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LEGAL ALERT

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Applying Costs of Performance to Apportion Service Income: Massachusetts and Oregon Courts Reach Differing Conclusions

Recent decisions from two different state judicial bodies differ on how to apply costs of performance to a telecommunications company's receipts from sales of services. These two cases demonstrate how states are applying – and misapplying – this long-standing apportionment method.

On June 8, 2011, the Massachusetts Appellate Tax Board (the Board) issued its written decision[1] in favor of AT&T regarding whether receipts from its interstate and international telecommunication services should be included in the Massachusetts sales factor numerator. *AT&T Corp. v. Commissioner of Revenue*, Mass. ATB Findings of Fact and Reports, 2011-524. The Board *accepted* the taxpayer's position that its income-producing activity was the business of providing a national, integrated telecommunications network that was operated and managed in New Jersey. Rather than requiring AT&T to provide evidence supporting the apportionment of each and every transaction, the Board accepted AT&T's evidence of costs associated with revenue streams and apportioned categories of income rather than individual transactions (referred to as the Operational Approach).

Twenty days later, on June 28, 2011, the Oregon Tax Court (the Tax Court) issued its decision *against* AT&T on whether its receipts from interstate and international communications services should be included in the Oregon sales factor numerator. *AT&T Corp. v. Department of Revenue*, Oregon Tax Court, TC 4814. On nearly identical facts and applying similar statutory law, the Tax Court rejected the Operational Approach and required AT&T to provide evidence supporting its apportionment of each and every transaction (referred to as the Transactional Approach).

Summary of AT&T's Facts

During the years at issue in the Massachusetts and Oregon cases (1996-1999),[2] AT&T, a New York corporation with its administrative headquarters located in New Jersey, provided interstate and international network telecommunications services. AT&T owned a vast network of assets including switches, fiber-optic lines, and satellite-related assets. These assets were used to provide AT&T's interstate and international telecommunications services in Massachusetts, Oregon and other states. AT&T's services were coordinated and maintained from its Global Network Operations Center (GNOC) located in Bedminster, New Jersey.

The receipts at issue in both cases were receipts from the sale of interstate and international voice and data telecommunications services. In filing its Massachusetts and Oregon tax returns, AT&T applied an

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[1] The ruling by the Board was rendered on May 28, 2010.

[2] The Oregon case involved a claim for refund filed by AT&T for the years 1996-1998. The Massachusetts case involved the denial of AT&T's request for the removal of the interstate and international telecommunications service revenue from its sales factor for the years 1996-1999.

Operational Approach – that its income-producing activity was the business of providing a national, integrated telecommunications network, which it operated and managed from its GNOC in New Jersey.

Massachusetts and Oregon Costs of Performance Apportionment

The applicable Massachusetts statute during the audit period provided that receipts from the sales of services should be sourced to the Commonwealth for sales factor purposes if the income-producing activity was performed both in and outside Massachusetts and a greater proportion of the income-producing activity was performed in Massachusetts than in any other state, based on costs of performance. Oregon adopted a substantially similar rule by regulation.[3] This method of apportionment (which is a part of the Uniform Division of Income for Tax Purposes Act) is commonly referred to as the "preponderance" costs of performance method – which assigns receipts to the state for sales if more costs are incurred in the state than in *any* other state.

What Are "Costs of Performance?"

Both states defined "costs of performance" as the taxpayer's "direct costs." Although not directly addressed by the Massachusetts Board, the Oregon Tax Court adopted a novel and restrictive "but for" approach to determine whether the scope of the taxpayer's "direct costs" was properly included in the costs of performance analysis. AT&T argued that direct costs include all costs that must be incurred to engage in the general business activity at issue. The court, however, held that direct costs only include costs incurred solely as a result of the occurrence of a revenue-producing transaction or activity, i.e., those which would not be incurred by the taxpayer "but for" the transaction or activity.

