

Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: 20133302F

Release Date: 8/16/2013

CC:LB&I:HMP:
POSTF-148622-12

UILC: 199.03-01

date: July 16, 2013

to: Revenue Agent
()

from: Associate Area Counsel
(Large Business & International)

subject: Section 199 Claim for Photo Processing Activities

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

LEGEND

Taxpayer =
Year X =
#a =
#b =
#c =
#d =
#e =
Brand Y =
#f =

g =
h =
i =
j =
k =
l =
m =

n =
o =
p =
q =
r =
s =
t =
aa =
bb =
cc =
dd =
ff =

ISSUE

Whether the Taxpayer's photo processing activities are manufacturing, production, growth, extraction (MPGE) of qualifying production property (QPP) for purposes of IRC § 199.

CONCLUSION

The Taxpayer's photo processing activities by which it produced photo products other than picture CDs or movie DVDs are MPGE activities. The affixing of a customer's photo and/or movie files onto photo CDs and movie DVDs is a service.

FACTS

The Taxpayer is a pharmacy care provider in the United States. The taxable year in issue is the Taxpayer's Year X. At the end of Year X, the Taxpayer had #a retail drugstores, #b clinic locations and #c retail specialty pharmacy stores. The Taxpayer also operates mail order pharmacies, and sells products through the Internet. The Taxpayer has photography labs (Photo Labs) and stand-alone photo printers (Photo Kiosks) in #d of its retail stores, and has only Photo Kiosks in the remainder of its retail stores. The equipment in the Photo Labs include: (i) three types of photographic processing machines; (ii) film processors; (iii) paper processors; (iv) duplex printers; and (v) Photo Kiosks.

A Photo Lab is a store area dedicated to photo processing. In a prototypical new store, this area is #e square feet. Customers provide undeveloped film, film negative images, and digital media. (Digital images may be uploaded and ordered online, then picked up in a store.) In the photo processing department, the film, negatives and digital media are converted into finished photographic products, including photographic prints, compact discs, photo albums, enlargements, and greeting cards (Photo Products). The Taxpayer's photo department employees also take passport photos for customers and

print the photos. The Taxpayer does not manufacture the supplies/components used in its photo processing operations.

The Taxpayer describes a Photo Kiosk as an ordering station for photo products at its store locations. A Photo Kiosk is a self-service station with a touch screen interface, but Taxpayer employees will assist a customer if needed. At the Photo Kiosk, customers can order prints, enlargements, picture sheets, picture CDs, picture movie DVDs, calendars, photo books and greeting cards. Only prints, enlargements, picture sheets, CDs and DVDs can be printed or created at a Photo Kiosk. A customer takes the products outputted by the Photo Kiosks and pays for them at a register. All products can be produced “behind the counter” in the Photo Labs. A customer may choose to order a product, such as a print, at a Photo Kiosk, and have it printed behind the counter, even though it could be printed at the kiosk.

<u>Product</u>	<u>Description</u>	<u>Gross Receipts \$</u>
<i>Photo Kiosk</i>		
Prints in Seconds	Prints from digital media from kiosk	<u>g</u>
Print Sheet	Proof sheets from kiosk	<u>h</u>
<i>Subtotal Kiosk</i>		<u>i</u>
<i>Behind Counter</i>		
4 X 6 Digital Print	Prints from digital media	<u>j</u>
One Hour Rolls & Logs	Film prints	<u>k</u>
On-Line Prints	Prints ordered online by digital upload	<u>l</u>
Passport Photos	Passport sized prints	<u>m</u>
Greeting Cards	Greeting cards	<u>n</u>
Photo Books	Photo books	<u>o</u>
Photo Calendars	Photo calendars	<u>p</u>
<i>Subtotal Behind Counter</i>		<u>q</u>
<i>Photo Kiosk and Behind Counter</i>		
One Hour Enlargements	Print enlargements	<u>r</u>
8 X 10 Print	Prints	<u>s</u>
Brand X Picture CD	Picture CD	<u>t</u>
Private Label CD	Picture CD	<u>aa</u>
Brand X Movie DVD	Picture movie DVD	<u>bb</u>
Memory Play DVD	Picture movie DVD	<u>cc</u>
<i>Subtotal CD& DVD</i>		
<i>Subtotal Photo Kiosk & Behind Counter</i>		<u>dd</u>
<i>Total Photo Products</i>		<u>ff</u>

The Taxpayer employs approximately #f photo department employees. Approximately half are managers or supervisors, and the other half are photo lab technicians. The Taxpayer trains these employees in-house to use and maintain the Photo Labs and Photo Kiosks. Only employees who have been trained and certified can perform photo processing functions. The key functions are:

- Daily startup, including (i) cleaning and testing the film processor; (ii) starting up machines; (iii) testing machines; (iv) running control strips; and (v) conducting preventative maintenance, filter changes, and minor repairs.
- Maintaining Photo Kiosks and assisting customers with the Photo Kiosks.
- Producing finished Photo Products.
- Producing passport photographs (including ensuring that the photographs meet federal guidelines).
- Performing quality reviews of Photo Products before packaging them for customers.
- Performing shut-down procedures at the end of each day, including emptying waste tanks, loading film, replenishing chemicals, equipment inspection and shut-down, and cleaning the lab and equipment.

