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Revisiting the Domestic Production Activities Deduction for Retail Food and Beverage Sales

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The domestic production activities deduction of section 199[1] (the "DPAD") does not apply to gross receipts derived from the sale of food or beverages prepared by the taxpayer at a retail establishment. Despite this facially broad exclusion, however, many retail food and beverage sales do in fact produce qualifying income entitling the taxpayer to this potentially valuable deduction. In particular, companies using off-site central kitchens or commissaries to assist in preparing food or beverage items sold at retail outlets—restaurants, hotels, grocery or other retail stores, and even theme parks—may be entitled to claim the DPAD for a portion of those sales. The deduction likewise may be available for restaurant operators using third-parties for off-site food preparation if the taxpayer has the "benefits and burdens of ownership" during the production process. While the concepts discussed in this article are not new, the discussion hopefully will assist companies seeking to freshen their section 199 positions and identify previously overlooked benefits.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

Background

Section 199 was added to the Code in 2004[2] to provide a permanent tax benefit to taxpayers engaged in qualifying production activities in the United States. The morass of definitions, special rules, exceptions, and limitations employed by section 199 and the Treasury regulations that attempt to clarify its application have been widely discussed elsewhere, and need not be repeated here.[3] In the broadest terms, however, section 199 provides a tax deduction equal to nine percent of either the taxpayer's taxable income for the year, or its "qualified production activities income" or "QPAI," whichever is lower. The taxpayer's QPAI, in turn, equals the taxpayer's gross receipts derived from qualifying production activities in the United States ("domestic production gross receipts," or "DPGR"), reduced by the direct and indirect costs of generating those gross receipts. The deduction cannot exceed one-half of the production-related W-2 wages paid by the taxpayer during that year.[4]

As designed by Congress, the scope of potentially qualifying production includes a wide range of activities involving the manufacture, production, growth, or extraction ("MPGE") in the United States of tangible personal property, software, films, sound recordings, electricity, natural gas, and a range of other products.[5] The DPAD likewise is available for limited categories of services (e.g., construction and engineering).[6] The Treasury regulations specifically exclude from the scope of qualifying activities, however, the sale of food or beverages prepared by the taxpayer at a retail establishment.[7]

As with so much of section 199, taxpayers must scrutinize the precise language of this exclusion to ensure that it is applied to—and only to—those "retail establishments" within its scope. For this purpose, the section 199 regulations define a retail establishment as tangible property (both real and personal) owned, leased, occupied, or otherwise used in the trade or business of selling food or beverages to the public at which retail sales are made. The regulations apply this exclusion expansively to include traditional dine-in restaurants, as well as take-out facilities, in-store bakeries, food carts, and

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[2] Section 102, Pub. L. 108-357, 118 Stat. 1418 (2004), as amended by section 403(a) of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109-135, 119 Stat. 25 (2005)), section 514 of the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109-222, 120 Stat. 345 (2005)), section 401 of the Tax Relief and Health Care Act of 2006 (Pub. L. 109-432, 120 Stat. 2922 (2006)), section 401(a), Division B of the Energy Improvement and Extension Act of 2008 (Pub. L. 110-343, 122 Stat. 3765 (2008)), sections 312(a) and 502(c), Division C of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (Pub. L. 110-343, 122 Stat. 3765 (2008)), section 746(a) of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. 111-312, 124 Stat. 3296 (2010)), section 318 of the American Taxpayer Relief Act of 2012 (Pub. L. 112-240, 126 Stat. 2313 (2013)), and sections 130 and 219(b) of the Tax Increase Prevention Act of 2014 (Pub. L. 113-295, 128 Stat. 4010 (2014)).

[3] *See* Beth Benko, 510-2d T.M., *Section 199: Deduction Relating to Income Attributable to Domestic Production Activities*. *See also* Beth Benko, "Section 199, The Domestic Production Deduction: A Case for Reform," 57 Tax Mgmt. Memo 327 (Aug. 8, 2016).

[4] Section 199(b); section 1.199-2.

[5] *See generally* section 1.199-3(a).

[6] Sections 1.199-3(m) and (n).

[7] Section 1.199-3(o)(1).

portable food stands. The regulations even include caterers within the scope of taxpayers preparing food or beverage for "take-out or delivery."[8]

Importantly, however, at least some portion of many food or beverage sales at retail locations remain eligible for the section 199 benefit. The so-called "coffee footnote" found in the legislative history of section 199 (and incorporated into the regulations through an example) makes clear that so long as the food or beverages are produced in whole or part at a non-retail facility, an allocable portion of the receipts from the retail sales of those items remains potentially eligible for the DPAD.[9]

In the coffee footnote, the taxpayer buys coffee beans and roasts them at a facility, the primary activity of which is the roasting and packaging of roasted coffee. The taxpayer sells the roasted coffee through a variety of unrelated third-party vendors and also sells the roasted coffee at the taxpayer's own retail establishments. In addition, the taxpayer prepares brewed coffee and other foods at its retail locations.

