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Manufacturers Hanover Leasing International Corp. v. Director of Revenue

Case Information:

Docket/Court: 1291, Delaware Tax Appeal Board

Date Issued: 11/01/2002

Tax Type(s): Corporate Income Tax

Disposition: DECISION AND ORDER

OPINION

The issue before the Board is whether petitioner's net operating loss ("NOL") carry forward is a "applicable or related expenses," as that term is used within 30 Del. C. § 1903(b)(1). We have concluded that petitioner's NOL is such an expense and, thus, that judgment should be entered in its favor.

Petitioner Manufacturers Hanover Leasing International Corp. ("Petitioner") is a Delaware corporation which is principally involved in the leasing of tangible personal property on a multi- state basis. Petitioner reported a NOL with respect to its leasing operations for tax years 1981 through 1989 and 1992. A NOL represents the excess of costs and expenses incurred in each year over income derived the same year.

Section 1903 sets forth the manner in which a corporation's income is taxed in Delaware.¹ In pertinent part, Section 1903 provides: "Taxable income" subject to taxation under this chapter means the portion of the entire net income of a corporation which is allocated and apportioned to this State in accordance with the following provisions: (1) Rents and royalties (less applicable or related expense) from tangible property shall be allocated to the state in which the property is physically located....

When Petitioner calculated its 1993, 1994 and 1995 income pursuant to the foregoing provision, it reduced its income by the NOLs recognized from 1981 through 1989 and 1992. Petitioner decreased its taxable income by classifying the NOLs as applicable and related expenses. The Director concedes that Petitioner calculated its NOLs correctly in each year, but contends it cannot carry the NOLs forward to offset that portion of Petitioner's income allocated to Delaware. The parties have stipulated that the expenses

which are embodied in the NOL are of a kind that would be included as "applicable and related expenses" within the meaning of Section 1903(b)(1) if such expenses had been incurred in 1993, 1994 or 1995. The tax in controversy is \$38,473.38, and the Director seeks an additional penalty of \$2,637.89.

The term "applicable and related expenses" is not defined in Section 1903 or any other provision of the Delaware tax code and, thus, we must determine the General Assembly's intent when adopting the language. In doing so, we are required to give the statutory language its ordinary and plain meaning.

Applying these principles, we read Section 1903(b)(1) as permitting Petitioner to reduce its 1993, 1994 and 1995 income by the NOL incurred from 1981 through 1989 and 1992. Although the Director raises a number of arguments, there is no real dispute that the expenses which created the NOLs are related to the income generated by Petitioner's leasing business. The Director admitted this when he stipulated that if the expenses which generated the NOLs had been incurred in the tax years at issue, Petitioner could deduct such expenses from its income.² As the expenses embodied in the NOLs are related to Petitioner's income, the plain language of Section 1903(b)(1) allows Petitioner to reduce its income by the NOLs.

One of the Director's arguments in his brief was that the NOL is a deduction and not an expense and thus it cannot be used to offset income under Section 1903(b)(1). At oral argument, the Director recognized that a NOL deduction is "an expense. An NOL deduction is generated from expenses, but expenses incurred in other years." (Transcript at 26-27) Even without this concession, however, the Director's effort to characterize the NOL as a deduction fails. Simply put, the fact that the expenses embodied by the NOLs are separated from the 1993, 1994 and 1995 income by an accounting construct does not sever the relationship between the expenses and the income. If the General Assembly had intended that the only "expenses" which could be used to offset income were those incurred in the tax year at issue, it could have included qualifying language making this clear. The absence of such language and the plain terms of the statute lead us to conclude that the term "expense" in Section 1903(b)(1) is not limited just to expenses incurred in the subject tax year.

We further disagree with the Directors reading of Section 1903(b)(1) because his reading of the statute allows a taxpayer with apportionable income to use the NOLs to offset such income while a taxpayer, such as the Petitioner, who has only allocable income cannot. The Delaware tax structure — which levies a tax on "the entire net income of a corporation which is allocated and apportioned to this State"³ — does not support such a disparity in treatment based solely on whether a taxpayer's income can be characterized as allocable or apportionable.

