IN THE SUPREME COURT OF PENNSYLVANIA

No. 6 EAP 2016

NEXTEL COMMUNICATIONS OF THE MID-ATLANTIC, INC.,

Appellee

v.

COMMONWEALTH OF PENNSYLVANIA,

Appellant.

Brief for *Amicus Curiae* Council On State Taxation

Appeal from the Orders of the Commonwealth Court of Pennsylvania entered on November 23, 2015 and December 30, 3015 at No. 98 F.R. 2012, reversing the Order of the Board of Finance and Revenue dated January 24, 2012, Docket Number 1107916

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INTRODUCTION

Pennsylvania's law which caps the net operating loss deduction ("NOL deduction") for taxpayers with over $3 million of Pennsylvania income but does not limit the NOL deduction for taxpayers with $3 million or less of Pennsylvania income is unconstitutional under the Uniformity Clause of Pennsylvania's Constitution, and the only available remedy is to provide taxpayers subject to the cap with the ability to take the full NOL deduction.

In the 2007 tax year, Appellee, Nextel Communications of the Mid-Atlantic, Inc. ("Nextel"), and other taxpayers had their NOL deductions capped simply because they had income over $3 million, while tens of thousands of other taxpayers were not subject to a similar cap because their income was $3 million or less. Stipulation of Facts Ex. D. As such, the NOL deduction cap created classes of taxpayers based solely on the amount of their Pennsylvania income. Such a classification runs afoul to the Uniformity Clause of the Pennsylvania Constitution which states "[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 and collected under general laws." Pa. Const. Art. VIII, § 1.

As the Commonwealth Court correctly stated, the NOL deduction cap is "unjust, arbitrary, and illegal." *Nextel Communication of the Mid-Atlantic, Inc. v.*

Commw., 129 A.3d 1 (Pa. Commw. 2015) ("*Nextel*").[1] This Court should affirm the Commonwealth Court's decision and allow Nextel to take its full NOL deduction.

INTEREST OF *AMICUS CURIAE*

Council on State Taxation ("COST") is a nonprofit trade association based in Washington, D.C. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce. Today COST has grown to an independent membership of nearly 600 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST members employ a substantial number of citizens in Pennsylvania, own extensive property in Pennsylvania and conduct substantial business in Pennsylvania.

Since 2000, COST has appeared as *amicus curiae* before this Court in cases involving the equitable treatment of multijurisdictional taxpayers. *Philadelphia Eagles Football Club, Inc. v. City of Philadelphia*, 573 Pa. 189 (2003); and *Northwood Construction Co. v. Township of Upper Moreland*, 579 Pa. 463 (2004).

COST has a strong interest in ensuring multijurisdictional taxpayers are treated equitably. Its membership is very concerned about the ramifications of any

[1] The opinion below is found in the Reproduced Record at pages 232 – 258.

reversal of the Commonwealth Court's decision which properly struck down a taxing system that created classes of taxpayers. Because the State seeks to improperly cap the NOL deduction based on a taxpayer's income, COST has a keen interest in providing this Court with reasons why it should uphold the lower court's decision.

STATEMENT OF THE CASE

COST adopts the Statement of the Case set forth by Petitioner in its Petition for Review.

ARGUMENT

I. THE NET OPERATING LOSS DEDUCTION CAP VIOLATES THE UNIFORMITY CLAUSE OF THE PENNSYLVANIA CONSTITUTION.

Like all other states imposing a corporate income tax, Pennsylvania provides a NOL deduction that allows a taxpayer to offset current year income by deducting losses incurred in prior years. The purpose of a NOL deduction is to allow taxpayers to balance profitable years with unprofitable years and not penalize taxpayers because their income (or the economy) is cyclical or because they incur substantial expenses from expanding or developing new lines of business. While Pennsylvania is not constitutionally required to provide a NOL deduction, if it chooses to provide one, it must do so in a manner that satisfies the Uniformity Clause of the Pennsylvania Constitution which requires that, "All taxes shall be

uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax...." *See Garofolo, Curtiss, Lambert & MacLean, Inc. v. Dep't of Rev.*, 648 A.2d 1329 (Pa. Commw. 1994) (holding that legislation suspending the net operating loss deduction did not violate the Uniformity Clause), *appeal dismissed*, 659 A.2d 561 (Pa. 1994); Pa. Const. Art. VIII, § 1.

