INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Sept 26 2000

Number: **200103005**
Release Date: 1/19/2001
Index (UIL) No.: 4161.01-00
CASE MIS No.: TAM-114046-00/CC:PSI:B8

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND: Fabricator =

ISSUE: Is Fabricator the manufacturer of fishing lures for purposes of the tax imposed by § 4161(a) of the Internal Revenue Code and therefore liable for this tax on its sales to its customers?

CONCLUSION: Fabricator is not the manufacturer of fishing lures for purposes of the tax imposed by § 4161(a) and therefore is not liable for this tax on its sales to its customers.

FACTS: Fabricator produces artificial plastic fishing lures (lures) for fishing tackle distributors (customer(s)). Fabricator uses a customer-supplied mold to produce lures only for the customer who supplied the mold. Apart from the customer-supplied molds, Fabricator owns all the equipment and materials used to produce the lures. Fabricator does not market its own brand of lures because Fabricator believes doing so would constitute direct competition with Fabricator's customers.

Fabricator does not have written contracts with its customers. Fabricator has the option of negotiating a new price each time a customer places an order. Therefore, Fabricator regularly evaluates costs and adjusts pricing to insure profitability. Customers reserve the right to reject lures that do not meet required specifications.

Fabricator's customers do not have any ownership or equity interest in Fabricator. Except for customers' payments for lures produced by Fabricator, there are no loans or other financial transactions between Fabricator and its customers.

LAW AND ANALYSIS:

Section 4161(a)(1) imposes a 10 percent excise tax on the sale of any article of sport fishing equipment by the manufacturer, producer, or importer. Section 4162(a)(5)(B) provides that the term “sport fishing equipment” means items of terminal tackle, including artificial lures.

Section 48.4161-1(c) of the Manufacturers and Retailers Excise Taxes Regulations provides that the tax imposed by § 4161(a) is payable by the manufacturer, producer, or importer making the sale.

Section 48.0-2(a)(4)(i) provides that the term “manufacturer” includes any person who produces a taxable article from scrap, salvage, or junk material, or from new or raw material, by processing, manipulating, or changing the form of an article or by combining or assembling two or more articles.

Section 48.0-2(a)(4)(ii) provides that, under certain circumstances, as where a person manufactures or produces a taxable article for another person who furnishes materials under an agreement whereby the person who furnishes the materials retains title thereto and to the finished article, the person for whom the taxable article is manufactured or produced, and not the person who actually manufactures or produces it, will be considered the manufacturer.

Section 48.0-2(a)(5) provides that the term “sale” means an agreement whereby the seller transfers the property (that is, the title or substantial incidents of ownership) in goods to the buyer for a consideration called the price, which may consist of money, service, or other things.

Rev. Rul. 76-181, 1976-1 C.B. 341, provides that where a fabricator owns the materials, tools, dies, machinery, and equipment used to manufacture an article and can produce and sell the article anywhere (except that articles with the trademark or trade name of a customer can only be sold to the customer that holds the trademark or trade name), the fabricator is the manufacturer liable for the excise tax on all sales of the article produced by fabricator.

Rev. Rul. 60-42, 1960-1 C.B. 474, provides that among the factors to be considered in determining whether a fabricator or the vendee is liable for the manufacturers excise tax are (1) the ownership of the raw materials used in producing the articles and (2) the right to control the production and sale of the articles.

Rev. Rul. 58-134, 1958-1 C.B. 395, provides that a company that owns the patents under which a taxable article is fabricated by another company, exercises control as to the amounts to be fabricated, has exclusive rights or first rights to the output, and designates territories where the fabricator may sell the article is considered

to be the manufacturer for purposes of the manufacturers excise tax on those articles the company sells.

In The Air Lift Co., Inc. v. U.S., 286 F.Supp. 249 (W.D. Mich. 1968), a taxpayer licensed fabricators to produce taxable spring boosters for automobiles. With the exception of the molds, the fabricators owned all the machinery and the materials. The fabricators provided all labor and had complete control of the manufacturing process. The fabricators could sell the spring boosters to other buyers for purposes other than automobile spring suspension devices.

The court concluded that the taxpayer was not liable for the excise tax imposed on the fabricators' sales of the spring boosters because the fabricators had proprietary interests in the spring boosters the transfers of which would constitute a sale for purposes of the tax imposed on automotive parts or accessories by § 4061(b).

