IN THE SUPERIOR COURT OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

CNA HOLDINGS, INC., F/K/A HOECHST CELANESE CORPORATION, Appellant, v. DIRECTOR OF REVENUE, Appellee.	:	C.A. No. 01A-03-001-SCD

Submitted: September 4, 2001
Decided: January 9, 2002

O P I N I O N

This appeal from the Tax Appeal Board ("Board")[1] turns on an issue of first impression in Delaware, the interpretation of the section of the Corporate Income Tax statute related to the sale of real property located in Delaware that is part of an integrated multistate manufacturing operation.[2]

Facts

There are no factual disputes. The parties have stipulated to the following:

The principal place of business of Hoechst Celanese Corporation ("Hoechst") is in New Jersey. For the tax year ending December 31, 1989 (the "year in issue"), Hoechst timely filed a Delaware Corporation Income Tax Return (the "original return"). Hoeschst paid Delaware corporation income tax through tentative tax payments and a payment with the original return in

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[1] The Board's decision is dated February 9, 2001. On December 4, 1992, Hoechst timely filed an Amended Delaware Corporate Income Tax Return (the "amended return") for the year in issue, requesting a refund in the amount of $817,166. In a letter dated January 20, 1993, Director of Revenue ("Director") issued a Notice of Determination to Hoechst, denying Hoechst's protest of Director's prior denial of its refund claim. Hoechst timely filed the Petition with the Board on March 12, 1993, in response to the Notice of Determination.
[2] 30 *Del. C.* § 1903(b)(3).

the total amount of $1,224,075. The taxes in controversy are Delaware corporation income taxes paid for the year in issue in the amount of $817,166, plus interest.

In the calendar year 1989, Hoechst sold its PVC Film Division plant ("PVC plant"), located in New Castle, Delaware. Hoechst had owned and operated the PVC plant since 1968 (the "ownership period") as part of an integrated multistate manufacturing operation. In the same year, Hoechst also sold plants in Louisiana and Texas.

In computing federal taxable income, Hoechst was required to include gain from the sale of the PVC plant. This gain included (1) ordinary income from the "recapture" of previously allowed depreciation, and (2) gain from the disposition of property, characterized as I.R.C. § 1231 gain. Hoechst's federal taxable income, the starting point for determining a corporation's Delaware corporation income tax, was $120,384,436.

The total gain recognized for federal income tax purposes upon the sale of the PVC plant for the year in issue was $14,004,480 (the sum of $127,344 and $13,877,136). The amount of recapture income is $45,242,998.

Depreciation recapture on the PVC plant, which is the income at issue in this matter and which forms the basis for the refund claim, calculated for federal income tax purposes, totaled $9,903,729 (the "Delaware recapture") and represents 8.2% of Hoechst's total federal taxable income for 1989.

In accordance with the instructions to the 1989 Form 1100, the original return allocated the full $14,004,480 of gain from the sale of the PVC plant (i.e., the $9,903,729 Delaware recapture and the balance, which is the economic gain) to Delaware, and Hoechst paid Delaware corporation income tax on said gain aggregating $1,218,390 (including $861,624 of tax on the Delaware recapture). Hoechst also paid tax in other states on the apportioned Delaware recapture in the aggregate amount of $649,030. On the original return Hoechst also reported $77,992,764 of taxable income that was allocated under the Delaware statutes to states other than Delaware. Of this amount, $63,499,534 was gain on the sale of depreciable tangible property located outside of Delaware that was sold in the year in issue. None of the income allocated to other states entered into the calculation of Hoechst's Delaware corporation income tax, as reflected in the original return.

The amended return for the year in issue excluded the Delaware recapture from the gain allocated to Delaware. In the amended return, Hoechst included the $9,903,729 Delaware recapture amount in the income subject to apportionment by Delaware and other states, but continued to allocate the balance of the gain from the sale of the PVC plant to Delaware. The amended return also included in apportionable income the $35,339,269 of recapture gain included in the aforementioned $77,992,764 of income allocated on the original return to other states. The total amount of recapture income reclassified as apportionable income in the amended return was $45,242,998. The amended return did not include in apportionable income the economic gain of $28,160,265 on the sale of depreciable tangible property located outside of Delaware that was sold in the year in issue.

