COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

THE FIRST YEARS, INC. v. COMMISSIONER OF REVENUE

Docket No. C267626

Promulgated:
September 17, 2007

This is an appeal under the formal procedure pursuant to G.L. c. 58, § 2 and G.L. c. 58A, § 6 and § 7, from the refusal of the Commissioner of Revenue ("Commissioner" or "appellee") to grant the Appellant, The First Years, Inc. ("TFY" or "appellant"), classification as a manufacturing corporation for the tax year ended December 31, 2003 ("tax year at issue").

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

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

Philip S. Olsen, Esq. and *Natasha N. Varyani,* Esq. for the appellant.

Kevin M. Daly, Esq. for the appellee.

FINDINGS OF FACT AND REPORT

On the basis of a Statement of Agreed Facts and the testimony and exhibits introduced in the hearing of this appeal, the Appellate Tax Board ("Board") made the following findings of fact.

During the tax year at issue, TFY was a Massachusetts corporation with its headquarters in Avon, Massachusetts. TFY was engaged in the business of designing, manufacturing and selling a variety of children's and child-care related products, such as cups, bottles, teethers, baby monitors, breast pumps, bathtubs, and toys. TFY employed approximately 182 employees at its Avon headquarters. Subsequent to the tax year at issue but prior to the hearing of this appeal, TFY was acquired by RC2 Corporation. Kyle Nanna, marketing manager for RC2 Corporation, testified on behalf of TFY and was the sole witness to give testimony at the hearing. The Board found her testimony to be credible.

Ms. Nanna described TFY's overall operations and product development process, which consisted of several distinct phases. Ms. Nanna testified that the employees were divided into groups by product area, i.e., bath, feeding, play, etc. Each group was headed by a New Product

Manager, who, after extensive research, drafted a “concept brief” for each proposed new product. The New Product Manager then worked with a Design Manager to create a detailed sketch of the product. During this phase, the quality and safety tests to which the potential new product should be submitted were determined.

Once the entire product group approved the product, it was then presented to TFY’s Product Approval Committee, (“PAC”) which was comprised of senior company management. If the PAC approved of the proposed product, models of the product would be created. At this phase of development a model might be a three-dimensional tangible model or a detailed sketch of the product created through computer-assisted design (“CAD”). Models were either designed by an in-house engineer or created by a third-party designer, who worked closely with the New Product Manager during the design phase. All designers were given detailed lists with the specifications for each product as well as the tests that each product should be able to withstand. Whether created by an employee of TFY or a third-party designer, all models were owned by TFY.

Upon completion of the models, TFY conducted additional consumer research and extensive design review, as well as testing of the product. A final model was then

commissioned and completed by a third-party designer, which incorporated any changes stemming from the testing or consumer research yielded from the launch of the initial models. TFY employees worked hand-in-hand with these third-parties during the creation of the final model, often working on-site with them in order to oversee the creation of the model. Upon completion, the final model was presented for review by the PAC. If the final model was approved, TFY commenced the tooling and molding process, which is the creation of the tooling and molds that actually mold raw materials into the product on the assembly line. While the tooling and molds were made by third-party contractors, they were made to the specification of TFY and were the property of TFY. After the tooling and molds were completed, the “first shots” of the products went through the production process at a third-party manufacturer. “First shot” products were then brought back to TFY for further testing, including drop, bite, and impact tests. TFY conducted its own quality testing and at times, also contracted out to independent labs to verify the testing.

Finally, a product that had met all of the quality assurance tests and been given approval by the PAC was produced in bulk by third-party manufacturers, many of whom

were located overseas. However, TFY employees closely monitored the manufacturing process, often traveling to the manufacturing location to pull samples from the production line and run quality assurance tests. Additional alterations to the product, ranging from minor changes to significant re-design, were made even at that late stage if the products did not live up to the quality assurance tests conducted by the TFY employees. Ms. Nanna testified that TFY conducted its own extensive and continuous testing and even contracted for independent testing to verify its own test results because TFY was a very safety-conscious company.

On January 31, 2003, TFY filed a Form 355Q Statement Relating to Manufacturing Activities with the Commissioner, seeking classification as a manufacturing corporation for the tax year at issue. On April 15, 2003, the Commissioner issued his list of manufacturing corporations to the local boards of assessors, and TFY was not included on that list. On May 15, 2003, TFY timely filed its Petition with the Board. On the basis of the foregoing, the Board found and ruled that it had jurisdiction to hear this appeal.