Under this narrow test, the only direct costs relevant to determining AT&T's costs of performance were the cost of the small amount of electricity used to actually place an individual call and the access fee paid to the third-party local exchange operating company (LEOC). The court based its holding on deference to the Oregon Department of Revenue and its conclusion that a narrow approach "fits much more nicely, both with the transaction focus of the relevant rule and the word 'direct.'"

AT&T's Apportionment Position – Operational Approach

AT&T's approach focused on its activities (core processes) both within and outside of Massachusetts/Oregon that were necessary to the overall activity of operating and managing its network. AT&T contended that these core processes enabled it to create and operate a viable long-distance telecommunications network. Thus, when analyzed under an Operational Approach, AT&T's costs of performance in Massachusetts/Oregon were less than its costs of performance incurred in New Jersey.

In support of its position in both cases, AT&T presented evidence detailing how transmission signals were connected from one end of a transaction to the other via AT&T's global, integrated network. To prove the location of its costs of performance, AT&T presented a cost accounting study supported by expert testimony. AT&T's expert witnesses testified that its entire integrated network, not just the portion of the network located in Massachusetts or Oregon, was needed to service in-state customers. Expert testimony also identified seven "core processes," that were necessary for AT&T to operate its network: (1)

service activation; (2) service assurance; (3) service creating (research and development); (4) service execution; (5) network capacity and servicing; (6) billing; and (7) support and guidance and the costs associated with these core processes. In identifying the costs associated with its services, AT&T argued that the costs of "access fees" it paid to the (LEOCs) were "third party costs," and thus excluded from AT&T's costs of performance.[4]

Sutherland Observation: Although AT&T presented much of the same evidence and called the same expert witnesses in both Massachusetts and Oregon, the two tribunals reached different conclusions, not only substantively but also with regard to the persuasiveness of the expert witnesses. The Massachusetts Board relied heavily on AT&T's "detailed and convincing evidence," while the Oregon court criticized AT&T's experts, calling them "inconsistent" and "highly conclusory."

The Taxing Authorities' Apportionment Positions – Transactional Approach

The Massachusetts Commissioner and the Oregon Department rejected AT&T's Operational Approach and argued in favor of a Transactional Approach, contending that AT&T's income-producing activity was its provision of each individual telephone call or data transmission to customers located in each state. Both taxing authorities argued that it was the performance of the individual calls (or transactions) which created an obligation of the customer to pay specific consideration to AT&T. Thus, the taxing authorities took the position that the greater proportion of the costs associated with these income-producing activities were conducted in Massachusetts/Oregon.

Sutherland Observation: The taxing authorities advocated that AT&T should be required to apply a Transactional Approach. In contrast to the Tax Court's decision, the Board recognized that the impact of forcing a company like AT&T to track and prove the costs associated with each individual transaction is an overwhelming task. Although not acknowledged in either opinion, the taxing authorities took the position that AT&T did not meet its burden of proof to establish that its costs of performance were incurred outside the state, and therefore AT&T was required to apply an alternative apportionment theory based on where its market was located. Neither the Tax Court nor Board provided any analysis on why this alternative apportionment method serves as a default apportionment method and applies to situations where the taxpayer did not provide sufficient evidence to support its costs of performance apportionment.

Massachusetts Board – Operational Approach Adopted

In the Massachusetts case, the Board agreed with AT&T and held that the costs of performance should be analyzed under the Operational Approach. In rendering its decision, the Board applied a two-step analysis: first, determining the "income-producing activity"; and second, analyzing whether the greater "costs of performing" that income-producing activity took place in Massachusetts than in any other state.

The Board observed that although there was no statutory definition of "income-producing activity," the Commissioner promulgated a regulation, which generally describes an "income-producing activity" as:

[4] While the Board accepted AT&T's expert testimony that its cost-view analysis was consistent with generally accepted accounting principles, the Tax Court rejected that testimony in favor of the state's expert who testified that the analysis was not a generally accepted accounting principle or industry-wide practice.

> a transaction, procedure, ***or*** operation directly engaged in by a taxpayer which results in separately identifiable item of income. In general, any activity whose performance creates an obligation of a particular customer to pay a specific consideration to the taxpayer is an income-producing activity.

