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Pennsylvania

\$3.9M Refund to Sprint Subsidiary Signals Potential Relief for Corporate Taxpayers

Through a recent decision involving a Sprint Nextel subsidiary, Pennsylvania's Commonwealth Court has joined a years-long call for legislative overhaul of the state's corporate tax structure that curtails net operating loss deductions, practitioners told Bloomberg BNA.

In a 5-2 decision on Nov. 23, an *en banc* panel of the court held that a statutory limitation on Pennsylvania's net loss carryover (NLC) deduction, as applied to a former Sprint subsidiary, violated the state's uniformity clause (*Nextel Commc'ns of the Mid-Atlantic, Inc. v. Commonwealth*) (227 DTR K-5, 11/25/15).

For the year at issue, the NLC deduction was limited to the greater of 12.5 percent of taxable income or \$3 million.

The majority opinion, written by Judge P. Kevin Brobson, issued a missive to the state's General Assembly, advising that they "should be guided accordingly" if the decision raises questions regarding the validity of the NLC deduction provision. Practitioners anticipate a legislative response and say it is much-needed. However, such forecasts may be complicated by Pennsylvania's volatile political climate, which has brewed a six-month budget impasse.

"The State has repeatedly heard from the business community over the years about how regressive the cap is and how it harms businesses," said Scott Austin, a principal in the Philadelphia office of PricewaterhouseCoopers LLP. "So they certainly shouldn't be surprised that there has been controversy over it, and maybe as a part of these budget negotiations, this case will get the repeal of the cap back on the table."

Far-Reaching Opinion? While the majority narrowed the Sprint subsidiary's remedy to a tax refund of \$3.9 million, in a companion opinion partially concurring and partially dissenting, President Judge Dan Pellegrini called for the court to strike the statutory \$3 million limitation.

"The dispute in the case, among the Commonwealth Court members, is not over whether there is a problem with the structure of the tax, it's over how we would fix it," said James R. Malone Jr., a Philadelphia-based principal with Post & Schell P.C. who serves as co-chair of the Tax Controversy Practice Group.

The majority qualified the opinion as confined to the facts under review, but noted that "we fully recognize that our decision in this case could be far-reaching."

Practitioners told Bloomberg BNA that the impact could extend beyond state lines.

"The Court does know that, now that the cat is out of the bag, anybody can raise a uniformity challenge, and they've got a road map to follow," said Frank J. Tobias, a tax principal with Reinsel Kuntz Leshner LLP, a Pennsylvania accounting and business consulting firm.

Tobias, who formerly served as director for the Pennsylvania Department of Revenue's Bureau of Corporation Taxes, said the opinion could have a broad reach implicating multiple tax years and taxpayers, where "if the facts are that close, then everybody behind Nextel that is similarly situated is entitled to that same type of relief."

Discriminatory Classifications. Pennsylvania's Tax Reform Code of 1971 (Tax Reform Code), under 72 P.S. Section 7401, permits taxpayers to carry unused net losses from prior years to reduce corporate net income (CNI) tax liability in subsequent years.

However, the Tax Reform Code subjects the carryover to a defined time frame, with a 20-year period as the maximum lifespan. And the statute imposes a monetary cap on the NLC deduction that varies among tax years.

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Kyle O. Sollie, a Reed Smith LLP partner who represents Nextel Communications of the Mid-Atlantic Inc. (Nextel) in the litigation, noted that Pennsylvania "is the only state that caps net operating loss (NOL) this way, year after year. So with a 20-year carryover period, NOLs that are capped every year will often expire unused."

Nextel contested the cap, as applied for the 2007 tax year, alleging that it facilitated disparate treatment of taxpayers based on income level. The court agreed, finding that the 2007 NLC deduction limitation favored a subset of taxpayers with taxable income valued at \$3 million or less. The impermissible division enabled 98.8 percent of taxpayers to wholly offset their tax liability, leaving 1.2 percent of taxpayers with some burden of CNI tax:

- 19,303 taxpayers with taxable income at or below \$3 million were able to reduce their taxable income to \$0; and

- 234 taxpayers with taxable income exceeding \$3 million—the majority surpassing \$6 million—were subject to CNI tax.

Nextel fell into the latter class, carrying more than \$150 million in losses and earning \$45 million in taxable income. The company was limited to a \$5.6 million deduction at 12.5 percent of its taxable income, which adjusted its taxable income to \$39.4 million, incurring almost \$4 million in CNI tax.

The court's decision reversed an earlier ruling from the Board of Finance and Revenue and awarded Nextel a refund for the 2007 tax year, which Sollie confirmed was the outcome that Nextel wanted.

Nextel was smart in narrowing its challenge, in that “they just wanted relief for this particular year, and that’s what it was confined to,” Tobias said. “They were going to win that challenge based on that alone, because the NOL cap did, in this instance for this year for this taxpayer, create two classes of taxpayers, taxed differently based on their amount of income.”

Practical Remedy. Emphasizing that Nextel pressed an “as-applied” challenge rather than a facial challenge to the NLC deduction cap, Brobson’s opinion declined the dissent’s recommendation to invalidate the flat-dollar cap of \$3 million.

The majority further noted that eliminating the flat-dollar limit “would only serve to highlight the fact that while Nextel paid what it was supposed to pay, many corporate net income taxpayers in the 2007 Tax Year benefited from the discriminatory cap and thus underpaid their corporate net income taxes—i.e., they benefited from the unconstitutional provision.”

Finding that the only practical solution was placing Nextel in the same position as those taxpayers who gained from the \$3 million cap, the court ordered a full refund of Nextel’s CNI paid in 2007.

