COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

AT&T CORP. v. COMMISSIONER OF REVENUE

Docket No. C293831

Promulgated:
June 8, 2011

This is an appeal filed under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39 from the refusal of the appellee, Commissioner of Revenue ("Commissioner"), to grant an abatement of public service corporate franchise taxes assessed against the appellant, AT&T Corp. ("AT&T" or "appellant") for tax years ending December 31, 1996 through December 31, 1999 ("tax years at issue").

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

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

David S. Ruskin, Esq., *Megan M. Mathias*, Esq. and *Kathleen King Parker*, Esq. for the appellant.

Jeffrey S. Ogilvie, Esq. and *Daniel Shapiro*, Esq. for the appellee.

FINDINGS OF FACT AND REPORT

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

At all times relevant to this appeal, AT&T was a New York corporation with its administrative headquarters located in New Jersey. AT&T was in the business of providing interstate and international network telecommunications services. The receipts at issue in this appeal were from its interstate and international voice and data telecommunications services.[1]

The appellant timely filed Massachusetts public service corporation franchise tax returns for each of the tax years at issue and paid the tax due as reflected on those returns in full. The total tax due on the original returns was $7,706,624. After an audit based on an issue unrelated to this appeal, the Commissioner assessed additional public service corporation franchise taxes against the appellant in the amount of $276,746 for the tax years at issue by Notice of Assessment dated July 19, 2005. The appellant did not contest this assessment. On October

[1] AT&T's receipts from intrastate telecommunications services are not at issue here.

17, 2005, the appellant timely filed a Form CA-6 Application for Abatement/Amended Return requesting abatements of the assessments in the total amount of $2,108,137 for the tax years at issue based upon what it deemed to be the proper calculation of its sales-factor numerator, the issue in this appeal.[2] On October 2, 2007, the Commissioner issued a Notice of Abatement Determination denying AT&T's abatement application. On November 15, 2007, AT&T seasonably filed its Petition Under Formal Procedure with the Board. On the basis of these facts, the Board found and ruled that it had jurisdiction over this appeal.

The central issue in this appeal is whether certain receipts from interstate and international telecommunications services provided by the appellant should be included in the numerator of the appellant's sales factor for purposes of determining its Massachusetts taxable income for the tax years at issue. As will be explained more fully in the Opinion, when a taxpayer is engaged in the sale of services, calculation of its sales factor requires a determination first of the taxpayer's so-

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[2] The requested abatements for each tax year at issue were:
1996: $337,450
1997: $137,256
1998: $997,790
1999: $655,641

called "income-producing activity." Once the income-producing activity is determined, then the "costs of performance" of that activity are analyzed to determine if the taxpayer incurred more of those costs in Massachusetts than in any other single state. This two-part determination ultimately establishes whether the taxpayer's receipts are Massachusetts sales and thus included in the numerator of its sales factor.

The Commissioner contended that AT&T's income-producing activity was its provision of each individual telephone call and data transmission (collectively, "transmission") for each of its customers located in Massachusetts, the performance of which created an obligation of the individual customer to pay specific consideration to AT&T. In support of her argument, the Commissioner cited the fact that AT&T's bills to its customers were based on discrete transactions, and it received its revenue by means of this transaction-based billing process. The Commissioner would thus analyze AT&T's receipts, derived from its customers located in Massachusetts, on a per-transmission basis. The Commissioner asserted that, when analyzed under this "transactional approach," AT&T's costs of performance incurred in Massachusetts, in serving its customers located in Massachusetts, were greater than the costs of performance incurred in any other single state.

AT&T, however, contended that its income-producing activity was its business of providing a national, integrated telecommunications network, which it operated and managed from its Global Network Operations Center located in Bedminster, New Jersey. In support of its position, 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. As will be explained below, AT&T demonstrated that it engaged in numerous activities (so-called "core processes," which will be described further in these Findings) both within and without Massachusetts that were necessary to the overall activity of operating and managing the network. The appellant contended that these core processes together enabled AT&T to create and make available a viable long-distance telecommunications network, which was designed to be 99.99% reliable at all times. When analyzed under this "operational approach," AT&T's costs of performance incurred in Massachusetts were less than its costs of performance incurred in another single state, namely, New Jersey.

