COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

INTERFACE GROUP-NEVADA, INC. v. COMMISSIONER OF REVENUE

Docket No. 182909 Promulgated:
May 25, 2000

This is an appeal under the formal procedure pursuant to G.L. c. 62C, § 39, from the refusal of the appellee to abate corporate excise taxes assessed against the appellant under G.L. c. 63, § 38.

Commissioner Scharaffa heard the appeal and was joined in the decision for the appellant by Chairman Burns and Commissioners Gorton and Egan.

These findings of fact and report are made at the requests of the appellant and the appellee pursuant to G.L. c. 58A, § 13 and 831 CMR 1.32.

Paul G. Roberts, Esq. and *John T. Gilbert,* Esq. for the appellant.

Thomas J. Nicholas, Esq. for the appellee.

FINDINGS OF FACT AND REPORT

On the basis of the testimony and exhibits introduced in the hearing of this appeal, the Appellate Tax Board ("Board") made the following findings of fact. Appellant, Interface Group-Nevada, Inc., is a successor corporation to the Interface Group, Inc. ("Interface"). At all relevant times, Interface was a corporation organized under the laws of the Commonwealth. Its usual place of business during 1985, the tax year in question, was on Gould Street in Needham, Massachusetts.

Interface was comprised of three divisions, GWV Travel, Five Star Airlines (collectively the "Travel Unit"),[1] and the Tradeshow division (the "Tradeshow Unit"). The Tradeshow Unit was engaged in the business of producing and managing trade shows for the computer, communications and information systems industries, which it did by renting exhibit hall space and then subletting the space to the company exhibitors. The Travel Unit organized and operated group travel tours in the form of package vacation tours, which included hotel accommodations, air fare and ground transfers.

[1] Interface conceded that GWV Travel and the Five Star Unit comprised a unitary business, together referred to hereinafter as the "Travel Unit."

Interface timely filed its corporate excise return for tax year 1985. In this return, Interface applied for an alternate apportionment factor, seeking to apportion the income of its Travel and Trade Show Units separately. Interface also reported its property factor for the net income portion of the excise as 43.369 percent.

The Commissioner of Revenue (the "Commissioner") subsequently issued a Notice of Intent to Assess ("NIA"), and more than thirty days from this date, but within three years from the due date of Interface's return, the Commissioner assessed a deficiency and issued a Notice of Assessment ("NOA") to Interface. The Commissioner's deficiency assessment was based on three issues: first, Interface's use of an alternative apportionment formula, such that separate formulas were used to calculate the net income of its Tradeshow Unit and its Travel Unit; second, Interface's inclusion of zero percent of the gross receipts from its Travel Unit as Massachusetts sales for purposes of its sales factor; and finally, Interface's failure to include one hundred percent of the value of two airplanes it purchased, for use by the Travel Unit, in the numerator of its property factor.

Interface filed its application for abatement within two years from the date of the assessment, and the

Commissioner denied this application. Within the requisite sixty days from the Commissioner's denial, Interface filed its appeal with the Board. On the basis of this information, the Board found that it had jurisdiction over the appeal for tax year 1985.[2]

The Travel and Tradeshow Units were separate corporations, called GWV Travel ("GWV") and Communication Trends, Inc. ("Communication Trends"), respectively, from 1972 until 1982. At that time, GWV merged into Communication Trends, which had since been renamed Interface, thereby forming a single subchapter "S" corporation. Interface acknowledged that the opportunity for tax savings[3] was a motivating factor behind the decision to merge into this particular entity.

Despite Interface's attempts to separate its Units, the Board found that the Travel and Tradeshow Units benefited from each other as divisions united within a

[2] In a previous case involving Interface, the Board had ordered a bifurcation of the taxpayer's appeals to address the procedural challenges to the subject assessments before addressing the substantive challenges. In the first case addressing the procedural challenges, the Board determined that the Commissioner's assessments for tax years 1983, 1984, 1986 and 1988 were procedurally defective under the relevant assessment statutes, and therefore decided in favor of Interface in the controversies involving those tax years. *See* ***Interface Group-Nevada, Inc. v. Commissioner of Revenue***, 1998 Mass. A.T.B. Adv. Sh. 1017 (Docket Nos. 182907, 182908, 182909, F214179, F214180, October 20, 1998). The only tax year with substantive issues that survived this earlier challenge was 1985, the tax year at issue in this present appeal.

[3] For an explanation of such tax savings, see ***infra***, note 8 and accompanying text.

single corporation. For example, while Interface attempted to create independent divisions by maintaining separate staff, bank accounts, payrolls, and customer bases, it nonetheless acted like any other single entity would by hiring a single accounting firm to prepare an annual consolidated statement and a single general counsel that represented it as a single entity. Interface alleged that when it relocated to the Needham office, the Units maintained offices on separate floors and entered into their lease contracts separately. However, the Board could not find that two leases obtained by the same company in the same office complex at the same time were negotiated independently without any benefit being derived from the combined purchasing power in leasing a larger total area in the complex.

Several officers and employees of Interface testified that, after the merger, the Travel and Tradeshow Units continued to operate independently. They claimed that the respective presidents' backgrounds were industry-specific, and so neither wanted to intrude into a line of business beyond their expertise. However, the Board found that the presence of interlocking shareholders, directors and officers among the three supposedly independent divisions was significant. Interface's shareholders during 1985 were

Sheldon G. Adelson, who held a 50.01 percent interest, Richard Katzeff, who held a 15 percent interest, Irwin Chafetz and Theodore Cutler (a.k.a. Ted Benard), who each owned a 12 percent interest, and Dr. Jordan Shapiro, who owned a 9.99 percent interest. These same five shareholders comprised Interface's Board of directors. In addition to being directors and shareholders, Mr. Adelson was the President and Chairman of the Board of Interface, and President and COO of the Tradeshow Unit, while Mr. Cutler was the President of the Travel division and Mr. Chafetz was the President of the Five Star division.