830 CMR § 63.38.1(9)(d)(2). Applying this provision, the Board concluded:

> Through detailed and convincing evidence, the appellant instead established that AT&T's income-producing activity was providing a long-distance transmission service by means of operating a complex and comprehensive network that routed and completed those transmissions, very often over unpredictable paths that were not necessarily the shortest geographic distance.

The Board also agreed with AT&T that the proper location of the majority of AT&T's costs associated with its service was associated with its GNOC in New Jersey. The Board acknowledged that while AT&T engaged in numerous activities, both within and outside of Massachusetts, that were essential to its income-producing activity, it provided ample evidence establishing the importance of the activities performed at its GNOC in New Jersey.

The Board ultimately concluded that AT&T met its burden of proving that, when including its expenses incurred at its GNOC and its administrative headquarters, both located in New Jersey, AT&T's costs of performance in Massachusetts were less than its costs incurred in New Jersey. Accordingly, the Board ruled that, because a greater proportion of AT&T's costs were incurred in another state (i.e., New Jersey) than Massachusetts, its receipts were not assigned to the Massachusetts sales factor numerator.

Oregon – Transactional Approach Adopted

The Tax Court deviated from the Board's decision and rejected AT&T's Operational Approach. Rather, the Tax Court held that the sourcing of AT&T's sales must be analyzed under the Transactional Approach advocated by the Oregon Department of Revenue. The Tax Court applied a three-step analysis substantially similar to the Massachusetts Board's analysis: first, determine the transactions that are or include the "income-producing activity";[5] second, identify the gross receipt from the transaction(s); and third, determine the geographic location where the direct costs of performance occurred. In concluding that the Transactional Approach must govern each step of the analysis, the Tax Court focused on a regulation issued by the Department which provided:

> (1) *In General.* Subsection (4) of ORS 314.655 provides for the inclusion in the numerator of the sales factor of gross receipts ***from transactions*** other than sales of tangible personal property . . .; under this section gross receipts . . . are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.
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> (2) *Income Producing Activity; Defined.* The term "income producing activity" applies *to each separate item of income* and means the *transactions* and *activity* directly engaged

[5] The Tax Court refers to the first step of the analysis as the "cost object question."

in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit.

Ore. Admin. R. 150-314.665(4)(1), (2) (emphasis in original). [6]

The Tax Court, found that “the [Operational Approach] of the taxpayer does not properly take into account that the focus of the inquiry at this point in the apportionment process, under the department’s rule, is to determine the receipts *from transactions* . . . A review of the relevant statutes and rules demonstrates this.” Following a restatement of selected statutes and regulations, the court held, without further analysis or explanation that: “[the regulation] focuses on ‘transactions’ and ‘income producing activity’ giving rise to any given receipt. The court is of the opinion that the statute and rules, as well as logic, dictate that the analysis must begin with transactions that are or include ‘income producing activities.’”

Applying the Transactional Approach to AT&T, the Tax Court held that AT&T had not carried its burden of proof and rejected its refund claim.

Sutherland Observation: The Oregon sourcing regulation interpreted by the Tax Court was nearly identical to the model apportionment regulation promulgated by the Multistate Tax Commission (Reg. 17(1)-(3)) prior to its revision on July 29, 2010, and adopted by a significant number of states. The Tax Court’s holding that AT&T did not carry its burden of proof and the court’s reluctance to accept the testimony of AT&T’s witnesses leaves open several questions for other taxpayers regarding identification of the proper income-producing activity and how costs associated with the income-producing activity are sourced.

Inclusion of Third-Party Costs

Both cases also raised the issue of whether third-party costs should be included in a taxpayer’s costs of performance analysis AT&T argued that the access fees it paid to the LEOCs were third-party costs and were excluded from its costs of performance analysis. The Board concluded the access fees were *not* direct costs and were thus excluded from AT&T’s costs of performance, while the Tax Court held the access fees were direct costs included in AT&T’s costs of performance.