A subsidiary issue raised in this appeal was the Commissioner's inclusion as AT&T's costs of performance the so-called "access fees" which AT&T paid to local exchange operating companies ("LEOCs"). Relying on 830 CMR § 63.38.1(9)(d)(2), AT&T excluded these costs from its analysis, considering them to be third-party costs, and thus not reflective of the appellant's costs of performance. 830 CMR § 63.38.1(9)(d)(2) provides that, in determining a taxpayer's income-producing activity, the "transaction, procedure or operation" must be an activity which is "directly engaged in by a taxpayer [and] which results in a separately identifiable item of income." Further on in the regulations, 830 CMR § 63.38.1(9)(d)(4) defines "costs of performance" as the taxpayer's "direct costs," which "do not include costs of independent contractors or services by subcontractors."

AT&T's first witness, Robert Holleron, a retired 36-year employee of AT&T, testified with respect to the evolution and functioning of AT&T's global network and to the workings of the Global Network Operations Center. Mr. Holleron explained that, in 1984, as a result of an anti-trust lawsuit, AT&T was required to be separated into seven regional LEOCs, known as the Bell Operating Companies, and one long-distance company called AT&T, the appellant. The result of this divestiture was that one LEOC was given monopoly rights over a specific regional "local access transport area," which was a relatively small geographic area in which the LEOC operated its own "access network." Long-distance carriers, like AT&T and its competitors, provided a global network over which long-distance transmissions traveled between customers located in different local access transport areas. However, completing a long-distance transmission between two different local access transport areas required the connection and termination of that transmission from one end, i.e., "point of presence," to another. AT&T did not own or control the access network, so this "first mile" and "last mile" service, respectively, was provided to long-distance carriers by the separate LEOCs. AT&T contracted with, and paid access fees to, the LEOCs for their provision of "first mile" and "last mile" service over their access networks. Access could not be purchased in bulk but instead was charged per transmission.

Mr. Holleron thoroughly described the complex nature of AT&T's global telecommunications network, depicting it as "a very large web" of fiber optic cable together with electronic switching devices known as "points of interface," data routers, test equipment and control devices. At the center of this network was the control hub known as the Global Network Operations Center, located in Bedminster, New Jersey. This signaling facility determined the best path for each transmission and sent messages to the LEOCs to alert them to the incoming transmissions.

Mr. Holleron next established the intricate functioning of AT&T's network in providing long-distance service to AT&T's customers. The network used Real Time Network Routing in its signaling system to find the best route for each of the transmissions traveling along AT&T's network – which he estimated at billions annually - based upon current traffic patterns. AT&T submitted into evidence a DVD explaining how its patented Real Time Network Routing System would determine the best path (from over 140 possible paths) for the completion of any given transmission, and how workers at each switching location could manually intervene and re-route transmissions. The DVD presented an example of how, in the event of heavy network traffic, a call originating in Boston and destined for Atlanta could actually travel by way of a switch located in Los Angeles. As demonstrated by this example, a transmission was not always completed over the path that was the shortest distance between two points but instead could travel cross-country and then to its destination.

AT&T's network also used SONET ring configuration for its fiber, which enabled the network to self-correct in the event of a failure in order to minimize service interruption. Mr. Holleron testified that the path of a transmission could actually change during its duration, depending upon network congestion or an unexpected disruption of service, in order to prevent the transmission from being disconnected or "dropped." He explained, "AT&T's network . . . [wa]s built to avoid [the scenario] where any single point of failure would result in an outage." Another DVD submitted into evidence detailed how, in the event of a service failure of significant proportions, AT&T's Network Disaster Recovery Team ("Recovery Team") could rapidly transport modular equipment to the disaster site to restore service to customers. The Recovery Team would report to and coordinate with the Global Network Operations Center in New Jersey to restore service to the area.

AT&T's primary witness was James Allen, a consultant with BI Solutions Group, which provides accounting services related to cost and performance management topics. The Board qualified Mr. Allen as an expert in the area of cost accounting. Based on his study and observation of AT&T's business, Mr. Allen testified that AT&T's network was designed to be 99.99% reliable at all times, notwithstanding power failures or other calamities.

