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From:
Sent: Friday, February 19, 2016 11:23 AM
To:
Cc:
Subject: 199 case advice

Legend:

Taxpayer =

Firm =

Brand Names =

Hi ,

You sent me an email requesting my views on a § 199 case related to Taxpayer that was made in a presentation by Firm and provided me with facts and Taxpayer's position (summarized below).

Issue: Whether Taxpayer can claim a portion of gross receipts derived from the sale of its products, which are manufactured, produced, grown, or extracted (MPGE) outside of the United States, are domestic production gross receipts (DPGR) from advertising income under § 1.199-3(i)(5)(ii)(A).

Conclusion: Taxpayer's gross receipts derived from the sale of its products are non-DPGR. None of the gross receipts derived from the sale of its products are advertising income under 1.199-3(i)(5)(ii)(A).

Facts: Taxpayer is a specialty retailer of private branded, casual-to-dressy clothing, intimates, accessories, and non-clothing gift items (collectively "products") under certain Brand Names. Taxpayer makes its products available to customers in US and international retail stores, through its website and via telephone through call centers for its catalogs. The MPGE of the physical products is outside of the United States.

Taxpayer claims to be the manufacturer of its catalogs, mailers and other similar printed publications (hereinafter "print media") in the US based on the benefits and burdens of ownership during the manufacturing of the printed media by third party contractors.

Taxpayer did not sell any print media to third parties. Taxpayer distributed the print media free of charge to existing customers. Neither did Taxpayer sell advertising to third parties for inclusion in the print media it distributed. The print media included only advertising for Taxpayer's own brands. Thus, there is no advertising revenue associated with the print media.

Taxpayer's position: Taxpayer expects to claim a § 199 deduction for its print media based on the argument that advertising is a component of the clothing and accessories it sells. Taxpayer argues that:

> Through its marketing and production teams, [Taxpayer] develops and produces these printed media (e.g. catalogs, mailers and other similar printed publications) for each of [Taxpayer's] [Brand Names]. [Taxpayer] produces these items in order to drive traffic to its stores and websites, encourage repeat sales, and foster customer loyalty.
>
> [Taxpayer's] price point for its products sold through [Taxpayer's] network is established to drive a profit on the various underlying components, including the goods being sold and the related print media, which is designed to cover storefront overhead costs, COGS, media production costs, SG&A, etc. … [Taxpayer] believes that it is the manufacturer of its printed media and that it has the benefits and burdens of ownership during the entire manufacturing process, including the printing process, typically provided by third party contractors. Therefore, [Taxpayer] believes that its advertising revenues generated from the disposition of its manufactured printed media which is included in the sales price of its goods sold in its stores and online is qualified under § 1.199-3(i)(5).

Per the Taxpayer, the price of Taxpayer's retail goods includes a component for the printed media produced, including a profit mark-up. Taxpayer claims that its printed media campaign is responsible for driving a portion of its sales. Taxpayer claims it is able to identify 92-95% of its incremental sales associated with its catalogs, mailers, and other printed media.

The Taxpayer asserts that "The regulations provide that the taxpayer must apply federal income tax principles to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange or other disposition, the gross receipts of which may constitute DPGR…."

> Based on the functional analysis interviews with [Taxpayer's] personnel, it was determined that [Taxpayer's] major qualified revenue stream relates to its print media. [Taxpayer] uses a sophisticated marketing and data analysis software to

track its customers' buying habits and impacts of its various mailings (catalogs, mailers or other printed media) called . Currently, [Taxpayer] is able to track 92-95% of all sales through the use of . is a leader in software and serves and allows its customers to transform raw data into information that businesses can use to improve customer relationships. is used by a large number of retailers for this purpose. Based on , [Taxpayer] is able to specifically identify incremental sales associated with their printed media (catalogs, mailers and other printed media). The system is also tied into their ERP system and they can track the actual COGS associated with these sales and the actual cost of the printed media that is driving the sales (i.e. their system can produce gross margin from the various printed media campaigns)… [Firm] determined [Taxpayer's] domestic production gross receipts by obtaining the incremental sales for the following [Taxpayer] brands: . Because only recently implemented a rewards program, the brand does not use the software. For this reason, [Firm] was unable to obtain incremental sales. However, as sales are almost wholly driven by catalog sales, [Firm] obtained and use Net Sales.

Analysis: It is inappropriate for Taxpayer to characterize any gross receipts derived from the sale of its products as DPGR from advertising income under § 1.199-3(i)(5)(ii)(A) (or any other § 199 rule). Taxpayer's products are MPGE outside of the United States, and therefore, gross receipts from the sale are non-DPGR.

The rules relating to deriving DPGR from advertising income are not applicable in this situation. Section 1.199-3(i)(5)(i) provides the general rule that gross receipts from the disposition of qualifying production property (QPP) do not include advertising income. The exception in § 1.199-3(i)(5)(ii)(A) for tangible personal property (a type of QPP) is limited to certain printed publications and only applies to advertising income from advertisements placed in those media. For example, the exception allows a newspaper producer (that meets all § 199 requirements with respect to the newspaper) to treat gross receipts derived from people/businesses placing advertisements in the newspaper as derived from the disposition of the newspaper and DPGR (See Example 1 of § 1.199-3(i)(5)(iii)). Thus, the exception in § 1.199-3(i)(5)(ii)(A) only applies when a taxpayer that has MPGE a printed publication (and meets all other § 199 requirements) derives gross receipts from someone advertising in such printed publication—and not when a taxpayer derives gross receipts from the sale of a product it advertises. In this case, no one is paying Taxpayer to have an advertisement placed into Taxpayer's printed media.

Taxpayer argues part of the gross receipts from the sale of its products should be treated as advertising income under § 1.199-3(i)(5)(ii)(A) because Taxpayer's advertising increases its sales. The fact that advertising your products increases your sales is of no consequence when applying § 1.199-3(i)(5)(ii)(A). For this rule to be

relevant, Taxpayer's customers have to pay to advertise in Taxpayer's print media. That is not happening when they buy a product. Taxpayer's argument is a misapplication of the rules in § 1.199-3(i)(5). Taxpayer's products are MPGE outside of the United States, and the gross receipts from their sale are non-DPGR.