In discussing this fact pattern, Congress makes clear that section 199 applies to the portion of food and beverage sales allocable to the off-site coffee roasting activities. While DPGR will not include all the gross receipts derived from the sale of coffee brewed at the retail establishment, the legislative history states that the taxpayer may determine the portion of the sales price of the brewed coffee allocable to the beans roasted off-site and treat that allocable portion as DPGR eligible for the section 199 benefit.[10]

As such, the coffee footnote establishes that even if a restaurant prepares and sells food or beverages to customers at a retail location, qualifying DPGR includes the allocable portion of the sales receipts derived from food or beverage preparation activities that the taxpayer performs at a non-retail location.

Further, food prepared at a non-retail location need not be limited to basic ingredients such as roasted coffee beans. In the so-called "doughnut paradox," then-IRS Commissioner Mark Everson described to members of a presidential advisory panel considering tax reform how the sale of two otherwise indistinguishable doughnuts may produce both qualifying and non-qualifying gross receipts for purposes of section 199:

> If I make a jelly doughnut at my retail establishment and sell it to [Customer A], that does not qualify for this new manufacturing deduction. On the other hand, if I sell to [Customer B] a box of doughnuts baked in the same oven, wholesale, to resell to [its customers], including [Customer A] if he wants a second doughnut, that sale qualifies for the special deduction. So [Customer A] has two doughnuts, basked side-by-side, but treated differently under the tax law.[11]

Although this example explores the differing tax consequences driven by the sale terms of identical food items cooked in the same facility (retail versus wholesale), the example is equally instructive in

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[8] *Id.*

[9] H.R. Conf. Rep. No. 108-755, 272, n. 27 (Oct. 7, 2004). *See also* section 1.199-3(o)(3) Example 1.

[10] H.R. Conf. Rep. No. 108-755, 272, n. 27 (Oct. 7, 2004).

[11] Herman, "The 'Doughnut Paradox' Is Explained by an IRS Official," Wall St. J. (Mar. 9, 2005) at D2.

considering the application of section 199 to otherwise identical food or beverage items produced at different locations (i.e., at a retail facility versus off-site). The plain language of the section 199 regulations excludes from the scope of the benefit only gross receipts derived from the sale of food or beverages prepared by the taxpayer *at a retail establishment*. Although defined broadly, "retail establishment" means property used by the taxpayer in its trade or business of selling food or beverages to the public *at which retail sales are made*. If a production facility is not engaged in selling food or beverages directly to customers, that location is not a retail establishment under the plain language of the regulations.

As such, otherwise qualifying production activities undertaken in that off-site facility are eligible for the DPAD, even if the taxpayer uses that facility's products in connection with a non-qualifying activity further downstream.

Central Kitchens and Commissaries

Many companies engaged in retail food and beverage sales rely on centralized facilities to prepare or produce ingredients, meal components, and even some ready-to-eat foods offered for sale in their restaurants or other retail locations.[12] These items may be produced by a company at a central kitchen or commissary, for example, and distributed to its retail locations within a defined geographic area. Upon reaching those locations, the restaurant's cooks generally use these ingredients or menu items to prepare the meals served to diners.

For example, assume a taxpayer operates numerous sandwich shops within a large metropolitan area. In addition to purchasing certain fresh ingredients (such as produce) delivered directly to its restaurants by third-party vendors, the taxpayer operates a large central kitchen at which it bakes all the bread used in each of its sandwich shops within that city. The taxpayer delivers the fresh bread to each of its restaurants each morning or throughout the day as needed. On these facts, the taxpayer's preparation of the bread would be analogous to the coffee beans roasted off-site and used by the taxpayer in brewing coffee at its retail locations. Just as the coffee shop treats an allocable portion of the sales price of each cup of coffee as DPGR, so too the restaurateur should be entitled to treat as DPGR an allocable portion of the sales price of each sandwich by reason of its off-site production of the bread used in preparing each sandwich.

As a further example, assume that a restaurant chain prepares nearly all of its menu items, including entrees, at a central location. The ready-to-eat food is prepared in the same manner as if prepared individually at a retail establishment. The items then are flash frozen and delivered to the chain's restaurants to be held until needed. Cooks at the restaurants use the frozen items to prepare each diner's meal.

Although the finished meal is indistinguishable from one prepared entirely on-site using fresh ingredients, the restaurant's use of a non-retail location to mass produce components of the meal entitles the restaurant to treat as DPGR an allocable portion of each meal's sales price. While a multi-

[12] For example, some large retailers offer rotisserie chicken, deli sandwiches, and similar ready-to-eat items.

course meal may be physically distinguishable from a roasted coffee bean, the plain language of the section 199 regulations applies equally to each.