For the foregoing reasons, judgment is issued in favor of Petitioner. FOOTNOTES

¹Section 1903 has a two step process. First, all portions of a corporations income which can be identified as having been generated within a particular state is allocated to that state. Second, any unallocated income is then apportioned among all states pursuant to a formula. All of Petitioner's leasing income can be identified as having been generated within a particular state and, thus, all of its income is allocated to particular states and none is apportioned among all states.

²Whether or not a particular expense embodied within a NOL is related to allocable income such that it can be used to reduce such income is a fact based question that is dependent upon the circumstances of each case. We need not address that issue here as

the Director has stipulated that "[t]he NOL was attributable to petitioner's leasing operations in 1981 through 1989 and 1992... and represents the excess of costs and expenses incurred in those years over income derived in those years" and that "the expenses which are now embodied in the NOL are of a kind that would be included in "applicable or related expenses" within the meaning of Del. C. § 1903(b)(1) if such expenses had been incurred" in 1993, 1994 and 1995. Thus, the expenses underlying Petitioner's NOL relate to Petitioner's leasing operations which generated Petitioner's 1993, 1994 and 1995 allocable income.

330 Del. C. § 1903(b) END OF FOOTNOTES

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Director of Revenue v. Manufacturers Hanover
 Leasing
 Del.Super.,2004.
 Only the Westlaw citation is currently available.
 UNPUBLISHED OPINION. CHECK COURT
 RULES BEFORE CITING.

Superior Court of Delaware, New Castle County,
 DIRECTOR OF REVENUE

v.

MANUFACTURERS HANOVER LEASING
 CORP.

No. Civ.A.04A-03-006 JOH.

Submitted: Sept. 16, 2004.

Decided: Dec. 3, 2004.

Upon Appeal from the Tax Appeal Board-
REVERSED and REMANDED.

Joseph Patrick Hurley, Jr., Deputy Attorney General,
 Department of Justice, for Director of Revenue.
Stanford L. Stevenson, III, Esquire, of Wilmington,
 Delaware, and Joseph E. DiGennaro, Esquire, of New
 York, New York, for defendant.

MEMORANDUM OPINION

HERLIHY, J.

*1 The Director of Revenue appeals the decision of the Tax Appeal Board finding that Manufacturers Hanover Leasing International Corporation's ^{FN1} net operating loss ("NOL") carryforwards qualifies as "applicable or related expenses" as the term is used within Title 30 of the Delaware Tax Code. The Director argues that the Board erred in finding that expenses included in the prior years' NOLs were related to income and deductible from current years' income. Manufacturers Hanover asserts that the inclusion of NOL in applicable or related expenses is consistent with the underlying purpose of the NOL carryforward provisions.

^{FN1}. Manufacturers Hanover is organized under Delaware law. Chase Manhattan Service Corporation was organized under New York law. On or about October 1, 1997, Chase Manhattan merged into Manufacturers Hanover. Any existing tax liabilities of Chase Manhattan became those

of Manufacturers Hanover.

Manufacturers Hanover leases tangible person property in Delaware and many other states. There is a specific statute in the Delaware Tax Code covering such business operations. In this case, like many other similar situations, there are two types of potential taxable income. One type is apportionable income which is that income allocated to business conducted in other states. The other type is non-apportionable income which is determined by a formula to be allocable to Delaware.

According to the Internal Revenue Code, NOL is "equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year." Manufacturers Hanover carried forward prior years NOL and applied it to offset non-apportionable, allocable, income in later years.

The issue before the Court is whether NOLs attributable to non-apportionable income incurred in past years should be included as a deduction in the statutorily allowed applicable or related expenses and used to reduce current tax year's allocable income. The Board's decision is REVERSED and REMANDED.

Procedural History

The Director audited the corporate tax return of Chase for the years 1993, 1994, and 1995. Director corrected the manner in which business income was reported for the audit years. The Tax Conferee upheld the Director when the resulting assessment was protested. Manufacturers Hanover appealed the Tax Conferee's determination to the Board. Sometime in November 2002, the Board issued an undated opinion invalidating the assessment. Director never received notice of the decision.