The Board found that Interface failed to meet its burden of proving that the Commissioner taxed extraterritorial values by combining the income of its Travel and Tradeshow Units. Interface's Travel and Tradeshow Units formed a single legal entity, as evidenced primarily by the presence of interlocking shareholders, directors and officers within a single corporate entity. In addition, the divisions each benefited from economies of scale created by uniting the divisions within a single corporate entity. For example, there were tax advantages inherent in a subchapter "S" formation. Interface also benefited from increased financial flexibility in its ability to make inter-divisional loans, thereby enabling one division to sustain the other during difficult financial periods. These advantages improved Interface’s overall creditworthiness and business value. Moreover, shareholders held stock in Interface as a single entity, rather than stock in a single division within the corporation. This single dividend distribution plan based upon the income generated by the entity as a whole, rather than income generated by a specific division, reduced the shareholders’ risk of poor performance in one of the divisions. As a single corporate entity, Interface had the burden to prove by clear and cogent evidence that it was entitled to an alternative apportionment formula which would have apportioned the income of its divisions separately. Interface failed to meet that burden.

As for the second issue, the apportioning of the Travel Unit’s gross income to Massachusetts in its sales factor, the Board made the following findings. The Travel Unit packaged tours almost exclusively to Mexico and the Caribbean. The Product Development Department would create the vacation packages by sending employee buyers to evaluate potential hotels at the various destinations. Most of the Travel Unit employees, about 130 to 150 employees, were located in the Needham offices, while about 14 to 20 employee buyers traveled to the various vacation sites to research the accommodations. Back in the Needham offices, the in-house Product Development Department would then evaluate the recommendations of these employee buyers, contract with the hotels and airlines via telephone, and input the information into a special computer software set to create the travel package. In addition, the Travel Unit employees in the Needham office developed and distributed brochures to the independent travel agents so as to advertise its vacation packages.

The Travel Unit purchased the hotel accommodations and airline tickets and assumed responsibility for payment on these contracts, providing letters of credit to the providers to secure the reservations. According to its accounting practices, the Travel Unit recorded all of its outlays for airfare and hotel accommodations as its own costs, and did not make the travel packages available for sale by the travel agents without incurring the obligation to pay for those reservations itself. The majority of trips were flown on Interface's two L-1011 airplanes. Interface offered testimony and evidence at the hearing to demonstrate that, of the Travel Unit's total costs including overhead, 54.1 percent were associated with paying for airfare reservations and another 26.3 percent of costs were associated with paying for hotel reservations, for a total of 80.6 percent of costs including overhead.

The Travel Unit's final products were sold to the traveling customer by an independent travel agency, not by Travel Unit employees. However, the Travel Unit's income ultimately was derived from the sale of the tour packages. Customers would inquire about vacation package options at a travel agency, and the travel agent would then contact the Travel Unit's Reservations Department for hotel and flight availability. The travel agent would confirm the booking with the Travel Unit, send the customer's deposit, and then send the customer's final payment to the Travel Unit. Government regulations required the Travel Unit to place customer deposits into an escrow account. While the Travel Unit could access portions of the funds to pay airline contracts and travel agent commissions, it could not access its own profits until three days after the customer returns from the vacation.

The Board found that Interface failed to meet its burden of proving that a greater proportion of its income-producing activity was performed in any single state other than Massachusetts. Interface argued that the sales did not occur in Massachusetts based upon the cost of performance test, as provided by G.L. c. 63, § 38(f) and in the regulation promulgated thereunder (830 CMR 63.38.1(9)). Thus, Interface contended that the great majority of the costs associated with the Travel Unit's activities, namely the 80.6 percent of costs, occurred outside of the Commonwealth, and therefore, were not properly classified as Massachusetts sales for purposes of the sales factor. However, in concentrating its efforts to argue that it had many costs of performance outside of the Commonwealth, Interface failed to prove that it incurred a greater amount of costs of performance in any single state other than Massachusetts. Moreover, the Board found that Interface had carried on significant income-producing activity in the Commonwealth at its Needham offices, based on the costs of performance associated with its Needham operations, such as office overhead costs and salaries paid to Travel Unit employees, the great majority of whom worked in the Needham office. The Board, therefore, found that apportionment to Massachusetts of the sales of the Travel Unit was proper.

Finally, as for the inclusion of one hundred percent of Interface's two airplanes to Massachusetts in the property factor, the Board made the following findings. In October of 1984, which was during taxpayer's 1985 fiscal year, the taxpayer purchased two Lockheed Model L1011-1 airplanes. The Travel Unit used the airplanes for five months of tax year 1985 and then leased them to TWA Airlines for six months of that year. The airplanes were hangered at Boston's Logan International Airport ("Logan") during the five-month period that the Travel Unit operated them. The average number of flights using Logan as a lift-off point was 50.49 percent for one airplane and 43.41 percent for the other, for an average of 46.96 percent of total flights during this period.

On its original return, Interface calculated its property factor to be 43.369 percent. In its application for abatement, Interface also claimed that the property factor "calculation used in the return as filed should be used" in assessing its liability. However, Interface subsequently maintained at trial that only five percent of the airplanes' values should be included in the numerator of the property factor. Interface's position was based on its contention that airplanes should be apportioned to Massachusetts based upon the percentage of "revenue ton miles" flown in the Commonwealth's airspace.[4] In support of this contention, Interface offered into evidence a March 16, 1982 letter from Deputy Commissioner John F. Coady to

[4] A "revenue ton mile" is a construct of the aviation industry that measures the movement of one net ton of property or persons for the distance of one mile, for consideration.

an Eastern Airlines representative, which stated in pertinent part:

> I am pleased to inform you that Commissioner Hampers has authorized the use of the agreed-to apportionment formula in accordance with the provisions of Massachusetts General Laws, Chapter 63, Section 42. Furthermore, the Commissioner has directed our Rulings and Regulations Bureau to implement the procedural steps necessary to formalize the formula into a regulation.
>
> **Enclosed for your review** is a copy of the formula as edited by my staff, detailing the composition of the individual factors as finalized at our January 29th meeting.
>
> **I anticipate your advising me of the industry's position in this matter at your earliest convenience**, in order that we may conclude our audit of the years currently on waiver in a timely manner. (Emphasis added.)

Interface determined that the percentage of revenue ton miles that the two airplanes flew in Massachusetts airspace was less than five percent, and thus argued that only five percent of the value of its two aircraft should be included in the numerator of its property factor. The Commissioner, however, contended that Interface should have included one hundred percent of the value of both airplanes in the numerator of the property factor for the five-month period that Interface operated the two airplanes.