As discussed in the Opinion below and to the extent that it is a finding of fact, the Board found and ruled that TFY conducted processes which were essential and

integral to the overall manufacturing process, and that therefore it was a corporation engaged in manufacturing during the tax year at issue. The Board found that the appellee's denial of manufacturing classification was improper and that the appellant was entitled to be classified as a manufacturing corporation under G.L. c. 58, § 2 for the tax year 2003, and accordingly, granted such classification to the appellant.

OPINION

The issue presented in this appeal is whether the appellant was engaged in manufacturing in Massachusetts during the tax year at issue such that it should be classified as a manufacturing corporation for the purposes of G.L. c. 63, § 38C. Classification as a manufacturing corporation under § 38C entitles a corporation to numerous tax advantages, including the exemption of its property from local taxes (G.L. c. 59, § 5, cl. 8) eligibility for investment tax credits (G.L. c. 63, § 31A) and certain sales and use tax exemptions (G.L. c. 64H, § 6 (r) and (s)). The issue of what it means to be engaged in manufacturing is one which the Board has considered with some frequency, most recently in ***Duracell, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and

Reports 2007-903 and ***Onex Communications Corp. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 2007-976. Likewise, the Supreme Judicial Court has considered the issue on numerous occasions. The Board and the court have embraced the basic definition of manufacturing articulated by the court decades ago in ***Boston & Me. R.R. v. Billerica***, 262 Mass. 439 (1928), as "[c]hange wrought through the application of forces directed by the human mind, which results in the transformation of some pre-existing substance or element into something different." ***Id.*** at 444-445. *See also* ***William F. Sullivan & Co., Inc. v. Commissioner of Revenue,*** 413 Mass. 576, 579 (1992). In addition, the Supreme Judicial Court has consistently held that the "phrase 'engaged in manufacturing' should not be given a narrow or restrictive meaning." ***Id.,*** *quoting* ***Joseph T. Rossi Corp. v. State Tax Comm'n,*** 369 Mass. 178, 181 (1975). A broad construction of the phrase effectuates the

> legislative intent and purpose [behind the statute] to promote the general welfare of the Commonwealth by inducing new industries to locate here and to foster the expansion and development of our own industries, so that the production of goods shall be stimulated, steady employment afforded our citizens, and a large measure of prosperity obtained.

Id. at 579, *quoting* ***Assessors of Boston v. Commissioner of Corps. & Taxation,*** 323 Mass. 730, 741 (1949). The court has therefore held that:

> processes which do not themselves produce a finished product for the ultimate consumer should still be deemed 'manufacturing' for the purposes of this tax exemption so long as they constitute an essential and integral part of a total manufacturing process.

Id. at 579-80, *quoting* ***Joseph T. Rossi Corp.*** at 181-82.

Further, there is no requirement that the source materials transformed in the manufacturing process be tangible. In ***Commissioner of Revenue v. Houghton Mifflin Company,*** 423 Mass. 42 (1996), the Supreme Judicial Court upheld the Board's determination that the research, design, writing and artwork created and conducted by the taxpayer's employees, and subsequently placed onto computer disks as final book manuscripts to be published into books by contract publishers, amounted to manufacturing. The court stated that "Houghton transforms 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." ***Id.*** at 48.

Despite these expansive interpretations, the Supreme Judicial Court has recognized that in establishing tax

exemptions for manufacturing corporations, the "Legislature did not intend to confer a windfall tax exemption on nonmanufacturing corporations that engage in manufacturing 'which is merely trivial or only incidental to its principal business.'" ***Fernandes Supermarkets, Inc. v. State Tax Comm'n,*** 371 Mass. 318, 322 (1976), *quoting* ***Commissioner of Corps. & Taxation v. Assessors of Boston,*** 321 Mass. 90, 97 (1947). Accordingly, "the degree of manufacturing must be 'substantial,' ***Commissioner of Corps.*** at 97, or 'important and material,' ***Assessors of Boston*** **v.** ***Commissioner of Corps. & Taxation***, 323 Mass. 730, 746 (1949), when measured against the entire operations of the corporation." ***Id.*** at 322. Applying these guidelines to the facts of the instant appeal, the Board found that the activities performed by TFY were essential and integral to the overall manufacturing process and that TFY was engaged in manufacturing to a substantial degree.

