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Pennsylvania Supreme Court Finds Net Loss Carryover Deduction Cap Violates Uniformity Clause; Severs Fixed Dollar Limitation

On October 18, 2017, the Pennsylvania Supreme Court held that the fixed dollar limitation of Pennsylvania's net loss carryover (NLC) deduction provision, as applied to Nextel Communications in 2007, violated the Uniformity Clause of the Pennsylvania Constitution.¹ In fashioning a remedy, the court severed the flat \$3 million cap from the statute, while retaining the 12.5 percent limitation.

Background

Pennsylvania allows corporate taxpayers to carry forward unused prior year net losses in order to reduce the amount of positive taxable income subject to Pennsylvania corporate net income (CNI) tax in future years.² However, Pennsylvania limits the amount of NLC deduction that taxpayers may use in any given tax year.³ Currently, the statute allows for a deduction of the greater of either: (i) a fixed dollar amount or (ii) a percentage of taxable income. For the 2007 tax year, the year at issue, the net loss deduction was capped at the greater of \$3 million or 12.5 percent of taxable income.⁴

The taxpayer, Nextel Communications of the Mid-Atlantic, does business in multiple states, including Pennsylvania. Nextel carried over net losses of approximately \$150 million from previous tax years into the 2007 tax year. In 2007, Nextel earned approximately \$45 million in taxable income. However, due to the NLC deduction limitation, the taxpayer was only able to use approximately \$5.6 million of its available NLCs to offset its 2007 taxable income. Therefore, instead of eliminating its taxable income, Nextel paid CNI tax of approximately \$4 million.

¹ *Nextel Communications of the Mid-Atlantic, Inc. v. Pennsylvania*, Pennsylvania Supreme Court, No. 6 EAP 2016 (Oct. 18, 2017).

² 72 PA. STAT. § 7401(3)4.

³ 72 PA. STAT. § 7401(3)4.(c)(2)(B).

⁴ 72 PA. STAT. § 7401(3)4.(c)(1)(A)(II). Although the NLC deduction cap has changed over time, it remains in place for tax years after 2007. For the 2010 to 2013 tax years, the applicable limitation was set at the greater of 20 percent of taxable income or \$3 million. For the 2014 tax year, the limitation was set at the greater of 25 percent of taxable income or \$4 million. For tax years after 2014, the limitation is set at the greater of 30 percent of taxable income or \$5 million. 72 PA. STAT. § 7401(3)4.(c)(1)(A)(IV)-(VI).

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Contact details

Matthew Melinson

Philadelphia

T 215.376.6050

E matthew.melinson@us.gt.com

Vito Cosmo

Philadelphia

T 215.701.8839

E vito.cosmo@us.gt.com

Gregory Rineberg

Philadelphia

T 215.701.8851

E gregory.rineberg@us.gt.com

Patrick Skeehan

Philadelphia

T 215.814.1743

E patrick.skeehan@us.gt.com

Katherine Piazza

Philadelphia

T 215.656.3053

E katie.piazza@us.gt.com

Jamie C. Yesnowitz

Washington, DC

T 202.521.1504

E jamie.yesnowitz@us.gt.com

www.GrantThornton.com/SALT

Procedural History

The taxpayer petitioned for a full refund of its 2007 CNI tax, claiming that the NLC deduction limitation of the greater of 12.5 percent or \$3 million was unconstitutional on an “as applied” basis.⁵ The Pennsylvania Department of Revenue Board of Appeals (BOA) determined that it lacked the authority to rule on Nextel’s constitutional challenge. Instead, it concluded that Nextel properly applied the NLC deduction provision as written when filing its 2007 Pennsylvania corporate tax report, and denied the taxpayer’s refund request. The taxpayer appealed the denial to the Commonwealth’s administrative appeal tribunal, the Board of Finance and Revenue, which affirmed the BOA decision, holding that it lacked the authority to consider Nextel’s constitutional argument. An appeal to the Pennsylvania Commonwealth Court followed.

Before the Commonwealth Court, Nextel argued that the NLC deduction limitation effectively resulted in the disparate treatment of taxpayers, based solely on the size of their business as determined by taxable income. The larger the taxpayer and the greater the income, the more disparate the impact. For example, a taxpayer in a positive NLC position in 2007 with \$3 million in taxable income in the 2007 tax year would have paid no CNI tax under the NLC deduction provision. In contrast, a similarly-situated taxpayer with \$3.1 million in taxable income would have paid approximately \$10,000 in CNI tax. Thus Nextel contended that the NLC deduction limitation created an “unconstitutional progressive tax structure,” where smaller taxpayers pay a lower effective tax rate than larger similarly-situated taxpayers.

