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Internal Revenue Service  
memorandum**

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to:

Lead Appeals Officer, Appeals  
(Office of Appeals)

from: \_\_\_\_\_, \_\_\_\_\_, Branch 5, Office of the Associate Chief Counsel  
(Passthroughs and Special Industries) CC:PSI:B5

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subject: Manufacturing, Production, Growth, Extraction of Qualifying Production Property and  
Section 199

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

LEGEND

Taxpayer =

Tax Years =

ISSUE

Whether Taxpayer's activities constitute the manufacture, production, growth, or  
extraction (MPGE) of qualifying production property (QPP) for purposes of the domestic  
production activities deduction under § 199?

CONCLUSION

Taxpayer's activities do not constitute the MPGE of QPP.

## FACTS

Taxpayer is a publisher of books, , and other printed materials (collectively "books"). Taxpayer's activities with respect to its books include market research, resource planning, content and layout development, and editing. These activities allow Taxpayer to create an electronic version of a book that contains exact electronic displays of each page. Taxpayer also develops print specifications that include type of paper, page sizes, type of printing process, type of ink, and whether to use thread, staples or glue for binding.

Taxpayer uses contract manufacturers to produce books in mass. Taxpayer provides a contract manufacturer with the electronic version of a book and its list of print specifications. The contract manufacturer uses the electronic version of the book to create printing plates, which the contract manufacturer then uses to print mass copies of the book. The contract manufacturer uses their employees, machinery, and plant to print and assemble books according to Taxpayer's print specifications.

After the books have been printed and assembled the contract manufacture may ship the books directly to Taxpayer's customers, or may ship them to Taxpayer so that Taxpayer can package and distribute the books.

For Tax Years, Taxpayer claims that its design, development, creation, materials analysis and selection, and packaging of its books constitute MPGE activities for purposes of § 199(c)(4)(A)(i)(I).

## LAW AND ANALYSIS

Under § 199(a), the domestic production activities deduction is determined by applying a percentage to the lesser of the taxpayer's qualified production activities income (QPAI) or taxable income (determined without regard to the § 199 deduction). The applicable percentage is 3% for taxable years beginning in 2005 and 2006, 6% for taxable years beginning in 2007 through 2009, and 9% for taxable years beginning after 2009.

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

Section 199(c)(4)(A)(i)(I) defines domestic production gross receipts (DPGR) as 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 tangible personal property, any computer software, and any property described in § 168(f)(4).

Section 1.199-3(e)(1) of the Income Tax Regulations provides, except as provided in §§ 1.199-3(e)(2) and (3), 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. The term MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with or incorporated into the MPGE of QPP, whether or not by the taxpayer. Pursuant to § 1.199-3(f)(1), the taxpayer must have the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the MPGE activity occurs in order for gross receipts derived from the MPGE of QPP to qualify as DPGR.

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 a taxpayer that has MPGE QPP for the taxable year should treat itself as a producer under § 263A with respect to the QPP unless the taxpayer is not subject to § 263A.

Section 1.199-3(j)(2)(i) defines tangible personal property as any tangible property other than land, real property described in § 1.199-3(m)(3), and any property described in §§ 1.199-3(j)(3), 1.199-3(j)(4), 1.199-3(k)(1), or 1.199-3(l). Tangible personal property also includes any gas (other than natural gas described in § 1.199-3(l)(2)), chemical, and similar property, for example, steam, oxygen, hydrogen, and nitrogen. Property such as machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks, and shelves, and neon and other signs that are contained in or attached to a building constitutes tangible personal property for purposes of § 1.199-3(j)(1)(i). Except as provided in §§ 1.199-3(j)(5)(ii) and 1.199-3(k)(2)(i), computer software, sound recordings, and qualified films are not treated as tangible personal property regardless of whether they are affixed to a tangible medium. However, the tangible medium to which such property may be affixed (for example, a videocassette, a computer diskette, or other similar tangible item) is tangible personal property.

Section 1.199-3(j)(2)(iii) provides the term tangible personal property does not include property in a form other than in a tangible medium. For example, mass-produced books are tangible personal property, but neither the rights to the underlying manuscript nor an online version of the book is tangible personal property.

Section 1.199-8(i) provides that § 1.199-3 is applicable for taxable years beginning on or after June 1, 2006.

Section 1.263A-2(a)(2)(i) provides §263A applies to the costs of producing tangible personal property, and not to the costs of producing intangible property.

Section 1.263A-2(a)(2)(ii) provides that for purposes of determining whether a taxpayer producing intellectual or creative property is producing tangible personal property or intangible property, the term tangible personal property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator thereof. Other similar property for this purpose generally means intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered. However, any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good or the creator is not similar property for these purposes.

Section 1.263-2(a)(2)(ii)(A) provides § 263A applies to tangible personal property defined in § 1.263A-2(a)(2) without regard to whether such property is treated as tangible or intangible under other sections of the Code. Thus, for example, § 263A applies to the costs of producing a motion picture or researching and writing a book even though these assets may be considered intangible for other purposes of the Code.