For the 2007 tax year, Pennsylvania imposed a cap on its NOL deduction limiting the deduction to the greater of 12.5 percent of taxable income or $3 million of the usable loss carryover amount. The cap does not affect taxpayers with taxable income under $3 million because those taxpayers are permitted to take a full NOL deduction to entirely offset their income. As a result, the cap violates the Uniformity Clause because it creates an impermissible difference in treatment between two classes of taxpayers based solely on the income of the taxpayer.

To sustain a constitutional challenge relating to the Uniformity Clause, a taxpayer bears the burden of satisfying two tests: 1) the challenged tax provision results in some form of classification; and 2) the classification is "unreasonable and not rationally related to any legitimate state purpose." *Nextel* at 8 *citing Clifton v. Allegheny County*, 969 A.2d 1197, 1211 (Pa. 2009).

There is no dispute that the first test is satisfied. Pennsylvania's NOL deduction cap creates two distinct classes: one class of taxpayers with taxable income of $3 million or less and another class of taxpayers with taxable income of

more than $3 million. As the Commonwealth Court stated, "The only factor that distinguishes between these two classes of taxpayers (those who paid no [corporate net income] tax as a result of the [NOL] deduction provision and those that paid some [corporate net income] tax as a result of the [NOL] deduction provisions) is the amount of taxable income in the 2007 Tax Year." *Nextel* at 9.

For the 2007 tax year, 19,537 taxpayers subject to the State's corporate net income tax had NOL deductions that exceeded their taxable income. *See Nextel* at 4. Of these taxpayers, 19,303, or 98.8 percent, had taxable incomes at or below the $3 million threshold. *Id.* Those taxpayers, therefore, paid no corporate net income tax in that year. *Id.* Conversely, 234 taxpayers (1.2 percent) did have taxable incomes above $3 million and were impacted by the cap which required them to pay some level of corporate net income tax even though their NOL deductions otherwise exceeded their taxable income that year. *Id.* Of this latter group, 26 taxpayers had taxable income above $24 million, and as a result of the Commonwealth's NOL deduction cap, those taxpayers could only reduce their taxable income by 12.5 percent. *Id.*

Turning to the second test, the Commonwealth Court correctly determined the classifications were unreasonable and not rationally related to any legitimate State purpose based on the long-standing precedent established by *In re Cope's Estate,* 43 A. 79 (Pa. 1899). *Nextel* at 9-10. In *In re Cope's Estate*, the

Pennsylvania Supreme Court reviewed a Uniformity Clause challenge to the Commonwealth's inheritance tax law. At the time, the inheritance tax law exempted $5,000 worth of assets from the estate tax calculation. The effective impact of this provision was to exempt 90 to 95 percent of the estates from the estate tax – very similar to the proportion of the "favored" taxpayers allowed to use 100 percent of their NOL deduction, effectively exempting them from corporate net income tax, in this case. *In re Cope's Estate*, 43 A. 82. The Pennsylvania Supreme Court held the estate tax provision violated the Uniformity Clause because the classification exempted most, but not all, taxpayers from the estate tax. Such classification was "unjust, arbitrary and illegal." *In re Cope's Estate* at 81.

The asset exemption threshold in *In re Cope's Estate* works the same way as the NOL deduction cap in this case. The NOL deduction cap creates a distinction between two classes of similarly situated taxpayers based solely on the levels of taxable income in violation of the Commonwealth's Uniformity Clause. As the Commonwealth Court concluded below, "*Cope's Estate* has stood the test of time, perhaps because of its simple adherence to a straightforward reading of the Uniformity Clause. . . . The Commonwealth offers no reasoned or persuasive argument to eschew this precedent in this case." *Nextel* at 10-11.