The Board found that Interface met its burden of proving that the Commissioner erred in including one hundred percent of the value of both airplanes in the property factor. The very nature of mobile property, particularly aircraft, is that it may be used outside of the Commonwealth. Interface introduced sufficient evidence, including flight records, to prove that its airplanes, while hangared in Logan, were nonetheless used outside of the Commonwealth for a significant period of time during the relevant five-month period. For example, Interface demonstrated at trial that only 46.97 percent of flights during this time departed from the Commonwealth. Moreover, it appeared to the Board that the Commissioner gave no consideration to the actual usage of the airplanes, and simply apportioned them to Massachusetts based solely on their being hangared in Logan. As detailed in the Opinion which follows, the Board ruled this method of apportionment was contrary to the language of the apportionment statute and constitutional principles.

However, the Board also found that Interface did not meet its burden of proving that only five percent of the value of the two airplanes was properly apportionable to Massachusetts. Interface failed to establish that the Deputy Commissioner’s letter achieved the level of a ruling issued by the Commissioner. The letter was written in tentative language, including such phrases as “[e]nclosed for your review” and “I anticipate your advising me of the industry’s position in this matter at your earliest convenience.” Moreover, the recipient of the letter understood the apportionment formula to be tentative, subject to review by the airline industry. In a subsequent letter to Eastern Airline’s Director of Taxation, Mr. Mirabella characterized the formula as a mere “proposed formula” that he was circulating for review:

> We have been asked by Mr. Cody [sic] to obtain an industry response on this formula by April 15. Accordingly, we would appreciate your assistance in polling the carriers and getting back to us with their answers before April 15.

The Board found that Interface could not rely on Deputy Commissioner Coady’s letter, as it was merely a tentative letter from a Deputy Commissioner, written to another taxpayer.

In addition, the Board found that the taxpayer did not demonstrate that the sourcing of an airplane’s value based upon revenue ton miles constituted an administrative practice entitled to weight in the interpretation of the relevant statutory language. Interface did not demonstrate any administrative interpretations or practices consistent with this method of sourcing that the Department of Revenue (“DOR”) had adopted contemporaneously with the enactment of the apportionment statute or any subsequent amendments. Interface thus did not meet its burden of proving that only five percent of the value of its airplanes was properly apportionable to Massachusetts.

Based on all the evidence, the Board determined that the most appropriate measure of the value of Interface's property, including its airplanes, to be apportioned to Massachusetts was 43.369 percent, the same figure Interface had included as its property factor on its original return. Interface provided ample evidence, including flight records, to demonstrate that the two airplanes were used outside of the Commonwealth for a significant amount of time during their operation by the Travel Unit. The Board thus found that the taxpayer supplied sufficient evidence to defeat the Commissioner's speculative assessment and to demonstrate that its approach was reasonable under the statute.

On this basis, the Board ruled that Interface was entitled to an abatement of its corporate excise based upon the use of a property apportionment factor of 43.369 percent.

OPINION

There were three issues to be resolved in this appeal: first, whether the Commissioner taxed extraterritorial income as a result of using a single three-factor apportionment formula pursuant to G. L. c. 63, § 38, which combined the property, payroll and sales of all three of Interface's divisions; second, whether the Commissioner erred in treating the gross receipts of the taxpayer's Travel Unit as Massachusetts sales for purposes of its sales factor under G. L. c. 63, § 38(f); and third, whether the Commissioner erroneously attributed one hundred percent of the value of two airplanes used by the Travel Unit in the numerator of the taxpayer's property factor under G.L. c. 63, § 38(d).

I. Combined Apportionment Formula or Alternatives

The first issue on appeal was whether Interface was entitled under G.L. c. 63, § 42 or elsewhere to an alternative apportionment formula which would separately apportion the income of its Tradeshow Unit from that of the Travel Unit.

Domestic and foreign companies that do business in the Commonwealth are required to pay an excise based in part on their net income derived from business activities carried on in Massachusetts. G.L. c. 63, §§ 32, 38 and 39. The "gross income" of a corporation for Massachusetts tax purposes is generally equal to gross income as defined under the Internal Revenue Code (the "Code") as amended and in effect for the taxable year, with some exceptions not relevant to these appeals. G.L. c. 63, § 30(5)(a).[5] Net income is equal to gross income minus all deductions allowable under the Code, with several exceptions contained in G.L. c. 63, § 30(5)(b).[6]

The entire amount of a corporation's net income is subject to the Massachusetts corporate excise if the corporation has no income from business activities which is taxable in another state due to federal constitutional limitations. G.L. c. 63, § 38(b). If, as in the present appeal, the corporation has income from business activities taxable both in Massachusetts and elsewhere, its taxable net income is apportioned to Massachusetts by means of a three-factor formula based on the ratio of its Massachusetts property, payroll and sales to its property, payroll and sales everywhere. G.L. c. 63, § 38(c) – (f).

Interface argued that the Commissioner taxed extraterritorial values by apportioning its income using a single three-factor formula comprised of all property, payroll and sales from its two divisions. Interface contended that it was entitled to an alternative

[5] The definition of gross income is now found at G.L. c. 63, § 30.3.

[6] The definition of net income is now found at G.L. c. 63, § 30.4.

apportionment formula, pursuant to G.L. c. 63, § 42 or elsewhere, which would have separately apportioned the income of the Tradeshow Unit from the income of the Travel Unit. The taxpayer has the burden of showing by "clear and cogent evidence" that the state tax results in extraterritorial values being taxed. ***Exxon Corp. v. Wisconsin Dept. of Revenue***, 447 U.S. 207, 221 (1980). Essentially, the appellant argued that its Travel Unit was not a member of a unitary business with the Tradeshow Unit, but was its own separate and distinct business.