Upon being made aware of the decision in May 2003, Director appealed the decision to the Superior Court. Manufacturers Hanover moved to dismiss the appeal as out of time. After oral argument, this Court remanded the matter to the Board, holding the Board, by issuing an undated opinion, failed to validly decide the case. Director and Manufacturers Hanover, jointly, requested the Board to enter a valid,

dated decision. On March 12, 2004, the Board reissued its decision. This appeal timely followed.

Factual Background

On or about May 20, 1997, Director issued three separate notices of assessment for tax years 1993, 1994, and 1995 ("audit years") to Manufacturers Hanover. The notices re-characterized Manufacturers Hanover's income, originally reported as apportionable income, as allocable or non-apportionable income.^{FN2} Director allowed Manufacturers Hanover to deduct expenses applicable or related to the allocable income as provided for in the tax code.

FN2. (b) "Taxable income" subject to taxation under this chapter means the portion of the entire net income the portion of the entire net income of a corporation which is allocated and apportioned to this State in accordance with the following provisions:

(6) If the entire business of the corporation is transacted or conducted within this State, the remainder of its entire net income shall be allocated to this State. If the business of the corporation is transacted or conducted in part without this State, such remainder, whether income or loss, shall be apportioned to this State on the basis of the ratio obtained by taking the arithmetical average of these 3 ratios:

a. The average of the value, at the beginning and the end of the income year, of all the real and tangible personal property, owned or rented, in this States by the taxpayer, expressed as a percentage of the average of the value at the beginning and end of the income year of all such property of the taxpayer both within and without this State; provided, that any property, the income from which is separately allocated under paragraph (1) of this subsection or which is not used in the taxpayer's business, shall be disregarded. For the purposes of this paragraph, property owned by the taxpayer shall be valued at its original cost to the taxpayer, and the property rented by the taxpayer shall be valued at 8 times the annual rental;

b. Wages, salaries and other compensations paid by the taxpayer to employees within

this State, except general executive officers, during the income year expressed as a percentage of all such wages, salaries and other compensation paid within and without this State during the income year to all employees of the taxpayer, except general executive officers;

c. Gross receipts from the sales of tangible personal property physically delivered within this State to the purchaser or the purchaser's agent (but not including delivery to the United States mail or to a common carrier for shipment to a place outside this State) and gross income from other sources within this State for the income year expressed as a percentage of all such gross receipts from sales of tangible personal property and gross income from other sources both within and without this State for the income year; provided, that any receipts or items of income that are excluded in determining the taxpayer's entire net income or are directly allocated under paragraphs (1) to (6) of this subsection shall be disregarded.

30 *Del. C.* § 1903(b)(6).

*2 Manufacturers Hanover filed a timely protest to the Tax Conferee, claiming it should be allowed to include the large NOL carryforward deduction in the statutorily allowed applicable or related expenses used to reduce allocable income. On November 26, 1997, the Tax Conferee issued a notice of determination, upholding the assessments and denying Manufacturers Hanover's claim that the NOL carryover deduction could be included in applicable or related expenses. A timely notice of appeal was presented to the Board. It upheld Manufacturer Hanover's position.

Manufacturers Hanover is principally engaged in the business of leasing tangible personal property on a multi-state basis. On the Delaware corporate tax returns for the audit years, items of income were treated as apportionable income, not non-apportionable income allocable to Delaware. Director reclassified substantially all Manufacturers Hanover's income from apportionable income to non-apportionable or allocated income. Manufacturers Hanover and Director agree to the treatment and reclassification of the non-apportionable income in each audit year.

For federal income tax purposes, NOLs were incurred in years preceding the audit years and

carried over for Delaware corporate income tax purposes in the amounts of \$50,152,359.00, \$127,280,847.00, and \$103,901,743.00. The NOLs, representing excess costs and expenses incurred over income derived in years 1981 through 1989 and 1992, and were attributable to Manufacturers Hanover's leasing operations. Manufacturers Hanover and Director agree that the NOL computations are correct and that a deduction in excess of \$30,000 attributable to a NOL carryback be carried forward and used in later years is required by 30 Del. C. § 1903(a)(8).^{FN3} They also agree that, for the audit years, Manufacturers Hanover properly carried forward prior years' NOLs and applied those NOLs to reduce federal taxable income reported on line 1 of the Delaware Form 1100 to zero on line 3 of Form 1100 (the figure reported after total "subtractions" from federal taxable income, itemized on lines 2(a) through 2(h)).

