

COMMONWEALTH OF MASSACHUSETTS

APPELLATE TAX BOARD

DECKERS OUTDOOR CORPORATION            v.            COMMISSIONER OF REVENUE

Docket Nos. C320020 & C321955

Promulgated:  
June 21, 2018

These are appeals filed under the formal procedure pursuant to G.L. c. 58A, § 7 and G.L. c. 62C, § 39(c) from the refusal of the Commissioner of Revenue ("Commissioner" or "appellee") to grant an abatement of corporate excise assessed to Deckers Outdoor Corporation ("Deckers" or "appellant") under G.L. c. 63, § 38 for the tax years ended December 31, 2007, December 31, 2008, December 31, 2009, and December 31, 2010 (collectively, the "tax years at issue").

Commissioner Good heard these appeals and was joined in the decisions for the appellant, in part, and for the appellee, in part, by Chairman Hammond and Commissioners Scharaffa, Rose, and Chmielinski.

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.

*John S. Brown, Esq., George P. Mair, Esq., Donald-Bruce Abrams, Esq., and Darcy A. Ryding, Esq.* for the appellant.

*Celine E. de la Foscade-Condon, Esq., and Brett M. Goldberg, Esq.* for the appellee.

## **FINDINGS OF FACT AND REPORT**

### **I. Introduction and Jurisdiction**

At all times relevant to these appeals, the appellant was a Delaware corporation whose principal place of business was in Goleta, California. The primary issue in these appeals was whether the appellant was a "manufacturing corporation" within the meaning of G.L. c. 63, § 38(1)(1) ("§ 38") during the tax years at issue, such that it was required to apportion its net income using a single-factor apportionment formula, based on sales. A secondary issue was whether the Commissioner properly assessed to the appellant penalties under G.L. c. 62C, § 35A ("§ 35A") for substantial underpayment of taxes.

For tax years 2007 and 2008, the appellant filed Massachusetts corporate excise returns on Form 355. On April 3, 2009, the appellant filed an amended return for tax year 2007. On October 28, 2011, following an audit, the Commissioner issued to the appellant a Notice of Intent to Assess additional taxes for the tax years 2007 and 2008. On December 1, 2012, the Commissioner assessed additional taxes in the amount of \$29,693 for tax year 2007 and \$86,368 for tax year 2008, and informed the appellant of those assessments by Notice of Assessment dated December 4, 2012.

On December 20, 2012, the appellant filed an Application for Abatement on Form CA-6 for tax years 2007 and 2008 with the

Commissioner, which the Commissioner denied by Notice of Abatement Determination dated April 24, 2013. On June 14, 2013, the appellant timely filed its petition with the Appellate Tax Board ("Board") for tax years 2007 and 2008, which was given Docket No. C320020. Based on the foregoing facts, the Board found and ruled that it had jurisdiction to hear and decide the appeal.

For tax year 2009, the appellant filed a Massachusetts corporate excise return on Form 355, which it later amended, and for tax year 2010 it filed corporate excise returns on both Forms 355 and 355U. Following an audit, the Commissioner issued to the appellant Notices of Intent to Assess additional taxes for tax years 2009 and 2010, dated July 12, 2013 and July 15, 2013, respectively. By Notices of Assessment dated August 20, 2013 and August 21, 2013, the Commissioner notified the appellant that he had assessed additional taxes in the amount of \$144,382 for tax year 2009 and \$104,139 for tax year 2010.

On September 13, 2013, the appellant filed Applications for Abatement on Form CA-6 for tax years 2009 and 2010 with the Commissioner, which were denied by Notice of Abatement Determination dated September 27, 2013. The appellant filed its petition for tax years 2009 and 2010 with the Board on November 12, 2013, which was given Docket No. C321955. Based on the

foregoing facts, the Board found and ruled that it had jurisdiction to hear and decide the appeal.

The evidence in these appeals consisted almost entirely of the Statement of Agreed Facts and stipulated exhibits offered by the parties, along with the testimony of a single witness, Mr. David Lafitte. At the time of the hearing of these appeals, Mr. Lafitte was the Chief Operating Officer of Deckers. Before assuming that position, Mr. Lafitte served as in-house counsel to Deckers, and before that, including during the tax years at issue, he served as outside counsel to Deckers. Based on the evidence entered into the record, including Mr. Lafitte's testimony, the Board made the following findings of fact.