Mr. Allen presented a report to the Board,[3] which utilized an operational-approach analysis, referred to as the "costing view" in accounting jargon. Mr. Allen's analysis started with the premise that the entire integrated network, not just the proportion of the network located in Massachusetts, was needed to service customers residing in Massachusetts. Therefore, all costs of performance related to operating and maintaining the network should be included in a costs-of-performance analysis. Mr. Allen explained that AT&T did not track costs by both product and jurisdiction, so AT&T hired him to perform that analysis for purposes of this appeal. For his analysis, Mr. Allen first identified AT&T's items of income as the receipts from its network telecommunications services. He then identified seven income-producing activities, called "core processes," that were necessary for AT&T to operate its network: (1) service activation; (2) service assurance; (3) service creating (research and

[3] Mr. Allen actually created two reports, the first from May, 2006, which presented Mr. Allen's transactional approach, or "demand view" analysis, and the second from September, 2009, which primarily presented Mr. Allen's operational approach, or "costing view" analysis. Mr. Allen testified that he had prepared the original report under the assumption that the Commissioner would require a transactional-approach analysis.

development); (4) service execution; (5) network capacity and servicing; (6) billing; and (7) support and guidance. Mr. Allen then identified the costs associated with those core processes. Following the regulations at 830 CMR § 63.38.1(9)(d)(2) and (4), Mr. Allen excluded what he deemed to be third-party costs from his direct-cost analysis.

Next, Mr. Allen determined where the direct costs were incurred. He then separated direct costs incurred in New Jersey from those incurred in Massachusetts and compared the two groups of costs. Mr. Allen concluded that more direct costs were incurred in New Jersey than in Massachusetts during the tax years at issue. Mr. Allen maintained that his costing-view analysis was consistent with generally accepted accounting principles.[4]

Mr. Allen's analysis did not include as costs of performance the access fees that AT&T paid to the LEOCs. He explained that the access fees represented AT&T's payment to the LEOCs for their provision of "first mile" and "last mile" service over the LEOCs' networks. He then

[4] Mr. Allen further performed a so-called "micro view" analysis, by which he examined direct costs that supported Massachusetts sales. For this "micro view" study, Mr. Allen compared the proportion of direct costs incurred in Massachusetts, versus those incurred in New Jersey, to support Massachusetts sales. Even under this "micro view," Mr. Allen concluded that the greater proportion of direct costs was incurred in New Jersey.

explained that his understanding of Massachusetts law and the regulations at 830 CMR 63.38.1(9)(d)(2) and (4) was that third-party costs were to be excluded from the taxpayer's costs of performance. He opined that, because the access fees represented services provided to AT&T by the LEOCs, they thus did not reflect AT&T's costs incurred in AT&T's performance of any income-producing activities. In any event, he testified that, when analyzed under the operational approach, costs of performance in New Jersey exceeded those in Massachusetts even when these access fees were included as AT&T's costs of performance.

AT&T also called two additional expert witnesses to support Mr. Allen's costing-view report. First, Robert Eiler, whom the Board qualified as an expert in cost accounting, with a particular expertise in the area of telecommunications cost accounting, confirmed that Mr. Allen's report correctly followed established principles of cost management and cost modeling, used the best available data,[5] and correctly identified direct costs. He further opined that Mr. Allen's analysis of costs of performance was consistent with generally accepted

[5] Mr. Eiler explained that Mr. Allen's study used "budgeted data," or approximations based on historical data, for certain periods where the actual data was not in existence. He explained, however, that when they compared Mr. Allen's results derived from using actual data and budgeted data (for those periods where actual data was available), there were no significant differences.

principles of accounting. In Mr. Eiler's opinion, Mr. Allen analyzed the correct level of income-producing activity (the operational level), and concluded that an analysis of direct costs at the transactional level would be "impractical" and "economically infeasible."

Next, Professor Pomp, whom the Board qualified as an expert in the area of state taxation, further confirmed that Mr. Allen's analysis under the operational/costing-view approach was correct under the Massachusetts statute, regulations and case law. He opined that it would be "inconsistent" with unitary-business principles to identify items of income at the "micro level."[6] He explained that the Board's and the Supreme Judicial Court's opinions in ***Boston Professional Hockey Association v. Commissioner of Revenue***[7] confirmed this principle by refusing to analyze the unitary taxpayer's activities at the micro level. Then, citing the U.S. Supreme Court case, ***Goldberg v. Sweet***,[8] Professor Pomp also opined that an analysis of the

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[6] The unitary-business principle recognizes that the corporate entity, while having activities in various states, receives benefits from the operation of the business as a whole, namely, functional integration, centralization of management and economies of scale. *See* ***Mobil Oil Corp. v. Comm'r of Taxes***, 445 U.S. 425, 438 (1980) ("Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'").

