

BEFORE THE TAX APPEAL BOARD  
FOR THE STATE OF DELAWARE

PRINCE CABLE, INC. )  
 )  
 Petitioner, )  
 )  
 v. ) Docket No. 1309  
 )  
 DIRECTOR OF REVENUE )  
 )  
 Respondent. )

**DECISION AND ORDER**

Jordan M. Goodman, Horwood, Marcus & Berk Chartered and Ralph J. Cetrulo, Cover & Rossiter P.A., for Petitioner

Joseph Patrick Hurley, Jr., Esq., Deputy Attorney General for Respondent.

Todd C. Schiltz, Esq., Vice Chairman. John N. Cordrey, Esq., Chairman, Regina C. Duziec, Member, and Cynthia L. Hughes, Member.

DATE: March 13, 2000

## **Introduction**

In this action, petitioner Prince Cable, Inc. challenges the decision of the Delaware Director of Revenue to calculate the percentage of petitioner's income apportionable to and taxed by Delaware using the three-factor apportionment formula set forth in Section 1903 of the Delaware Corporate Income Tax Code. Petitioner claims the Director abused his discretion by applying the three-factor formula and by refusing to adopt one of petitioner's two proposed alternative methods of calculating the amount of petitioner's income apportionable to Delaware. For the reasons set forth below, the Board concludes that the Director did not abuse his discretion in this instance and that petitioner's apportionable income should be calculated using the standard three-factor formula.

## **Statutory Framework**

Section 1903 of title 30 of the Delaware Code addresses the taxation of corporations engaged in business in numerous states. 30 Del. C. § 1903. In general, the statute provides that if a corporation conducts business in part within Delaware and in part without the state, then a portion of the corporation's income must be apportioned to Delaware and taxed by the State.

Under Section 1903, the amount of income apportionable to Delaware is determined through a two step process. First, income that can be allocated to a particular state is allocated to that state. 30 Del. C. § 1903(b)(1)-(5). Next, any unallocated income is multiplied by an apportionment percentage to determine what proportion of the unallocated income should be apportioned to and taxed by Delaware. 30 Del. C. § 1903(b)(6).

The apportionment percentage utilized in Delaware is commonly referred to as the three-factor formula and is set forth in Section 1903(b)(6). The three factors utilized in the formula are property, payroll and sales. Each of the three factors is calculated using a numerator that is based

on activities in Delaware and a denominator that is based on total corporate activities. The average of the fractional amounts is the apportionment percentage and represents what portion of income will be attributable to Delaware and is subject to taxation by the State.

The formula for calculating the apportionment percentage is stated as follows:

$$\text{Apportionment Percentage} = \frac{\frac{\text{DE Property}}{\text{Total Property}} + \frac{\text{DE Payroll}}{\text{Total Payroll}} + \frac{\text{DE Sales}}{\text{Total Sales}}}{3}$$

Accurately apportioning income among various taxing jurisdictions is a difficult, if not impossible, undertaking. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 192 (1983); Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123, 134 (1931) ("apportionment with mathematical exactness is impossible"). Section 1903's three-factor formula has been recognized as an acceptable, although imperfect, means of apportioning income. See Container Corp., at 170, 183 ("the three-factor formula ... has become ... something of a benchmark" although it "is necessarily imperfect"); In re Decision of Tax Appeal Board No. 348, DE Tax App. Board (May 12, 1971) ("It is impossible to determine exactly what share of income of a multistate business is attributable to operations in one state but the formula is, nevertheless, intended and justifiable as a reasonable attempt to fix a portion of the corporation's income attributable to business conducted in Delaware").

Because the three-factor formula does not apportion income in a perfect manner and because circumstances may exist where application of the formula does not accurately reflect a taxpayer's income producing activities in Delaware, Section 1903(c) gives the Director of Revenue the discretion to alter the formula in appropriate circumstances:

If, in the discretion of the Secretary of Finance, the application of the allocation or apportionment provisions of this section results in

an unfair or inequitable proportion of the taxpayer's entire net income being assigned to this State, then the Secretary of Finance or the Secretary's delegate may permit or require the exclusion or alteration of the weight to be given to one or more of the factors in the formula specified above or the use of separate accounting method to produce a fair and equitable result.