## **II. The Appellant's Business Operations**

### **A. United States Operations**

Deckers was founded as a footwear company in 1973. At that time, its principal product was a flip-flop sandal, which, by the tax years at issue, it no longer sold. During the 1990s, Deckers acquired the UGG footwear brand, which is best known for its line of sheepskin boots. Its other major brand was Teva, which is best known for its outdoor-lifestyle sandals. Deckers also owned a few lesser-known footwear brands, and a very minor portion of its business involved the sale of accessories other than footwear.

During the tax years at issue, Deckers had between 350 and 900 employees in the United States ("U.S."). Deckers was the principal reporting corporation for a large corporate group which included several subsidiaries that were disregarded entities for tax purposes.

Deckers headquarters was located in Goleta, California. The headquarters facilities consisted of two buildings which contained primarily office and administrative space, in addition to a materials library. The materials library was essentially a showroom containing numerous swatches of textiles, leathers, and other materials that may become part of a footwear product. Deckers designers used the materials library to review and select components of potential new footwear products. The materials library also contained packaging material samples. The Goleta facility did not have a manufacturing floor, nor did any facility owned by Deckers. Instead, as will be discussed further below, Deckers engaged third-party factories to produce its footwear products.

Deckers also operated two distribution centers, both located in California. In addition, Deckers operated several UGG brand retail stores during the tax years at issue, including in Massachusetts.

## **B. International Operations**

While Deckers itself did not own facilities or have employees outside of the U.S., it was the parent corporation for a group of international subsidiaries. Most relevant for purposes of these appeals were Deckers Macau Ltd. ("Macau") and Deckers Outdoor (Guangzhou) Consulting Co., Ltd. ("Guangzhou").

The Guangzhou office is located in Pan Yu City, Guangzhou, China. During the tax years at issue, it employed from 40 to 70 people. Guangzhou had its own local management team, but that team ultimately reported to senior management at Deckers.

The function of Guangzhou within the Deckers organization was to act as a liaison between the U.S.-based design team and the third-party factories that produced the footwear products. Because ensuring the completion and delivery of a product line in time for the appropriate season was of the essence, one of the functions performed by Guangzhou was ensuring that a factory had adequate capacity to deliver the products on time. Guangzhou employees were also involved with compliance and quality control at the factories.

Macau had five to seven employees during the tax years at issue. Like Guangzhou, it had its own local management team, but that team reported most directly to Guangzhou and, ultimately, to senior management at Deckers. The function of Macau within the Deckers organization was to place purchase orders with

factories and to act as a liaison with the factories. Macau was also involved in managing the shipping of finished products.

### **III. The Creation of Deckers' Products: "The Critical Path"**

Mr. Lafitte described the way that Deckers footwear products come into being. The process, referred to as "the critical path," takes approximately 18 months. It begins at Deckers with the creation of a product brief. A product line manager for a particular brand creates a product brief for a proposed shoe, and this brief contains information such as the nature of the shoe, its target customers and price point, and information regarding its market competitors. A product brief might also include photographs of similar products and more detailed marketing information.

The next step in the process is the design drawings, done by a Deckers product designer. Initial sketches of a product might be done manually or with graphics software. These initial drawings are two dimensional, and might include information about the leather or materials to be used in the product. These drawings are always done for sample sizes, which are men's size nine and women's size seven.

Following this step, and with more input from a Deckers product line manager and product developer, the designer will create more detailed drawings, typically using software. At this point, color schemes for the products are selected, a

process which Deckers calls "colorways." Similarly, materials for each portion of the potential products are specified, a process which Deckers calls "materials mapping." Drawings at this stage are still two dimensional, but contain much more information, often stating measurements down to the millimeter. The detailed drawings present both lateral and medial views of the shoe, and contain specifications as to the type of stitching for each component, placement of the logo, and the color scheme and materials to be used. All of the foregoing steps are performed by Deckers employees.

These more detailed, two-dimensional drawings are then sent to Guangzhou, which will work with local factories to create an actual shoe from them. The resulting three-dimensional sample products, always in men's size nine and women's size seven, are sent back to Deckers for the next step in the process, the initial line review.