The "unitary business principle" refines the rule against extraterritorial taxation to allow consideration of the values of an interstate business as a whole. ***Allied-Signal, Inc. v. Director of Tax Div.***, 504 U.S. 768, 778-780 (1992). The unitary business principle is the "linchpin" of a state's authority to consider out-of-state values in taxing a corporation for the privilege of conducting business in that state. *See generally* ***Mobil Oil Corp. v. Comm'r of Taxes of Vt.***, 445 U.S. 425, 439 (1980). As the Supreme Court explained in ***F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico***, 458 U.S. 354, 364 (1982), "if . . . 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State." *Accord* ***W.R. Grace & Co. v. Commissioner of Revenue***, 378 Mass. 577, 585 (1979) ("[W]e recognize that some minimal connection between the business carried on in this Commonwealth, and [the object of tax], must exist. That connection has generally been found when the activity sought to be taxed is a component of an enterprise which is deemed 'unitary' with the business carried on in the taxing State"). By contrast, a state transgresses clearly marked constitutional boundaries when it extends its taxing power to out-of-state business activities that are not part of a unitary business. *See* ***F.W. Woolworth***, 458 U.S. at 372.

While the Supreme Court has stated that the indicia of a unitary business are functional integration, centralization of management and economies of scale, there is no single test for determining the existence of a unitary business. Rather, there exists a wide range of constitutionally acceptable variations of the unitary business principle. ***Container Corp. of America v. Franchise Tax Board***, 463 U.S. 159, 167 (1983) ("A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary; there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.").

Interface first argued that its business entity lacked functional integration. The Travel and Tradeshow divisions were separately owned businesses until they merged into one "S" corporation in 1982. Even after the merger, they continued to maintain separate employee staffs with no cross-over, separate banks and bank accounts, separate payrolls, separate customer bases, separate comptrollers, ledgers and profit and loss statements, and while they shared an office building, they were located on separate floors and had separate identification signs. Interface further argued that functional integration was virtually impossible for its Travel and Tradeshow Units, as they were engaged in two completely separate lines of business: leisure travel versus tradeshows. To support this contention, Interface pointed out that none of the foundational Supreme Court cases have found a unitary business to exist when business enterprises were engaged in different lines of business.

However, Interface's argument fell short of its burden. First, a taxpayer's use of "separate functional accounting" to segregate its operations cannot shield it from the unitary business principle: "[a]s this Court has on several occasions recognized, a company's internal accounting techniques are not binding on a State for tax purposes." ***Exxon***, 447 U.S. at 221. *Accord* ***Jacob Licht, Inc. v. Commissioner of Revenue***, 1999 Mass. A.T.B. Adv. Sh. 12, 28-29 (Docket No. 206695, January 28, 1999)("Formal accounting, whether geographical or transactional, is subject to manipulation and imprecision and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise.") (*citing* ***Container Corp.***, 463 U.S. at 164-65).

Second, while Interface contended that no Supreme Court cases have found a unitary business enterprise for entities engaged in separate lines of business, the Board noted that all of these foundational cases have addressed the ability of a state to combine the incomes of separate corporations; none stand for the proposition that a state must separately apportion the income of divisions of the same corporation. As the Board declared in ***Jacob Licht***, "[i]n this appeal, we are dealing with the income of a division of a unified corporation and not the income from a separate legal entity, as was the case in ***Woolworth*** and ***ASARCO***. That fact alone puts the Appellant in different circumstances than the taxpayers in the cases described above." ***Jacob Licht***, 1999 Mass. A.T.B. Adv. Sh. at 24-25. The precedential value of the cases on which Interface relied is therefore limited, given its single-entity structure.

However, one Supreme Court case in particular did involve a single-entity taxpayer which was divided into separate divisions. In ***Exxon***, a single-entity taxpayer was engaged in three diverse and financially segregated operations: Corporate Management, Coordination and Services Management, and Operations. There, the Supreme Court found that "[a]t all relevant times each operating department was independently responsible for its performance." ***Id.*** at 212. However, unitariness in ***Exxon*** nevertheless arose from the taxpayer's centralized management structure. The Court stated that, while it treated its operational departments as "independent profit centers," Exxon had not carried its burden of showing that these functionally separate departments were "discrete business enterprises" that did not benefit from "an umbrella of centralized management and controlled interaction."[7] 447 U.S. at 221.

Similar to the taxpayer in ***Exxon***, Interface did not show that its units did not benefit from an "umbrella of centralized management and controlled interaction." While the Trade Show Unit may have been engaged in a separate line of business from the Travel Unit, the Board found that a critical factor was the presence of interlocking officers and directors within a single legal entity, and the actual control of the board in the hands of the President of Interface, who also happened to be the President and CEO of the Tradeshow Unit.

Interface's second argument was that its business lacked a centralized management scheme due to the independence of each line of business to make its own decisions. Interface contended that the operations of its divisions were even more distinct than those in ***Woolworth***.

[7] It is difficult to conceive of a set of facts in which divisions within a single corporate entity structure would be able to meet the burden of showing that such departments were "discrete business enterprises." The taxpayer cites ***Central National-Gottesman, Inc. v. Commissioner of Revenue,*** 1998 Mass. A.T.B. Advance Sheets 860 (Docket No. F232651, September 4, 1998), a case involving a single-entity corporation with two divisions, as authority for this possibility. However, it was pursuant to the parties' stipulation for the purposes of their appeal that the two divisions did not comprise a unitary business enterprise. Because the parties stipulated to this non-unitary status, the Board made no finding or ruling on the question.

In that case, the Court found a non-unitary business, despite the existence of "some managerial links" between the parent and its subsidiaries, three of which were wholly owned and the fourth of which Woolworth owned a 52.7 percent majority interest. 458 U.S. at 368. The Court pointed to "irregular in-person and 'frequent' mail, telephone and teletype communication between the upper echelons of management of the parent and the subsidiaries," the fact that "major financial decisions, such as the amount of dividends to be paid by the subsidiaries and the creation of substantial debt had to be approved by the parent," and the fact that the parent maintained "one or several common directors with some of the subsidiaries" as factors creating such a managerial link. ***Id.***

Interface contended that the absence of any of the above interactions between the Travel and Tradeshow Units demonstrated the lack of "interference" between the Travel and Tradeshow Units. The two divisions ran separately under the management of two separate co-owners, Sheldon G. Adelson of the Tradeshow Unit and Theodore Cutler of the Travel Unit. Interface contended that each director's background was "industry specific" and thus each director made all management decisions for their respective division.