[7] ***Boston Professional Hockey Ass'n, Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2003-273, *aff'd in relevant part*, 443 Mass. 276 (2005).

[8] ***Goldberg v. Sweet***, 488 U.S. 252, 255 (1989).

appellant's direct costs at the transactional level would be particularly arduous, if not impossible, given the volume of transmissions and the ability of AT&T's network to route and re-route them, often not along the most direct paths. He further noted that, because the Global Network Operations Center and administrative headquarters were located in New Jersey, "it's just sort of obvious" that New Jersey would have more costs of performance than Massachusetts. Finally, Professor Pomp criticized the Commissioner's transactional approach -- which analyzes costs of performance associated with "income from sales to [AT&T's] customers in Massachusetts"[9] -- as contrary to Massachusetts law. He pointed out that G.L. c. 63, § 38(f) started with "all gross receipts of the corporation" and then determined which sales were "in this commonwealth" based on income-producing activity and costs of performance. He concluded that the Commissioner's premise of starting with "Massachusetts sales" and analyzing their costs of performance assumed away the very issue that the statute is intended to answer – which of AT&T's receipts should be viewed as Massachusetts receipts.

AT&T's final witness was Beth Sosidka, a tax director for AT&T who worked on the appellant's state income tax

[9] Post-Trial Brief of Appellee Commissioner of Revenue at 18.

audits. Ms. Sosidka filed the subject abatement application, which removed AT&T's interstate and international sales income from the numerator of its sales factor. Ms. Sosidka had experience working as a liaison between AT&T's tax department and its business operations area to ensure that "the tax department ha[d] an understanding of AT&T's business and [could] reflect taxes accordingly." She emphasized the complex nature of a telecommunications transaction and the need for a functioning network to complete it: "making a phone call is not . . . two tin cans connected by a string, you are paying for that network to be reliable." She explained that the rationale behind the abatement application was her understanding, based on her experience, that the business of AT&T was the operation of its long-distance network, not the provision of individual transmissions. With this as her premise, Ms. Sosidka determined that AT&T incurred more costs in New Jersey than in Massachusetts for the tax periods at issue. In fact, AT&T had "significant operations" in numerous states and thus "there could have been other states as well where you would compare your costs in those states" with those incurred in Massachusetts and would have reached the same determination that costs in one of those other states were greater than costs incurred in Massachusetts.

For its case-in-chief, the Commissioner called as a witness Michael Starkey, an economist who acts as a consultant specializing in telecommunications. The Board qualified Mr. Starkey as an expert in the area of telecommunications cost analysis. Mr. Starkey did not perform his own study, but his report offered several critiques of Mr. Allen's May, 2006 study,[10] and in his testimony he offered several critiques of the September, 2009 study.[11] Mr. Starkey essentially criticized the appellant's lack of evidence demonstrating how AT&T's geographical network costs supported the services it sold to its Massachusetts customers. His report cited the following example: "consider an operator who sits in a call center in Chicago but spends part of his/her time supporting calls from Massachusetts or other jurisdictions." From this, Mr. Starkey opined that by focusing on AT&T's costs of operating its network as a whole, AT&T failed to establish its costs of performance

[10] *See supra*, note 3.
[11] Mr. Starkey's report did not address Mr. Allen's more recent September, 2009 study. However, Mr. Starkey testified that he had an opportunity to review the September, 2009 study before giving his testimony in this appeal. Therefore, his testimony includes his critique of Mr. Allen's "costing view" analysis.

for providing services specifically to its Massachusetts customers.

Mr. Starkey offered the "communities of interest" theory, which suggests that a person's community will dictate the pattern of calls that will be made, and these calls will supposedly travel along the same assets repeatedly, and because states on the east coast in particular "are so closely packed, a good part of interstate traffic may never travel a hundred miles much of which rely on assets that never leave Massachusetts." Mr. Starkey's report also included a "traffic factors adjustment" to Mr. Allen's original demand-view report based on, as he testified, "how [actual transactions] happened." However, Mr. Starkey did not explain how he was able to deduce this information.