The Commonwealth argues that since the nominal tax rate is the same for all taxpayers under the corporate net income tax (9.99 percent), the Uniformity Clause

is not violated in this case. However, the Uniformity Clause's protections apply to the base of taxation as well as the rate of taxation. For corporate net income tax purposes, the base of taxation equals gross income less deductions (including the NOL deduction).[2] 72 P.S. § 7401(3)1.(a). As the NOL deduction varies by the amount of income so necessarily does the resulting base of taxation.

The Commonwealth's courts have long held that a classification of the tax base, made solely upon the amount of net income in the tax base, is unconstitutional even if the nominal tax rates are the same. In the 1935 case *Kelley v. Kalodner*, 181 A. 598, 599-600 (Pa. 1935), the Pennsylvania Supreme Court held that exemptions from the tax base for lower income taxpayers violated the Uniformity Clause even though tax rates were otherwise held constant within the tax brackets.[3] Similarly, in the 1971 case *Amidon v. Kane*, 279 A.2d 53 (Pa. 1971), the Pennsylvania Supreme Court held a newly-reenacted personal income tax with a flat **nominal** rate of 3.5 percent nonetheless violated the Uniformity Clause because of the progressive **effective** tax rates that resulted from various federal deductions and personal exemptions utilized in computing Pennsylvania taxable income. This case is no different – although the nominal tax rate remains the same, the effective tax rate differs dramatically for taxpayers with income of $3

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[2] This base is commonly referred to as "taxable income." *See also* 26 U.S. Code § 63.

[3] It should be noted that the Court went on to conclude that varying the tax rates upon "'pretended'" classifications was separately and distinctly repugnant to the Uniformity Clause. *Id.* at 602. This variation of the issue is not before the Court today.

million or less (who have a zero percent effective tax rate) and taxpayers with income greater than $3 million.

Finally, the Commonwealth makes several arguments that fail to justify its position that the NOL deduction cap was constitutional. For instance, the Commonwealth asserts that the NOL deduction cap satisfies the constitutional test of "rough" uniformity. *See* Appellant Br. at 23-24. Those arguments, however, miss the central point: the Commonwealth cannot create two separate classes of taxpayers based solely on the taxpayer's income and still satisfy the requirements of the Commonwealth's Uniformity Clause.

II. THE ONLY APPROPRIATE REMEDY IN THIS CASE TO CURE A VIOLATION OF PENNSYLVANIA'S UNIFORMITY CLAUSE IS TO ALLOW A FULL NET OPERATING LOSS DEDUCTION.

Upon finding that the NOL deduction cap violates the Uniformity Clause, this Court is required to craft a remedy which would treat both classes of taxpayers similarly. Insomuch as the Department of Revenue cannot assess the taxpayers with income of $3 million or less (*e.g.* by limiting those taxpayers' NOL deduction to 12.5% of their income) due to the statute of limitations, the only available remedy is to eliminate the cap for taxpayers with income in excess of $3 million. The Department of Revenue has three years from the date a taxpayer filed its return to assess that taxpayer. *See* 72 P.S. § 7407(3)(a). Given it is now 2016 and

the tax year in dispute is 2007,[4] the three-year statute of limitations period has run. Thus, the Department is precluded from assessing additional tax against those taxpayers with income of $3 million or less to cure the favored treatment they were given by being able to take their full NOL deductions. The only remedy this Court may provide is to order a refund of the taxes Nextel paid due to it being subject to the NOL deduction cap because the Department is barred from assessing those taxpayers not subject to the NOL deduction cap. It is simply too late for this Court to rule that the 19,000 taxpayers below the $3 million threshold now should be subject to the NOL deduction cap. The violation of Pennsylvania's Uniformity Clause caused by the NOL deduction cap can only be fixed by this Court granting Nextel and other similarly situated taxpayers the ability to claim a full NOL deduction for 2007 tax year. Those taxpayers should be allowed to take the NOL deduction in the same manner as those other taxpayers below the $3 million income threshold.