Section 1.263-2(a)(2)(ii)(A)(1) provides the cost of producing and developing books (including teaching aids and other literary works) required to be capitalized under § 263A include costs incurred by an author in researching, preparing, and writing the book. (However, see § 263A(h), which provides an exemption from the capitalization requirements of § 263A in the case of certain free-lance authors.) In addition, the costs of producing and developing books include prepublication expenditures incurred by publishers, including payment made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books. The costs of producing a book also include the costs of producing the underlying manuscript, copyright, or license. (These costs are distinguished from the separately capitalizable costs of printing and binding the tangible medium embodying the book (e.g. paper and ink).) See § 1.174-2(a)(1), which provides that the term research or experimental expenditures does not include expenditures incurred for research in connection with literary, historical, or similar projects.

Appeals asked our Office whether Taxpayer's activities, as described above, are MPGE activities under § 199(c)(4)(A)(i)(I). This advice does not attribute any of the contract manufacturer's activities (e.g. printing and binding the books) to Taxpayer. The Taxpayer and the Field agree that the contract manufacturer's activities are the MPGE

of QPP. Our Office notes that Taxpayer claims under § 1.199-3(f) to have the benefits and burdens of ownership of the mass produced books during period that the contract manufacturer's activities take place. Appeals requested that we **not** address the benefits and burdens issue.

### Electronic Version of a Book

Taxpayer's activities related to producing an electronic version of a book do not result in QPP. Section 199(c)(5)(A) defines QPP as tangible personal property, computer software, and property described in § 168(f)(4) (i.e. sound recordings). Section 1.199-3(j)(2)(iii) provides that tangible personal property does not include property in a form other than in a tangible medium. The example in the section is that mass-produced books are tangible personal property, but neither the rights to the underlying manuscript nor an online version of the book is tangible personal property. Section 1.199-3(j)(3)(i) provides an electronic book available online or for download is not computer software. Taxpayer's market research, content and layout development, and editing are activities that result in Taxpayer creating an electronic version of a book. Taxpayer's electronic version of a book has the same layout and design as the book would have if printed and bound, but it is not tangible personal property or computer software.<sup>1</sup> While our Office recognizes that Taxpayer's activities create valuable assets, those assets are intangibles, and do not qualify as QPP for purposes of § 199.

The definition of an MPGE activity is an activity that results in QPP. Section 1.199-3(e)(1) provides, in relevant part, 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. (Emphasis added.) Taxpayer's activities create intangible property that is not QPP. Thus, Taxpayer's activities should not be considered MPGE activities.

Under § 199, a taxpayer's non-MPGE activities may be treated as part of the MPGE of QPP if the taxpayer also MPGE the QPP. Example 5 of § 1.199-3(e)(5) illustrates this situation. In that example, the taxpayer performs materials analysis and selections, subcontractor inspections and qualifications, testing of component parts, assisting customers in their review and approval of the QPP, routine production inspections, product documentation, diagnosis and correction of system failure, and packaging for shipment to customers. The example concludes that these activities are part of the MPGE of QPP **because** the taxpayer MPGE the QPP. (Emphasis added.) If the taxpayer did not MPGE the QPP, then those activities are not part of the MPGE of QPP. Based on Example 5 of § 1.199-3(e)(5), Taxpayer's activities would be part of the MPGE of QPP if Taxpayer MPGE the QPP. Taxpayer, however, contracted with a manufacturer for the contract manufacturer to mass produce the books. The contract

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1. Taxpayer's electronic version of a book is also not property described in § 168(f)(4).

manufacturer's activities are the activities that constitute the MPGE of QPP (i.e. mass-produced books). Therefore, when applying Example 5 to Taxpayer's facts, Taxpayer's activities are not treated as part of the MPGE of QPP because Taxpayer did not MPGE the QPP.<sup>2</sup>

While our Office believes that the above analysis sufficiently answers the question there are several more reasons supporting the conclusion that Taxpayer's activities are non-MPGE activities under § 199, unless the Taxpayer MPGE the mass-produced books.

For example, the definition of MPGE in § 1.199-3(e)(1) requires pursuant to § 1.199-3(f)(1) for a taxpayer to have the benefits and burdens of ownership of the QPP under Federal income tax principles during the period the MPGE activity occurs in order for gross receipts derived from the MPGE of QPP to qualify as DPGR. Our Office questions how Taxpayer's activities could be considered MPGE because there is no QPP throughout the entire time of Taxpayer's activities before the contract manufacturer MPGE the books.

Congress provided that certain activities that create intangible property are treated as the MPGE of QPP. Under § 199, creating and developing computer software qualifies as the MPGE of QPP because computer software is in the definition of QPP. The same treatment applies for property described in § 168(f)(4) (i.e. sound recordings). These are the two forms of intangible property that Congress included within the definition of QPP in § 199(c)(5). The electronic version of a book that Taxpayer's activities create does not fall within these types of included and qualifying intangible property. Therefore, Taxpayer's activities are not the MPGE of QPP.

