ADVO, Inc. & Subsidiaries v. Commissioner of Internal Revenue, 141 T. C. No. 9 (2013)

In ADVO, Inc. & Subsidiaries v. Commissioner, the U. S. Tax Court ruled that ADVO, a direct mail advertising company, was not entitled to a domestic production deduction under I. R. C. § 199 for its direct mail products. Despite ADVO's extensive involvement in the design and distribution process, the court determined that ADVO did not possess the requisite benefits and burdens of ownership during the production phase, which was outsourced to third-party printers. This decision highlights the complexities of applying tax deductions in contract manufacturing scenarios, emphasizing the necessity of ownership during production for eligibility under Section 199.

Parties

ADVO, Inc. & Subsidiaries, the petitioner, was the common parent of a consolidated group and the plaintiff in the case. The Commissioner of Internal Revenue was the respondent and defendant. ADVO was represented by attorneys Michael P. Walutes, Craig A. Raabe, John R. Shaugnessy, Jr. , Gary D. Yeats, and Scott E. Sebastian, while the Commissioner was represented by Donald K. Rogers, Charles E. Buxbaum, and William T. Derick.

Facts

ADVO, Inc. distributed direct mail advertising in the United States, utilizing both solo and cooperative mail packages. For its operations, ADVO either used materials supplied by its clients or materials it supplied itself. When supplying its own materials, ADVO contracted third-party printers to produce the printed advertisements. The company also developed and marketed a portfolio of turnkey products, which included the 'Shopwise' wrap and various inserts, and managed the entire process from design to delivery. ADVO's operations were substantial, distributing 60 to 80 million packages weekly and engaging in significant sales and design activities. The company's contracts with clients and printers stipulated the specifics of the production and delivery process.

Procedural History

The Commissioner disallowed ADVO's claimed deductions under I. R. C. § 199 for the tax years 2006 and the short 2007 tax year, asserting that ADVO did not manufacture, produce, grow, or extract qualifying production property with respect to its direct advertising mailings. ADVO petitioned the U. S. Tax Court for a redetermination of these deficiencies. The case was bifurcated, with the issue of the Section 199 deduction being addressed in the first trial, while a separate issue regarding a credit under I. R. C. § 41 for increasing research activities was to be resolved in a subsequent trial. The Tax Court's decision was based on the application of the benefits and burdens of ownership test to determine eligibility for

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the Section 199 deduction.

Issue(s)

Whether ADVO, Inc. & Subsidiaries is entitled to a deduction under I. R. C. § 199 for the tax years 2006 and the short 2007 tax year, given that it contracted with third-party printers to produce its direct advertising mailings?

Rule(s) of Law

I. R. C. § 199 allows a taxpayer a deduction for income attributable to domestic production activities, but requires that the taxpayer have manufactured, produced, grown, or extracted qualifying production property. The Treasury Regulations under Section 199, specifically § 1. 199-3(e)(1), define 'manufactured, produced, grown, or extracted' to include activities such as manufacturing, producing, improving, and creating qualifying production property. The regulations further stipulate that when a taxpayer contracts with an unrelated third party for manufacturing, the taxpayer must have the benefits and burdens of ownership of the qualifying production property during the period the manufacturing activity occurs, as per § 1. 199-3(f)(1).

Holding

The Tax Court held that ADVO, Inc. & Subsidiaries was not entitled to a deduction under I. R. C. § 199 for the tax years in question. The court determined that ADVO did not have the benefits and burdens of ownership of the direct advertising materials during the period of production by the third-party printers, as required by the regulations under Section 199.

Reasoning

The Tax Court applied the benefits and burdens of ownership test, which is based on various factors including legal title, possession, control, risk of loss, and active participation in the production process. The court analyzed these factors in the context of ADVO's relationship with its third-party printers and found that ADVO did not have the requisite control or ownership during the manufacturing process. Specifically, the court noted that legal title to the printed materials did not transfer to ADVO until after production was complete, and ADVO did not have day-to-day control over the printing process. Additionally, the third-party printers bore the risk of loss during production and enjoyed the economic gain from the sales, further supporting the conclusion that they, not ADVO, had the benefits and burdens of ownership during the production phase. The court also distinguished this case from previous cases like Suzy's Zoo, which involved a different section of the tax code (Section 263A) and a broader test for ownership. The court emphasized that under Section 199, only one taxpayer may claim the deduction, and the facts did not support ADVO's claim to that status.

Disposition

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The court denied ADVO’s petition for a redetermination of the deficiencies in income tax determined by the Commissioner for the tax years 2006 and the short 2007 tax year, affirming the disallowance of the Section 199 deduction.

Significance/Impact

The ADVO case is significant for its clarification of the application of the domestic production deduction under I. R. C. § 199 in the context of contract manufacturing arrangements. It underscores the necessity for a taxpayer to have the benefits and burdens of ownership during the manufacturing process to be eligible for the deduction. This decision has implications for companies engaged in similar arrangements, potentially affecting their tax planning and the structuring of contracts with third-party manufacturers. The case also illustrates the fact-intensive nature of the benefits and burdens test, which requires a careful examination of each specific relationship between the taxpayer and the contract manufacturer. Subsequent cases and IRS guidance may further refine the application of this test, but ADVO remains a key precedent for understanding the limits of Section 199 in contract manufacturing scenarios.

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