Mr. Starkey further contended that including access fees into Mr. Allen's cost study would have resulted in Massachusetts having a greater amount of costs of performance than any other single state with respect to items of income derived from customers ***located in Massachusetts***. In response, AT&T re-called Mr. Allen to testify after Mr. Starkey concluded his testimony. Unlike Mr. Starkey, Mr. Allen did not analyze the costs of performance associated with income derived from so-called

"Massachusetts customers" under a transactional approach. He instead analyzed the costs of performance associated with AT&T's operation and management of its national integrated network, i.e., the operational approach. Mr. Allen testified that, under the operational approach, even when including access fees together with all other costs of performance, the total cost of performance in Massachusetts was still less than the total cost of performance in New Jersey.

On the basis of the foregoing, the Board found that the manner in which AT&T provided its long-distance transmission services to its customers was over its long-distance network. The Board in particular noted the example of the transmission originating in Boston and traveling to Atlanta via a switch located in Los Angeles in the event of heavy network traffic. The Board found that the appellant proved that this cross-country routing of transmissions was both a frequent and an unpredictable occurrence. This example illustrated that the entire integrated network, not just the proportion of the network located in Massachusetts, was needed for AT&T to provide its long-distance service with 99.99% reliability and virtually no interruption, and moreover, that the tracking of the exact path of each of the millions of transmissions per year would be a next-to-impossible endeavor. On the other hand, the Board found that the Commissioner's expert, Mr. Starkey, failed to support his bare assumptions that "communities of interest" could create predictable "calling patterns," and he did not attempt to explain whether heavy network traffic or network outages would affect those patterns. Moreover, he failed to explain his "traffic factors adjustment," based on a supposed ability to parcel out unpredictable telecommunications traffic according to "how [actual transactions] happened." The Board thus found that the appellant provided ample evidence demonstrating that its income-producing activity was its operation and management of a long-distance telecommunications network, with its hub in New Jersey at the Global Network Operations Center.

The Board next found that the appellant met its burden of proving that, when analyzing its income-producing activity under the operational approach, AT&T's costs of performance incurred in New Jersey were greater than its costs of performance incurred in Massachusetts during the tax years at issue. Therefore, the Board found that AT&T met its burden of proving that it incurred greater costs of performance in one single state other than in Massachusetts during each of the tax years at issue.

The Board also found that the access fees paid by AT&T were for services that were provided to AT&T by independent contractors or subcontractors -- the origination and termination of long-distance transmissions by LEOCs over access networks that the LEOCs owned and controlled. Therefore, for the reasons discussed more fully in the Opinion, the Board found that the access fees were for third-party services and thus were not properly includable as AT&T's costs of performance for purposes of calculating the numerator of its sales factor. Even assuming for the sake of argument that access fees were AT&T's costs of performance, the Board found that an analysis under the operational approach still resulted in less cost of performance incurred in Massachusetts than in another single state, namely New Jersey, during the tax years at issue.

Accordingly, on the basis of its findings, and as will be explained in the following Opinion, the Board issued a decision for the appellant abating a total of $2,108,137 in taxes, plus statutory additions.

OPINION

At all times relevant to this appeal, AT&T was a utility corporation subject to the excise imposed by

G.L. c. 63, § 52A, the public service franchise tax. Pursuant to § 52A(3), as in effect during the tax years at issue, AT&T's net income should have been apportioned under the standard rules in G.L. c. 63, § 38 ("§ 38(f)"), except that the sales factor should have been single-weighted.[12]

1. **<u>Whether certain of AT&T's receipts from its interstate and international telecommunications services were Massachusetts sales and thus included in the numerator of its Massachusetts sales factor.</u>**

The central issue in this appeal is whether certain receipts from interstate and international telecommunications services provided by AT&T should have been included in the numerator of AT&T's sales factor as calculated under § 38(f).

Pursuant to § 38(f) as in effect during the tax years at issue, receipts from sales other than sales of tangible personal property (including sales of telecommunications services) were Massachusetts sales if:

> 1. the income-producing activity [wa]s performed in this commonwealth; or

[12] If a foreign 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). The general rule under G.L. c. 63, § 38 is that the apportionment factor is computed as "a fraction, the numerator of which is the property factor plus the payroll factor plus ***twice*** times the sales factor, and the denominator of which is four." G.L. c. 63, § 38(c) (emphasis added). In computing the public service franchise tax, however, the sales factor is given equivalent weight to the property and payroll factors.