FN3. (a) The "entire net income" of a corporation for any income year means the amount of its federal taxable income for such year as computed for purposes of the federal income tax increased by (i) any interest income (including discount) on obligations issued by states of the United States or political subdivisions thereof other than this State and its subdivisions, and (ii) the amount of any deduction allowed for purposes of the federal income tax pursuant to § § 164 of the Internal Revenue Code (26 U.S.C. § § 164) for taxes paid on, or according to or measured by, in whole or in part, such corporation's net income or profits, to any state (including this State), territory, county or political subdivision thereof, or any tax paid in lieu of such income tax, and its federal taxable income shall be further adjusted by eliminating:

(8) Any deduction, to the extent such deduction exceeds \$30,000, for a net operating loss carryback as provided for in Internal Revenue Code [26 U.S.C. § 172] or successor provisions; provided, however, that the taxpayer may increase deductions in any year, consistent with the operation of § 172, to carryforward losses which were carried back in calculating federal income taxable income, but which were prevented from being carried back under this paragraph.

30 Del. C. § 1903(8).

Director allowed Manufacturers Hanover to deduct applicable or related expenses incurred in each audit year from non-apportionable income in each respective audit year in the calculation of non-apportionable income. Director, however, did not increase expenses related to the production of non-apportionable income to again include the NOL reportable on line 2g of Form 1100 in the recalculation of the non-apportionable income for the audit years.

Director and Manufacturers Hanover agree that the expenses now embodied in the NOLs are of a kind that would be included in "applicable or related expenses" within the meaning of Section 1903(b)(1) if such expenses were incurred during the audit years (1993, 1994 and 1995). There were no mathematical errors in the auditor's recalculation of Manufacturers Hanover's income. Manufacturers Hanover and Director disagree on the methodology used by the auditor to recalculate Manufacturers Hanover's income.

*3 The amount in controversy is a tax in the amount of \$38,473.38 with a penalty in the amount of \$2,637.89. Manufacturers Hanover claims that Director erred in failing to allow the amount of NOL carryforward to be included in and deducted as "applicable or related expenses" from the non-apportionable income within the meaning of Section 1903(b)(1).^{FN4} The Board found that NOL was included in "applicable and related expenses" as used within Section 1903(b)(1).

FN4. (b) "Taxable income" subject to taxation under this chapter means the portion of the entire net income the portion of the entire net income of a corporation which is allocated and apportioned to this State in accordance with the following provisions:

(1) Rents and royalties (less applicable or related expenses) from tangible property shall be allocated to the state in which the property is physically located.

30 Del. C. § 1903(b)(1).

Issue

The parties submitted their dispute to the Board and now to this Court on a stipulation of fact. The issue before the Court is purely a legal one and is whether a NOL carryforward deduction is properly included in "applicable or related expenses" and, therefore,

available to be deducted in the determination of non-apportionable income.

FN11.Coleman, 729 A.2d at 851.

Discussion

Standard of Review

On an appeal from the Board, this court is to determine whether the agency's decision was supported by substantial evidence and the record is free from errors of law.^{FN5}Conclusions of law are reviewed *de novo*.^{FN6}The only issue before the Court is one of law.

FN5.Director of Revenue v. Stroup, 611 A.2d 24, 26 (Del.Super.1992).

FN6.In re Doughty, 832 A.2d 724 (Del.2003).

In construing statutes related to taxation, the Court is not to concern itself "with legislative intent unless the clear meaning of the statute is in question."^{FN7}If the statute imposes a tax, any doubts are to be resolved in favor of the taxpayer and against the government, but, if the statute provides for an exemption from taxation, any doubts are to be resolved in favor of the government and against the claimed exemption.^{FN8}

FN7.Capano v. Director of Revenue, 2002 WL 1485352, at *4 (Del.Super.).

