

## Out-Of-State Companies Beware Mass. 'Manufacturer' Tag

By Philip Olsen and Michael Penza (May 18, 2018, 3:46 PM EDT)

In Massachusetts, the concept of manufacturing has evolved. Smoke stacks and assembly lines, once common in the Commonwealth, continue to disappear as businesses increasingly rely on multinational, contract manufacturing processes. However, Massachusetts' definition of manufacturing has not changed dramatically over the years. In 1928, the Massachusetts Supreme Judicial Court defined manufacturing as "change wrought through the application of forces directed by the human mind, which results in the transformation of some preexisting substance or element into something different."<sup>[1]</sup> Compare that with the current statutory definition of manufacturing: "transforming raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name, nature and adapted to a new use."<sup>[2]</sup> While the definitions could reasonably be read as requiring direct involvement by the taxpayer throughout the process, the Supreme Judicial Court has interpreted the term "manufacturing" expansively to include those companies that design and sell products manufactured by third parties. The Massachusetts Department of Revenue was initially unsuccessful in arguing against this expansive interpretation when Massachusetts businesses claimed sales and use tax exemptions as manufacturers. Undaunted, the department embraced this expansive view in order to increase the corporate excise tax burden on businesses located outside the Commonwealth.



Philip Olsen



Michael Penza

### "Manufacturing" as Applied to Massachusetts Businesses

Massachusetts provides property tax exemptions, sales and use tax exemptions, and investment tax credits to manufacturers located in Massachusetts.<sup>[3]</sup> Early on, the Supreme Judicial Court recognized that such benefits were designed to encourage manufacturing activities in the Commonwealth.<sup>[4]</sup> With this goal in mind, the court has explained that the phrase "engaged in manufacturing" should not be given "a narrow or restricted meaning."<sup>[5]</sup> Thus, the court and the Massachusetts Appellate Tax Board have consistently held that a company does not itself have to build and distribute a finished product to be considered a manufacturer. The proper test, therefore, for determining whether a company is engaged in manufacturing is whether its activities are an "essential and integral step" in the manufacturing process.<sup>[6]</sup>

This "essential and integral step" test repeatedly thwarted the department's efforts to deny

manufacturing status to in-state businesses that relied on contract manufacturing. For example, in 1995, the Supreme Judicial Court held in *Commissioner of Revenue v. Houghton Mifflin Co.* that a Massachusetts book publisher was a manufacturer entitled to investment tax credits.[7] The publisher did not print or bind the books that it published; rather, it outsourced that work to independent contractors.[8] The publisher provided the independent contractors with CD-ROMs that contained the publisher's specifications regarding content, design and layout.[9] The court reasoned that the publisher was engaged in manufacturing because it transformed:

Ideas, art, information, and photographs, by application of human knowledge, intelligence, and skill, into computer disks, ready for use by independent printers, containing an immense amount of information in a highly organized form.[10]

It concluded that the publisher's creation of the CD-ROMs was an "essential and integral" step in the manufacture of books, as they were "physically useful" in the manufacturing process.[11]

In 2007, the Appellate Tax Board determined in *The First Years Inc. v. Commissioner of Revenue* that a Massachusetts designer of childcare products was also a manufacturer.[12] The company developed designs and models of childcare products, and then, with the aid of third parties, created the tooling and molds necessary to manufacture those products.[13] The company provided the tooling and molds to third-party manufacturers, which mass-produced the company's products according to the company's specifications.[14] In finding that the company performed an "essential and integral" step in the manufacturing process, the board analogized the tooling and molds to the CD-ROMs in *Houghton Mifflin* — both were "physically useful" to manufacturing a finished product.[15]

Then in 2010, the Supreme Judicial Court appeared to take an even more expansive view of manufacturing in *Onex Communications v. Commissioner of Revenue*.<sup>[16]</sup> In *Onex*, a Massachusetts company created a "telecommunications switching chip set, known as the OMNI chip."<sup>[17]</sup> The company created a "blueprint" for the OMNI chip, which was "a computer-edited design that included technical specifications of the hardware and software components" of the OMNI chip and "included detailed manufacturing instructions."<sup>[18]</sup> The company provided the "blueprint" on a computer disk to a third-party manufacturer, which produced the OMNI chips.<sup>[19]</sup> The court found that the manufacture of the OMNI chip was "entirely dependent" on the "blueprint" created by the company and, thus, concluded that the company performed an "essential and integral step" in the manufacturing process.<sup>[20]</sup> The court stated that the creation of the "blueprint" was "virtually identical" to the creation of the CD-ROMs in *Houghton Mifflin*.<sup>[21]</sup> However, unlike in *Houghton Mifflin*, the court did not characterize the "blueprint" as "physically useful" in the manufacturing process and did not mention that the "blueprint" was transferred on a computer disk, possibly suggesting that a company could be a manufacturer without contributing anything tangible to the manufacturing process performed by a third-party.<sup>[22]</sup>

### **"Manufacturing" as Applied to Out-Of-State Businesses**

Ironically, with the adoption of single sales factor apportionment for manufacturers beginning in 2000, the department has relied on its defeats in *Houghton Mifflin*, *The First Years*, and *Onex* to successfully litigate against non-Massachusetts businesses. The imposition of a single sales factor formula favors in-state manufacturers while disadvantaging out-of-state manufacturers whose payroll and property would primarily be located outside Massachusetts. Thus, the department has modified its approach to manufacturing: instead of opposing in-state companies' claims to sales or property tax exemptions or investment tax credits, it is now focused on deeming out-of-state corporations to be manufacturers

required to use single sales factor apportionment.