The initial line review takes place in California and typically involves a large team of Deckers employees, from the product line manager to the designer to members of the sales and marketing departments. They review every aspect of the sample, from its look and feel to its functionality. The design and selected materials, which in turn influence price point, are also discussed in the context of the shoe's viability as a market product. At this point, Deckers could drop a proposed



shoe from a line altogether, or make significant changes to the proposed design elements.

The changes desired by Deckers following the initial line review are communicated back to Guangzhou, and in turn, the factories, which produce a second set of samples incorporating those changes. A final line review of the footwear samples is then conducted. Fit testing is part of both the initial and final line review. Personnel in Guangzhou as well as Deckers employees in California with the correct shoe size - men's size nine and women's size seven - try on the sample shoes and give feedback on their fit. The feedback is documented in a report called "Fit Sample Results," and Deckers may make changes to a product based on that feedback. For example, following the fit testing for a Teva Tamur shoe, Deckers instructions based on the tester's comment that the U-throat area was tight were: "Please cut off the supertuff 6600 at the bottom of the eyestay. It's making the U-throat area too stiff." For a Teva Sunkosi shoe, following a tester's comment that "the binding stitches are rough and can be felt," the instructions were: "the joint of the binding at the back center needs to be moved to the medial side," and those instructions were accompanied by a photograph pointing to the problem area.

Following the final line review, a sales meeting is held in California to forecast the demand for the product. A new set of

samples, which incorporates any changes made as a result of the final line review, will be produced for this meeting.

During the preceding steps, Deckers creates a spec sheet for the proposed shoe. The spec sheets include: drawings of the product, the materials to be used for each component of the proposed shoe, the color scheme, the intended season for the product (spring/summer or fall/winter), and the product design team members involved. Spec sheets will specify information such as the type of material to be used for stitching, along with the number of stitches per inch. Precise information as to each component of the shoe is imperative so that an accurate cost breakdown of the shoe can be computed. The spec sheets also typically state the vendor from whom the materials are to be acquired.

All of these steps culminate in the creation of a tech pack. A tech pack is a multi-page document created by Deckers containing detailed information about the footwear item to which it relates, including drawings, materials, precise measurements of the features, and colors. A sample tech pack entered into the record as Exhibit 52 shows that the front page of a tech pack consists of a "designer check list," and the items on that list that must be completed are: line art of the individual shoe (left lateral view); line art of all relevant different views; technical line art of hardware/software molded components, to

scale with cross-sections and measurements; dimensions for all logos and straps; material and texture preferences, including material name, code, supplier, and reference swatch; information for hardware/molded components; and lastly, colorway and material mapping information. The tech packs also include information about the molds, tooling, and lasts<sup>1</sup> to be used for the creation of the product.

The tech pack is usually e-mailed by Deckers to the factories. The factories will use the tech pack to create three-dimensional renderings of the shoe. The factories then engage a mold-maker to create the molds and other items necessary for mass production of the shoe. Because the molds contain valuable Deckers trademarks, title to them does not pass to third-party factories, only possession.

Once a final sample has been approved, usually by both Guangzhou and Deckers personnel, the mass production of the shoe begins. Because all iterations of the product to this point, both two and three dimensional, have been limited to a men's size nine and women's size seven, the factories will use computer-assisted technology to scale the designs for other sizes.

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<sup>1</sup> A last is a type of foot model, or dummy foot, used in manufacturing footwear.

Quality control is conducted throughout the production process. This includes inspection of the raw materials as well as checks such as stress and pull tests on random samples coming off of a production line. Factories have their own quality control teams, but Guangzhou personnel are also present in the factories to facilitate quality control. A final quality control inspection takes place at Deckers distribution centers in California following shipment from the factories. This inspection is conducted by Deckers employees.

#### **IV. Deckers was "Engaged in Manufacturing."**

On the basis of the record in its totality, the Board concluded that Deckers was "engaged in manufacturing" for purposes of § 38. The Board found that Deckers' activities throughout the entirety of the critical path amounted to the transformation of "raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name, nature, and adapted to a new use." G.L. c. 63, § 38(1)(1). In reaching this conclusion, the Board found that the materials created by Deckers, including the tech packs, were physically useful in making the footwear products that it ultimately sold. They were not valuable solely for their artistic or intellectual content, but for the exact and precise information they specified for every component of every shoe. Further, the Board found that Deckers employees

physically interacted with the footwear products throughout the production process, including fit testing and final quality inspection, and that their feedback resulted in physical modifications to the products.

