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SALT Alert!

SALT Alert! 2017-27: Pennsylvania NOL Flat-Dollar Cap Violates Uniformity Clause; Taxpayer Not Allowed an Uncapped NOL

On October 18, 2017, in *Nextel Communications Inc. v. Pennsylvania*, the Pennsylvania Supreme Court affirmed a Commonwealth Court decision holding that the flat-dollar net loss deduction limitation in effect for the tax year at issue violated the Uniformity Clause of the Pennsylvania Constitution as applied to a particular taxpayer. However, the court reversed the lower court's holding that the appropriate remedy was to allow the taxpayer to apply an uncapped net loss deduction and to refund the tax paid as a result of the unconstitutional cap. In the court's view, the legislature intended to limit the net loss deduction, and the appropriate remedy was to sever the flat-dollar cap deduction limitation.

Background

For Corporate Net Income (CNI) Tax purposes, Pennsylvania has limited net loss deductions for many years. Under Pennsylvania law in effect for the tax year at issue (2007), the net loss deduction was limited to the greater of 12½ percent of taxable income or $3 million. The taxpayer, a telecommunications company doing business in Pennsylvania and a number of other states, carried forward $150 million of losses to the 2007 tax year, during which it had $45 million in Pennsylvania income. Applying the 12 ½ percent limitation resulted in a deduction of $5.6 million, and the taxpayer paid approximately $4 million in CNI tax on its remaining income. The taxpayer subsequently requested a refund of the tax paid for 2007 on the basis that the net loss cap, as applied to it, violated the Uniformity Clause of the state constitution. After the Board of Appeals and the Board of Finance and Revenue determined that they lacked authority to rule on the taxpayer's constitutional challenge and denied the taxpayer's refund, the matter went before the Commonwealth Court.

The Commonwealth's Uniformity Clause provides that: "All taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax . . . ." The Commonwealth Court ultimately held that although the Uniformity Clause does not require absolute equality and perfect uniformity in taxation, the legislature cannot treat similarly situated taxpayers differently. In the court's view, the taxpayer demonstrated that the net loss deduction provision created classes of taxpayers according to their taxable income. As written, the deduction provision could, and in the 2007 tax year did, allow some taxpayers to reduce their taxable income to $0 and, as a result, pay no CNI tax. The only factor distinguishing these two classes of taxpayers was the amount of taxable income in the 2007 tax year.

Having determined that the net loss cap violated the Uniformity Clause, the Commonwealth Court next addressed the proper remedy to cure the constitutional infirmity. Simply striking the $3 million cap, the court stated, would not remedy the wrong suffered by the taxpayer, as it would be impractical (or impossible because 2007 was a closed tax year) to go back and assess tax against corporations that benefited from the $3 million cap. The court concluded that the only "practical remedy" was to strike the total limitation allowing the taxpayer to apply an uncapped NOL for the closed tax year at issue.

Decision on Appeal

In a 38-page opinion, the Pennsylvania Supreme Court spent 30 pages reciting the facts and procedural history, then ultimately agreed with the Commonwealth Court that the flat-dollar cap on the net loss deduction violated the Uniformity Clause as applied to Nextel. The court found that its precedents over time had consistently held that provisions differentiating among taxpayers based on their income levels violated the Uniformity Clause.

The court next addressed the appropriate remedy and noted that under Pennsylvania law, it was required to undertake a severability analysis. The Department argued that the court should sever the flat-dollar cap limitation, but leave in place the percentage limitation. In the Department's view, this was consistent with the Legislature's recognition that the state budget "could not sustain an unlimited deduction." Nextel's position was that because the statute of limitations was generally closed for the 2007 tax year (and the Department could not assess those who benefited from the flat-dollar cap), the only proper remedy was to remove the limitation entirely and place Nextel in the same position as the other 19,303 taxpayers that had net loss deductions and paid no taxes at all. In Nextel's view, "the only remedy for a Uniformity Clause violation is to grant the disfavored taxpayer relief by refunding all the taxes it paid under the unconstitutional statute; any lesser remedy it contends would have "a chilling effect" on taxpayers who wish to make such challenges."

The court observed that it had three options: (1) sever the flat-dollar cap; (2) allow an uncapped net loss deduction; or (3) disallow any deduction for losses. After reviewing the legislative history, the court concluded that striking the flat-dollar cap was the option that best effectuated the Legislature's intent that there be some limit on the deduction. As such, the taxpayer was not entitled to a refund for the 2007 tax year and that portion of the lower court's ruling was reversed.

Next Steps and Action Steps

Nextel has 14 days to request re-argument before the Pennsylvania Supreme Court and could potentially also file a petition for certiorari before the U.S. Supreme Court. Barring those occurrences, the decision would appear to be final, and the Department could assess any taxpayer that took a position inconsistent with the holding.

There are taxpayers that filed original returns or amended returns applying an uncapped NOL. It is likely that the Department will assess taxpayers that took this position on original returns and will deny refunds related to amended returns applying an uncapped NOL. Corporate taxpayers with *Nextel* appeals pending at the Board of Appeals and/or Board of Finance and Revenue should assess whether to withdraw those appeals. There are, however, also taxpayers that filed as provided for by law and benefitted from the flat dollar cap in tax years that are currently open and that would owe additional tax if the percentage cap was applied. Corporate taxpayers that took either an uncapped net loss deduction or a net loss deduction based upon the flat-dollar limitation should assess the potential tax provision impact. However, it may be advisable for those that utilized the flat-dollar cap to wait before filing amended returns. The Department may issue guidance on how it intends to apply the holding and/or the Pennsylvania legislature may address the issue.

There is already legislation pending that would prospectively revise the net loss deduction limitations. On October 17, 2017, the House approved House Bill 542 to fund the FY 2017-2018 budget. The bill now goes to the Senate for concurrence. The bill repeals the flat-dollar cap entirely and amends the net loss deduction for tax years beginning after December 31, 2017 to 35 percent of taxable income and for tax years beginning after December 31, 2018 to 40 percent of taxable income. In light of the holding in *Nextel*, it is possible the bill will be amended to address tax prior tax years.

Please contact Howard Sklaroff, Glenn Todd, or Jon Sedon with questions.
