

## MA ATB - Retailer is "Manufacturing Corporation" for Massachusetts Excise tax purposes based on involvement in product design process

### Overview

On June 21, 2018, the Massachusetts Appellate Tax Board (Board) decided *Deckers Outdoors Corporation v. Commissioner*,<sup>1</sup> a case addressing the scope of the "manufacturing corporation" definition for Massachusetts corporate excise tax purposes as it applied to a taxpayer that did not physically manufacture any of the products that it sold. Instead, the taxpayer contracted with a third party manufacturer to produce the shoes according to a detailed design sketch and a description of materials developed by the taxpayer. The Board determined that taxpayer was properly treated as a manufacturing corporation and therefore required to use a single-sales factor apportionment formula.<sup>2</sup>

This tax alert summarizes the Board's decision and considers the potential impact it may have upon retailers with customers in Massachusetts.

### Background

As outlined in the Board's decision, the taxpayer's process for developing products typically spanned about 18 months.<sup>3</sup> The process began with a product brief for a proposed shoe, developed by company employees, containing information such as the nature of the shoe, its target customers and price point, and information regarding its market competitors.<sup>4</sup> Taxpayer's designers then developed detailed drawings and decided the materials to be used in the product.<sup>5</sup> The contract manufacturer then would produce prototypes, which taxpayer's employees would test for fit and quality.<sup>6</sup> Based on the feedback from that testing, taxpayer created a "tech pack," a multi-page document including drawings, materials, precise measurements of the features, and colors.<sup>7</sup> Using these tech packs, the contract manufacturer produced the shoes to be sold by the taxpayer.<sup>8</sup>

### Summary of the decision

The Board found that "the materials created by [taxpayer], including the tech packs, were physically useful in making the footwear products that it ultimately sold."<sup>9</sup> Furthermore, the Board found that "[taxpayer] employees physically interacted with the footwear products throughout the production process...and that their feedback resulted in physical modifications to the products."<sup>10</sup> The Board concluded that taxpayer was engaged in manufacturing, finding that taxpayer's activities, "throughout the entirety of the critical path amounted to the transformation of '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,'" required by the statutory definition of manufacturing.<sup>11</sup>

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<sup>1</sup> Mass. ATB Docket Nos. C320020 and C321955 (June 21, 2018). A copy of the Board decision is available [here](#).

<sup>2</sup> Mass. Gen. Laws ch. 63, § 38(l); 830 CMR 63.38.1(10)(a).

<sup>3</sup> Mass. ATB Findings of Fact and Reports 2018-227, 233.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 234.

<sup>7</sup> *Id.* at 236.

<sup>8</sup> *Id.* at 237.

<sup>9</sup> *Id.* at 238.

<sup>10</sup> *Id.* at 238-239.

<sup>11</sup> *Id.* at 238 (quoting M.G.L. c. 63, § 38(l)(1)).

## External Multistate Tax Alert

At the time of this alert, it is unclear whether the taxpayer plans to appeal this decision.<sup>12</sup>

### Potential impact on retailers using contract manufacturing

Based on this decision, companies involved in the development of the specifications to be used by a third party contractor to produce tangible goods on its behalf may be considered a “manufacturing corporation” for Massachusetts excise tax purposes. In earlier cases involving manufacturers using third party contractors to actually produce their products, it was determined that the taxpayer had produced something that had “physical application” in the manufacturing process.<sup>13</sup> However, the decision in *Deckers* suggests that merely producing the specifications for finished products, without producing anything which comes in physical contact in the actual manufacturing process, satisfies this “physical application” test. Accordingly, this decision (and the potential application of single sales factor apportionment) may apply to a variety of retailers beyond the apparel industry who develop designs for products manufactured by third parties.

## Contacts:

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<sup>12</sup> A Notice of Appeal is required to be filed within 60 days of the date of the entry of judgment appealed from.

<sup>13</sup> See *Commissioner of Revenue v. Fashion Affiliates, Inc.*, 387 Mass. 543, 545-46 (1982). (A computer system used to produce dress patterns which were then transferred for use onto the actual fabric for the mass production of dresses, provided a function that was an integral and necessary step in the making of dresses, and thus constituted manufacturing.)