The evidence of record reflects that TFY employees were integrally involved in every step of the product creation process, from the conception of an idea for a new product through the completion of the final product offered for sale to consumers. TFY employees were responsible for proposing new products, conducting extensive background and consumer research for any proposed new product, creating

and/or overseeing the creation of intricate preliminary models, establishing the regimen of tests for a proposed new product, conducting the testing of the product and overseeing independent testing of the product, overseeing the creation of the "final model," overseeing the tooling and molding process, and finally, auditing the final product manufacturing process and conducting quality assurance tests even during this final stage. At any point in the process if the product did not satisfy quality assurance tests conducted by or on behalf of TFY, TFY re-directed the design of the product, from minor to significant changes. TFY employees were so involved in the manufacturing process that they often worked on-site at the third-party manufacturer's location during that process. The property involved in the manufacturing process belonged to TFY, including the original models and the tooling and molds used to make the final products.

Based on these facts, the Board found that the activities undertaken by TFY amounted to "the application of forces directed by the human mind, which result[ed] in the transformation of some pre-existing substance or element into something different." ***Boston & Me. R.R. v. Billerica*** at 444-445. Much like the taxpayer in ***Houghton Mifflin,*** TFY transformed "ideas, art, information and

photographs, by application of human knowledge and skill, into [designs, models, molds and tooling], ready for use by independent [manufacturers], containing an immense amount of information in a highly organized form." ***Houghton Mifflin*** at 48.

The appellee argued in this case, as he did in ***Houghton Mifflin,*** that the taxpayer's activities were more like those of an author who furnishes a manuscript to be published or a furniture designer who merely produces designs used by others to build furniture. ***Id.*** at 49. In ***Houghton Mifflin,*** the Supreme Judicial Court agreed that authors or furniture designers should not be considered "manufacturers," but found a "reasonable basis for distinguishing Houghton's activities." ***Id.*** at 49. That basis, as the appellee pointed out in attempting to distinguish ***Houghton Mifflin*** from the instant appeal, was that the completed computer disks generated by Houghton were "physically useful in making the finished product." ***Id.*** at 49. The appellee argued that TFY produces nothing comparable to the computer disks, and therefore, cannot be considered to be engaged in manufacturing.

On the contrary, the evidence showed that among the many activities engaged in by TFY during the product creation process was the design and creation of custom

tooling and molds, with the resulting tooling and molds being used directly in the actual manufacture of the final products. Although TFY contracted out the actual production of the tooling and molds, such tooling and molds were created under its oversight and to its exact specifications, and also became the property of TFY upon completion. The tooling and molds were then sent by TFY, along with elaborate design specifications, to the contract manufacturer for use in the manufacture of the ultimate product. The Board found, as the Supreme Judicial Court held in ***Houghton Mifflin,*** that this was "similar to the dress cutting 'markers'… used 'directly and exclusively' in the manufacture of dresses in ***Commissioner of Revenue v. Fashion Affiliates, Inc.,*** 387 Mass. 543, 545-46 (1982)…" ***Id.*** at 49.[1] In ***Fashion Affiliates,*** the court held that the computer system whose exemption from tax was at issue was used directly and exclusively in the actual manufacture of dresses when it was used to produce dress patterns on paper markers, which were then transferred for use onto the actual fabric for the mass production of dresses. The

[1] The court acknowledged in ***Houghton Mifflin*** when discussing ***Fashion Affiliates*** that ***Fashion Affiliates*** involved a sales and use tax exemption, rather than the investment tax credit at issue in ***Houghton Mifflin.*** However, as in the instant appeal, which involves neither a credit nor a sales and use tax exemption but manufacturing classification, the analysis is relevant in that the ultimate question addressed by the court was what activities constituted manufacturing.

court held that the system was used to "guide and measure a direct and immediate physical change in the material, a function that is an integral and necessary step in producing properly cut portions of the dresses being manufactured." ***Id.*** at 546. Similarly, the tooling and molds designed, commissioned and owned by TFY were used to guide, measure and mold the raw materials into the completed products to be sold. The Board found and ruled that this was an integral and necessary role in the manufacture of TFY's products.

Furthermore, the Supreme Judicial Court has held that the testing of products can be an essential and integral part of the manufacturing process in and of itself, so long as it is a necessary part of bringing the products to market. ***Associated Testing Laboratories, Inc. v. Commissioner of Revenue***, 429 Mass. 628, 630 (1999). This is true regardless of whether the testing is performed by a different entity or at a different location than the other manufacturing activities. ***Id.*** at 631. The evidence of record reflects the extensive and continuous product testing performed by TFY at all stages of the product development process. TFY engaged in substantial quality assurance testing and further contracted out for additional independent testing to verify its own test results. Given that the vast majority of TFY's products were consumer products oriented for use by infants and children, product

safety was of paramount importance. The Board therefore found and ruled that the testing engaged in by TFY constituted an essential and integral part of the manufacturing process.