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

For the tax years at issue, the characterization of AT&T's "income-producing activity" determined how its costs of performance were to be analyzed, which ultimately determined which of its sales were Massachusetts sales to be included in the numerator of its sales factor. The appellant contended that its income-producing activity was the operation of its long-distance telecommunications network, which consisted of interconnected equipment located in every state of the United States and with both its Global Network Operations Center and administrative headquarters located in New Jersey ("operational approach"). In contrast, the Commissioner determined that AT&T's income-producing activity was each individual long-distance transmission placed by a customer ("transactional approach").

Section 38(f) does not define "income-producing activity." The Commissioner has promulgated a regulation, 830 CMR § 63.38.1(9)(d)(2), which generally describes 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). The regulation might appear to offer a choice between a transaction ***or*** a procedure ***or*** an operation. However, it does not offer a choice. Instead, the statute requires a determination of the correct income-producing activity, based on a close analysis of the particular facts presented. *See* ***Boston Professional Hockey Ass'n, Inc. v. Commissioner of Revenue,*** 443 Mass. 276, 286 (2005).

In ***Boston Professional Hockey Association v. Commissioner of Revenue***, the Board analyzed the above regulation to determine the taxpayer's income-producing activity. In that appeal, the taxpayer, Boston Professional Hockey Association, the owner and operator of the Boston Bruins Professional Hockey Club ("Bruins"), had its corporate headquarters in Boston, where a group of twenty employees performed such duties as media relations, payroll, accounts payable, financial, secretarial, travel arrangements, and equipment purchases. ***Boston Professional Hockey Ass'n v. Commissioner of Revenue***, Mass. ATB Findings of Facts and Reports 2003-273, 279. The General Manager for the Bruins also maintained his office at the Boston headquarters, where he negotiated contracts for players, broadcasters and insurance, and registered BPHA trademarks and Bruins logos and trademarks. ***Id.*** at 2003-279. The taxpayer argued for the transactional approach, i.e., analyzing its costs of performance on a per-game basis, which resulted in the greater proportion of income-producing activities being performed in jurisdictions other than Massachusetts for each separate away game. ***Id.*** at 2003-298-99. Accordingly, the taxpayer claimed that the numerator of its sales factor should exclude the costs of performance associated with those games, resulting in the exclusion from its sales factor of the revenue associated with all of its away games. ***Id.*** at 2003-299-300.

The Board, however, emphasized the importance to the Bruins franchise of all of the activities performed by the taxpayer, including those performed at headquarters: "these subsidiary activities, most of them performed by the administrative and office staff on Causeway Street, were necessary in creating a viable NHL franchise." ***Id.*** at 2003-284. The Board thus ruled that many of the costs, which the taxpayer tried to exclude from its costs-of-performance analysis, "like salaries to BPHA's executive and administrative staff working at the Causeway Street office and the correlating payroll and pension tax expenditures on these salaries," were necessary to creating the obligation in the customers to pay consideration for Bruins tickets, and that only the operational approach would capture these costs of performance. ***Id.*** at 2003-301, 302, *aff'd*, 443 Mass. at 284. *Accord* ***General Mills, Inc. v. Commissioner of Revenue,*** Mass. ATB Findings of Fact and Reports 2001-474, 528 (citing ***Clipper Express v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 1986-409).

Similarly, the taxpayer in ***The Interface Group v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 2008-1343, 1356-57, a Massachusetts public charter tour operator that created and marketed vacation travel packages to destinations primarily in the Caribbean Islands and Mexico, also argued for a transactional approach, which would have required analyzing its costs of performance on a per-trip basis. The effect of a transactional-approach analysis would have been the exclusion from the numerator of its Massachusetts sales factor of the revenue from all of the trips sold by the taxpayer. In that appeal, the importance of the activities performed at the taxpayer's headquarters in Massachusetts also factored strongly into the Board's decision - the Board found that it was the negotiating of travel accommodations in bulk which secured the taxpayer's competitive prices on those packages, in keeping with its business model of selling discounted travel packages. ***Interface***, Mass. ATB Findings of Fact and Reports at 2008-1364-65.