However, there were crucial differences between the facts of ***Woolworth*** and the present case, which strongly supported a finding of unitariness here. First, each subsidiary in ***Woolworth*** was a separate legal entity, unlike the single subchapter "S" corporation structure under which Interface's two divisions were organized. *See* ***Jacob Licht,*** 1999 Mass. A.T.B. Adv. Sh. at 24-25. Second, each of the Woolworth subsidiaries "operated as a distinct business enterprise at the level of fulltime management. With one possible exception, none of the subsidiaries' officers during the year in question was a current or former employee of the parent." ***Woolworth***, 458 U.S. at 366. In direct contrast with the facts of ***Woolworth***, the management structure of Interface lacked such "a distinct business enterprise at the level of fulltime management," as the Board of directors for Interface was comprised solely of the five sole shareholders, which included the Presidents of the Tradeshow and Travel Units. Mr. Adelson, the President of Interface, who was also the President and CEO of the Tradeshow Unit, held a controlling 50.01 percent interest in Interface, while Mr. Cutler, the President of the Travel Unit, held a 12.5 percent interest. The Board found that this overlap among the upper echelon of management was significant to its finding of a centralized management.

In this same respect, Interface's management structure also differed significantly from that in ***ASARCO***. In that case, "[t]he closest question" of unitariness involved the receipt by the parent corporation of dividends from one of its subsidiaries, Southern Peru Copper Corporation, of which the parent held a 51.5 percent stock interest. 458 U.S. at 320.

The ***ASARCO*** Court applied and articulated the principle that actual exercise of control, as distinguished from the legal right to control, is the *sine qua non* of the unitary business principle. Applying this principle, the Court there found the controlled subsidiary to be "merely an investment" of the parent. ***Id.*** at 323. First, ASARCO and its subsidiary did not have any common directors or officers, enabling the Court to find that the subsidiary "operates entirely independently of and has minimal contact with" its parent. ***Id.*** Second, while the parent held a controlling interest in the subsidiary, the remaining three subsidiary shareholders refused to allow the parent to dominate management of the subsidiary, and so required the parent to enter a management agreement giving it the right to appoint fewer than a majority of directors -- six out of thirteen. ***Id.*** at 322. Finally, the subsidiary's bylaws required eight votes to pass any resolution, and its articles and bylaws could only be changed by unanimous consent of all four stockholders. ***Id.*** at 322.

The presence of "any common directors or officers," especially those with control, was central to the inquiry of unitariness in ASARCO, where the parent and subsidiary were separate legal entities. *See* ***ASARCO***, *supra*. The Board found the presence of common directors and officers to be particularly compelling evidence of centralized management here, where the divisions were united under the umbrella of a single subchapter "S" corporation entity. The Board has previously found that a "noteworthy" consideration in the presence of unitariness is the "managerial role" played by the controlling division. *See* ***Jacob Licht***, 1999 Mass. A.T.B. Adv. Sh. at 24 (*quoting* ***Container***, 463 U.S. at 180, n. 19). Moreover, in the present case, there was no agreement as in ***ASARCO*** preventing domination of the Travel Unit management by the President of the Tradeshow Unit, who also held the positions of controlling shareholder, director and President of Interface. Therefore, as in ***Jacob Licht***, the Board similarly found that a state may "properly treat [a taxpayer's] business as a unitary one" in the presence of "unity of ownership and management" created by interlocking shareholders and directors within a single subchapter "S" corporation housed within a single office building. 1999 Mass. A.T.B. Adv. Sh. at 24 (*quoting* ***Butler Brothers v. McColgan***, 315 U.S. 501, 508 (1942)).

Interface's third argument, the lack of any economies of scale *vis-à-vis* the Travel and Tradeshow Units, also failed. Interface refuted the presence of any economies of scale by arguing that it lacked combined purchasing power, such as for the purchasing of computer systems and the leasing of office space. Interface did acknowledge that the Tradeshow Unit purchased airline tickets from the Five Star Unit. However, it argued that there was an absence of any economies of scale in these arrangements, as Five Star charged retail price for these tickets.

The Board was unpersuaded by Interface's argument. As in ***Jacob Licht***, these divisions within a single subchapter "S" corporation structure benefited from economies of scale "through the provision of centralized services." ***Jacob Licht***, 1999 Mass. A.T.B. Adv. Sh. at 26. These divisions shared a single general counsel, and a single accounting firm for the preparation of an annual consolidated financial statement. *See* ***Id.*** Moreover, while there may have been no cross-over of staff, there was some evidence of a common payroll processing for the year in question, as checks for all three divisions were prepared by ADP, and appellant offered testimony that one Interface employee most likely submitted the consolidated information to ADP. The Board also found suspect the taxpayer's allegations that two leases obtained by the same company in the same office complex at the same time were negotiated completely independently without any benefit being derived from the combined purchasing power in leasing a larger total area in the complex.

The most crucial evidence of economies of scale, however, was the flow of financial benefit among the divisions, made possible by their operating as a single "S" corporation entity. *See* ***Container Corp. of America v. Franchise Tax Board***, 463 U.S. 159 (1983). First, Interface's own stated reason for merging the Travel and Tradeshow Units was to enjoy the tax advantages available to the unified "S" corporation.[8] "Thus, at the very least, the two divisions are able to decrease their tax burden by doing business as an "S" corporation, thereby eliminating

[8] For federal income tax purposes, with minor exceptions, a subchapter "S" corporation is not a taxable entity. I.R.C. 1363(a). Instead, its income, loss, deductions and credits flow through to its shareholders. ***Id.*** Thus, while entity principles are used for the computation of a subchapter "S" corporation's income or loss, generally its profits are subject to tax only at the shareholder level. By contrast, subchapter "C" corporations are subject to tax at both the corporate and shareholder levels.

tax at the entity level." ***Jacob Licht***, 1999 Mass. A.T.B. Adv. Sh. at 27. Second, the Board viewed as significant the ability of Interface to make inter-divisional loans, thus enabling one unit to serve as a "buffer" to enable the other unit to survive during financially difficult periods, perhaps during a "downturn" in a unit's particular market. ***Id.*** Finally, shareholders held stock in Interface as a single entity, rather than stock in a single division within the corporation. This single dividend distribution plan based upon the income generated by the entity as a whole, rather than income generated by a specific division, reduced the shareholders' risk of poor performance in one of the divisions. Based on the above evidence, the Board concluded that all of the divisions of Interface received a substantial benefit from a flow of tangible and intangible values under the single corporate entity umbrella.