Through the ownership period, Hoechst filed income tax returns in 34 taxing jurisdictions, including Delaware, Ohio and South Carolina (the 33 taxing jurisdictions other than Delaware are hereinafter sometimes referred to as the "other jurisdictions"), apportioning between 82% and 95.6% of its business income among those states. In the year in issue the aggregate apportionment percentage among all jurisdictions in which Hoechst filed returns was 95.6%. Delaware's average apportionment factor in these years ranged between a high of 8.83% between 1968 and 1980, and a low of 1.96% between 1981 and 1989. The Delaware apportionment factor in 1989 was 1.12%. Except for Ohio and South Carolina, all of the other jurisdictions apportioned the gain from the sale of the PVC plant, rather than geographically allocating it. Ohio and South Carolina each geographically allocated the $4,224,226 economic gain from the sale of the real estate component of the PVC plant outside of their tax bases. Ohio and South Carolina, like the rest of the other jurisdictions, apportioned the $9,903,729 Delaware recapture.

During the ownership period, Hoechst included PVC plant depreciation deductions in its determination of federal taxable income. Hoechst apportioned its federal taxable income among the states in which it conducted business. Therefore, Hoechst apportioned its PVC plant depreciation deductions among the states in which it conducted business, including the State of Delaware, receiving an apportioned amount of its depreciation deduction benefit for Delaware tax purposes. Hoechst, in all years of the ownership period, did not receive the full income tax benefit of the depreciation deduction because less than 100% of its income was apportioned to states with income taxes.

The depreciation expense claimed in all states on PVC plant assets throughout the entire ownership period of the facility, totaled $31,582,830. The portion of that number deducted in Delaware during the ownership period under Delaware's apportionment percentage was $1,363,951. The tax benefit obtained by Hoechst from those deductions for those years for Delaware purposes was $118,664. The portion of that number deducted in the other jurisdictions during the ownership period under the average apportionment percentage of the other jurisdictions was $30,218,879. The tax benefit obtained by Hoechst from these deductions for those years using the average tax rate was $1,845,796.

During the ownership period, Hoechst included depreciation deductions attributable to plants, offices and facilities located in other states in its determination of federal taxable income. Hoechst apportioned its federal taxable income among the states in which it conducted business, including Delaware. Therefore, Hoechst apportioned its depreciation deductions from plants, offices, and facilities not located in Delaware among the states in which it conducted business, including Delaware, receiving a depreciation deduction benefit for Delaware tax purposes. This benefit reduced Hoechst's federal income apportioned to Delaware, and thus reduced Delaware's corporation income tax during the ownership period by $520,750.

When plants, offices, and facilities located in other states were sold, any gain attributable to depreciation recapture under the Delaware statutes was allocated for Delaware corporation income tax purposes to the states wherein the real property was located. None of the previously deducted depreciation expense with respect to plants, offices, and facilities located in other states that was recaptured on the sale entered into the calculation of Delaware taxable income on the original return. It was, however, included on the amended return as part of the apportioned recapture income.

Standard of Review

In reviewing a decision of the Board, this Court must take due account of the experience and specialized competence of the Board, and of the purposes of the basic law under which the Board has acted. This Court's review is limited to a determination of whether the agency's decision was supported by substantial evidence and correct as a matter of law.[3]

[3] Administrative Procedures Act, 29 *Del. C.* § 10142(d); *United Water Delaware, Inc. v. Public Service Com'n*, Del. Supr., 723 A.2d 1172, 1173 (1999).

Discussion

The Board determined in its Decision and Order that: (1) the Delaware statute clearly and unambiguously required Hoechst to include in Delaware income the entire profit reported for federal income tax purposes on the sale of the plant; and (2) the Director did not abuse his discretion in denying Hoechst's request for an adjustment of its entire net income, pursuant to 30 *Del. C.* § 1903(c).