In Polaroid Corp. v. U.S., 235 F.2d 276 (1st Cir. 1956), a taxpayer contracted with a fabricator to produce taxable cameras for which the taxpayer had a patent. The contract provided that the fabricator would sell and deliver to the taxpayer 100,000 cameras that met contractual specifications at a fixed price per camera. The fabricator developed the production techniques, established the unit price, purchased all materials and parts, supplied all labor and supervisory personnel, independently financed the project, completely controlled the processes and production, owned all standard production tools, and retained title to the cameras until the cameras passed certain quality controls. The taxpayer purchased over a period of time at cost the fabricator's specialized tools. The contract included an escalator clause that allowed for changes in the price of a camera if there was a minimum increase in the fabricator's costs.

The appeals court affirmed the trial court's decision that the taxpayer was the manufacturer of the cameras. The appeals court referred to the trial court's findings that the taxpayer was the manufacturer because the taxpayer bought the fabricator's entire output, dictated the amount of the output, prohibited the fabricator from selling the cameras to anyone but the taxpayer, bore the risk of a cost increase, benefitted if costs dropped, owned specialized tools, and retained the patent under which the fabricator made the cameras. The fabricator did not pay the taxpayer royalties for the patented cameras. The appeals court added to this analysis that what the taxpayer argued was a sale was no more than the mere transfer of ". . .the bare right to possession of the physical materials", the only interest the fabricator had in the cameras. The fabricator could not transfer to the taxpayer the rights to use or sell the cameras because the fabricator did not possess these rights; the taxpayer had retained these rights.

In Peckat Manufacturing Co. v. Jaarecki, 196 F.2d 849 (7th Cir. 1952), a fabricator owned the machinery used to make taxable sun visors for a taxpayer. The fabricator's employees operated this machinery. Although the fabricator ordered the

raw materials necessary to produce the sun visors, the fabricator only did so based on the taxpayer's order for the sun visors. The fabricator was not responsible for raw materials and fabricated parts and supplies purchased for the taxpayer's orders. The fabricator had no authority to make the sun visors for sale by itself to others because an integral part of each sun visor was the taxpayer's patented bracket. The fabricator could only dispose of the sun visors as directed by the taxpayer. The court found that the taxpayer was the manufacturer of the sun visors because the terms of the manufacturing contract did not give the fabricator any proprietary interest in the sun visors. Therefore, the fabricator was making the sun visors for the taxpayer on a piecework basis.

Here Fabricator submitted a Form 637, Application for Registration (For Certain Excise Tax Activities), to its District Director. The District Director determined that Fabricator was not liable for the tax imposed by § 4161 on the sale of lures to Fabricator's customers because Fabricator was not the manufacturer of the lures . Therefore, the District Director did not issue Fabricator a Letter of Registration for excise tax purposes.

The District Director based its decision not to issue a Letter of Registration on the fact that Fabricator, like the fabricators in Polaroid and Peckant, did not have a proprietary interest in what Fabricator produced. Fabricator's purchasing the necessary raw materials, providing the labor, and controlling the manufacturing process did not create a proprietary interest in the lures. Fabricator could only transfer a right of possession because that was Fabricator's only interest in the lures. Fabricator could not sell the lures to anyone other than the customer that owned the mold from which the lures were made. In other words, Fabricator's customers retained the exclusive right to sell the lures Fabricator produced. The District Director distinguishes Fabricator's situation from that in Air Lift because (1) in Air Lift the fabricator was free to sell the rubber cylinders, which the fabricator made using Air Lift's patent, only if the rubber cylinders were not sold for use as suspension devices on automobiles; and (2) in Air Lift there were no provisions for adjusting the unit charge based on production costs.

Fabricator's position is that Fabricator's situation is similar to that in Air Lift and clearly distinguishable from Polaroid and Peckat. Fabricator argues that although it uses molds provided by its customers to produce the lures, this fact alone is not determinative of the issue. Fabricator argues that it is free to produce and sell fishing lures to other parties that supply molds. Therefore, Fabricator is not "captive" to a single vendor. Furthermore, apart from the molds, Fabricator owns all of the other items necessary to produce the lures and, therefore, bears all risk of loss in producing the lures. This risk of loss constitutes a proprietary interest in lures that Fabricator transfers when it sells lures. Therefore, Fabricator's transfers constitute sales for purposes of the excise tax imposed by § 4161.

The District Director's position reflects the IRS position articulated in Rev. Rul.

76-181, Rev. Rul. 60-42, and Rev. Rul. 58-134 that absent the right to sell the article manufactured a fabricator cannot be considered the manufacturer of the article for purposes of § 4161. The fact that Fabricator has multiple customers whose lures Fabricator cannot sell to third parties does not change the nature of Fabricator's interest in the lures from mere possession to a proprietary interest. Fabricator's argument that Fabricator bears the risk of loss because Fabricator owns all of the items necessary to produce the lures, apart from the molds, is mitigated by the fact that the Fabricator has the prerogative of adjusting the price to account for increased costs each time a customer places an order.

CAVEAT: A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.