30 Del. C. § 1903(c).

The issue before the Board is whether respondent Director of Revenue abused his discretion in refusing to allow petitioner to disregard the three-factor formula for tax years 1996 and 1997. More specifically, the issue is whether the Director abused his discretion by enforcing the three-factor test and not allowing petitioner to calculate the income subject to Delaware tax using the sales factor only, and/or, in the alternative, by denying petitioner the right to include the cost of independent contract labor as part of its total payroll expense for purposes of calculating the payroll factor.

#### **Factual Background**

Petitioner is a Delaware corporation headquartered in New Castle, Delaware. Petitioner, a service company, is in the business of coordinating the installation of cable television for residential customers. The process is as follows: a cable company receives a request for services from a residential customer, the cable company contacts petitioner asking it to install the service, petitioner distributes the job orders among cable installers who are located near the installation sites, and the cable installers install the cable. The cable installers are independent contractors and not employees of petitioner and, hence, amounts paid to these individuals are not accounted for as payroll expenses. In 1996 and 1997, petitioner incurred costs of \$4,170,444 and \$5,381,021 respectively for contract labor.

Petitioner performs its accounting, payroll, billing and collection, computer and technical support, legal and other administrative and management functions at its Delaware headquarters. Petitioner admits that there is value associated with its home office and "that the activities of its employees in Delaware . . . contribute to its apportionable income." (Petitioner's Initial Brief at 8; Oral Argument Transcript at 43).

In 1996, wages in the amount of \$1,085,716 paid to petitioner's Delaware employees accounted for 55.4% of the \$1,957,062 in wages petitioner paid to all of its employees. In 1997, wages in the amount of \$1,167,318 paid to Delaware employees accounted for 50.5% of petitioner's \$2,310,616 wage payments. Petitioner's Delaware property constituted approximately 62% and 40% of its total property for 1996 and 1997, respectively. In 1996 and 1997, petitioner had very limited sales in Delaware. Indeed, only .0057% of petitioner's installation revenue came from Delaware in 1996 and only .3208% of its installation revenue came from Delaware in 1997.

### **Petitioner's Corporate Income Tax Returns**

Prior to the initiation of these proceedings, petitioner made a formal application to the Director asking him to exercise his discretion under Section 1903(c) and permit the petitioner to calculate its apportionment percentage for the 1991 tax year using a single-factor, sales only formula.<sup>1</sup> On January 27, 1997, the Director issued a Notice of Determination wherein the Director refused to adopt the petitioner's single-factor apportionment formula.

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<sup>1</sup> Stated as a formula, petitioner requested that its apportionment percentage be calculated as follows:

$$\text{Apportionment Percentage} = \frac{\text{DE 1991 Sales}}{\text{Total 1991 Sales}}$$

Thereafter, on or about September 15, 1997, petitioner filed a 1996 Delaware corporate income tax return claiming it had overpaid its Delaware corporate income tax by \$21,898. Petitioner requested that the overpayment be carried over and applied to its 1997 income.

Petitioner did not utilize Section 1903's three-factor formula to determine its apportionment percentage when preparing its 1996 return and calculating its taxable income. Rather, petitioner disregarded the property and payroll factors and calculated its 1996 apportionment percentage using only the sales factor.<sup>2</sup> Petitioner adopted the single-factor formula despite the Director's previous rejection of this approach.

Petitioner's single-factor test resulted in only .0057% of petitioner's 1996 income being apportioned to Delaware. Petitioner sent a letter to the Division of Revenue with its 1996 return stating that it had employed a single-factor formula and claiming that this formula was appropriate because it accurately reflected petitioner's income producing activities in Delaware.

When processing petitioner's 1996 return, the Division of Revenue disregarded the single-factor test employed by petitioner and calculated petitioner's apportionment percentage using the three-factors required by Section 1903. This change increased the apportionment percentage from .0057% to 39.5% and increased the amount of income allocable to Delaware from \$39.00 to approximately \$252,000. The change also increased petitioner's overall tax liability from \$1,410.00 to \$23,268.90. As a result of these changes, petitioner's 1997 carryover was only \$39.10, as opposed to the \$21,898 claimed by petitioner. The Division failed to notify

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<sup>2</sup> Stated as a formula, petitioner calculated its 1996 apportionment percentage as follows:

$$\text{Apportionment Percentage} = \frac{\text{DE 1996 Sales}}{\text{Total 1996 Sales}}$$

petitioner that it applied the three-factor formula and of the corresponding increase in tax liability and reduction in the carryover.