The Delaware statutory provisions relevant to this case provide:

> (b) "Taxable income" subject to taxation . . . 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:
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> * * *
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> (3) Gains and losses from the *sale* or other disposition of real property shall be *allocated to the state in which the property . . . is physically located*;
>
> (4) Gains and losses from the *sale* or other disposition of tangible property for which an allowance for depreciation is permitted for federal income tax purposes . . . shall *be allocated to the state where the property is physically located* or is normally used in the taxpayer's business.
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> * * *
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> (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:
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> a. The average of the value . . . of all the real and tangible personal property . . . in this State . . . expressed as a percentage of the average of the value . . . of all such property . . . both within and without this State . . . ;
>
> b. Wages, salaries and other compensation paid by the taxpayer to employees within this State . . . expressed as a

> percentage of all such wages, salaries and other compensation paid within and without this State . . . ;
>
> c. Gross receipts from sales of tangible personal property physical delivered within this State . . . and gross income from other sources within this State . . . 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 the State . . . .
>
> (c) If, in the discretion of the Secretary of Finance, the application of the allocation or apportionment provisions of this section result 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 alternation of the weight to be given to 1 or more of the factors in the formula specified above *or the use of separate accounting or other method to produce a fair and equitable result.*
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> (emphasis added).[4]

In sum, the Corporation Income Tax statute recognizes the need to apportion ordinary income for a corporation transacting business in and outside the State and has provided a formula for calculating that number. Under the Board's interpretation of 30 *Del. C.* § 1903(b), there is no apportionment of the gain associated with the sale of real property in the state; 100% of that gain is taxable in Delaware. The Board concluded that full taxation is proper notwithstanding the fact that a portion of that gain was taxed by other states. In the instant case, Hoechst's sale of real estate in Delaware in 1989 resulted in the taxation of 187% of the proceeds of the sale of the Delaware plant.

The issue in this proceeding is whether the Director properly disallowed Hoechst's claim for refund of Delaware corporation income tax paid for the year in issue. The analysis begins with the question of whether 30 *Del. C.* § 1903(b) provides for the allocation of the entire profit on the sale of the Delaware plant to Delaware or whether the word "gains" in 30 *Del. C.* § 1903(b)(3) must be interpreted to exclude the depreciation which is recaptured at the time of the

[4] 30 *Del. C.* § 1903.

sale. Hoechst argues that 30 *Del. C.* § 1903 should be interpreted to require only the allocation of the economic appreciation on the plant during the ownership ("economic gain"), not the recovery of depreciation deductions that were allowed on the plant during the ownership period ("recapture gain"). Hoechst reasons that because depreciation is apportioned, the recapture gain must also be apportioned. The economic gain on the sale of the plant was $4,100,751 while the recapture gain was $9,903,729. The definitional portion of the statute does not define "gain" or "gains."[5]

Delaware is out of step with the rest of the country in the way it handles the proceeds from the sale of a plant.[6] The Director acknowledges that his interpretation of the statute costs the State considerable revenue because Delaware foregoes revenue on sales of facilities in all other states that could be partially apportioned to Delaware.[7] His decision not to permit the

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[5] 30 *Del. C.* § 1901.

[6] Professor Richard D. Pomp, of the University of Connecticut, testified as an expert witness for Hoechst as follows:

> Q. Are you aware of any other states that would reach a similar, I didn't say identical, just a vaguely similar outcome as Delaware with expect [sic] to this identical transaction?
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> A. There is no state that I'm aware of, and certainly none of the states in which they filed returns that would allocate the entire gain, both the recapture and the economic component of the gain to itself.
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> Transcript of Hearing at 103 (February 14, 1997).

[7] Testifying about the impact on Delaware revenue of the Director's interpretation of 30 *Del. C.* § 1903 in the tax year 1989, the Director responded:

> A. The number of accounts with allocatable income, that was about 9,000 accounts, number of accounts with gains on the sale of real and depreciable or tangible property, that's about 100 accounts, amount of gain and loss from real and intangible property located in Delaware, that's about $30 million of gain, $5 million of losses, and the net is 24.9 gain. And amount of gain/loss from real and intangible property located outside of Delaware is about 6.2 billion, losses about half a billion, and the net is about 5.7 billion.
>
> Q. So on a net basis in '89, Delaware allocated to itself about 30 million in gain?
>
> A. Yeah, in gross gain, yeah.
>
> Q. And allocated outside of itself or forgave tax in the amount of about 1.6 billion?
>
> A. No, 6.2 billion.
>
> Q. 6.2 billion. I'm sorry. And that confirms your view that overall the statute is working fairly to tax only the business relations in Delaware?
>
> A. Well, as a matter of fact I think it's working to tax less than could be taxed under an apportionment scheme.
>
> *Id.* at 142.