Under the facts of this appeal, the Board found that AT&T's income-producing activity was not the connection of an individual transmission over a specifically designated wire. 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. Simply put, AT&T could not provide its long-distance service without operating its entire long-distance network. The Board found that the Commissioner's expert's proposed "calling patterns" and "traffic factors adjustment" theories, which lacked specific evidentiary foundation, were not sufficient to support the Commissioner's transactional approach. Moreover, these theories could not be supported, particularly in the event of heavy network traffic or unforeseen network outages, both of which, the appellant proved, were common occurrences. The Board thus found and ruled that, in accordance with the statute and the regulations, AT&T's income-producing activity was its operation of its global network. This finding:

> fits comfortably within the text of the regulation that states that "an income-producing activity is a transaction, procedure, or **operation** directly engaged in by a taxpayer which results in a separately identifiable item of income". . . . [quoting 830 CMR § 63.38.1 (9)(d)(2)(emphasis provided by Supreme Judicial Court)]. This construction of the regulation is neither "patently wrong, unreasonable, arbitrary, whimsical, or capricious.

Boston Professional Hockey Ass'n, 443 Mass. at 286 (quoting ***Box Pond Ass'n v. Energy Facilities Siting Bd.,*** 435 Mass. 408, 416 (2001) (other citation omitted)).

Moreover, while AT&T engaged in numerous subsidiary activities, both within and outside Massachusetts, that were an essential part of its income-producing activity, it provided ample evidence establishing the importance of the activities performed at its Global Network Operations Center, where employees operated and managed a network capable of routing and re-routing each transmission in order to ensure its successful completion. Because of the work there, AT&T was able to maintain its reported 99.99% reliability rating, notwithstanding events like natural disasters and national emergencies. Appellate courts have consistently upheld the Board in rejecting adoption of a transactional approach when doing so would have trivialized the actual income-producing activities performed at a taxpayer's Massachusetts headquarters. *See, e.g.,* ***Interface*** and ***Boston Professional Hockey Ass'n,*** *supra*. Just as it has recognized the importance of a taxpayer's Massachusetts headquarters, the Board here must equally recognize the importance of AT&T's centralized network hub, which was located outside of Massachusetts. The Commissioner cannot have it both ways and argue for the transactional approach when the taxpayer's headquarters happen to be located outside of the Commonwealth. *See* ***Interface***, Mass. ATB Findings of Fact and Reports at 2008-1360 (recognizing that the regulation does not permit either party to "cherry-pick" from among a taxpayer's activities to reach a tax-favored result) (citing ***Boston Professional Hockey Ass'n***, 443 Mass. at 284). It bears repeating that 830 CMR § 63.38.1(9)(d)(2) does not offer a choice of an income-producing activity but requires a determination of the correct income-producing activity based on a specific set of facts.

With respect to personal services, when the service is rendered partly within the Commonwealth and partly without, the Commissioner's regulation provides that the receipts are attributed to Massachusetts "if, based upon costs of performance, a greater proportion of the services is rendered in Massachusetts than in any other state." 830 CMR § 63.38.1(9)(d)(3)(a). *See* ***Surel International, Inc. v. Commissioner of Revenue***, Mass. ATB Findings of Fact and Reports 1998-494, 505. The Board found that the appellant met its burden of proving that, when including its expenses incurred at its Global Network Operations Center and its administrative headquarters, both located in New Jersey, AT&T's costs to maintain its network, which were incurred in Massachusetts, were less than those costs incurred in New Jersey. The Board thus ruled that, under the facts of this appeal, because a greater proportion of AT&T's services were rendered in one single state other than Massachusetts, then its receipts from these services should not be apportioned to Massachusetts.

The Board also agreed with AT&T's expert, Professor Pomp, that the Commissioner's overall analysis was contrary to the Massachusetts statute and case law. The Commissioner began with what she claimed to be "income from sales to [AT&T's] customers in Massachusetts" and then analyzed the costs of those sales. However, the purpose of § 38(f) is to analyze a taxpayer's costs of performance associated with its income-producing activity and then to use that analysis in order to determine which sales are in Massachusetts. Starting with a predisposed assumption that certain sales are "Massachusetts sales" forces a conclusion before allowing the cost-of-performance evidence to lead to the correct result.

While not central to its decision, the Board also recognized the problems associated with adoption of the transactional approach for analyzing AT&T's costs of performance under the facts of this appeal. In particular, the costs of maintaining particular switches could not be allocated to individual transmissions unless it were known which particular switches that those transmissions had used. Determining this information would be a monumentally challenging task, both given the volume of AT&T's transmissions and the fact that a transmission would frequently be re-routed during its transmittal. The United States Supreme Court, over twenty years ago, recognized the complex path of telecommunications signals:

> [T]he path taken by the electronic signals [for interstate telephone calls] is often indirect and typically bears no relation to state boundaries. The number of possible paths, the nature of the electronic signals, and the system of computerized switching makes it virtually impossible to trace and record the actual paths taken by the electronic signals which create an individual telephone call.