Petitioner filed its 1997 tax return again using just the sales factor to determine the amount of income apportionable to Delaware. The return showed an apportionment percentage of .3208% and a tax due in the amount of \$4,936. Petitioner asked that the claimed 1996 carryover be applied to its 1997 tax liability. Because of the adjustments made to petitioner's 1996 return, the Division of Revenue allowed petitioner a carryover of just \$39.10. This resulted in a tax due according to the return as filed of approximately \$4,896.44 which the Division assessed against petitioner by notice dated April 29, 1998.<sup>3</sup>

#### **Petitioner's Protest and The Director's Denial Thereof**

On June 18, 1998, petitioner protested the \$4,896.44 assessment and the denial of the \$21,898 carryover arguing the Director should exercise his discretion under Section 1903(c) and modified the three-factor formula. Petitioner argued it should be permitted to calculate its apportionment percentage using just the sales factor.

Thereafter, petitioner advised the Director it would use the three-factor formula if it was permitted to include amounts paid to the independent cable installers for purposes of determining the payroll factor. Including such payments would increase the total amount of petitioner's

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<sup>3</sup> When the Division processed petitioner's 1997 tax return it did not recalculate the amount of tax petitioner owed using Section 1903's three-factor formula. This appears to have been an oversight. If petitioner's 1997 return had been prepared using the three-factor formula, the return would have shown petitioner owed \$13,976.89 in taxes for 1997. While aware of its oversight, the Division has never issued an assessment against petitioner to recover this amount, instead seeking to recover merely \$4,896.44.

payroll and, correspondingly, reduce the percentage of petitioner's payroll attributable to Delaware.<sup>4</sup>

Petitioner's protest presented the director with three options: impose the three-factor formula, adopt petitioner's modified three-factor formula, or adopt petitioner's single-factor formula. The following tables summarize the apportionment percentage and the amount of taxable income apportionable to Delaware under each of the three options.

APPORTIONMENT PERCENTAGE

	Director's Three Factor Formula	Petitioner's Modified Three Factor Formula	Petitioner's Single Factor Formula
1996	39.5%	26.7%	.006%
1997	30.4%	18.6%	.3208%

TAXABLE INCOME APPORTIONABLE TO DELAWARE

	Director's Three Factor Formula	Petitioner's Modified Three Factor Formula	Petitioner's Single Factor Formula
1996	\$252,588	\$171,603	\$38.56
1997	\$105,032	\$64,263	\$1,108

The Director rejected petitioner's protest in total and determined that the amount of petitioner's taxable income should be calculated in accordance with the three-factor formula set forth in Section 1903 and that petitioner was not entitled to the claimed \$21,898 carryover. Petitioner filed a timely appeal from the Director's decision.

<sup>4</sup> Stated as a formula, petitioner proposed the following:

$$\text{Apportionment Percentage} = \frac{\frac{\text{DE Property}}{\text{Total Property}} + \frac{\text{DE Payroll}}{\text{Total Payroll} + \text{Payments to Contractors}} + \frac{\text{DE Sales}}{\text{Total Sales}}}{3}$$



## Analysis

In this appeal, petitioner contends the Director abused his discretion under Section 1903(c) by: (i) deciding petitioner could not employ a single-factor, sales only formula to calculate its apportionment percentage, and (ii) refusing to allow petitioner to include all sums paid to independent cable installers as part of the payroll factor of the three-factor formula.<sup>5</sup> The amount in controversy includes \$4,896.44 plus interest and penalties.

### I. Burden and Standard of Proof.

Petitioner bears the burden of proving the Director abused his discretion in applying the three-factor formula. 30 Del. C. § 526. Under Section 1903, the three-factor formula applies unless the Director determines in his discretion that the application of the three-factor formula "results in an unfair or inequitable proportion of the taxpayer's entire net income being assigned to [Delaware]." 30 Del. C. § 1903(c). To show the Director abused his discretion in finding that application of Section 1903 was not unfair or unreasonable, petitioner must show the Director "exceeded the bounds of reason in view of the circumstances" and has "so ignored recognized rules of law or practice so as to produce injustice. . . ." Deibler v. Atlantic Properties, Inc., Del. Supr., 652 A.2d 553, 558 (1995).

