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Department of the Treasury

Washington, DC 20224

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Date:
March 24, 2003

Attn:

LEGEND

Parent =

Sub 1 =

Sub 2 =

Sub 3 =

Sub 4 =

Sub 5 =

Sub 6 =

Date 1 =

Technology 1 =

Technology 2 =

Technology 3 =

Technology 4 =

Technology 5 =

Technology 6 =

Dear :

This letter refers to a Form 3115, Application for Change in Accounting Method, filed by Parent on behalf of Sub 1, Sub 2, Sub 3, Sub 4, Sub 5 and Sub 6 (collectively the Subsidiaries) requesting permission to change their methods of accounting related to the production of delivery systems and the manufacture of packaging for the taxable year beginning Date 1 (year of change).

FACTS

Parent and the Subsidiaries are members of a group of affiliated corporations filing consolidated federal income tax returns. Each member uses an overall accrual method of accounting.

The Subsidiaries develop, produce and manufacture “delivery systems” for customers in the pharmaceutical industry. The term delivery systems generally refers to the means by which a pharmaceutical product is introduced into the user’s body, e.g., a gelcap, capsule, or inhaler. Production of delivery systems includes the incorporation or conversion of a customer’s proprietary ingredient(s) into topical, oral, inhaled, or ophthalmic products. Before production begins, the Subsidiaries often provide early guidance to their customers on compatibility of various pharmaceutical and non-pharmaceutical ingredients, alternative pharmaceutical delivery methods and their efficacy, dosage, capsule size and shape, etc. As part of these delivery system design and development activities, the Subsidiaries may perform clinical trials, analytical studies, and stability studies.

Some of the Subsidiaries also manufacture packages for customers in the pharmaceutical industry and fill those packages with the customers’ products. Packaging activities include: manufacturing and filling bottles, blister packaging, and child-resistant packaging; folding, filling, and sealing cartons; and printing inserts, outserts, and labels. Some of the packages are produced using the Subsidiaries’ own proprietary packaging processes and technologies.

Under the present method, the Subsidiaries use an inventory accounting method under § 471 of the Internal Revenue Code to account for their manufacturing and production activities. The Subsidiaries include in inventory costs all of the direct costs and the indirect costs properly allocable to the production activities in accordance with § 263A and the Income Tax Regulations thereunder. The inventory costs are recovered through cost of goods sold.

Under the proposed method, the Subsidiaries would no longer use an inventory accounting method for their manufacturing and production activities. The Subsidiaries propose to deduct direct labor costs and indirect production costs (other than indirect materials) as the costs are incurred. The Subsidiaries propose to account for the direct materials and indirect materials used in the production or manufacturing activities as non-incidental materials and supplies under §§ 1.162-3 and 461(h). The Subsidiaries state that the proposed method of accounting does not conform to Generally Accepted Accounting Principles or to the best accounting practice in the Subsidiaries' trade or business.

LAW & ANALYSIS

Section 471(a) provides that whenever in the opinion of the Secretary the use of inventories is necessary in order to clearly determine the income of any taxpayer, inventories shall be taken by such taxpayer. These inventories shall be taken on such basis as the Secretary may prescribe, conforming as nearly as possible to the best accounting practice in the trade or business, and as most clearly reflecting the income. In order to clearly reflect income, § 471 requires taxpayers to maintain inventories in every case in which the production, purchase, or sale of merchandise is an income producing factor. See § 1.471-1.

Section 263A requires producers and resellers of tangible personal property to include in inventory costs all of the direct and indirect costs allocable to the production or resale activity. Taxpayers that produce custom-ordered goods pursuant to a contract with a customer or customers are generally subject to the inventory requirements of § 471 and the inventory cost capitalization requirements of § 263A.

Section 263A(g) defines the term "produce" very broadly. By statute, the term includes "construct, build, install, manufacture, develop, or improve". The regulations add "create, raise, or grow" to the definition. See § 1.263A-2(a)(1)(i). Though an activity may qualify as production under this broad definition, a taxpayer is not considered to be producing property for purposes of section 263A unless it is also an owner of the property for federal income tax purposes. See § 1.263A-2(a)(1)(ii)(A). The determination of whether a taxpayer is an owner of property it produces is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. See § 1.263A-2(a)(1)(ii)(A). A taxpayer may be considered an owner of property produced even though it does not have legal title to the property. Some of the benefits and burdens of ownership are economic risk, degree of control exercised by the parties, right to dispose of the property, and rights and compulsion to repurchase the property. See Paccar, Inc. v. Commissioner, 85 T.C. 754 (1985), aff'd 849 F.2d. 393 (9th Cir. 1988) and Rev. Rul. 83-59, 1983-1 C.B. 103.