Organization of Interface as a single corporate entity enhanced its overall financial stability. In ***Exxon***, the Supreme Court found that a single corporate entity provided greater profits stability for the taxpayer's individual segments, as "nonparallel and nonmutual economic factors which may affect one department may be offset by the factors existing in another department." 447 U.S. at 225. Likewise, as in ***Jacob Licht***, it is reasonable to infer here that Interface’s separate divisions gained enhanced financial stability by reason of their organization as a single entity:

> Moreover, it is reasonable to infer that, as a single corporate entity, the Appellant can undoubtedly borrow money and maintain a credit rating based on its overall net worth. This is so because lenders and creditors of the Appellant have a legal right to pursue the assets of the entire corporation in satisfaction of any debts owed by the Appellant.

Jacob Licht, 1999 Mass. A.T.B. Adv. Sh. at 27-28. The Board thus concluded that the divisions of Interface benefited from a flow of value, both tangible and intangible, and accordingly found the Travel and Tradeshow Units to be in a unitary business with one another.

Moreover, the Board ruled that Interface did not meet its burden of proof on the issue of whether the Commissioner taxed extraterritorial values. The appellant has the burden of proving the facts necessary to justify its claim for abatement. ***William Rodman & Sons, Inc. v. State Tax Commissioner***, 373 Mass. 606 (1977). Interface was required to demonstrate by clear and cogent evidence that there was no rational relationship between the income attributed to the state and the intrastate values of the enterprise. ***Container***, 462 U.S. at 180. Given the facts found above, which demonstrated the presence of functional integration, centralized management and economies of scale, the Board concluded that Interface was a unitary business, and did not show by clear and cogent evidence that non-unitary, extraterritorial values were being taxed by the Commonwealth. *See* ***Becton Dickinson & Co. v. Department of Revenue***, 383 Mass. 786 (1981). Therefore, the Board upheld the Commissioner's application of a single three-factor apportionment formula to Interface's combined net income.

II. Inclusion of Travel Unit Receipts in the Sales Factor

The second issue on appeal was whether the gross receipts from Interface's Travel Unit constituted "Massachusetts sales" for purposes of the sales factor computed under G.L. c. 63, § 38(f). Resolution of this issue depended on whether the income-producing activity that appellant performed in Massachusetts exceeded its income-producing activity in any other state, based upon costs of performance. G.L. c. 63, § 38(f).

Section 38(f) provides in relevant part that receipts from sales, other than sales of tangible personal property, are considered to be Massachusetts sales if:

1. the income-producing activity is performed in this commonwealth; or

> 2. the income-producing activity is performed both in and outside this commonwealth and a greater proportion of this income-producing activity is performed in this commonwealth **than in any other state**, based on costs of performance.

G.L. c. 63, § 38(f) (emphasis added).

First, Interface argued that none of its Travel Unit's receipts should be apportioned to Massachusetts, because it performed no income-producing activity in Massachusetts. To support this contention, Interface cited 830 CMR 63.38.1(9), which defines an income-producing activity as:

> a transaction, procedure, or operation **directly engaged in by a taxpayer** which results in a 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. (Emphasis added).

Interface contended that its Travel Unit performed no income-producing activity in Massachusetts, because the activities of its employees did not directly produce any obligation of customers to pay a consideration to Interface. Interface maintained that the activity of selling travel packages to the ultimate vacationing customer was the sole activity that produced an obligation in the customer to pay a consideration. Because such activity was performed by travel agents who were independent contractors, Interface contended that such activities could not be imputed to itself. 830 CMR 63.38.1(9)(d)(2) ("Income-producing activity does not include activities performed on behalf of a taxpayer by another person, such as services performed on its behalf by an independent contractor"). Therefore, the appellant maintained, the Travel Unit had no income-producing activities in Massachusetts.

The plain language of the statute refutes Interface's contention. Contrary to Interface's argument, "direct" does not refer to the customer's obligation to pay consideration to the taxpayer. Rather, "direct" refers to the taxpayer's participation in some activity, indeed, "**any activity** whose performance creates an obligation" in a customer to pay consideration to the taxpayer.

While independent travel agents sold the travel package to the ultimate customer, Travel Unit employees nonetheless "directly" engaged in the packaging of vacation tours in Massachusetts. Interface concedes, and its testimony showed, that many of the activities necessary to package a vacation tour were performed in its Needham office. Activities performed by Travel Unit employees in this office included product development, which consisted of placing telephone calls to investigate and reserve airline and hotel accommodations, recording hotel and airline booking information onto special computer software, and developing and distributing brochures to travel agents who used such brochures in making their sales to the ultimate traveling customer.

For example, when a customer selected a particular type of travel package, the travel agent would telephone the Travel Unit's reservations center, located in Needham, to inquire as to the availability of the specific category of hotel on the particular dates selected. If the package were available, the Travel Unit reservations center employee, located in Needham, would review the booking and payment procedures with the agent, who then remitted a deposit payment from the customer to the Travel Unit's Needham office to reserve the particular package. While Travel Unit employees did not correspond directly with the traveling customer, their activities in the Needham office of booking and marketing the accommodations were necessary steps in creating the ultimate vacation tour product, and thus constituted activities whose performance created an obligation in the ultimate customers to pay consideration.

