

State & Local Tax **Alert**

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Company Utilizing Third-Party Contract Manufacturers Required to Use Single Sales Factor Apportionment Formula in Massachusetts

The Massachusetts Department of Revenue has ruled that a taxpayer utilizing third-party contract manufacturers was considered to be engaged in manufacturing for Massachusetts apportionment purposes because the taxpayer's activities were essential and integral to the manufacturing process.¹ Therefore, the taxpayer was required to use a single sales factor apportionment formula rather than the general three-factor apportionment formula with a double-weighted sales factor.

Background

The taxpayer, a global consumer products company based in California that engaged in the development, manufacture and distribution of several brands of lubricants and cleaning products, derived significant revenue from the manufacture and sale of a moisture displacement and lubricant product. Much of the manufacturing of the product was performed by third-party contractors, but the required formula and processes to be followed were developed and owned by the taxpayer. In addition, the taxpayer internally manufactured approximately 30 percent of a major component of the product. The taxpayer was closely involved in the activities performed by its contract manufacturers and sought to maintain control in the process from start to finish.² The taxpayer requested a letter ruling from the Department that these activities would result in the taxpayer being considered a manufacturing corporation for purposes of apportionment.

Single Sales Factor Apportionment for Manufacturers

In Massachusetts, income is generally apportioned using a three-factor formula comprised of a property, payroll, and a double-weighted sales factor.³ However, Massachusetts law provides that a manufacturing corporation that has income from business activity that is taxable both within and outside Massachusetts is required to apportion its net income to Massachusetts by use of a single sales factor.⁴ A corporation is classified as a "manufacturing corporation" if it is engaged, in substantial part, in transforming raw or finished physical materials by hand or machinery, and through human skill or knowledge,

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¹ *Letter Ruling 11-8*, Massachusetts Department of Revenue, Dec. 16, 2011.

² The decision provides a lengthy summary of the taxpayer's involvement with its contract manufacturers.

³ MASS. GEN. LAWS ch. 63, § 38(c).

⁴ MASS. GEN. LAWS ch. 63, § 38(l)(2).

into a new product possessing a new name, nature and adapted to a new use.⁵ A manufacturing corporation's activities are considered to be "substantial" if any of the following tests are met:

- At least 25 percent of its gross receipts are derived from the sale of manufactured goods that it manufactures;
- At least 25 percent of its payroll is paid to employees working in its manufacturing operations and at least 15 percent of its gross receipts are derived from the sale of manufactured goods that it manufactures;
- At least 25 percent of its tangible property is used in its manufacturing operations and at least 15 percent of its gross receipts are derived from the sale of manufactured goods that it manufactures;
- At least 35 percent of its tangible property is used in its manufacturing operations; or
- The corporation's manufacturing activities are deemed substantial under relevant regulations.⁶

Essential and Integral to Manufacturing Process

In arguing for the manufacturer classification, the taxpayer stated that its internal production of a portion of the product component clearly constituted manufacturing under the statute. While this internal production did not result in the generation of at least 25 percent of the taxpayer's receipts the taxpayer claimed that the 25 percent gross receipts test for substantial manufacturing would be met if the product being manufactured through third-party contractors was included in the calculation.

In the letter ruling, the Commissioner noted that in a situation where products are being produced through an outsourcing arrangement, the issue is whether the taxpayer's activities are essential and integral to the overall manufacturing process such that its activities constitute manufacturing. Relying on regulations covering local taxes explaining the manufacturing classification,⁷ the Commissioner stated that a process that does not produce a finished product may still constitute manufacturing if it is an essential and integral part of the total manufacturing process.⁸ In addition, a process that is a practical and necessary step in the production of a finished product for sale is generally an essential and integral part of the total manufacturing process.⁹

⁵ MASS. GEN. LAWS ch. 63, § 38(l)(1).

⁶ *Id.* For further guidance, see MASS. REGS. CODE tit. 830, § 63.38.1(10).

⁷ The regulation relied upon by the Commissioner details the tax treatment of corporations classified as manufacturing corporations, which includes property tax exemptions, investment tax credits and sales and use tax exemptions for the sale or use of certain research and development property. MASS. REGS. CODE tit. 830, § 58.2.1(4). In that regulation, a "manufacturing corporation" is required to be engaged in manufacturing in Massachusetts. MASS. REGS. CODE tit. 830, § 58.2.1(2). The issue of what constitutes substantial manufacturing is addressed in that regulation in the same manner as for the manufacturing classification contained in the corporate income tax apportionment regulation. MASS. REGS. CODE tit. 830, § 58.2.1(6)(d).

⁸ MASS. REGS. CODE tit. 830, § 58.2.1(6)(b)7.

⁹ *Id.*

The Commissioner considered several prior decisions that supported its conclusion that the taxpayer's activities should be considered to be manufacturing in substantial part. In reaching its decision, the Commissioner noted that the taxpayer was integrally involved in the creation of the product from start to finish. The taxpayer invented the product formula, manufacturing process and testing procedures. In addition, the taxpayer controlled the overall manufacturing process by managing the numerous third parties involved in the production process. Finally, the taxpayer mandated specific quality requirements and testing procedures for each activity. Based on the taxpayer's involvement in the total manufacturing process, the Commissioner agreed with the taxpayer, concluding that the taxpayer was engaged in manufacturing and therefore was required to use a single sales factor for apportionment purposes.

Commentary

This ruling is instructive to taxpayers that the use of third-party contract manufacturers to produce goods may result in a manufacturer classification for Massachusetts corporate income tax apportionment purposes, requiring the use of a single sales factor apportionment method. Use of the single sales factor apportionment method may provide benefits to manufacturing companies with significant presence in Massachusetts as compared to their in-state sales. However, it should be noted that the manufacturer classification is not discretionary. If a taxpayer meets the conditions for being a manufacturer, it must use single sales factor apportionment.

The classification of being engaged in manufacturing will depend on factors such as the control and involvement that a taxpayer has over the manufacturing process. These factors may change over time as a taxpayer's business model evolves, and may impact whether the manufacturer classification will consistently apply to the taxpayer. Further, the changes in the taxpayer's business model that impact the manufacturer classification in Massachusetts can arise from activities occurring wholly outside Massachusetts.

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