The Massachusetts regulation provides that, in determining a taxpayer’s income-producing activity, the “transaction, procedure or operation” must be an activity that is “directly engaged in by a taxpayer [and] which results in a separately identifiable item of income.” 830 CMR § 63.38.1(9)(d)(2). The regulation further defines “costs of performance” as the taxpayer’s “direct costs,” which “do not include costs of independent contractors or services by subcontractors.” The Appellate Tax Board ruled that regardless of whether the LEOCs were independent contractors or subcontractors, their activities were not attributable to AT&T. The Board concluded that because the access fees paid by AT&T represented payment for activities performed on the taxpayer’s behalf by the LEOCs, the fees should not have been included as the taxpayer’s costs of performing *its* income-producing activity for purposes of calculating the sales factor numerator.

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[6] It was undisputed in the case that under Oregon law, AT&T was a “public utility” subject to the costs of performance apportionment rules promulgated by the Department in Ore. Admin. R. 150-314.665(4).

The Oregon Tax Court reached the opposite conclusion, holding that AT&T's direct costs of performance included the access fee paid to the LEOC. The applicable Oregon regulation, similar to the Massachusetts regulation, defined "income producing activity" to exclude "transactions and activities performed *on behalf of a taxpayer*, such as those conducted on its behalf by an independent contractor." Ore. Admin. R. 150-314.665(4)(2)[7]. The court drew a distinction between services provided *to* a taxpayer, which are direct costs, and those provided *on behalf of* a taxpayer, which are not direct costs. Using an unusual analogy to a law firm incurring lodging and restaurant costs associated with sending a lawyer to an out-of-state trial, and concluding that these costs were direct costs, the Tax Court held that the LEOC "is no more performing a service *on behalf of* taxpayer than the hotel or restaurant is performing a service *on behalf of* the law firm in the example."

Sutherland Observation: These decisions highlight the continued confusion surrounding the inclusion or exclusion of third-party costs from a costs of performance analysis. States continue to split on whether third-party costs should be included (and what constitutes third-party costs). For example, California[8] as well as the Multistate Tax Commission's model regulations[9] specifically provide for the inclusion of third-party costs in the costs of performance analysis. The Virginia Supreme Court[10] in 2010 also rejected a narrow interpretation of its statutes and regulations and concluded that costs of performance were not limited to direct costs and should include the costs of activities provided by third parties. However, the majority of states that adopt a costs of performance methodology continue to exclude third-party costs from consideration.[11]

Sutherland Observation: Conclusion: While both courts similarly held that a taxpayer is required to source its sales from other than tangible personal property based on its costs of performance, the courts took very different approaches in applying costs of apportionment. Given that the cases involved virtually identical facts, it is quite likely that AT&T will appeal the Oregon Tax Court's decision to the Oregon Supreme Court.[12] As more states move to single-sales factor apportionment, we expect that controversies surrounding the application of sales factor sourcing rules like the costs of performance rule will increase in both frequency and importance.

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[7] Ore. Admin. R. 150-314.665(4)(2) was amended, effective for tax years beginning on or after January 1, 2008, to specifically include transactions "performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor." Accordingly, application of the court's analysis regarding the inclusion of third-party costs is limited to pre-2008 tax years.

[8] Cal. Cod. Regs. § 25136(b).

[9] The MTC, in 2007, revised the regulation addressing Section 17. The amendment provides that income-producing activity "includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor."

[10] *General Motors Corp. v. Commonwealth of Virginia*, 602 SE 2d 123 (Va. 2004)

[11] *See, e.g.,* Ind. Admin. Code tit. 45, § 3.1-1-55; Kan. Admin. Regs. 92-12-100(a); Tenn. Comp. R. & Regs. 1320-6-1-.34(2).

[12] Decisions of the Oregon Tax Court may be appealed to the Oregon Supreme Court within 30 days of the Tax Court's final judgment pursuant to Ore. Rev. Stat. §§ 305.445 and 19.255. While decisions by the Appellate Tax Board may be appealed 60 days after the final judgment, it does not appear that the ruling was appealed.

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