In order to be considered a § 38 manufacturer, a company must not only "engag[e] in manufacturing," but it must also do so "in substantial part." In its post-hearing brief, Deckers argued that even assuming arguendo that it "engaged in manufacturing" for purposes of § 38, it did not do so "in substantial part." G.L. c. 63, § 38(1)(1). The statute sets out methodologies for making a determination of substantiality, including numerical thresholds based on the taxpayer's gross receipts, tangible property, and payroll, as well as by reference to the Commissioner's regulations, but the appellant asserted that only one of those tests was relevant here - "gross receipts . . . derived from the sale of manufactured goods that it manufactures." G.L. c. 63, § 38 (1)(1).

The appellant made the somewhat tautological argument that because Deckers does not manufacture goods at all, it does not derive gross receipts from the sale of goods that it manufactures. This argument was negated by the Board's findings that the appellant was in fact "engaged in manufacturing." The appellant offered no evidence showing that it fell short of numerical thresholds set forth within the statute. As the

appellant had the burden of proof on this issue, the Board found that it did not meet its burden of demonstrating that it was not "engaged in manufacturing . . . in substantial part[.]" G.L. c. 63, § 38 (1)(1).

#### **V. The Assessment of § 35A Penalties**

A subsidiary issue in these appeals was whether the Commissioner properly assessed penalties under § 35A for the tax years at issue. That section is applicable in cases where a portion of any underpayment is attributable to either negligence or disregard of the applicable legal authorities or if there is a substantial understatement of tax, that is, an amount that is the greater of 10 percent of the tax required to be shown on the return for the period or \$1,000. However, G.L. c. 62C, § 35B provides that § 35A penalties shall not be assessed "with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion," with certain exceptions not relevant to these appeals. G.L. c. 62C, § 35B.

Based on the evidence, and as will be discussed further in the Opinion below, the Board found that, although the appellant's tax returns for the tax years at issue each had a substantial understatement of tax as defined by § 35A, the

appellant had reasonable cause and acted in good faith in reporting its taxes. Among the factors considered by the Board in reaching this conclusion was the appellant's retention of national accounting firms KPMG and Ernst & Young to assist with the preparation of its tax returns. Accordingly, the Board found that the Commissioner's assessment of penalties under § 35A was improper, and it therefore ordered an abatement of those penalties.

In conclusion, based on the record in its totality and the reasonable inferences drawn therefrom, the Board found and ruled that Deckers was a "manufacturing corporation" for purposes of § 38, and as such, it was required to use a single-factor apportionment formula for the tax years at issue. It therefore decided that issue in favor of the Commissioner. However, the Board found that the appellant demonstrated reasonable cause and acted in good faith in reporting the taxes due on its returns for each of the tax years at issue, and it therefore granted an abatement of the substantial understatement penalties assessed by the Commissioner under § 35A.

#### **OPINION**

Pursuant to § 38, a "manufacturing corporation" that has income from business activity that is taxable both within and without Massachusetts is required to apportion its net income

using a single-factor formula, based entirely on its sales, rather than the three-factor formula based upon property, payroll, and sales factors. The use of a single-factor formula based on sales for businesses with little payroll or property within Massachusetts tends to increase their tax liability as compared to the use of a three-factor formula that non-manufacturing corporations are entitled to use. That was precisely the case for Deckers, and the primary issue presented for the Board's consideration was whether Deckers was a "manufacturing corporation" for purposes of § 38.

Section 38 defines "manufacturing corporation" as follows:

[A] corporation that is engaged in manufacturing. In order to be engaged in manufacturing, the corporation must be engaged, in substantial part, in transforming raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name, nature, and adapted to a new use.

G.L. c. 63, § 38(1)(1). The statutory definition closely follows the definition articulated by the Supreme Judicial Court decades ago in *Boston & Me. R.R. v. Billerica*, 262 Mass. 439, 444-45 (1928): "[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, with a new name, nature or use." Because status as a manufacturing corporation has significance for tax purposes beyond § 38, what activities constitute manufacturing



is a question that courts and this Board have long and often been asked to consider. See **Commissioner of Revenue v. Houghton Mifflin Company**, 423 Mass. 42, 44 (1996) (noting that this issue has "spawned a great body of caselaw").