Practitioners largely agreed with the majority’s form of relief, saying the dissent proposed a fix that may not be available under the limitations period and would unduly burden Pennsylvania resources. If available, elimination of the flat-capped NLC deduction theoretically could trigger liability for those 19,000 taxpayers that offset their 2007 taxable income, sparking a state-wide search to “claw the money back,” Malone explained.

“The state government may not care for it,” he said. “Certainly either the Treasury or Revenue Department is going to be worse off. But in terms of assuring that you have an adequate remedy for the violation, the majority’s approach is clearly, on a common sense level, more practical to effectuate.”

However, Malone joined other practitioners in embracing the dissent’s proposed remedy as potential prospective relief, observing that “as every year ticks off that this problem is unrepaired, they are losing potentially some significant tax revenue.”

Requiring Legislative Response. While the practitioners interviewed by Bloomberg BNA agreed that the General Assembly will answer the court’s opinion, the substance and speed of legislative action remain unknown. Potential legislative tactics may range from a permanent repeal of the NLC deduction cap to a permanent repeal of the NOL deduction or a temporary suspension of the

deduction, the latter action taken by the General Assembly in the 1990s.

Ultimately, however, practitioners view a short-lived fix as only further delaying an issue overdue for change.

“Eventually, you need a far-reaching and permanent remedy,” Tobias said. “And that is legislation which is going to either wipe out the NOL in its entirety and you can imagine how much fun that will be. Or eliminate the cap and bite the bullet on it. And that would be the preferred way to go, I would think, to make the most people happy.”

In the midst of stalled fiscal measures, where political gridlock has rendered Pennsylvania one of two states without a budget, restructuring the NLC deduction regime will be an uphill struggle—especially in what Tobias described as the “perfect storm,” where the court’s decision introduces the chaos of corporate tax overhaul into an ongoing battle of competing political agendas.

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“For the first time in a number of years, there are so many tax issues that are going to be part of the budget this year,” he said, identifying proposals that include sales and use tax base expansion, personal income tax rate increase or reduction, and property tax overhaul.

Noting that the NLC deduction cap “has to be addressed this time around,” he said, “how do you do that and still meet all your other objectives and still balance your budget and get the results that you want?”

Nextel’s award of \$3.9 million alone likely wouldn’t motivate the General Assembly, as it is well within the state’s tolerance for revenue impact, Tobias said. However, increasing depletion of revenue may instill a sense of legislative urgency.

“It’s not going to take too many other taxpayers with a similar income and NOL profile, multiplied over the number of years that are open under the statute of limitations, to get to a significant amount of refunds that might have to be paid out,” Austin said. “That number gets pretty big quickly.”

Wide Scope of Decision. Notwithstanding the majority’s suggestion that the decision is case-specific, practitioners detect no such limitation in the opinion.

“Even though the Court has narrowly drafted this as an ‘as-applied’ decision, only applicable to the taxpayer and tax year at issue in the case, I don’t see why the holding wouldn’t apply to other taxpayers or tax years,” Austin said. Rather, “there are a lot of other taxpayers out there with similar fact patterns with respect to their taxable income and amount of net operating losses that are limited by the cap.”

Malone, who was “nonplussed” by the majority’s characterization of the decision’s reach, interpreted the

opinion as setting precedent for similarly situated taxpayers.

“If the next large company with a similar fact pattern came down the turnpike, you kind of expect there would be a similar result, unless there was some material change in the facts,” he said.

Tobias noted that while the court confined its ruling to Nextel’s Pennsylvania business, the decision may cross state borders as a tool to contest other states with an analogous scheme.

Protective Refund Claims. Recognizing a broad, non-discrete problem underlying the court’s decision, practitioners shared the opinion that taxpayers should consider refund claims for those years open under the three-year limitations period. However, the hazards of a protracted dispute may restrain a decision to pursue a claim.

In assessing the prudence of a refund claim, Austin breaks taxpayers down into two categories:

- taxpayers with significant NOLs that can be exhausted before the expiration period; and
- taxpayers with significant NOLs that because of the cap and carry-forward limitation won’t be exhausted.

For the latter group, Austin suggested they consider filing a refund claim, as those taxpayers “are really facing a loss of an asset.” And given the unknown legislative response, which may suspend the NOL deduction, he favored prompt refund claim filings.

On the other hand, the former group faces only a “timing issue,” which may discourage the filing of a re-

fund claim because of the time and expense incurred. However, Austin qualified this view, noting that a taxpayer may be inclined toward refund relief where the cap forces a spread of NOLs over a long period.

Supreme Court Review. With appellate review as a matter of right, practitioners expect the Pennsylvania Supreme Court will engage in a robust analysis of the Commonwealth Court’s decision.

Projecting a potential outcome, Malone noted prior jurisprudence that may signal that the higher court would affirm. In *Annenberg v. Commonwealth*, 757 A.2d 338 (Pa. 2000), the state Supreme Court granted remedial relief that mirrored the *Nextel* refund award. While the *Annenberg* matter raised a facial constitutional claim under federal law, the legal reasoning may steer the state Supreme Court’s ruling.

“It certainly will give you some comfort that there will be some receptivity by the Supreme Court when it gets there to say, yes, this is an appropriate approach to the remedy,” Malone said. And, he added, “it gives you some sense that the majority on the Commonwealth Court is certainly not way off the reservation, even if the case isn’t squarely controlling in this context.”

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The Commonwealth Court’s opinion is at <http://src.bna.com/bf1>.