Second, while some income-producing activities were performed outside of Massachusetts, such as visiting various hotels to research potential bookings and to sign booking contracts on site, Interface failed to meet its burden of proving that a greater proportion of the Travel Unit's income-producing activity was performed in any single state other than Massachusetts. As quoted above, the sales factor formula for sales of intangible goods apportions such sales to Massachusetts if "the greater proportion of this income-producing activity is performed in this commonwealth **than in any other state**, based on costs of performance." G.L. c. 63, § 38(f) (emphasis added). Interface introduced evidence demonstrating significant costs of performance that were not performed in the Commonwealth, such as the Travel Unit's payment of deposits to airlines and hotels necessary to reserve such bookings. However, Interface never attempted to prove a greater proportion of costs of performance **in any one state** other than Massachusetts. Its attempt to prove that costs of performance were greater in all other states and foreign countries combined than in Massachusetts was not the requisite means of challenging the Commissioner's apportionment of the Travel Unit's sales to Massachusetts. *See* ***Surel International, Inc. v. Commissioner of Revenue***, 24 Mass. App. Tax Bd. Rep. 38, 43 (1998) ("The Board ruled that in determining whether gross receipts are to be regarded as Massachusetts sales, G.L. c. 63, § 38(f), requires a comparison of costs between those incurred in Massachusetts and those incurred in other individual states and not, as the Appellant contends, between costs incurred in Massachusetts and those incurred in all other states combined.").

The appellant has the burden of establishing the facts necessary to justify its claim for abatement. ***William Rodman & Sons, Inc. v. State Tax Commission***, 373 Mass. 606 (1977). Appellant could not refute, nor did it attempt to refute, that costs of performance were incurred in Massachusetts. According to the regulations, costs of performance include direct costs associated with income-producing activities in accordance with generally accepted accounting principles. 830 CMR 63.38.1(9)(d)(4). Direct costs incurred in Massachusetts include the payment of salaries to the 150 to 160 Travel Unit employees, the majority of workers for the Travel Unit, who worked solely in the Needham office to package and market the vacation tours. The Board thus found that Interface had not met its burden of proving that more direct costs associated with the Travel Unit's income-producing activities were incurred in any one state other than Massachusetts. *See* ***Surel***, 24 Mass. App. Tax Bd. Rep. at 43. Therefore, the Board upheld the Commissioner's assessment on this issue.

III. Value of Airplanes To Be Included in Property Factor

Pursuant to G.L. c. 63, § 38(d), the property factor is calculated as follows:

> The property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property **owned or rented and used in this commonwealth** during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the taxable year. (Emphasis added).

Under the terms of the statute, property must be "used" in the Commonwealth, not merely "owned or rented," to be included in the property factor of the three-factor apportionment formula. *See* ***Commissioner of Revenue v. New***

England Power Co., 411 Mass. 418 (1991); ***Commissioner of Revenue v. Exxon Companies***, 407 Mass. 17 (1990).

Accordingly, the value of Interface's property used in the Commonwealth is included in the numerator, while the value of all its property wherever used, is included in the denominator. Attributing the value of mobile property, such as Interface's aircraft, to the numerator of the property factor presents a unique issue, since it is used both within and outside of Massachusetts. The Commissioner himself, in regulations promulgated after the tax year at issue, provides for the allocation of the value of mobile property to the numerator of the property factor based on the percentage of use of the property in Massachusetts. See 830 CMR 63.38.1. Such an allocation of value to the numerator based on the percentage of the mobile property's use in Massachusetts is consistent with the constitutional requirement that "the income attributed to [a] State for tax purposes must be rationally related to 'values connected with the taxing State.'" ***Norfolk & Western R. Co. v. State Tax Comm'n***, 390 U.S. 317, 325 (1968) (*quoting* ***Fargo v. Hart***, 193 U.S. 490, 499-500 (1904). In light of this constitutional requirement and his own regulation, the Commissioner's sparse defense of his inclusion of one hundred percent of the airplanes' value in the property factor's numerator is not surprising.

The Board found that Interface introduced sufficient evidence to meet its burden of showing that the Commissioner's inclusion of one hundred percent of the value of the two airplanes for the period of five months was in error. At the hearing, Interface introduced evidence, both testimony and documents such as flight records, demonstrating that the airplanes were used outside of the Commonwealth a significant amount of time during the relevant five-month period. For example, even though the airplanes were hangared at Logan, the average number of flights using Logan as a lift-off point was only 50.49 percent for one airplane and 43.41 percent for the other, for an average of 46.96 percent of total flights, less than half of all flights during this period. "'Evidence of a party having the burden of proof may not be disbelieved without an explicit and objectively adequate reason. . . . If the proponent has presented the best available evidence, which is logically adequate, and is neither contradicted nor improbable, it must be credited.'" ***New Boston Garden Corp. v. Assessors of Boston***, 383 Mass. 456, 470-471 (1981), *quoting* L. L. Jaffe, *Judicial Control of Administrative Action* 607-608 (1965).

Testimony from one of the Commissioner's tax examiners strongly suggested that no consideration was given to the actual usage of the airplanes within the Commonwealth. The Commissioner seemed to apportion the airplanes based solely upon their being hangared at Logan for the five month period in question. Yet the statute by its terms requires a consideration of the property's use in the Commonwealth. The Board, therefore, found that Interface's evidence of the airplanes' extensive usage outside of the Commonwealth was sufficient to meet its burden of disproving the Commissioner's assessment, which was based upon apportioning one hundred percent of the airplanes' values to Massachusetts.

However, the Board also found that Interface did not meet its burden of proving that only five percent of the airplanes' values were properly apportioned to the Commonwealth. Interface calculated this percentage based upon the revenue ton miles that were flown within Massachusetts airspace. In apportioning the airplanes according to this formula, Interface relied upon a letter dated March 16, 1982 from Deputy Commissioner John F. Coady addressed to a manager of Eastern Airlines, in which the Commissioner allegedly assented to the revenue-ton-mile apportionment for the airline industry. In this letter, the Deputy Commissioner stated, "I am pleased to inform you that Commissioner Hampers has authorized the use of the agreed-to apportionment formula . . ." Interface claimed that this letter, and the attached formula, created an agreement which bound the Commissioner to allow all airline carriers, including Interface, to source the value of their airplanes based upon a percentage of revenue ton miles flown in a state's airspace.

However, the letter from Deputy Commissioner Coady does not have the weight of authority, because it is not a regulation but merely a letter suggesting a proposed course of action, addressed to another taxpayer. *See* G.L. c. 30A, 830 CMR § 62C.3.1(3)(b). As discussed in the Findings above, the letter itself indicated that the declaration was tentative, as the formula's finalization by the Commissioner was dependent in part upon the industry's approval. Moreover, as discussed in the Findings, the recipient of this letter, Joseph A. Mirabella, also understood the apportionment formula to be tentative, subject to review by the industry and to final approval by the Commissioner.