A focal point in these cases has been "whether the processes under study 'effect[ed] the kind of change and caus[ed] a correlative degree of refinement to the source material,' sufficient to qualify as 'manufacturing.'" **Houghton Mifflin**, 423 Mass. at 47 (quoting **William F. Sullivan & Co. v. Commissioner of Revenue** 413 Mass. 576, 581 (1992)). For example, converting frozen steak into cooked steak and crushing larger stones into smaller stones was not manufacturing. **York Steak House Sys., Inc. v. Commissioner of Revenue**, 393 Mass. 424, 426 (1984); **Tilcon-Warren Quarries, Inc. v. Commissioner of Revenue**, 392 Mass. 670 (1984). However, scouring raw waste wool into wool ready to be spun into thread or cloth; converting cast off pipe, appliances, automotive parts and other metal items into compressed and baled scrap metal; and converting standing timber into cut lumber all constituted manufacturing. See **Assessors of Boston v. Commissioner of Corps. & Taxation**, 323 Mass. 730, 748 (1949); **William F. Sullivan & Co.**, 413 Mass. at 581; **Joseph T. Rossi Corp. v. State Tax Comm'n**, 369 Mass. 178, 181-82 (1975).

In recent years, given the prominent role that contract labor now plays in modern business, there have been numerous opportunities to consider scenarios substantially similar to the present appeals, i.e., whether a company was "engaged in manufacturing" when it created drafts, plans, designs, or blueprints for products and then sent them off-site or to a third party for mass production. That question has consistently been answered in the affirmative. See **Houghton Mifflin**, 423 Mass. at 49 (holding that a book publisher that edited and compiled photographs, drawings, and text onto discs and sent them to a third-party printer for the production of books was "engaged in manufacturing"); **The First Years, Inc. v. Commissioner of Revenue**, Mass. ATB Findings of Fact and Reports 2007-1004, 1013 (finding that creation of designs for child-care products, building of models and development of specifications for molds produced by third parties, returned to company for testing, and then sent to third-party factories for production was "engaged in manufacturing"); **Onex Communications Corporation v. Commissioner of Revenue**, 457 Mass. 419, 431 (2010) (holding that the development of computer-edited blueprints containing the technical specifications and detailed manufacturing instructions for certain components that were then sent elsewhere for final production constituted manufacturing); **Duracell, Inc. v. Commissioner of Revenue**, Mass. ATB Findings of Fact and Reports 2007-903, 918 (finding that extensive research and development

and quality testing that was incorporated into sample batteries that were ultimately mass produced elsewhere constituted manufacturing); **Random House, Inc. v. Commissioner of Revenue**, Mass. ATB Findings of Fact and Reports 2012-973, 981 (finding that company that edited and formatted content that was ultimately transmitted electronically to a third-party printer for production, to taxpayer's exact specifications, was "engaged in manufacturing").

In reaching these determinations, courts have encouraged a broad construction of the phrase "engaged in manufacturing." See **Assessors of Boston**, 323 Mass. at 748-49 ("The words 'engaged in manufacturing' are not to be given a narrow or restrictive meaning."). See also **William F. Sullivan & Co.**, 413 Mass. at 579. To that end, processes which themselves do not yield a finished product have nonetheless been found to constitute manufacturing, so long as "'they constitute an essential and integral part of a total manufacturing process.'" **William F. Sullivan & Co.**, 413 Mass. at 579-80 (quoting **Joseph T. Rossi Corp.**, 369 Mass. at 181-82). See also **Commissioner of Revenue v. Fashion Affiliates, Inc.**, 387 Mass. 543, 545-46 (1982) (finding that a computer system used to produce dress patterns on paper markers, which were then transferred for use onto the actual fabric for the mass production of dresses, provided "a function that is an integral and necessary" step in the making of dresses and thus constituted manufacturing). See also 830 CMR 58.2.1(b)(7).