refund was based on his conclusion that under the circumstances applicable to this taxpayer, throughout the ownership period, the tax is "fair and equitable."[8]

The first task of statutory interpretation is to determine whether 30 *Del. C.* § 1903(b)(3) is ambiguous.[9] A statute is ambiguous when it is reasonably susceptible to different conclusions or interpretations.[10] Ambiguity may be found if a literal reading of the statute would lead to an unreasonable or absurd result.[11] A taxing statute may not be sustained if, as applied to the taxpayer, it operates "unreasonably or arbitrarily . . . in attributing to [a state] a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state."[12] "If there is doubt regarding the breadth of a taxing statute, the court must construe the statute against the taxing authority and in favor of the taxpayer."[13]

Under the facts of this case, taxation of 187% of the proceeds of the sale of the PVC plant because of the almost double taxation of the recapture component of the gain on the sale of the property constitutes an unreasonable result. Interpreting the word "gain" in the statute to mean only the economic gain results in a tax liability which is consistent with the apportionment of the ordinary income among the various states where Hoechst was doing business, and reconciles the apportionment provisions of subpart (6) with the gain and losses part of subpart (3) and (4).

This conclusion is supported by *Hercules Inc. v. South Carolina Tax Comm'n*.[14] which is squarely on point. Hercules sold a plant and apportioned the gain from the sale among all of the approximately forty states in which it did business and which also required the payment of income tax. The Tax Commission disallowed apportionment of the gain and assessed additional

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[8] 30 *Del. C.* § 1903(c).
[9] *Newtowne Vill. Serv. v. Newtowne Rd. Dev Co., Inc.*, Del. Supr., 772 A.2d 172, 175 (2001).
[10] *Id.*
[11] *Id.*
[12] *Hans Rees' Sons v. State of North Carolina ex. rel. Maxwell,* 283 U.S. 123, 135 (1931).
[13] *Abrern-Wilmington v. Director of Revenue,* Del. Supr., 596 A.2d 1385, 1388 (1991).
[14] *Hercules Inc. v. South Carolina Tax Comm'n*, S.C. Supr., 304 S.E.2d 815 (1983).

taxes on the basis of a code provision which taxed transactions occurring wholly within the state. The South Carolina Supreme Court held:

> If we were to hold that [the tax code] allows South Carolina the sole benefit of recapturing all of the depreciation taken, one of two gross inequities would result. Either all other states which allowed depreciation would be denied the right to recapture or Hercules would be subjected to double taxation. It cannot be seriously argued that the legislature intended such a result.[15]

The Court interpreted "gain" in the statute to be the gain, which reflects a "true and actual profit as contrasted with a profit brought into being by reason of recapturing depreciation. In addition, the gain would, of course, include the recapture of depreciation actually allocated to South Carolina."[16] The analysis of *Hercules* applies here. The term "gain" in 30 *Del. C.* § 1903(b)(3) is the economic gain from the sale of the property, $4,100,751 plus the Delaware depreciation of $118,664. In view of the conclusion reached here, it is not necessary to consider Hoechst's argument regarding the constitutionality of the statute or the Director's abuse of discretion. The decision of the Board is reversed and remanded for further proceedings in accordance with this decision. In view of the age of this matter and the inexplicable delay in its resolution below, the Board is directed to report on this status of this remand, unless appealed, on or before March 15, 2002.

IT IS SO ORDERED.

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Judge Susan C. Del Pesco

Original to Prothonotary
xc: Stanford L. Stevenson, III, Esquire
Paul H. Frankel, Esquire

[15] *Id.* at 818.
[16] *Id.*

Michael A. Pearl, Esquire
Jos. Patrick Hurley, Esquire