On November 23, 2015, the Commonwealth Court ruled that the statutory NLC deduction limitation violated the Uniformity Clause as applied to the taxpayer in the 2007 tax year.⁶ The Commonwealth Court stated that its holding was not a *per se* rejection of the NLC cap, but rather applied solely to Nextel’s facts. Although the Commonwealth Court’s decision only addressed the \$3 million limitation, the court granted Nextel a full refund of all of the CNI tax paid in 2007, which effectively eliminated the 12.5 percent cap as applied to Nextel.⁷ The Pennsylvania Department of Revenue appealed the decision to the Pennsylvania Supreme Court.

In a concurring and dissenting opinion, two judges disagreed with the majority on the extent of the remedy advanced by the majority. The dissenting judges would have severed the flat cap deduction for 2007 and all other relevant years, leaving the percentage limitation in place. The dissent argued that severing the dollar cap provision carried out the legislative intent to place a limitation on NLC deductions for each tax year.

Pennsylvania Supreme Court Upholds Uniformity Clause Violation

The Uniformity Clause provides that “[a]ll taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied

⁵ An “as applied” challenge to a statute is limited to a particular application of the statute to certain persons. In contrast, a “facial” challenge alleges a statute, or one of its component parts, is unconstitutional as written.

⁶ *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth*, Pennsylvania Commonwealth Court, 129 A.3d 1 (Pa. Commw. Ct. 2015).

⁷ For an in-depth look at this decision, see [GT SALT Alert: Pennsylvania Court Holds Net Loss Carryover Deduction Cap Unconstitutional in Violation of Uniformity Clause.](#)

and collected under general laws.”⁸ Accordingly, it is unconstitutional for Pennsylvania to impose a tax with varying rates on the same class of taxpayers. The Department asserted that the Commonwealth Court, in incorrectly holding that the NLC deduction provision violated uniformity, erroneously measured uniformity based on a taxpayer’s effective corporate tax rate. Citing precedential case law, the Department asserted that where a uniform tax rate is applied to the same tax base – which for a corporation is considered to be its net taxable income – there is no Uniformity Clause violation.⁹ The Department noted that corporations are created for the purpose of producing profits, and deductions from corporate income, or costs associated with producing that income, are applied first to establish the tax base before any uniformity analysis is conducted.

Alternatively, the Department argued that even if the \$3 million cap implicated uniformity, it nevertheless is constitutional because the Uniformity Clause requires only substantial, and not perfect, uniformity. The Department noted that only 234 out of 19,537 corporate taxpayers filing Pennsylvania corporate tax reports in 2007 – 1.2 percent of all taxpayers – were unable to reduce their taxable income to \$0 since their net income was above \$3 million. Because those corporations were still able to take a net loss deduction, the Department claimed, the NLC deduction provision is “as nearly uniform as practicable,” and thus satisfies the constitutional requirement of “rough uniformity.”¹⁰

In response, Nextel asserted that the NLC provision allows corporate taxpayers with net loss carryovers in excess of 2007 income to deduct losses without limitation if they have \$3 million or less in taxable income, while simultaneously limiting the amount of loss that taxpayers with over \$3 million in taxable income may deduct, obligating those corporations to pay income tax. As a result, Nextel argued, corporate taxpayers are taxed on different tax bases solely on the basis of taxable income. Additionally, Nextel argued that the NLC statute operates in a manner that causes a disparity in the effective tax rate paid by various groups of taxpayers subject to the tax. Thus the difference in an effective tax rate of 8.74 percent – the rate paid by Nextel and 26 other corporations – and zero percent paid by 19,303 other corporations in the 2007 tax year does not satisfy “rough uniformity” because it exceeds the “immaterial deviation” permitted under Pennsylvania case law.

In its majority opinion, the court first explained that the standard to be used in determining whether a tax law violates the Uniformity Clause is “whether the classification is based upon some legitimate distinction between the classes that provides a non-arbitrary, reasonable, and just basis for the disparate treatment.”¹¹ The Pennsylvania Supreme Court has consistently held that classifications based solely upon the quantity or value of the property being taxed are arbitrary and unreasonable and, thus, forbidden under the Uniformity Clause.¹²

⁸ PA. CONST. art. VIII, § 1.

⁹ See *Turco Paint v. Kalodner*, 184 A. 37 (Pa. 1936); *Commonwealth v. Warner Brothers Theaters*, 27 A.2d 62 (Pa. 1942).

¹⁰ *Clifton v. Allegheny County*, 969 A.2d 1197 (Pa. 2009).

¹¹ *Mount Airy #1 LLC v. Pennsylvania Department of Revenue*, 154 A.3d 268 (Pa. 2016).

