



MORE WINE IN NEW BOTTLES: REPACKAGING AND QUALIFIED PRODUCTION ACTIVITIES

Posted on **October 7, 2015** by **Jim Malone**



The Internal Revenue Code is not just about revenue: it also reflects a variety of Congressional policies. At times, Congress uses tax incentives to promote activities that it wants to foster. An example is Section 199, which provides an incentive for taxpayers to conduct certain business activities, such as manufacturing and film-making, here in the United States by providing a deduction for the costs associated with those activities.

The amount of the deduction is a function of the taxpayer's "qualified production activities income," I.R.C. § 199(a)(1), which represents the taxpayer's "domestic production gross receipts" less cost of goods sold and other related expenses. I.R.C. § 199(c)(1). "Domestic production gross receipts" include revenue derived from transactions that involve "qualifying production property which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." I.R.C. § 199(c)(4)(A)(i)(I).

Since the availability of the deduction turns on whether particular "production property" was "manufactured, produced, grown, or extracted" here in the United States, there are regulations in place that interpret those key terms. See Treas. Reg. § 1.199-3(e)(1). And the regulations include a significant exception: "production property" that is merely repackaged does not qualify. Treas. Reg. § 1.199-3(e)(2).

Recently, a district court considered this repackaging exception in a refund action brought by a company that produced unit doses of medication. *Precision Dose, Inc. v. United States*, No. 12 C 50180, 2015 U.S. Dist. LEXIS 128115 (N.D. Ill. Sept. 24, 2015). The taxpayer's business involved acquiring certain drugs in bulk and then selling them in individual dose packages that consisted of sealed cups or syringes. While this sounds simple, it was actually quite involved, covering a range

of activities that included:

- selecting drugs that were appropriate for sale in that manner;
- developing the containers to hold the medicine;
- preparing specifications and operating procedures;
- contracting with labs to conduct stability studies to assure that drugs
- stayed within specifications;
- running validation batches;
- setting up and running full operations; and
- related record keeping.

2015 U.S. Dist. LEXIS 128115 at *4-*5.

The district court began its analysis by examining whether the taxpayer's activities fell within the scope of manufacturing, production, growing or extraction (or "MPGE") activities under Section 1-199-3(e)(1) of the regulations. The court had little difficulty resolving this issue in the taxpayer's favor: "The drugs, the cups, and the syringes exist independently of each other but none of them alone is a unit dose." *Id.* at *6.

As for the repackaging exception, the court acknowledged that in the absence of other MPGE activity, a taxpayer who "packages, repackages, labels, or performs minor assembly" does not qualify for the deduction under Section 199. *Id.* at *7 (quoting Treas. Reg. § 1.199-3(e)(2)). In the court's view, however, the exception did not apply to the taxpayer's business.

Relying upon [United States v. Dean](#), 945 F. Supp. 2d 1110 (C.D. Cal. 2013), the court concluded that the taxpayer was involved in more than mere repackaging. [Dean](#), which is discussed [here](#), involved a company that manufactured gift baskets and held that the taxpayer was engaged in manufacturing, not repackaging. In light of the involved process that the taxpayer used to create single dose units of medication, the court in *Precision Dose* had little difficulty concluding that the taxpayer was involved "in a complex production process that results in a distinct final product." 2015 U.S. Dist. LEXIS 128115 at *11 (quoting *Dean*, 945 F. Supp. 2d at 1118 n. 10).

Given the overlay of testing and other FDA regulatory requirements that the taxpayer faced in *Precision Dose*, this appears to be a stronger case for the Section 199 domestic production activity deduction than *Dean* was.



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