Courts have recognized that manufacturing involves a "multiplicity of processes," *William F. Sullivan & Co.*, 413 Mass. at 580, and that, in analyzing these cases, "the requisite inquiry should focus less on the technical means and materials used by [the taxpayer] and more on [the taxpayer's] role in the overall production of the [products]." *Random House*, Mass. ATB Findings of Fact and Reports at 2012-985-86. Significant to the Court in *Houghton Mifflin*, and described in some detail, was Houghton Mifflin's involvement in every step of the "book-production process," described as follows:

Initially, editors, ordinarily employed by [Houghton], engage in extensive research and development activities regarding a proposed book. These activities include researching the probable marketability and developing the content and format of a proposed book. [Houghton's] employees then design, write, and produce a manuscript to serve as the content of a proposed book. Various writers and editors working on different portions and aspects of a proposed book combine their work on a network.

Next, [Houghton's] employees produce and then circulate among the company's marketing, production, and editing personnel thumbnail sketches for further processing and refinement. After that step, electronic-production specialists transform the manuscript and thumbnail sketches into templates which are analogous to blueprints or page outlines without any text. [Houghton's] art department then creates drawings, develops charts and graphs, and creates line art for inclusion in the ultimate product. The art department also selects, retrieves, and transforms photographs for incorporation into the ultimate product.

Following these steps, all of the aforementioned items are assembled into layouts. First proofs are subsequently produced and marked for changes and

corrections, resulting in the production of second proofs which further refine the product. The second proofs are then converted into color proofs. Throughout this process, [Houghton] uses, among other things, human skill and knowledge as well as various implements, materials, and machines or machinery such as computers, digital modems, printers, photocopiers, writing utensils, lighting machines, drawing equipment and materials, graphic art tools, electronic equipment, sophisticated software, and scanners.

From the color proof stage of the process, [Houghton] either produces CD ROM tapes which are then sent to independent contractors for final packaging in compact discs, or it sends the proofs (usually on computer diskettes) to independent contractors for printing and binding into conventional books.

**Houghton Mifflin**, 423 Mass. at 43-45. Likewise, in **The First**

**Years**, the Board noted that the taxpayer's 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. [The First Years] 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 [The First Years], [The First Years] re-directed the design of the product, from minor to significant changes.

**The First Years**, Mass. ATB Findings of Fact and Reports at 2007-1012-13.

As in *Houghton Mifflin* and *The First Years*, the evidence here demonstrated Deckers' continuous involvement in the creation of its footwear products, from the conception of an idea for a shoe in an initial product brief to its ultimate mass production. The record showed, as it did in the many aforementioned cases, that Deckers transformed "ideas, art, information, and photographs, by application of human knowledge, intelligence, and skill," *Houghton Mifflin*, 423 Mass. at 48, into something new, first tech packs, and later, a completed shoe. Based on these facts, the Board found that the activities undertaken by Deckers amounted to the transformation of "raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name, nature, and adapted to a new use." G.L. c. 63, § 38(1)(1).

The appellant argued in these appeals that the Legislature's 1995 amendment of § 38, which inserted the word "physical" before the word "materials" in the statute, signified the Legislature's intent to narrow the range of activities that would qualify as manufacturing activities for purposes of the statute. This argument ignores the fact that cases decided following the statutory amendment have used the same analysis to determine what activities constitute being "engaged in manufacturing" as those which preceded the statutory change. See *Onex Communications*, 457 Mass. at 431; *Genentech, Inc. v.*

**Commissioner of Revenue**, 476 Mass. 258 (2017); **The First Years**, Mass. ATB Findings of Fact and Reports at 2007-1004; **Duracell**, Mass. ATB Findings of Fact and Reports at 2007-918; **Random House**, Mass. ATB Findings of Fact and Reports at 2012-981.

Indeed, the Board noted in **Random House** that

the requirement in § 38(1)(1) for the transformation of 'physical materials' does not negate the long-standing holdings of the Court and the Board that manufacturing can involve the creation of electronic processes and products in the production process so long as they have a substantial and physical impact on the final tangible products produced.

