

Massachusetts Appeals Court Uses an Entity Level Transactional Approach in Applying Cost of Performance Rules

Overview

On April 26, 2019, the Massachusetts Appeals Court (the "Court") decided *Comcast of Mass. I, Inc. v. Commissioner of Revenue*,¹ in which the Court affirmed the decision by the Massachusetts Appellate Tax Board (the "Board") to deny the claims for corporate excise tax refunds by Comcast of Massachusetts I, Inc. ("Mass. I") and affiliates (collectively "Taxpayer") related to sourcing of receipts of sales other than sales of tangible personal property ("TPP").² The Taxpayer's claims for refund were based upon the argument that receipts from video and internet services provided to Massachusetts subscribers for tax years 2003 through 2008 (the "years at issue") should have been sourced to Pennsylvania, instead of Massachusetts, because the greater cost of performance associated with these sales occurred outside of Massachusetts at the headquarters of the Taxpayer's parent company. In applying Massachusetts' sales factor cost of performance rules, the Court used a "transactional approach" at the legal entity level to conclude the relevant income-producing activity took place wholly in Massachusetts.

This Tax Alert discusses Massachusetts' sourcing rules applicable during the years at issue, summarizes the Court's decision, and considers the potential impact of this decision.

Background

During the years at issue, Comcast Corporation was the direct or indirect parent company of various subsidiaries, including the Taxpayer (Comcast Corporation and its subsidiaries, collectively referred to as the "Company"). The Company's officers located in Pennsylvania were responsible for setting companywide business strategies, as well as operating and maintaining the national network required to provide video, internet, and telephone services to customers. Generally, the Company entered into franchise agreements with municipalities, through individual subsidiaries, to provide services to subscribers within a specific community. Each subsidiary would then pay a franchise fee to the municipality, the amount of which was based upon the number of subscribers in the relevant community. As the Court described the Company's structure, "[t]he subsidiaries themselves did not directly engage in any operations, such as day-to-day activities. Rather, the subsidiaries relied on Comcast to provide the resources that the subsidiaries did not have." Notwithstanding this structure, the Company delivered internet, video and telephone services to subscribers through a single converged network.

For tax years beginning before January 1, 2014, sales other than sales of TPP were sourced to Massachusetts if the greater portion of the income-producing activity was performed in Massachusetts versus any other state based on costs of performance.³ Specifically, "costs of performance" are the taxpayer's "direct costs determined in a manner consistent with generally accepted accounting principles..."⁴

Certain subsidiaries of the Company joined the Taxpayer's Massachusetts combined corporate excise tax returns during the years at issue. In the Taxpayer's originally filed returns, sales from video and internet services provided to subscribers located in Massachusetts were sourced to the state and included in the numerator of the sales factor. Subsequently, the Taxpayer hired a third party to conduct a study analyzing the costs of performance associated with each subsidiary's income-producing activity. Based upon the results of this study, which identified the direct costs associated with internet and video services occurring outside of Massachusetts, the Taxpayer amended its returns for the years at issue to remove

¹ No. 18-P-561, 2019 Mass. App. Unpub. LEXIS 318 (App. Ct. Apr. 26, 2019).

² The Appeals Court decision is an unpublished decision issued under Appeals Court rule 1:28. Summary decisions issued by the Appeals Court pursuant to Rule 1:28 are primarily directed to the parties and may not fully address the facts of the case or the panel's rationale. Such a decision issued after February 25, 2008 may be cited for its persuasive value but is not binding precedent.

³ See Technical Information Release 13-15. For tax years beginning on or after January 1, 2014, sales other than sales of TPP are sourced to Massachusetts if the corporation's market for the sale is in the state. Mass. Gen. Laws. ch. 63, § 38(f).

⁴ 830 Mass. Code Regs. § 63.38.1(9)(d)(4) (1999) (emphasis added).

these receipts from the numerator of the sales factor. The Commissioner of Revenue (the "Commissioner") denied the claims for refund, and the Taxpayer subsequently filed a petition with the Board.

