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SALT WATCH

Commonwealth Court of Pennsylvania Holds That the State's Net Operating Loss Deduction Limitation as Applied is Unconstitutional

Summary

On November 23, 2015, the Commonwealth Court of Pennsylvania issued a decision in *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth of Pennsylvania*, Docket No. 98 F.R. 2012 (Pa. Commw. Ct. 2015). Reversing a contrary Board of Finance and Revenue decision, the Commonwealth Court held that the state's 2007 net operating loss deduction ("NOLD") limitation as applied to the taxpayer violates the Uniformity Clause of the Pennsylvania Constitution. The court granted the taxpayer full use of its net operating loss carryovers and a $3.94 million refund.

Details

Background

Nextel Communications filed its 2007 Pennsylvania corporation income tax return reporting state taxable income before NOLD of $45 million. Nextel Communications had Pennsylvania net operating loss carryforwards totaling $150 million – the use of which would have reduced its taxable income to zero. However, as a result of Pennsylvania's 2007 NOLD limitation, which limits the use of NOLDs to the greater of $3 million or 12.5-percent of taxable income, Nextel Communications utilized only $5.6 million of its available NOL carryovers, and reported and paid a corporation income tax liability of $3.94 million for the year.

Nextel filed petitions with the Board of Appeals and the Board of Finance and Revenue claiming a Uniformity Clause violation – a clause in the Pennsylvania Constitution which requires all taxes be uniform upon the same class of subjects – seeking refund of the tax paid. Because these tribunals do not have jurisdiction to declare a state law unconstitutional or invalid, each tribunal denied Nextel Communications' petition. Nextel Communications appealed to Commonwealth Court.

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Arguments of Nextel Communications and the Commonwealth

At Commonwealth Court, Nextel Communications argued that the 2007 NOLD limitation favors businesses with taxable income of $3 million or less. If one of these smaller taxpayers has available net operating loss carryovers in excess of taxable income, it may reduce its taxable income to zero. However, a taxpayer such as Nextel Communications, with taxable income greater than $3 million and available net operating loss carryovers, would not be able to similarly reduce its taxable income to zero. Nextel contended that the disparate treatment of taxpayers is based solely on the size of the business, and the larger the taxpayer the more disparate the impact – the effect of which is a progressive tax structure.

The Commonwealth contended that, because 98.8 percent of taxpayers were not disadvantaged by the limitation, the statute meets the constitutional test of "rough uniformity." In addition, the Commonwealth argued that: (i) even if the NOLD limitation creates a classification, the classification is rationally related to the legitimate state interest of budgetary planning; (ii) the legislature has the authority to enact legislation that benefits small business, and (iii) the 20-year carryover provision should allow Nextel Communications the benefit of any NOL not used to offset 2007 taxable income due to the $3 million limitation.

The Court's Analysis

The Commonwealth Court held that the 2007 NOLD limitation as applied to Nextel Communications violates the Uniformity Clause. The court reasoned that, while the Uniformity Clause does not require absolute equality and perfect uniformity in taxation, if no legitimate distinction exists between the classes subject to differing tax treatment, and a substantially unequal tax burden is imposed on similarly-situated taxpayers, the tax violates the Uniformity Clause. The court determined the only factor that distinguishes between those who paid no tax as a result of the 2007 NOLD limitation provision and those that paid some, was the amount of taxable income – a classification that cannot withstand scrutiny under the Uniformity Clause.

The court rejected the Commonwealth's arguments regarding the legislature's legitimate interest of budgetary planning, and Nextel Communication's ability to use unused NOLs in later years due to the 20 year carryover period. As per the court, the legislature is not permitted to enact budget-related legislation that violates the state constitution, and a taxpayer should not have to wait 20 years to take the same deduction another taxpayer was able to take currently because of a legislatively-imposed cap.

The Commonwealth Court also held that the only practical remedy for the unequal treatment in this case is a refund to Nextel Communications. Payment of tax by the taxpayers that were not subject to the NOLD limitation was the other option.

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Insights

- Because the court found the 2007 NOLD limitation to be unconstitutional as applied to the taxpayer, as opposed to being facially unconstitutional, the remedy in this case was limited to relief for Nextel Communications. The court did not strike down the NOLD limitation provision as unconstitutional (or address the NOLD limitation applied in other taxable years), because the court felt that statutory revision would not remedy the wrong suffered by Nextel Communications.
- The Commonwealth filed a notice of appeal with the Supreme Court of Pennsylvania on January 20, 2016, seeking review of the Commonwealth Court's decision. Appeals to the Supreme Court of Pennsylvania from the Commonwealth Court are as a matter of right and not subject to the court's discretion.
- Even though the court limited its decision to Nextel and the 2007 NOLD limitation, the NOLD limitation applied in other taxable years or to other large taxpayers operates no differently. Thus, taxpayers affected by the NOLD limitation applied in other taxable years should consider filing protective refund claims preserving their right to a refund under the state's three-year refund limitations period in the event Nextel Communications ultimately prevails.