opportunity to purchase "gift packages" and have them shipped directly to a single recipient. Under the promotion, customers purchase multiple items from Y's website, and Y ships them in a single package with a card addressed from the customer. Under these facts, a reasonable question exists as to whether this process constitutes MPGE under section 1.199-3(e)(1) of the regulations. Therefore, a "minor assembly" analysis under section 1.199-3(e)(2) of the regulations is necessary. Under that analysis, because an end user could reasonably be expected to ship them in a single package without significant capital investment in items not ordinarily found in the home, Y is not considered to have engaged in the MPGE of QPP under paragraph (e)(2) of this section.

We believe these proposed examples, along with the proposed definition of minor assembly, create an objective, administrable standard for determining when a process is MPGE and when it is minor assembly, while staying true to the original purpose of section 199, which

was to create and preserve U.S. manufacturing jobs, no matter what the form those manufacturing jobs might take. The legislative purpose behind section 199 was to reduce the tax burden on domestic manufacturers, and the section 199 regulations should not adopt an unnecessarily heightened definition of minor assembly that would have the ultimate effect of increasing the tax burden on U.S. manufacturing activities.

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Tax Executives Institute appreciates this opportunity to present its views on the proposed regulations in REG-136459-09. If you have any questions about these comments, please contact Katrina Welch, chair of TEI's Federal Tax Committee, at (214) 479-1022 or katrina@TI.com or John L. Schoenecker, Tax Counsel at TEI, at (202) 470-3600 or jschoenecker@tei.org.

Respectfully submitted,

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