While the various benefits and burdens of ownership are important in analyzing tax ownership, they are not the exclusive tax ownership factors. Indeed, § 1.263A-2(a)(1)(ii)(A) specifies that the determination should be based on all the facts and circumstances. Other facts and circumstances relevant to the determination of whether a taxpayer is an owner of property it produces include the degree of utility or value added by the taxpayer, the separability of the products, the extent to which a taxpayer's production activities transform or convert the materials into a different product, and whether the taxpayer's efforts are necessary for a merchantable product.

The Subsidiaries contend that they are service providers providing manufacturing services rather than producers and sellers of manufactured goods. The Subsidiaries argue that they are providing a service because they assemble custom-ordered products under specifications provided by the customer. But even if we were to assume (which we do not) that the Subsidiaries can be characterized as service providers, it is well-settled that service providers are not automatically exempt from the requirement to maintain inventories. See Wilkinson-Beane, Inc. v. Commisioner, 420 F.2d 352, 354 (1st Cir., 1970). Inventories are required in every case in which the production, purchase or sale of merchandise is an income producing factor. See § 1.471-1. This requirement applies even where the taxpayer also provides services to its customers. See Wilkinson-Beane, 420 F.2d 352. Moreover, the mere fact that the Subsidiaries manufacture custom items does not exempt them from the requirements of §§ 471 and 263A. See Frank K. Wikstrom & Sons, Inc. v. Commissioner, 20 T.C. 359 (1953); The Fame Tool & Manufacturing Co., Inc. v. Commissioner, 334 F. Supp. 23 (S.D. Ohio 1971). In Wikstrom, as in the instant case, the product was made exclusively pursuant to contract, according to specifications provided by the customer, and the product, if rejected by the customer, could not be sold to others. In Wikstrom, the Tax Court held that the term merchandise was intended to cover items such as custom production tooling on order. The court noted that Wikstrom's business was one in which there was a product to which revenues and expenses could readily be assigned.

The Subsidiaries also contend that they are not tax owners of the property they produce and therefore should not be required to maintain inventories or capitalize production costs. The Subsidiaries argue that they are not tax owners because they have limited rights to sell the property they produce to parties other than the customer for whom the property was produced. The Subsidiaries' customers have intellectual property rights in the products or the packaging produced by the Subsidiaries. Also, federal, state and local law governing pharmaceutical distribution restricts or prohibits the Subsidiaries from reselling some of the items they produce to parties other than the customer for whom it was produced. According to the Subsidiaries, these factors preclude them from having the right to sell the finished goods to other parties and without the right to sell to other parties, the Subsidiaries cannot have sufficient benefits and burdens of ownership to be considered the tax owners of the property. We do not believe, however, that these factors necessarily lead to the conclusion advocated by the Subsidiaries.

The Subsidiaries' situation is not uncommon insofar as they produce goods that incorporate the intellectual property of their customers. When goods are produced to a customer's specifications, it is common for the finished goods to contain some intellectual property right owned by the customer. The goods may be produced according to a patented design, using a patented material, or may simply bear the trade name of the customer. In many cases, the customer may be able to exercise its intellectual property rights to restrict or prevent the manufacturer from selling the goods to other customers. The fact that the customer has intellectual property rights in the goods does not automatically mean that the manufacturer of those goods is not required to maintain inventories or capitalize the direct and indirect costs of producing them. See Fame Tool and Wikstrom.

We also do not believe that the legal restrictions on the Subsidiaries' ability to sell the pharmaceutical products to anyone of its choosing preclude the Subsidiaries from being considered a tax owner of the products. Legal restrictions on the resale of pharmaceutical products exist at virtually every level of the pharmaceutical distribution chain. Even the Subsidiaries' customers cannot sell certain pharmaceutical products to anyone of their choosing. Likewise, retail pharmacies generally cannot dispense certain pharmaceuticals without a prescription from a licensed physician; nor can the retail customer resell those pharmaceuticals. Given that legal restrictions on resale apply throughout the pharmaceutical distribution chain, we do not believe that unfettered rights to sell certain pharmaceuticals are necessary for a determination of tax ownership.