Goldberg v. Sweet, 488 U.S. 252, 255 (1989). To require AT&T to track these signals, or attempt to do so, under a transactional analysis would cause an undue administrative burden under the facts of this appeal. More to the point, a micro-level analysis of the path of individual transmissions would not be useful in determining AT&T's costs of performing its business, which the Board found to be the provision of telecommunications services over its long-distance network.

2. Whether access fees should be included as AT&T's costs of performance.

The Commissioner's regulation at 830 CMR 63.38.1(9)(d)(2) 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." (emphasis added). The regulation further instructs that "income-producing activity includes only the activities of the taxpayer whose income is being apportioned." The regulation then provides this caveat:

> 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*** or by any other party whose activities are not attributable to the taxpayer for the purposes of determining tax jurisdiction under 830 CMR 63.39.1.

830 CMR 63.38.1(9)(d)(2) (emphasis added). The regulation later defines "cost of performance" as a taxpayer's "direct costs," which specifically "do not include costs of independent contractors or ***services by subcontractors***." 830 CMR 63.38.1(9)(d)(4) (emphasis added).

It is undisputed that AT&T did not own or control the access networks and that the access fees it paid to the LEOCs were for services provided to AT&T by the LEOCs, *i.e.*, the origination and termination of long-distance transmissions over the LEOCs' networks. The Commissioner contended that, because AT&T was required to pay these access fees in its provision of long-distance telecommunications services, they thus became part of AT&T's costs of performance. This argument is based on the Commissioner's understanding that "costs of independent contractors" in 830 CMR 63.38.1(9)(d)(4) refers to those costs that the independent contractor incurs in performing its own activities. The appellant, on the other hand, cites the remainder of (d)(4), which specifies that direct costs "do not include costs of independent contractors or ***services by subcontractors***"; the appellant also cites the regulation at (d)(2) which specifically excludes from income-producing activity "***services performed on its behalf by an independent contractor***." (emphasis added).

The Board agreed with the appellant. The Board found that the originations and terminations of long-distance transmissions by the LEOCs reflected costs for services by the LEOCs, whom the Board found to be acting independently of AT&T for purposes of completing AT&T's long-distance transmissions. Whether the LEOCs were independent contractors or subcontractors of AT&T, their activities were not attributable to AT&T for purposes of determining corporate nexus. The Board thus found and ruled that, because the access fees paid by AT&T represented payment for "activities performed on [AT&T's] behalf by [the LEOCs]," the access fees should not have been included as AT&T's costs of performing its income-producing activity for purposes of calculating the numerator of its sales factor.

Assuming for the sake of argument, however, that access fees were properly considered AT&T's costs of performance, the net result would be unchanged. The Board was further persuaded by Mr. Allen, who showed that, even when access fees were included in a costs-of-performance analysis under the operational approach, the total cost of performance incurred in New Jersey still exceeded the total cost of performance incurred in Massachusetts. Therefore, the Board found and ruled that adding access fees into the costs-of-performance analysis would not change the result, which is that AT&T incurred more costs of performance in one single state other than Massachusetts, namely New Jersey, during the tax years at issue.

Conclusion

The Board found and ruled that the operational approach was the proper method for determining AT&T's costs of performance for purposes of calculating its sales factor. Under the operational approach, the greater proportion of AT&T's costs was incurred in New Jersey, not in Massachusetts. Therefore, the Board found and ruled that AT&T met its burden of proving that the Commissioner improperly denied its abatement application for the tax years at issue. Accordingly, the Board granted abatements of taxes to AT&T in the total amount of $2,108,137 as follows:

Tax year ending 12/31/1996	$337,450
Tax year ending 12/31/1997	$137,256
Tax year ending 12/31/1998	$977,790
Tax year ending 12/31/1999	$655,641

plus statutory additions.

THE APPELLATE TAX BOARD

By: ____________________________________

Thomas W. Hammond, Jr., Chairman

A true copy,

Attest: ______________________________

Clerk of the Board