¹² The court referenced several landmark decisions in which it struck down Pennsylvania taxes whose operation resulted in non-uniform tax rates applied to the same class of taxpayers. See *In re*

In the tradition of its uniformity jurisprudence, the court highlighted that it has found unconstitutional those tax laws that are applicable to an entire class of taxpayers, yet wholly exempt some of those taxpayers from paying the tax. Such statutes are generally structured so that some taxpayers whose total income or value of their property falls below the maximum value of the exemption are required to pay no taxes at all, while other taxpayers with income or property value in excess of the exempted amount are required to pay taxes on the value of the non-exempted income or property, thus shouldering the entire tax burden. The court stated this type of tax law contravenes the Uniformity Clause's paramount tenet that the tax burden should be borne equally by all those who are obligated to pay a tax.

Applying the above principles to Nextel's case, the court concluded that the NLC fixed dollar cap violated the Uniformity Clause because it effectively created two classes of taxpayers by allowing certain taxpayers to take a flat \$3 million NLC deduction against their taxable income and requiring others to shoulder the entire CNI tax burden for that tax year. The court held that because the NLC created disparate tax obligations between two classes of similarly situated taxpayers based solely on each class member's taxable income, "it is, as the Commonwealth Court determined, an arbitrary and unreasonable classification which is prohibited by the Uniformity Clause." Accordingly, the court affirmed the Commonwealth Court's decision that the NLC provision is unconstitutional as applied to Nextel.

Remedy

In fashioning an appropriate remedy, the court undertook a severability analysis to determine whether the \$3 million flat deduction could be severed from the remainder of the NLC statute. The court determined it had three available options to resolve the constitutional issue: (i) sever the flat \$3 million deduction from the remainder of the NLC statute; (ii) sever both the \$3 million and 12.5 percent deduction caps, allowing corporations to claim an unlimited net loss (the remedy chosen by the Commonwealth Court majority); or (iii) strike down the entire NLC provision, thus disallowing any net loss carryovers.

In reversing the Commonwealth Court, the court concluded that the \$3 million flat deduction could be severed from the remainder of the statute, while still enabling the statute to operate as the legislature intended. Retaining the percentage limitation, the court reasoned, would be most consistent with the legislature's intent to balance the "twin policy objectives" of encouraging investment and maintaining Pennsylvania's financial health. Further, each corporation would be entitled to avail itself of a NLC deduction, but such deduction would be equally available to all corporations during that year, no matter what their taxable income. The court explained that, under this remedy, Nextel would not

Cope's Estate, 43 A. 79 (Pa. 1899) (invalidating an inheritance tax provision that exempted estates worth \$5,000 or less from paying tax); *Kelley v. Kalodner*, 181 A. 598 (Pa. 1935) (holding personal income tax providing for a flat exemption from taxation for single taxpayers with taxable income below \$1,000, and below \$1,500 for married taxpayers violated uniformity); *Mt. Airy*, 154 A.3d 268 (declaring portions of the local tax assessment on casino revenue in the Gaming Act violative of uniformity).

be entitled to have its 2007 tax assessment forgiven because it is subject to the same tax liability for the 2007 tax year as previously assessed by the Department.

Concurring Opinion

Although unanimous in holding that the NLC deduction limitation is unconstitutional, the court's members differed on how to reconcile the "as applied" challenge brought by Nextel. The majority observed that the distinction between an as-applied and a facial constitutional challenge was essentially meaningless in this case given the prospective impact of the court's decision. In a concurring opinion, three justices wrote to clarify that in their view, the majority's holding effectively declared the NLC provision unconstitutional on its face.

The concurrence emphasized that the court should not be constrained in its holding by the manner in which a litigant has characterized its claim. Where the majority attached no real significance to Nextel's classification of its claim as an as-applied challenge, the concurrence sought to clarify any confusion as to whether the majority's holding was limited, based on Nextel's designation. While Nextel presented an as-applied challenge, the concurring justices noted that the challenge necessarily implicated the facial validity of the NLC.

Commentary

The *Nextel* decision was widely awaited by taxpayers and practitioners alike, as the result potentially impacts thousands of Pennsylvania corporate taxpayers utilizing Pennsylvania's NLC deduction. In 2007, 98.8 percent of corporate taxpayers benefitted from the fixed dollar limitation and reduced their taxable income to zero, while the remaining 1.2 percent of taxpayers paid tax on account of their taxable income exceeding the \$3 million limitation.¹³ Doing away with the fixed dollar limitation would generate additional revenue of approximately \$52.6 million in the 2017-18 fiscal year.¹⁴

