Oregon Supreme Court denies AT&T’s refund in cost-of-performance decision

Overview
In an opinion issued on September 11, 2015, the Oregon Supreme Court (supreme court) upheld the Oregon Tax Court’s decision denying Oregon corporate excise tax (CET) refund claims submitted by AT&T Corporation & Subsidiaries (AT&T).1 AT&T had filed refund claims for the 1996–1999 tax years in which it utilized Oregon’s greater-cost-of-performance apportionment method for sourcing sales of items other than tangible personal property (TPP) in calculating its Oregon sales factor. Applying this method, as part of its refund claims, AT&T asserted that in New Jersey it incurred more costs of providing a long-distance telecommunications network than it incurred in Oregon, which resulted in a reduction in AT&T’s Oregon sales factor numerator and, accordingly, reduced CET liability.

In affirming the Oregon Tax Court’s rejection of AT&T’s refund claims, the supreme court concluded that AT&T, in its greater-costs-of-performance study, “did not identify the correct income-producing activities[,] … did not correctly calculate the costs of performance for those activities[, and] … thus failed to … meet its burden of proof.”2 As determined by the supreme court, AT&T incorrectly defined “income-producing activity” as “network-based, … [focusing] on the operation of its network as a whole[, whereas the supreme court viewed as the] correct understanding … [a] transaction-based … [approach that] examines individual sales to customers.”3

Taxpayers who calculate their sales factor using Oregon’s greater-cost-of-performance method for sales of items other than TPP should discuss this decision with their qualified professional adviser, and consider how the case may impact their methodology for calculating their Oregon sales factor.

This Tax Alert discusses Oregon’s greater-cost-of-performance method, reviews the parties’ arguments, and summarizes the supreme court’s decision upholding the denial of AT&T’s CET refund claims.

Oregon’s greater-cost-of-performance method for sourcing sales of items other than TPP
For apportionment purposes, Oregon requires taxpayers who make sales of items other than TPP to source sales depending on where the taxpayer’s “income-producing activity” occurs.4 Such sales are sourced to Oregon if: a) the entire income-producing activity occurs in Oregon, or b) the income-producing activity occurs both within and outside Oregon and Oregon’s share of the costs of performance of that activity is greater than that of any other state.5

Oregon applies the term “income-producing activity” to “each separate item of income and [the term] means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business ….”6 Oregon defines “costs of performance” as the “direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.”7

AT&T’s argument—“income-producing activity” is a broad term that encompasses AT&T’s entire network
AT&T based its refund claim on its interpretation that its income-producing activity was the operation of its global telecommunications network that enables long-distance telecommunication. By doing so, AT&T included in its cost-of-performance analysis8 the costs that it incurred in the operation of its Global Network Operations Center, which is a massive operation in New Jersey. By considering these network costs as “direct costs,” AT&T’s cost-of-

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1 AT&T Corp. and Subsidiaries v. Department of Revenue, 357 Or. 691, 717 (Sept. 11, 2015) (Justice Virginia Linder did not participate in the decision; the remaining six Justices issued the decision without dissent). A copy of the decision is available here.
2 Id.
3 Id. at 693.
5 Id.
8 AT&T retained BI Solutions Group, LLC, to conduct a cost-of-performance study for the relevant tax years; the study ran almost 300 pages and is briefly summarized by the supreme court. AT&T, 357 Or. at 696.
performance analysis determined that AT&T’s costs in New Jersey exceeded its costs incurred in Oregon, thus resulting in AT&T reporting reduced Oregon sales factor numerators on its amended CET returns.

**Department of Revenue’s argument—“income-producing activity” means each individual transaction**

The Oregon Department of Revenue (Department) rejected AT&T’s refund claims on the grounds that AT&T’s income-producing activity, under Oregon law, “was the activity that produced each individual interstate and international phone and data transmission that was billed to an Oregon customer.” Based on this argument, the Department rejected AT&T’s cost-of-performance study as flawed due to the study’s incorrect focus on AT&T’s operation of its entire network. Rather, the Department argued that the only direct costs of performance of AT&T’s income-producing activity “were (1) the cost of electricity for the calls and data transmission and (2) the access charges levied by the local exchange carrier for connecting the customer with AT&T’s network.”