Given its tentative tone, the Deputy Commissioner's letter with the attached "proposed formula" also cannot be regarded as a letter ruling from the Commissioner. The

Supreme Judicial Court in ***Commissioner of Revenue v. Marr Scaffolding Co.***, 414 Mass. 489, 492 (1993) held that a similarly tentative letter from a DOR Bureau Chief failed to meet the standards of "a letter ruling issued by the Commissioner on a specific set of facts," as described in 830 Code Mass. Regs. § 62C.3.2(2)(a): "The letter did not make a ruling but stated only that 'it does not appear' that a sales tax is payable." In addressing a "formal notice" actually issued by the Commissioner, the Supreme Judicial Court, in ***Wellington v. Commissioner of Corp. & Tax.***, 359 Mass. 448, 451-452 (1971), found a tentative tone to be fatal to the notice's authoritative weight:

> The notice issued in September, 1968, states that "we have, after review and research determined that our current policy and procedure should be changed to comply with our interpretation of the . . . statute." It does not purport to be a "regulation" pursuant to G.L. c. 14, § 4, or to be in compliance with the requirements of G.L. c. 30, § 37, or G.L. c. 30A, § 2 or § 3.

Accord ***Baybank Middlesex v. Commissioner of Revenue***, 16 Mass. App. Tax Bd. Rep. 92 (1994), *aff'd*, 421 Mass. 736 (1996). Deputy Commissioner Coady's letter cannot be classified as a letter ruling, but rather is merely a letter suggesting a proposed course of action to Eastern Airlines, another taxpayer. Interface could not rely upon a tentative proposal, directed to a different taxpayer, as creating precedent for its dealings with the Commissioner.

Furthermore, the Board found that the proposed sourcing of an airplane's value to the Commonwealth based upon revenue ton miles, referred to in Deputy Commissioner Coady's letter, did not constitute the type of administrative practice which is entitled to great weight in the interpretation of statutory language. Administrative interpretation and practice adopted contemporaneously with the enactment of a statute are entitled to great weight. *See* ***Lowell Gas Co. v. Commissioner of Corporations & Taxation***, 377 Mass. 255 (1979); ***Ace Heating Service, Inc. v. State Tax Comm'n***, 371 Mass. 254 (1976). However, great weight should not be accorded unpublished administrative interpretation or practice that was not adopted contemporaneously with the statute. ***General Elec. Co. v. Commissioner of Revenue***, 402 Mass. 523, 532 (1988) (*citing* ***Polaroid Corp. v. Commissioner of Revenue***, 393 Mass. 490, 497 (1984) and ***Xtra, Inc. v. Commissioner of Revenue***, 380 Mass. 277, 282-283 (1980)). Interface presented no evidence of administrative interpretation or practice that was adopted contemporaneously with the enactment or subsequent amendment of G.L. c. 63, § 38(d). The Deputy

Commissioner’s letter, written to a different taxpayer in 1982, was not contemporaneous with either the enactment of this section, nor any amendments pertaining to the property factor. Moreover, the letter’s tentative tone in no way indicated that it reflected an administrative interpretation or a practice that DOR had adopted. Rather, the letter merely suggested a possible course of action, and indicated that DOR would await further response from the industry before considering implementation of the suggested action. Accordingly, the letter did not evidence the type of administrative practice entitled to great weight in interpreting the relevant statutory provision, nor does the taxpayer cite any other actions amounting to such practice that could possibly bind the Commissioner to accept this revenue-ton-mileage calculation.

Having dismissed both the Commissioner’s one hundred percent apportionment formula and Interface’s five percent apportionment formula, the Board found that the apportionment figure from Interface’s original return was the most reasonable measure of its property taxable in the Commonwealth, especially in the absence of any regulation at that time. The Board has previously found that a speculative assessment by the Commissioner cannot stand where extensive records showing a more probable figure have been maintained and supplied by the taxpayer. *See* ***Chef Chang's House, Inc. v. Commissioner of Revenue***, 20 Mass. App. Tax Bd. Rep. 67 (1996). For this showing, a taxpayer's burden of proof "extends only to persuading the Board" that its calculations in determining its full amount of tax on its return "are more probable than those calculated by the [Commissioner]." ***Suprenant v. Commissioner of Revenue***, 14 Mass. App. Tax Bd. Rep. 12, 17 (1991). Interface produced ample evidence, including testimony and flight records, to prove extensive usage of the two airplanes outside of the Commonwealth. This evidence was sufficient to support the conclusion that the Commissioner's inclusion of one hundred percent of the airplanes' values could not be sustained.

Moreover, this evidence was sufficient to support that the 43.369 percent property factor used by Interface in its original return was reasonable. This 43.369 percent property factor consisted of all of the taxpayer's property in the Commonwealth, and it reflected the actual usage of the two airplanes in the Commonwealth. One of Interface's witnesses testified that 46.97 percent of the two airplanes' total number of departures was from the Commonwealth as compared with departures outside the Commonwealth. Interface stated that its 43.369 percent property factor was based in part upon this calculation of departures for its two airplanes. This method of apportionment was consistent with the Commissioner's own subsequently-adopted regulation, 830 CMR § 63.38.2(a)(2), which apportions the value of airplanes according to "the percentage of departures of the airline, of that aircraft type, taking place within Massachusetts." While the regulation was not controlling authority in this appeal,[9] the taxpayer's use of a method consistent with the regulation demonstrated further the reasonableness of the figure from the original return.

Therefore, the Board ruled that the most appropriate measure of the value of Interface's property to be apportioned to Massachusetts was 43.369 percent, the figure Interface had used on its original return. Accordingly, the Board issued a decision that appellant was entitled to an abatement based on the use of a 43.369 percent property factor to calculate its corporate excise liability.

[9] This regulation was promulgated in 1989, after the time period relevant to this appeal. Therefore, both parties agree that this regulation is not controlling authority for this appeal.

On this basis, the Board ordered an abatement to the appellant of $158,158.00 of the disputed tax, plus statutory additions.

APPELLATE TAX BOARD

By:______________________________

Abigail A. Burns, Chairman

A true copy:

Attest: ______________________
Clerk of the Board