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<sup>5</sup> At oral argument, petitioner also asserted that the trucks, tools, and other assets utilized by the independent contractors it hires should be included within the total amount of property for purposes of calculating the property factor. Petitioner never presented this argument to the Director when responding to the assessment and, thus, the Director had no opportunity to address it. As the Director never considered this issue and as our function is limited to determining whether the Director abused his discretion, we can not consider this argument here. Even if we could consider this argument, however, petitioner's evidence of the contractors' property costs is mere speculation and does not provide a sufficient basis on which we could find that the cost of the assets utilized by the contractors should be included within the property factor.

## II. Petitioner's Single-Factor, Sales Only Formula.

Petitioner argues that the nature of its business dictates that its apportionment percentage be determined using just the sales factor and that the Director's decision to the contrary was an abuse of discretion. More specifically, petitioner asserts that its business is installing cable, that the income realized from installing cable is generated in the state where the sale occurs and the service is provided and, therefore, that the proper way to apportion its income among various states is to look only at the sales factor.<sup>6</sup> In addition, the petitioner claims the property and payroll factors should be disregarded because they inappropriately distort the apportionment percentage.

Utilizing petitioner's single-factor, sales only formula results in an apportionment percentage of .006% and taxable income of \$39.00 for 1996 and an apportionment percentage of .3208% and taxable income of \$4,936 for 1997. The Director determined that these apportionment percentages and levels of taxable income did not accurately reflect petitioner's income generating activities in Delaware and, therefore, refused to adopt petitioner's single-factor formula.

We find that the Director did not abuse his discretion in refusing to adopt petitioner's single-factor, sales only formula. Petitioner's position disregards the economic reality of the manner in which income is generated. Activities other than sales contribute to the generation of income. See Container Corp., 463 U.S. at 182, 183 (recognizing that it is not appropriate to focus on a single factor to apportion income and that the three-factor test has gained wide

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<sup>6</sup> Petitioner's business is more accurately characterized as a facilitator of the installation of cable service. Petitioner has no employees who actually install cable. Rather, it is a service company which directs third party independent contractors to install cable service based on orders it receives from cable companies. (Oral Argument Transcript at 13) Hence, petitioner acts as a middle-man between the cable company that requests cable be installed and the independent contractor who installs the service.

ranging approval because payroll, property and sales in combination reflect a very large share of the activities which contribute to an enterprises income). Petitioner admitted that the services which occur at its Delaware headquarters and which are performed by Delaware employees add value to the enterprise and contribute to its income. (Petitioner's Initial Brief at 8; Oral Argument Transcript at 43) As the property petitioner maintains in Delaware and the individuals petitioner employs in Delaware admittedly contribute to petitioner's income, there is no basis to exclude the property and payroll factors from the three-factor formula.

We also conclude that the property and payroll factors do not unfairly or inequitably distort the apportionment percentage. We reach this conclusion for two reasons. First, the evidence demonstrates that the sales factor, not the property and payroll factors, is the outlying factor. In 1996, petitioner's property, payroll and sales factors were 62.42%, 55.47% and .0057%, respectively. In 1997, these factors were 40.40%, 50.50% and .3208%, respectively. Thus, to the extent a factor is distorting petitioner's apportionment percentage, the sales factor, not the property or payroll factors, is the outlier.

Second, whether one factor distorts the others is not the nature of the inquiry. As petitioner acknowledges, "apportionment factors are designed to balance each other" and "distortion in one factor does not necessarily produce an inaccurate measure of a taxpayer's overall business activity in the taxing state . . . ." (Petitioner's Initial Brief at 5-6) Hence, the issue is not whether one of the three factors distorts the other two. Rather, the issue is whether the apportionment percentage calculated using all three factors is unfair or inequitable. If it is, then the Director can look to the individual factors to correct any distortion. If it is not, then there is no reason to compare the three factors against each other to determine the impact each has on the apportionment percentage.