**Random House**, Mass. ATB Findings of Fact and Reports at 2012-985.

The appellant attempted to distinguish Deckers' activities from those of the taxpayers in these cases by asserting that nothing created by Deckers was either physically useful in the ultimate manufacture of footwear or had a tangible application in the manufacturing process. Deckers' creations, according to the appellant, were unlike the blueprints created in **Onex Communications**, which contained detailed manufacturing instructions that were physically useful in the ultimate creation of the end product in that case - computer chips - as well as the CD-ROMS and computer diskettes compiled by **Houghton Mifflin** that were ultimately sent to third-party printers for printing en masse. **Onex Communications**, 457 Mass. at 431;

**Houghton Mifflin**, 423 Mass. at 44.

The Board found this argument unpersuasive, as it takes too narrow a view of Deckers' activities. The record amply demonstrated the involvement of Deckers employees throughout the product creation process. The conception of an idea for a shoe began at Deckers with a product developer, and through the various stages of the critical path that idea was developed and refined, with accompanying drawings, photographs, and information, into a more precise and technical format. The spec sheets and tech packs created by Deckers contained exact specifications for each and every component of each shoe, down to the millimeter, such that an actual shoe could be created using them. Thus, the Board found that the materials produced by Deckers throughout the critical path, including the design drawings, spec sheets, and tech packs, were physically useful in the manufacture of a completed product.

Further, once a sample shoe was created, Deckers employees interacted with the shoe sample by inspecting it and engaging in fit testing, and their feedback was incorporated into - that is, had a physical impact on - subsequent renditions of that shoe, including its construction and design. See **Duracell**, Mass. ATB Findings of Fact and Reports at 2007-923. Deckers' activities were not merely prerequisites to the manufacturing process, as they occurred throughout its entirety, right down to final



quality inspection of the mass-produced goods. See 830 CMR 58.2.1(b)(5). In sum, the Board found that Deckers' activities were very much like those of the taxpayers in **Houghton Mifflin, The First Years, Duracell, Onex Communications,** and **Random House,** and it therefore found and ruled that Deckers was "engaged in manufacturing" for purposes of § 38.<sup>2</sup>

The statute imposes an additional requirement. In order to be considered a manufacturing corporation for purposes of § 38, a corporation must be "engaged in manufacturing. . . in substantial part[.]" G.L. c. 63, § 38(1)(1) (emphasis added). The statute sets forth specific tests for determining whether a taxpayer's manufacturing activities will be considered "substantial." A corporation's manufacturing activities will be considered "substantial" if any one of the follow five tests is met:

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<sup>2</sup> The appellant likened its activities to those of the hypothetical furniture designer discussed by the Court in **Houghton Mifflin**, whose creation of furniture designs to be used by another party to build furniture, the Court suggested, would not be considered manufacturing. **Houghton Mifflin**, 423 Mass. at 49. The Board did not find this analogy compelling, for several reasons. First, the Court's statements regarding the furniture designer were not the result of an analysis of a factual record developed during a full evidentiary hearing concerning the furniture designer's activities throughout the entire furniture creation process. The Court referenced the furniture designer only to address an argument made by the Commissioner in that case, an argument that ultimately did not prevail. Moreover, the Court's observation regarding the furniture designer was hardly a resounding endorsement of the Commissioner's argument. It consisted of the lukewarm acknowledgement that the Court agreed, "in principle, with [the] general statement" that a furniture designer would not be classified as a manufacturer, before concluding that there was a "reasonable basis for distinguishing," the taxpayer's activities in that case. **Id.** The Board found the appellant's analogy to the hypothetical furniture designer to be unpersuasive, and it therefore rejected this argument.

1. twenty-five percent or more of its gross receipts are derived from the sale of manufactured goods that it manufactures;
2. twenty-five percent or more of its payroll is paid to employees working in its manufacturing operations and fifteen percent or more of its gross receipts are derived from the sale of manufactured goods that it manufactures;
3. twenty-five percent or more of its tangible property is used in its manufacturing operations and fifteen percent or more of its gross receipts are derived from the sale of manufactured goods that it manufactures;
4. thirty-five percent or more of its tangible property is used in its manufacturing operations; or
5. the corporation's manufacturing activities are deemed substantial under relevant regulations promulgated by the commissioner.

G.L. c. 63, § 38(1)(1).

The appellant claimed that only one of the factors applied here - gross receipts - and that it did not satisfy that test because, as it did not manufacture any goods, its gross receipts were not derived from goods that "it manufactures." G.L. c. 63, § 38(1)(1). This argument was undermined by the Board's finding that the appellant was "engaged in manufacturing" for purposes of § 38.