Although not specifically expressed, the Subsidiaries' written submissions assume that if a manufacturer produces a component or additive for property owned by another and installs or otherwise incorporates that component or additive into the other's property pursuant to a contract, the manufacturer is not a tax owner of the component or additive that it produced. This assumption is incorrect. The fact that a taxpayer incorporates property that it produced into property owned by another does not necessarily mean that the taxpayer is not a tax owner of the separate property it produced. Clearly, a tire manufacturer is no less an owner of tires it manufactures merely because it also installs those tires on automobiles owned by customers. Similarly, we do not believe that a Subsidiary's lack of ownership in the pharmaceutical product contained in a package produced by the Subsidiary precludes that Subsidiary from qualifying as a tax owner of the packaging.

After reviewing the Subsidiaries' submitted facts and circumstances, we believe that the Subsidiaries have not demonstrated that their proposed method will clearly reflect income or is consistent with §§ 471 and 263A and the regulations thereunder. The Subsidiaries acknowledge that the proposed method is not the best accounting practice in the trade or business. The production, purchase, or sale of merchandise is an income producing factor in the Subsidiaries businesses. Although contract rights, intellectual property rights, and governmental regulations prevent the Subsidiaries from having legal title or unfettered rights to dispose of the property, the Subsidiaries still have sufficient indicia of ownership in regard to the delivery systems, the final products, or both to be subject to §§ 471 and 263A.

Sub 1, Sub 2, and Sub 3 produce packaging by constructing boxes and other packaging from the raw materials and then filling the packaging with their customers' pharmaceuticals. Packaging items produced include bottles, blister packaging, child-resistant packaging, cartons, inserts/outserts and labels. Sub 1, Sub 2, and Sub 3 are engaged in the production of merchandise that is an income producing factor and are therefore subject to § 471. Additionally, they have sufficient indicia of ownership in the boxes, bottles, and other packaging products to be considered tax owners under § 263A.

Sub 4 develops and produces unique delivery systems for specific products.

Customers receive early guidance from Sub 4 on ingredient compatibility, variations in methods of delivery, dosage and capsule size, and shape recommendations. Sub 4's delivery systems, some of which are proprietary technologies, can improve the efficacy of the customers' pharmaceuticals. These proprietary technologies include Technology 2, Technology 3, Technology 4, and Technology 5. Due to the fact Sub 4 assists its customers in maximizing the merchantability of the customers' product, uses Sub 4's own proprietary technologies, and provides many of the raw materials used to produce the products, we conclude that Sub 4 is subject to §§ 471 and 263A.

Sub 5 is a leading producer of Technology 1 and other health-care products in topical, oral, inhaled and ophthalmic forms. Sub 5 has developed a proprietary Technology 6, which it uses to package various pharmaceutical products for its customers. Sub 5 is capable of handling projects from design through implementation for sophisticated pharmaceutical Technology 6 applications. Since Sub 5 uses its own materials and proprietary pharmaceutical enhancement technologies to produce pharmaceuticals for its customers, it is subject to §§ 471 and 263A.

Sub 6 produces advanced controlled-release drug delivery systems for prescription and over-the-counter products. Sub 6 uses specialized coating on granular drug particles in the production of oral tablets to provide controlled-release capabilities and taste masking abilities. Sub 6 provides collaboration on the efficacy of the customer's proprietary materials, utility (taste masking and controlled-release), merchantability of the customer's product, and direct materials for the final form. Due to these factors, Sub 6 is subject to §§ 471 and 263A.

Because the Subsidiaries have not demonstrated that the proposed method will clearly reflect income or is consistent with §§ 471 and 263A and the regulations thereunder, we cannot approve the Subsidiaries' requests to change to the proposed method of accounting.

This letter is directed only to the taxpayers that requested it and may not be used or cited as precedent.

In accordance with the provisions of a power of attorney on file with this office, we are sending a copy of this ruling letter to the taxpayer's authorized representatives.

Sincerely yours,

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JEFFERY G. MITCHELL
Senior Technician Reviewer, Branch 7
Office of Associate Chief Counsel
(Income Tax & Accounting)