The decision marks the latest in a series of uniformity cases taken up by the Pennsylvania Supreme Court, which has applied a historically strict interpretation the state's Uniformity Clause.¹⁵ Most recently, the court ruled that the Uniformity Clause prohibited a school district from selectively appealing only the assessment of commercial properties while choosing not to appeal the assessments of residential homes, because the program represented a policy based on classification by property type.¹⁶ Similarly, the court held that the local share assessment imposed under the state's Gaming Act violated the Uniformity Clause because it imposed grossly unequal local share assessments upon

¹³ *Nextel*, No. 6 EAP 2016 (Pa. Oct. 18, 2017). The court cited to Departmental data, showing that 19,537 corporations had NLC deductions that equaled or exceeded their taxable income in 2007, while 234 corporations paid tax because their taxable income apportioned to Pennsylvania exceeded the \$3 million deduction.

¹⁴ Fiscal Note, H.B. 542, Pa. House Committee on Appropriations.

¹⁵ For further discussion of Pennsylvania's Uniformity Clause, see Vito A. Cosmo, Jr., Matthew D. Melinson and Patrick K. Skeeahan, *The Power behind Pennsylvania's Uniformity Clause*, PA. CPA JOURNAL, Fall 2015.

¹⁶ *Valley Forge Towers Apartments N, LP v. Upper Merion School District*, 163 A.3d 962 (Pa. July 5, 2017). For a discussion of this case, see [GT SALT Alert: Pennsylvania Supreme Court Finds Selective Appeals of Commercial Property Assessments by School District Unconstitutional](#).

similarly situated licensed casinos located outside of Philadelphia based on gross terminal revenue.¹⁷

Although the majority opinion addressed an as-applied constitutional challenge and apparently limited the reach of its decision to Nextel for the 2007 tax year, the court did not address whether the removal of the fixed dollar cap applies to all taxpayers, particularly during open tax years. On November 16, 2017, the Department appeared to give the removal of the fixed dollar cap prospective effect through the issuance of guidance in the form of a bulletin. The bulletin advises taxpayers that the flat-dollar cap on the NLC, currently at \$5 million, will not be available for taxable years beginning in 2017 and thereafter.¹⁸ Additionally, the NLC limitation of 30 percent of taxable income will continue to be effective for taxable years beginning in 2017. Furthermore, in a welcome development that will be appreciated by taxpayers and practitioners alike, the Department indicated that it will be revising its forms and procedures to implement the decision of the court prospectively, rather than on a retroactive basis.

It should be noted that on October 30, two weeks after the *Nextel* decision, the Pennsylvania legislature, as part of enacted budget legislation, permanently removed the fixed dollar cap from Pennsylvania's NLC statute for tax years beginning after December 31, 2017, increasing the percentage limitation to 35 percent of taxable income for tax years beginning after December 31, 2017, and 40 percent of taxable income for tax years after December 31, 2018.¹⁹

While the budget legislation eliminates the fixed dollar cap and forecloses any potential challenges to the NLC deduction limitation for tax years beginning after 2017, the *Nextel* decision still impacts taxpayers with pending tax appeals before the Pennsylvania Board of Appeals, the Pennsylvania Board of Finance and Revenue and in court. It should also be noted that the *Nextel* decision is not yet final. Nextel filed an application for reargument with the Pennsylvania Supreme Court on November 1, asking the court to reconsider the remedy provided. Nextel requested that its case be consolidated with a similar case on appeal from the Commonwealth Court, *R.B. Alden Corporation v. Pennsylvania*.²⁰ In that case, the Commonwealth Court struck down the NLC dollar cap as applied to the taxpayer for the 2006 tax year. However, the 2006 NLC statute contained only a flat-dollar cap, which allowed the taxpayer to take an unlimited NLC deduction for that year. Thus the remedy in *Nextel* creates an irreconcilable conflict with the remedy granted in *R.B. Alden*, meaning that certain taxpayers would not be subject to any cap on net losses.

Given the uncertainty surrounding the *Nextel* decision as it currently stands, taxpayers should consider the potential financial statement impact of the decision, including an evaluation of their current Pennsylvania NLC. For those with refunds pending, taxpayers

¹⁷ *Mt. Airy*, 154 A.3d 268 (Pa. 2016).

¹⁸ Pennsylvania Department of Revenue, *Corporation Tax Bulletin 2017-01* (Issued: November 16, 2017).

¹⁹ H.B. 542, § 27, adding 72 PA. STAT. § 7401(3)4.(c)(1)(A)(VII)-(VIII).

²⁰ 142 A.3d 169 (Pa. Commw. Ct. 2016), *exceptions denied*, 169 A.3d 727 (Pa. Commw. Ct. Sept. 12, 2017).

should consider the merits of proceeding with or withdrawing such claims based on the particular facts and circumstances of their case.

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