As noted by the U.S. Supreme Court in addressing a bank being unfairly taxed in violation of the Equal Protection Clause, "it is well settled that a taxpayer who has been subjected to discriminatory taxation through the favoring of others in

[4] It is approximately eight years after taxpayers filed their 2007 returns in 2008 and five years past the expiration of the three-year statute of limitations. Thus, the Department of Revenue would be unable to assess the over 19,000 taxpayers that were allowed to take a net loss deduction in excess of 12.5% of their income to address the restriction on corporations with over $3 million in income from taking a full deduction. *See* 72 Pa. 7401(3)4.(c)(1)(A)(II).

violation of federal law cannot be required himself to assume the burden of seeking an increase of the taxes which the others should have paid." *Iowa-Des Moines Nat'l Bank v. Bennet*, 284 U.S. 239, 247 (1931). This Court has held "the Uniformity Clause of the Constitution of Pennsylvania and the Equal Protection Clause of the Constitution of the United States stand *in pari materia*." *Leventhal v. City of Philadelphia,* 542 A.2d 1328, 1331 (Pa. 1988), *see also Clifton v. Allegheny County*, 969 A.2d 1197, n.20 (Pa. 2009). Thus, cases interpreting remedies under the Equal Protection Clause are instructive to remedy violations under Pennsylvania's Uniformity Clause. There is no reason why this Court should not follow its prior holding in *Commonwealth v. Molycorp, Inc.*, 392 A.2d 321 (Pa. 1978), which affirmatively cited *Iowa-Des Moines Nat'l Bank.* The Court in *Molycorp* held the Commonwealth could not subject the taxpayer to an additional corporate income tax that was discriminatory. *Id.* at 324.

The Commonwealth Court correctly held the remedy for the discriminatory tax Nextel paid is to allow Nextel to obtain a refund for the tax it paid in 2007, reducing its tax liability for that tax year to zero. The Commonwealth, however, suggests this Court could just sever the dollar cap on the NOL deduction and leave the percentage cap in place – which provides no remedy at all. As stated above, the Department is precluded from assessing the taxpayers not subject to the NOL deduction cap. *See* Appellant Br. at 27-31. Prospectively, the General Assembly

can cure this constitutional infirmity. However, that is something for the General Assembly to decide after fully considering all constitutional restrictions and tax policy issues. Although budgetary issues are important, the Commonwealth's budget should not be used as an excuse to deny relief to taxpayers that were subject to a tax that violates Pennsylvania's Uniformity Clause. Pursuant to the Uniformity Clause, all taxpayers are required to be treated equally. "[I]t is hornbook law that 'equity suffers no wrong without a remedy.'" *Sprague v. Nelson, 1924 Pa. Dist. & Cnty.*, Dec. LEXIS 427 (Pa. C.P. 1924). Allowing Nextel to use its NOL deduction in the same fashion as the over 19,000 taxpayers below the $3 million threshold is the only way to put it on equal standing with those other taxpayers.

III. PENNSYLVANIA'S NET OPERATING LOSS DEDUCTION CAP REFLECTS BAD TAX POLICY.

Pennsylvania's NOL deduction cap results in a non-uniform application of taxes that reflects bad tax policy, which the Commonwealth's Uniformity Clause prohibits. Pennsylvania is a lone outlier among the states with its discriminatory NOL deduction cap and that statutory cap makes Pennsylvania uncompetitive.