The section 199 regulations' reference to catering as a non-qualifying activity has no bearing on this conclusion. In a parenthetical with no legal analysis, the regulations cite caterers as an example of a facility that prepares food or beverage for take-out service or delivery.[13] In doing so, the IRS presumably analogizes a caterer to a pizza delivery outlet (for example), at which the food is prepared at the company's location and delivered directly to customers for immediate consumption. While this analogy is questionable, it would be completely inapposite to a taxpayer's off-site production of items that it delivers to its own restaurants for later use in preparing food or beverage offerings at those retail locations.

Other Potential Applications

The potential application of section 199 to retail food and beverage sales is relatively broad. For example, depending on the taxpayer's facts, the section 199 benefit may be available for:

- A hamburger chain's preparation and flash-freezing of ground beef patties and french fries and its baking of buns at one or more central locations
- The off-site preparation of rotisserie chickens to be sold in retail grocery stores
- The production of ingredients to be used in the final preparation of menu items (e.g., preparing roast beef to be delivered to and sliced at the retail location for use in preparing sandwiches)
- The baking of desserts in a central kitchen and delivering the desserts to the taxpayer's local restaurants
- A grocer's use of a central kitchen to prepare deli or prepared food items for sale to customers at an in-store prepared-foods counter with a seating area (e.g., pasta salads, chicken salad, fried chicken, macaroni and cheese, etc.)
- A grocer's company-owned and operated dairy processing plant, producing milk, cheese, etc., for sale in the grocer's retail stores; a central meat processing facility preparing meat products for sales in the grocer's stores; and a central bakery producing bread and similar products for sale in the grocer's stores
- A bakery-café chain's use of a central kitchen to prepare muffins, bagels, doughnuts, breads, etc., to be distributed daily to and sold by the taxpayer's individual storefronts
- A theme park's use of a central kitchen to produce food offerings distributed to various retail locations (including food carts) throughout the theme park

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[13] Section 1.199-3(o)(1).

Third-Party Facilities

Many restaurant operators contract with third-parties rather than operating their own off-site central kitchens or commissaries. The restaurant operator may contract with one or more third-parties to prepare menu items, ingredients, or components to the restaurant operator's exacting specifications. To ensure the consistent tastes, appearance, and quality expected by the restaurant operator's diners, the taxpayer generally imposes stringent standards and specifications and carefully oversees the third-party's production of the items destined for its retail locations.

Restaurant operators should carefully review the terms of contract manufacturing arrangements to determine the extent to which it has the "benefits and burdens of ownership" during the production process. Currently, restaurant operators may be entitled to claim the benefits of section 199 under contract manufacturing arrangements, depending upon a particular contract's terms. The IRS generally allows a taxpayer to claim the section 199 benefit if it can provide a statement explaining its determination that it has the benefits and burdens of ownership, along with certification statements by the taxpayer and the counterparty verifying that only the taxpayer is claiming the DPAD.[14]

The government has proposed regulations, however, that would restrict the benefit of the DPAD to the party that "performs the activity."[15] If the proposed regulations are finalized without change, this likely would eliminate the restaurant operator's ability to claim the benefits of section 199 under third-party arrangements.

Next Steps

The first critical step in sustaining a section 199 deduction for retail sales of food or beverages is demonstrating the extent to which the food or beverage offerings are prepared at least in part at a non-retail location, such as an off-site commissary or central kitchen.

Second, the taxpayer must be prepared to show that the off-site production activities otherwise satisfy the requirements of section 199. In particular, the off-site activities must be "substantial in nature."[16] While many food preparation activities should qualify, some minor food prep activities might not.

Finally, upon concluding that it is engaged in sufficiently substantial off-site production activities related to its food or beverage sales, the taxpayer must determine the portion of its gross receipts from those sales allocable to off-site activities. As in the coffee footnote, the taxpayer will need to employ a methodology akin to that required by section 482 to "shrink back" to the portion of its food or beverage gross receipts allocable to the off-site production. The bottom-line tax benefit available for off-site food and beverage production correlates directly with the taxpayer's precision in computing and ultimately sustaining this allocation. As such, the use of valuation specialists may pay dividends if and when the IRS scrutinizes the methodology and results of that allocation.

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[14] LB&I-04-1013-008 (Oct. 29, 2013).

[15] Proposed section 1.199-3(f)(1). *See also* 80 Fed. Reg. 51978, 51982 (Aug. 27, 2015).

[16] *See generally* section 1.199-3(g).

In summary, to derive a section 199 benefit from retail food or beverage sales, taxpayers must satisfy three principal requirements:

- The taxpayer prepares the food or beverage in whole or part at a non-retail location (either directly or through a qualifying contract manufacturing arrangement)
- The off-site preparation activities are substantial in nature
- A demonstrable portion of the gross receipts from the retail food or beverage sales are allocable to the off-site production

Upon making these showings (and satisfying the other requirements of section 199), the taxpayer may be entitled to the permanent tax benefits offered by the domestic production activities deduction for a portion of its retail sales of food or beverages.

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