**Oregon Supreme Court upholds Tax Court’s denial of refund claims**

The Oregon Tax Court accepted the Department’s argument when it previously rejected AT&T’s refund claim. As summarized by the supreme court:

> The Tax Court apparently agreed with the [Department] that the direct costs were only those costs that AT&T incurred in carrying a particular individual phone call[,] and ... specifically rejected AT&T’s argument that the access charges paid to local exchange carriers did not count as direct costs for purposes of the “costs of performance” analysis.

The supreme court agreed with AT&T that Oregon’s “cost-of-performance” test focuses on where the taxpayer’s income-producing activity occurs and does not focus on where the taxpayer’s customers are located. However, the supreme court deferred to the Department’s interpretation of “income-producing activity,” finding that the term refers to each individual transaction, namely, “each ‘item of income’—for each individual sale ...” engaged in by the taxpayer with a customer. Thus, the supreme court concluded that the Department’s interpretation was “plausible and not inconsistent with the text of the rule in its context or with the statute, or with any other source of law.”

The supreme court determined further that AT&T’s “network-focused” definition of “income-producing activity” was incorrect, and “[t]hat alone would justify affirming the Tax Court’s decision [to reject the refund claim].” However, the supreme court further stated that “AT&T’s erroneous interpretation of ‘income-producing activity’ also distorted its calculation of the ‘costs of performance.’” A cost study that focused on individual transactions “would also narrow what constitute[s] the ‘direct costs’ for the ‘costs of performance’ part of the analysis.” By focusing on AT&T’s costs of operating the entire network rather than the costs of individual transactions, “AT&T’s cost study again failed to meet AT&T’s burden of proof.” Based on the foregoing, the supreme court concluded that the Tax Court properly denied AT&T’s request for refund and, accordingly, affirmed the Tax Court’s decision.

**Considerations**

The supreme court’s opinion focuses on whether AT&T sustained its burden of proof in this particular instance. It is interesting that the supreme court refrained from using several of the terms employed by the Tax Court in its opinion (e.g., there was no mention of the Tax Court’s “but for” test). Notwithstanding any potential effort by the supreme court to narrow the application of this opinion, the supreme court specified that it respected the Department’s interpretation of “income-producing activity” as applicable to separate “items of income,” meaning “individual exchange[s] between a buyer and a seller.” Keeping in mind the supreme court’s finding on this aspect of the case, taxpayers who have prepared or are considering preparing cost-of-performance studies for Oregon

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9 Id. at 700.
10 Id.
12 AT&T, 357 Or. at 701.
13 Id. at 708.
14 Id. at 712.
15 Id. (citation omitted).
16 Id. at 715.
17 Id.
18 Id.
19 Id. at 716.
20 Id. at 717.
21 The Tax Court held that the only costs of performance that should be analyzed are those costs that pass the “but for” test, meaning those costs that the taxpayer would not have incurred “but for” the customer initiating the order/transaction. AT&T, 20 Or. Tax at 307. The supreme court also did not refer specifically to the “Cost Object Question,” which the Tax Court identified as what “activity or object should be the subject of a cost of performance analysis ....” Id. at 303.
22 AT&T, 357 Or. at 712.
should, as part of a consultation with their qualified professional adviser, review those studies to examine the applicable income-producing activity definition and the included direct costs.

Contacts
If you have questions regarding this supreme court decision or other Oregon tax matters, please contact any of the following Deloitte Tax professionals:

- **Doug Andersen**
  Partner
  Deloitte Tax LLP, Seattle
  +1 206 716 7430

- **Valerie Dickerson**
  Partner–Washington National Tax
  Deloitte Tax LLP, Washington DC
  +1 202 220 2693

- **Scott Schiefelbein**
  Senior Manager–Washington National Tax
  Deloitte Tax LLP, Portland
  +1 503 727 5382

- **Mike Bryan**
  Director–Washington National Tax
  Deloitte Tax LLP, Philadelphia
  +1 215 977 7564

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