FN8.Director of Revenue v. Magness Const. Co., 1986 WL 3645, at *11 (Del.Super.).

When a statute is clear and unambiguous, the Court is to apply the literal meaning of the words.^{FN9}A statute is ambiguous when it is "reasonably susceptible of different conclusions or interpretations."^{FN10}When the Court finds a statute to be ambiguous, the Court should "ascertain and give effect to the intent of the legislature."^{FN11}

FN9.Coleman v. State, 729 A.2d 847, 851 (Del.Super.1999) (quoting Hudson Farms, Inc. v. McGrellis, 620 A.2d 215, 217 (Del. Supr.1993).

FN10.Coastal Barge Corp. v. Coastal Zone Indus. Control Bd., 492 A.2d 1242, 1246 (Del.Super.1985).

Manufacturers Hanover, a foreign corporation not exempt from taxation under 30 Del.C. § 1902(b), was to pay a tax on its entire net income derived from business activities carried on and property located within Delaware during the audit years, 1993-1995.^{FN12}Manufacturers Hanover contested Director's failure to include any NOL carryforward in the *expense* base then attributed to non-apportionable income. Both parties stipulated that the expenses embodied in NOL were expenses that would be included as "applicable and related" expenses within the meaning of 30 Del.C. § 1903(b)(1) if those expenses were incurred in the audit years. They were not.

FN12.30 Del.C. § 1902(a).

The Board based its conclusion that the NOL in question is an "applicable or related expense" within the meaning of Section 1903(b)(1) on several bases. First, the Board stated that, as "applicable and related expenses" were not defined in Section 1903 or any other provision of the Delaware Code, it would have to determine the General Assembly's intent when it adopted the language, by giving the statutory language its ordinary and plain meaning.^{FN13} The Board stated that, as there was no real dispute that the expenses embodied in the NOLs were related to income, the plain language of Section 1903(b)(1) allows Manufacturers Hanover to reduce its income by the NOLs. Second, the Board also found that the Director's interpretation of Section 1903 allowed disparate treatment of taxpayers.^{FN14}

FN13. Board Decision dated March 12, 2004, at 2.

FN14. Board Decision, at 3-4.

A

*4 Manufacturers Hanover and Director agree that the deductions in the NOLs include expenses that, if they were incurred in the same year as the gross income, would be deductible. However, the expenses were incurred in 1981 through 1989 and 1992. The tax years in question are 1993, 1994 and 1995. It is undisputed that the deductions in the NOLs were not incurred in the tax years in question. Director asserts

that NOL is fully taken into account as intended by the legislature when allocable, non-apportionable income is calculated. He adds that there is no reason to allow Manufacturers Hanover to again include some part of the NOL as an expense when calculating allocable income.

Terms in the Delaware Tax Code have the same meaning as when used in the Internal Revenue Code, except where a different meaning is clearly intended.^{FN15} According to the Internal Revenue Code, NOL is the excess of allowed deductions over the gross income, with certain modifications.^{FN16} Deduction is defined as "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."^{FN17}

^{FN15}. (a) *Meaning of terms, in general.*- Any term used in this chapter shall have the same meaning as when used in a comparable context in the internal revenue laws of the United States, unless a different meaning is clearly required or unless subsection (b) of this section ascribes a different meaning to such term. Any reference in this chapter to the internal revenue laws of the United States shall mean the Internal Revenue Code of 1986 (26 U.S.C. § 1 et seq.) And amendments thereto and other laws of the United States relating to federal taxes, as the same are or may be effective for the taxable year.

30 Del.C. § 502.

^{FN16}.26 *U.S.C.A. § 172(c).*

^{FN17}.26 *U.S.C.A. § 162(a).*

Under 26 U.S.C.A. § 162, an expenditure must be paid or incurred during the taxable year, made to carry on a trade or business, and be an ordinary and necessary expense.^{FN18} In addition, to be deductible, the expense must be paid or incurred by Manufacturers Hanover within the taxable year.^{FN19} Ordinary and necessary business expense is properly recognized when the liability for the expense is incurred and/or when it is paid.^{FN20}

^{FN18}.*Ellis Banking Corp. v. C.I.R., C.A.11, 668 F.2d 1376, 1378 (1982).*

^{FN19}.*Hill v. C.I.R., C.A.4, 181 F.2d 906,*

908 (1950).