Here, the Director determined that the application of the standard three-factor formula resulted in an apportionment percentage that was fair and equitable. Given that (i) the payroll, property and sales factors in combination reflect activities which contribute to petitioner's income, (ii) petitioner maintains its principal operations in Delaware, and (iii) petitioner admits its Delaware activities contribute to its income, we find no basis to overturn this decision. Quite simply, other than the rejected contention that income should be apportioned among various states in lock-step with where the sales occurred, petitioner has introduced no evidence or argument which even suggests that the three-factor formula does not accurately apportion its income. Accordingly, there is no reason to examine the purported distortive affect of the property and payroll factors.

## **II. Petitioner's Modified Three-Factor Formula.**

Petitioner's alternative argument, that the Director abused his discretion by failing to allow petitioner to include amounts paid to the independent cable installers when calculating total payroll expenditures, is also unfounded.

Petitioner argues its costs associated with hiring independent cable installers should be included within the payroll factor because it is the activities of these individuals which generate virtually all of petitioner's apportionable income. As stated by petitioner:

because the standard wage factor excludes Petitioner's subcontractor labor costs, the wage factor, and the apportionment formula as a whole, yield an unfair depiction of Petitioner's income producing activities, and an inaccurate measure of where Petitioner's income was generated. The payments to independent contractors represent approximately 70% of Petitioner's total labor costs for the at issue. . . . By failing to give Petitioner credit for those costs, the costs most closely associated with the production of Petitioner's income, the wage factor is hyperinflated by amounts paid to Petitioner's employees in Delaware. In so doing, the wage factor "puts the entire apportionment formula out of focus."

(Petitioner's Reply Brief at 8). Petitioner supports this argument with various calculations that demonstrate how the payroll factor and the overall apportionment percentage are impacted by the exclusion of the costs associated with the subcontractors.

The problem with petitioner's argument is that the evidence offered fails to establish that the amount of petitioner's income allocated to Delaware under Section 1903 was unfair or inequitable. Petitioner's calculations – which show that the apportionment percentage would diminish if the subcontractor labor costs were included in the payroll factor – do not demonstrate that the percentage of income petitioner earned from its Delaware business activities was so different from the apportionment percentage that application of the apportionment percentage brings about an unjust result. Absent evidence of this nature, we cannot conclude that the Director abused his discretion in refusing to include the subcontractors' labor costs when calculating the payroll factor.<sup>7</sup>

### **III. Interest and Penalties.**

Petitioner also contends that the interest and penalties due on the \$4,896.44 assessment should be abated arguing that it calculated its 1996 and 1997 taxable income in good faith. We find no reason to abate the interest or the penalty owed by petitioner.

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<sup>7</sup> Petitioner also asserts that the Director's application of the three-factor formula deprives it of its Constitutional rights. An apportionment formula is Constitutionally invalid if its application results in income being apportioned to a state that is "out of all appropriate proportion to the business transacted in that State." Container Corp., 463 U.S. at 180-81. Given petitioner's substantial presence in Delaware, we conclude that the income attributable to the State is not out of all proportion to petitioner's activities in Delaware and that the Director's application of Section 1903 did not violate petitioner's Constitutional rights.

With respect to interest, "[u]nder Delaware law, this Board does not have the authority to waive or abate interest." Reitman v. Director of Revenue, DE Tax App. Board (May 10, 1996). In comparison, the Board does have the authority to abate penalties upon a showing of reasonable cause. 30 Del. C. § 534. Here, there is no such showing.

Section 1903(c), the authority on which petitioner relies to vary the statutory scheme, contemplates the taxpayer making an application to the Director and the Director granting permission to exclude or alter one or more of the apportionment factors. Petitioner never asked the Director to vary the statutory scheme for the 1996 and 1997 tax years. Rather, all petitioner did was to advise the Director with the filing of its returns that it was altering the statutory scheme. Petitioner took this action despite the Director's prior rejection of its proposed single-factor formula. In light of the Director's prior ruling, the petitioner did not have reasonable cause to unilaterally deviate from the three-factor formula to its preferred single-factor formula and, therefore, there is no reason to abate the penalties due in this case. 30 Del. C. § 534.

SO ORDERED this 13<sup>th</sup> day of March, 2000.

Regina C. Anderson

J. H. Conley

Paul C. Sibley

Cynthia L. Hughes