Summary of the Appellate Tax Board Decision

The Board affirmed the Commissioner's decision to deny the Taxpayer's claims for refund, concluding that on its original returns, the Taxpayer properly included receipts from the sale of video and internet services provided to Massachusetts subscribers in the numerator of the sales factor. In reaching this decision, the Board determined that the income-producing activity was to function as a cable franchise licensee with Massachusetts cities and towns. Furthermore, the Board closely examined the Company's corporate structure and determined that the legal entity structure could not be ignored for tax purposes. Through this analysis, the Board determined that it could not apply an operational approach to the Taxpayer's income-producing activity because the Taxpayer did not directly engage in any operations. Further, it concluded that the franchise fees paid to Massachusetts municipalities were the *only* direct costs associated with holding a cable franchise license with a Massachusetts city or town.⁵

Summary of the Massachusetts Appeals Court Decision

In affirming the decision of the Board, the Court described two approaches used to determine the income-producing activity for purposes of the cost of performance analysis: (1) an operational approach, which examines the overall operation needed to provide the service, and (2) a transactional approach, which requires consideration of each individual transaction that results in payments from customers. Based on the Taxpayer's corporate structure, the Court determined that the subsidiaries at issue did not directly engage in any day-to-day operations or activities. Instead, the subsidiaries relied on their corporate parent and national network to fulfill the terms of the licenses. For this reason, the Court concluded that it was proper to apply a transactional approach under which each franchise agreement is viewed as a separate transaction used to deliver services.

Applying a transactional approach, the Court agreed with the Board's determination that the only direct costs incurred by each subsidiary associated with entering into franchise agreements were the franchise fees paid to municipalities. The costs associated with the corporate parent's national network of operations were not direct costs of the subsidiaries based on the corporate structure. Accordingly, the Court held that the Board did not err in ruling that the Taxpayer's cost of performance was higher in Massachusetts than any other state because it properly considered only the direct costs of each legal entity to determine where the relevant income-producing activity occurred.

Considerations

Although the Court's ruling in *Comcast* appears to run counter to established Massachusetts case law, which has applied an operational approach to determine a taxpayer's income-producing activity for apportionment purposes,⁶ according to the Court, the Taxpayer's corporate structure and franchise agreement arrangements distinguish it from appellants in previous cases and warranted a separate entity level transactional analysis. Based on this decision, the Commissioner may apply a similar approach when auditing returns for tax years before 2014 where a taxpayer generates receipts from services and is organized in a similar corporate structure. However, as the Company's corporate structure was unique in that the subsidiaries at issue did not directly engage in any operations or activities, it is unclear if this decision will have broader application.

On May 17, 2019, the Taxpayer docketed a Petition for Further Appellate Review with the Massachusetts Supreme Judicial Court. The parties are awaiting the Supreme Judicial Court's action on said petition.

⁵ *Comcast of Massachusetts I, Inc., et al. v. Commissioner of Revenue*, ATB Docket Nos. C321986, C321987, C321988, C321989, C321990, C321991, C321992, C321993, C321994, C322268 (2019).

⁶ See *Boston Professional Hockey Ass'n v. Commission of Revenue*, 443 Mass. 276 (2005) (Court affirmed the Board's use of an operational approach to determine the income-producing activity of a professional hockey team and ruled that the taxpayer's income-producing activity was operating an NHL franchise not the playing of individual games.); see also *AT&T Corp. v. Commissioner of Revenue*, A.T.B. Docket No. C293831, aff'd, 82 Mass. App. Ct. 1106 (2012) (decision under Rule 1:28), further appellate review denied, 463 Mass. 1112 (2012). (Board ruled in favor of a telecommunications company's use of an operational approach and determined that its income-producing activity was operating a global network not providing individual telephone calls and data transmissions.).

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