Further, the appellant offered no evidence showing that it fell short of the specific numerical thresholds set forth within the statute. The only inference to be drawn from the record is that the appellant derived all of its gross receipts from the

sale of products that it manufactured. As the appellant had the burden of proof on this issue, the Board found that it did not meet its burden of demonstrating that it was not "engaged in manufacturing... in substantial part[.]" G.L. c. 63, § 38 (1)(1). See *Staples v. Commissioner of Corp. & Tax*, 305 Mass. 20, 26 (1940) (finding that a person who claims to be aggrieved by the refusal of the Commissioner to abate a tax in whole or in part has the burden of establishing the right to an abatement).

A subsidiary issue in these appeals was whether the Commissioner properly assessed penalties for substantial understatement of taxes against Deckers under § 35A. That statute is applicable in cases where, as here, the understatement for the period exceeds the greater of 10 per cent of the tax required to be shown on the return for the period or \$1,000. G.L. c. 62C, § 35A. However, the penalty may be abated, in whole or in part, if the taxpayer can demonstrate that it had reasonable cause and acted in good faith in taking the position that it did. G.L. c. 62C, § 35B.<sup>3</sup>

Reasonable cause and good faith are determined on a "case-by-case basis, taking into account all pertinent facts and

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<sup>3</sup> The penalty may also be abated if the taxpayer can show that "substantial authority" existed for the tax treatment of the item at issue. G.L. c. 62C, § 35A. Because the Board concluded that the appellant demonstrated that it acted in good faith and had reasonable cause for filing as a non-manufacturing corporation, it did not reach the issue of whether substantial authority existed for the appellant's position.

circumstances." See **DOR Directive 12-7**. Among the factors to be considered in making a determination of reasonable cause is whether the taxpayer placed reasonable reliance on professional tax advice. **Id.** The record in the present appeals showed that the appellant engaged national accounting firms KPMG and Ernst & Young to assist in the preparation and filing of its tax return, thus this factor must be weighed in the appellant's favor.

Moreover, as discussed above, the determination of whether a particular company is "engaged in manufacturing" is a fact-based inquiry. See **William F. Sullivan & Co.**, 413 Mass. at 581 ("[T]he undefinable nature of the operative terms in these . . . cases necessitates case-by-case, analogical development of their meaning."). The long history of cases, cited above, shows that this determination often hinges on subtle factual distinctions.<sup>4</sup> Deckers considered itself to be a designer and seller of footwear products whose activities did not fall within the scope of § 38. While the Board disagreed, the appellant certainly did not flout a bright-line rule. Based on the evidence in its totality, and reasonable inferences drawn therefrom, the Board found and ruled that the appellant acted with reasonable cause

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<sup>4</sup> It is worth mentioning that in many of the above-referenced cases, the Commissioner was the party arguing that the activities at issue did not constitute manufacturing. See **Houghton Mifflin**, 423 Mass. at 44; **The First Years**, Mass. ATB Findings of Fact and Reports at 2007-1004; **Onex Communications**, 457 Mass. at 431; **Duracell**, Mass. ATB Findings of Fact and Reports at 2007-918.

and in good faith in filing its tax returns for the tax years at issue. Accordingly, the Board found and ruled that the appellee's assessment of penalties under § 35A was improper, and it issued an abatement of those penalties, along with associated interest, for each of the tax years at issue.

In conclusion, on the basis of all of the evidence, the Board found and ruled that the appellant was "engaged in manufacturing . . . in substantial part," for purposes of § 38 during the tax years at issue, such that it was required to use a single-factor apportionment formula. Accordingly, the Board decided that issue in favor of the appellee. However, the Board found and ruled that the appellant had reasonable cause and acted in good faith in filing its tax returns as a non-manufacturing corporation for the tax years at issue, and the appellee's assessment of penalties under § 35A was improper. The Board therefore decided that issue in favor of the appellant, and granted an abatement of those penalties, along with associated interest.

**THE APPELLATE TAX BOARD**

**By:** \_\_\_\_\_  
**Thomas W. Hammond, Jr., Chairman**

**A true copy,**

**Attest:** \_\_\_\_\_  
**Clerk of the Board**