^{FN20}.*Alsobrook v. United State, E.D.Ark., 431 F.Supp. 1122, 1127 (1977), affirmed 566 F.2d 628 (1977).*

Manufacturers Hanover asserts that "related" means "connected" or "associated" according to The American Heritage Dictionary, Second College Edition (1982). The NOLs were determined by finding the excess of the allowed deductions over the gross income in each of the years 1981 through 1989 and 1992. The expenses included in the deduction in NOL are not related, connected or associated with the gross income in the years 1993, 1994 and 1995 as they were not incurred in those years. Applying the literal meaning of the words, NOL, deduction and related, the Court finds that the Board erred as a matter of law in finding that the NOLs are expenses related to income and allowing Manufacturers Hanover to reduce its income by the NOLs.

B

The Board also found that the Director's interpretation of Section 1903 allowed a taxpayer with apportionable income to use the NOL to offset income while the taxpayer with only allocable income could not do so. The Board held that the Delaware Tax Code does not support a disparity in treatment based solely on the characterization of the taxpayer's income.

Manufacturers Hanover maintains that the Director's method of limiting NOL to apportionable income is not supported by Delaware statute or regulation as that expenses incurred to produce the income are improperly excluded from the expense base. It contends the Director's methodology results in disparate treatment of similarly situated taxpayers. The example used is:

*5 Two taxpayers involved in rental activities both of which produce \$75 in gross receipts and incur \$50 of expenses over a two year period. Taxpayer A earns \$25 and \$50 in gross receipts and incurs \$35 and \$15 of expenses in years 1 and 2, respectively. Taxpayer B likewise earns \$25 and \$50 in gross receipt but instead incurs \$20 and \$30 of expenses in years 1 and 2, respectively.^{FN21}

^{FN21}. Appellee's Answering Brief, at 22.

Not Reported in A.2d
 Not Reported in A.2d, 2004 WL 5356392 (Del.Super.)
(Cite as: Not Reported in A.2d)

Manufacturers Hanover continues there would be disparate treatment of taxpayers, even though over the two year period each economically earned net income of \$25, as the taxpayers's NOL from year 1 would not be carried forward to offset income in year 2. It claims that Taxpayer A would be required to report fictitious or phantom net income in the amount of \$10.

(Del.Super.)

END OF DOCUMENT

The two taxpayers in the example presented by Manufacturers Hanover are similar only in that their net income totaled over a two year period is the same. In year 1, Taxpayer A had total net income of a negative \$10, owing not tax, while Taxpayer B's total net income was \$5 and would owe tax. In year 2, Taxpayer A's income was \$35 with Taxpayer B earning \$20; both needing to pay tax on the income. Accounting is done on an annual basis, not biennially. The treatment of each taxpayer is the same for year 1 and year 2. The years are not to be combined unless there is a specific code section that permits such treatment. There is no disparate treatment of the two taxpayers.

Calculation of taxable income under the Delaware Tax Code is a mathematical exercise following what the statute says to do.^{FN22} Director calculated the taxable income of Manufacturers Hanover by following the statute. Therefore the Court finds that the Board erred as a matter of law in finding that the Delaware tax structure did not support disparity in treatment based solely on whether a taxpayer's income was characterized as allocable or apportionable. If this is not the desired result, the General Assembly must change the statutory taxing plan.^{FN23}

FN22.*In re State Tax Comm. V. Atlantic Aviation Corp.*, 1 Del. Tax Cases, ¶ 200-149. (Del.Super. February 18, 1966).

FN23.*Id.*

Conclusion

Accordingly, the decision of the Tax Appeal Board upholding Manufacturers Hanover Leasing International Corp. is REVERSED and REMANDED for proceedings consistent herewith.

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