For instance, in 2012, the department successfully argued in *Random House, Inc. v. Commissioner of Revenue* that a book publisher located outside of Massachusetts was a manufacturer required to use the single sales factor formula.[23] The facts in *Random House* were similar to those in *Houghton Mifflin*, except that the publisher in *Random House* transferred its specifications regarding content and design to its third-party manufacturer electronically.[24] The board found this distinction irrelevant and, citing *Onex*, stated that “the [Supreme Judicial Court] and the Board recognize the crucial role that electronic sources and processes are increasingly playing in the modern manufacture of tangible personal property.”[25] The board then determined that the publisher’s “design and editorial activities” were “essential and integral steps” in the manufacture of books.[26]

More recently, on May 23, 2017, in a one-line decision, the board denied a California footwear company’s attempt to avoid single sales factor apportionment in *Deckers Outdoor Corp. v. Commissioner of Revenue*. [27] The board ruled that the company, which relied on third parties to manufacture its footwear overseas, was a manufacturer, reaffirming the principle that a company does not literally have to manufacture goods in order to be considered a manufacturer.[28] The board is expected to issue its full opinion in *Deckers* in the near future.

As a result of *Deckers* and *Random House*, non-Massachusetts corporations, which may outsource certain operations and not consider themselves engaged in manufacturing in their home state, could nevertheless be found to be manufacturers in Massachusetts.

## **Summary**

Considering the expansive interpretation given to the term “manufacturing,” Massachusetts-based businesses that rely on contract manufacturing should continue to claim all benefits associated with being a “manufacturer” under the Commonwealth’s tax laws.

Out-of-state businesses, however, should not simply roll over if the department asserts that they are manufacturers based on the board’s decisions in *Random House* and *Deckers*. Whether a company’s activities result in it being considered a manufacturer under Massachusetts law is a fact-driven question, determined on a case-by-case basis. It is important to have a clear understanding of the process through which a company brings a product to market. This may present the company with an opportunity to distinguish its facts from those set forth in the Massachusetts cases. One example would involve the level of supervision or control over the third-party manufacturer. The less control exercised, the less likely a finding of manufacturing.

Finally, although it may seem unconstitutional on its face, in *Genentech Inc. v. Commissioner of Revenue*, the Supreme Judicial Court rejected the claim that application of the Massachusetts single sales factor apportionment formula to an out-of-state manufacturer violates the Commerce Clause.[29] However, the *Genentech* case did not involve contract manufacturing. The question remains whether the Supreme Judicial Court might revisit this issue if faced with the expansive approach to manufacturing applied in the *Deckers* case.

---

*Philip Olsen is of counsel at Morrison & Foerster LLP.*

*Michael Penza is an associate with the firm.*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc. or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

[1] Bos. & Me. R.R. v. Billerica, 262 Mass. 439, 444-45 (1928).

[2] Mass. Gen. Laws ch. 63, Section 38(l)(1). This definition applies for purposes of the Massachusetts Corporation Excise Tax. A substantially similar definition applies for purposes of the Massachusetts sales, use, and property taxes. See 830 Mass. Code Regs. 58.2.1(6)(b).

[3] 830 Mass. Code Regs. 58.2.1(4).

[4] See, e.g., Assessors of Bos. v. Comm’r of Corps. & Taxation, 323 Mass. 730, 741 (1949) (explaining that the local property tax exemption provided to manufacturers was designed to encourage manufacturing in Massachusetts).

[5] William F. Sullivan & Co. v. Comm’r of Revenue, 413 Mass. 576, 579 (1992) (quoting Joseph T. Rossi Corp. v. State Tax Comm’n, 369 Mass. 178, 181 (1975)).

[6] See Onex Commc’ns Corp. v. Comm’r of Revenue, 457 Mass. 419 (2010) (creation of blueprint for production of a computer chip was an essential and integral step in the manufacturing process even though the chip was produced by a third-party).

[7] 423 Mass. 42 (1996).

[8] Id. at 44.

[9] Id.

[10] Id. at 48.

[11] Id. at 49.

[12] Docket No. C267626 (Mass. App. Tax Bd. Sept. 17, 2007).

[13] Id.

[14] Id.

[15] Id.

[16] 457 Mass. 419.

[17] Id. at 420.

[18] Id. 420-21.

[19] Id. at 421.

[20] Id. at 431.

[21] Id.

[22] See id.

[23] Docket No. C303502 (Mass. App. Tax Bd. Oct. 2, 2012).

[24] Id.

[25] Id.

[26] Id.

[27] Docket Nos. C320020 & C321955 (Mass. App. Tax Bd. May 23, 2017).

[28] Id.

[29] 476 Mass. 258 (2017).