The Taxpayer's direct labor and overhead for producing the photo products from the Photo Kiosks and behind the counter amounts to more than _____ percent of the cost of goods sold of all the photo products. (The Taxpayer asserts that its direct labor and overhead is _____ % of the cost of goods sold for the photo products. The Taxpayer determined a percentage for each photo product, and the numbers were similar for all products.)

In analyzing whether the Taxpayer's photo processing activities are MPGE activities, we assume that the Taxpayer had the burden and benefits of ownership of the photo products during the photo processing activities.

LAW AND ANALYSIS

Section 199 provides a deduction for income attributable to domestic production activities. The deduction is generally equal to nine percent of the lesser of a taxpayer's qualified production activities income or its taxable income for the taxable year. See section 199(a)(1) and Treas. Reg. § 1.199-1(a). A taxpayer's domestic production gross receipts (DPGR) are the starting point in calculating its qualified production activities income (QPAI).

Section 199(c)(4)(A) and section 1.199-3(a)(1) provide that gross receipts from any lease, rental, license, sale, exchange, or other disposition of QPP that is MPGE by the taxpayer in whole or in significant part within the United States are DPGR. By definition, QPP includes tangible personal property. See section 199(c)(5)(A) and section 1.199-3(j)(1)(i).

Section 1.199-3(d)(1) provides that a taxpayer must determine whether gross receipts qualify as DPGR on an item-by-item basis. Under section 1.199-3(d)(1), the term “item” means the property offered for sale by the taxpayer in the normal course of the taxpayer’s business, if the gross receipts from the disposition of such property qualify as DPGR, or, if not, any component of such property, if the gross receipts attributable to such component qualify as DPGR.

Section 1.199-3(e)(1) provides generally that the term MPGE includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating QPP and making QPP from 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.

Section 1.199-3(e)(2) provides that 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(e)(4) provides that a taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under section 263A with respect to the QPP unless the taxpayer is not subject to section 263A.

Section 1.199-3(g)(1) provides that 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 give rise to DPGR. Under section 1.199-3(g)(2), QPP will be treated as MPGE in significant part by the taxpayer within the United States 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) provides a safe harbor under which a taxpayer will be treated as having MPGE QPP in whole or in significant part within the United States. A taxpayer comes within the safe harbor if, in connection with the QPP, the direct labor and overhead of such taxpayer to MPGE the QPP within the United States account for twenty percent or more of the taxpayer’s CGS of the QPP.

Section 199(b)(1) and section 1.199-2(a) provide that the section 199 deduction for any taxable year shall not exceed 50 percent of the W-2 wages of the taxpayer. Under section 199(b)(2)(B) and section 1.199-2(e)(2)(i), the term W-2 wages includes only such wages that are properly allocable to DPGR. A taxpayer may determine the amount of W-2 wages properly allocable to DPGR using any reasonable method that is satisfactory to the Secretary of the Treasury, based on all of the facts and circumstances. Section 1.199-2(e)(2)(ii) provides a wage expense safe harbor.

The Taxpayer applies a concise overall argument to support its position that its photo processing activities are MPGE activities. The Taxpayer asserts that it MPGEs the photo products (including passport photos) because its employees create the photo products from raw materials such as paper, ink, chemicals and blank computer disks, using sophisticated machinery and equipment. The Taxpayer asserts that it thus transforms raw materials into the finished photo products.

We agree with the Taxpayer that under section 1.199-3(e)(1), the photo processing and printing activities through which the Taxpayer produced photo products (other than the picture CDs, movie DVDs) are the MPGE of QPP. The Taxpayer, using its own equipment, used raw materials (the photo paper, ink and other chemicals) to produce a different tangible product in form and function - finished photos or photo books sold to its customers.

However, the process of affixing a customer's intangible files to a CD or DVD not manufactured by the taxpayer is not an MPGE activity. In this process, neither the intangible files nor the CD or DVD are changed to a different form. This process of affixing files onto a CD or DVD is a service that the Taxpayer performs for its customers, which is not an MPGE activity. The gross receipts from the sale of picture CDs and movie DVDs are not DPGR.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

This advice has been coordinated with Branch 5 of Passthroughs & Special Industries. Please call _____ if you have any further questions.

Associate Area Counsel
(Large Business & International)