Every state which imposes a corporate income tax provides a NOL deduction. *See, e.g.*, Ala. Admin. Code R.. 810-3-35.1-.02. "When businesses suffer losses in a calendar year, well-structured corporate tax codes allow them to deduct those losses against previous or future tax returns. . . . NOL carryforwards

and carrybacks help those businesses to 'smooth' their income, so that the tax code is more neutral with respect to time." Scott Drenkard & Richard Borean, *Corporate Net Operating Loss Carryforward and Carryback Provisions by State*, Tax Foundation Blog, *available at* http://taxfoundation.org/ blog/corporate-net-operating-loss-carryforward-and-carryback-provisions-state. Pennsylvania, however, currently is the only state which imposes a cap on certain taxpayers' NOL deductions based on the taxpayer's taxable income. That differential treatment undermines the "smoothing" effects of NOL deductions for those taxpayers that are subject to the cap, making Pennsylvania an outlier and an unattractive place for business.

Pennsylvania penalizes businesses with taxable income over $3 million by limiting their NOL deduction. Forty-four states impose a corporate income tax. Notably, all of those states (and the federal government) provide some sort of NOL deduction. 26 U.S. Code § 172(b)(1)(A)(ii). Yet during 2007, the period at issue in this case, only Pennsylvania capped the deductibility of NOLs.[5]

States generally do not cap NOL deductions because it is bad tax policy. Economies can fluctuate widely year-to-year resulting in corporate losses. Similarly, businesses can make major investments in certain years resulting in

[5] New Hampshire, the only other state with an analogous NOL limitation capped the carryover, not the deduction. N.H. Rev. Stat. Ann. § 77–A:4, XIII provides "On or after July 1, 2005, the amount of net operating loss generated in a tax year that may be carried forward may not exceed $1,000,000."

corporate losses when expenses exceed taxable income. "NOL relief can help companies in a broad cross-section of industries weather the current economic conditions." *See* Issue Brief, *Net Operating Loss Needed for Companies of All Sizes*, IPC, *available at* http://www.ipc.org/3.0_Industry/3.3_Gov_Relations/NOL-Issue-Brief.pdf. The NOL deduction allows taxpayers to properly offset the current and future years' income with unused losses from prior years. The NOL deduction provides not only a benefit for taxpayers, but also benefits the communities where they conduct business and make those investments. NOL deduction caps are particularly egregious when the cap is only imposed on taxpayers with the largest taxable income. As the Commonwealth Court points out, "Taxpayers with $3 million or less in taxable income in 2007 [in Pennsylvania] could offset up to 100% of their taxable income. . . because the statute allows a *greater of* 12.5% of taxable income or $3 million deduction. . . . [T]he higher the taxable income of the taxpayer, the lower the percentage of taxable income the taxpayer could offset through the NLC deduction." *Nextel* at 9. Fortune 500 companies will tend to have greater taxable income than smaller companies, and they also tend to employ a greater number of employees than smaller companies. By limiting the NOL deduction only for taxpayers with large taxable income, those taxpayers with more income are discouraged from locating or expanding their operations in the Commonwealth. In the long run, this will

reduce jobs and harm the Commonwealth's economy as well as reduce the state's overall tax revenues. That outcome helps explain why no other state imposes such a limitation on its NOL deduction: it's bad tax policy. The Uniformity Clause functions to protect taxpayers against discriminatory tax policies and those protections ensure that the deleterious economic effects of such bad tax policies are held in check.

CONCLUSION

Amicus respectfully requests this Court hold that the NOL deduction cap, which restricted Nextel from utilizing its full NOL deduction, violates the Commonwealth's Uniformity Clause. *Amicus* further urges this Court to hold that the only available remedy is to allow Nextel to fully utilize its NOL deduction for the 2007 tax year and that the Department should grant Nextel's refund.

DATED: June 24, 2016

Respectfully submitted,

By: /s/ David J. Shipley

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CERTIFICATE OF SERVICE

I, David J. Shipley, Esq., hereby certify that on June 24, 2016, I caused to be served the foregoing Brief for *Amicus Curiae* by first-class mail, addressed to the following:

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