Taxpayer's reliance on the consistency requirement in § 1.199-3(e)(4) is misplaced. 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 § 263A, unless that taxpayer is not subject to § 263A. Section 1.199-3(e)(4) does not provide that a producer under § 263A is treated as a producer under § 199. Our Office believes there are cases where a taxpayer is treated as a producer for purposes of § 263A and should not be considered a manufacturer for purposes of § 199. See e.g., Suzy Zoo v. Commissioner, 114 T.C. 1 (2000), *aff'd*, 273 F.3d 875 (9th Cir. 2001). Therefore, reading the requirement in § 1.199-3(e)(4) to require consistency between § 199 and § 263A in all cases is inappropriate.

In Taxpayer's case, § 199 and § 263A are not consistent in the treatment of the production of books. Section 263A includes the costs of Taxpayer's activities that create the intangible aspects of a book as costs related to the production of tangible personal property. See § 1.263-2(a)(2)(ii). Section 263A treats the costs attributable to printing and binding of books as separately capitalizable costs also attributable to

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2. Our Office notes that this conclusion would change if Taxpayer has the benefits and burdens of ownership during the period in which the qualifying activity occurs under § 1.199-3(f)(1) in the contractual arrangement with the contract manufacturer that mass-produces the books.

tangible personal property. See § 1.263-2(a)(2)(ii)(A)(1). In contrast, § 199 treats the underlying manuscript and an online version of a book as intangible property under § 1.199-3(j)(2)(iii). The activities that create manuscript and online version are properly treated as the production of non-qualifying intangible property for § 199 purposes. Section 199 treats the printing and binding of books as the MPGE of QPP, and therefore, those activities are property treated as the MPGE of QPP. Thus, Taxpayer may be treated as a producer of tangible personal property for purposes of § 263A, but a producer of non-qualifying intangible property for purposes of § 199.

Section 199 does not treat the production of intangible property as the production of tangible personal property. For example, consider films, the costs of producing films under § 1.263A-2(a)(2)(ii) are treated as costs to produce tangible personal property. Section 1.199-3(j)(2) provides that qualified films are not treated as tangible personal property regardless of whether they are affixed to a tangible medium. Further, under § 1.199-3(k)(2)(ii), if a taxpayer produces a qualified film and affixes it to a DVD that it did not MPGE, then the taxpayer can treat the combined property as the intangible qualified film, or as separate intangible or tangible property. Congress did not provide that production of a manuscript or electronic book are qualifying activities. However, if the activities did qualify, then the rule would probably be consistent with that of other qualifying intangible property under § 199. The rule would not treat Taxpayer's activities as the production of tangible personal property as allowed under § 263A. Thus, the rules under § 263A in the context of books are not applicable for purposes of § 199.

Because our Office believes in some cases a § 263A production activity is not a § 199 MPGE activity, our Office also believes cases analyzing the producer requirement of § 263A, including Suzy Zoo v. Commissioner, are not useful in making the determination for purposes of § 199. Section 263A cases determine whether a taxpayer is a producer by relying on activities that, under § 199, result in the creation of intangible property.

The Field believes for a taxpayer to MPGE tangible personal property, the taxpayer must show that it applied some type of physical force to the property. Further, it must show that this physical force should be considered more than minor assembly as contemplated in § 1.199-3(e)(2). While we recognize that physical force may be an activity that occurs in the MPGE of tangible personal property, and often is a clear MPGE activity, the term 'physical force' has not been defined, and has not been mentioned as a standard for determining whether an activity is an MPGE activity. We also note, for example, gases, such as oxygen, hydrogen, and nitrogen are considered tangible personal property under § 1.199-3(j)(2)(i), but the production of those gases may not involve physical force. Therefore, we decline to say that the MPGE of tangible personal property categorically involves the use of physical force.

Print Specifications

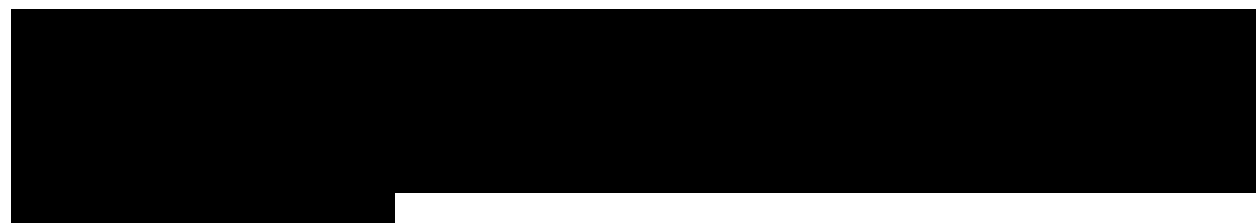
Our Office believes that print specification activities are non-MPGE activities. While providing the print specifications to the contract manufacturer gives the contract manufacturer a detailed description of how the Taxpayer desires the mass-produced books to look (e.g., size, color, print type, etc.), the print specifications do not produce QPP.

Packaging Activities

Taxpayer's activities in some circumstances also include packaging books. 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. Because Taxpayer's other activities are not the MPGE of QPP, Taxpayer's packaging activities do not qualify as the MPGE of QPP.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This request included memorandums from both the Field and the Taxpayer. Our Office took all of the submissions into consideration before reaching our conclusions.



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Please call \_\_\_\_\_ at \_\_\_\_\_ if you have any further questions.