The appellee argued that TFY's activities were more in the nature of research and development and were prerequisites to the manufacturing process rather than part of that actual process. The evidence cannot support such a finding. As discussed above, TFY's employees were involved continuously in the product creation process, from the conception of a proposed product to the quality testing of the final, manufactured products. Unlike in ***Electronics Corporation of America v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports, 1995-202, 212, where the Board found that the taxpayer's "design and creation of the prototypical products [were] not 'manufacturing,' but rather, more in the nature of research and development," and therefore, based on the facts of that appeal, "preliminary to the actual manufacturing process," TFY's activities cannot properly be labeled as merely prerequisite to the manufacturing process when they occurred throughout the entire process. Moreover, as the Board recently stated in ***Duracell, Inc.***, research and development and manufacturing activities are not mutually

exclusive. **Duracell, Inc.** at 921. While G.L. c. 63, § 38C makes a distinction between research and development and manufacturing, it also acknowledges that a corporation can simultaneously be engaged in both research and development and manufacturing activities, when it states, in pertinent part,

> A corporation that is engaged in research and development and that conducts manufacturing activities shall exclude expenditures related to manufacturing from total expenditures for the purpose of assessing whether 2/3 of expenditures are allocable to research and development…

As noted above, the Board was careful to limit its findings in ***Electronics Corporation of America*** to only the facts of that appeal. Therefore, the Board found no merit in the appellee's argument that TFY's activities were more in the nature of research and development than manufacturing.

The appellee further argued that TFY's activities were limited to the "mere transmission or manipulation of knowledge or intelligence." *See* ***First Data Corp. v. State Tax Comm'n,*** 371 Mass. 444, 447-48 (1976). Again, the evidence does not support this assertion, but rather demonstrated that TFY's activities involved a physical component beyond the mere manipulation of knowledge or intelligence. TFY designed and owned the tooling and molds used by the contract manufacturers in the manufacture of

the ultimate products. The tooling and molds directly shaped and transformed the raw materials into the completed products. In addition, TFY employees conducted hands-on quality assurance testing during all phases of the manufacturing process, including pulling random products from the manufacturing plant and conducting testing. The Board found that these activities were different from those of the taxpayer in ***First Data Corp***., which operated a "commercial on-line, real-time computer time sharing system," that took certain information supplied by First Data's customers and transmitted back to the customers, via electrical impulses carried on telephone lines, that same information applied to a certain purpose, e.g., payroll data or the like. ***Id.*** at 445-446. TFY produced and sold hundreds of different children's and child-care related products, and its activities encompassed physical interaction with raw materials which ultimately resulted in the creation of a tangible product. Therefore, the Board found and ruled that its activities were not limited to the "mere transmission or manipulation of knowledge or intelligence."

Finally, to qualify for manufacturing classification, a corporation must show that it was engaged in manufacturing to a substantial degree, rather than manufacturing which was

merely trivial or incidental to its main business. *See* ***Fernandes Supermarkets, Inc.*** at 322, *citing* ***Commissioner of Corps. & Taxation*** at 97. While the Commissioner's regulation sets forth four specific numerical tests for determining whether a corporation's manufacturing activities are substantial, the regulation also provides that a corporation can demonstrate through other criteria that its manufacturing activities were substantial. 830 CMR 58.2.1(6)(d). TFY was engaged in the business of designing, manufacturing and selling its line of children's and child-care related products, and derived all of its receipts from the sale of those products. Since its receipts depended entirely on producing and bringing its products to market, it cannot be said that the manufacturing of those products was merely incidental to TFY's principal business. Given that the relevant products were "'not a mere sideline, but the heart of the corporate business', the degree of manufacturing is considered to be 'substantial' for purposes of the statute." ***Onex Communications Corp.*** at 1002, *quoting* ***Noreast Fresh, Inc. v. Commissioner of Revenue,*** 50 Mass. App. Ct. 352, 358 (2000). As discussed above, the Board found and ruled that the activities conducted by TFY at its Massachusetts headquarters were essential and integral to the

manufacturing process. The Board therefore found and ruled that TFY was engaged in manufacturing to a substantial degree in Massachusetts.

CONCLUSION

Based on all of the foregoing, the Board found and ruled that TFY was "engaged in manufacturing" for the purposes of G.L. c. 63, § 38C during the tax year at issue, and therefore was entitled to be classified as a manufacturing corporation under G.L. c. 58, § 2 for the tax year 2003. Accordingly, the Board granted such classification to the appellant.

APPELLATE TAX BOARD

By: _____
Thomas W. Hammond, Jr., Chairman

A true copy,

Attest: _____
Clerk of the Board