

Pennsylvania's NOL cap found unconstitutional

Overview

The Commonwealth Court of Pennsylvania recently held that the statutory cap on Pennsylvania's net operating loss (NOL) carryover deduction, as applied to Nextel Communications of the Mid-Atlantic, Inc. (Nextel) for Corporate Net Income Tax (CNIT) purposes, violates the Uniformity Clause of the Pennsylvania Constitution.¹ The court's remedy would allow Nextel to deduct its NOLs without regard to the cap in calculating its CNIT. The period during which the Commonwealth may appeal the decision or otherwise file exceptions to protest the decision remains open. Accordingly, the case is not final.

This Tax Alert outlines Pennsylvania's NOL cap and summarizes the Commonwealth Court ruling.

Pennsylvania's NOL cap

Pennsylvania generally allows corporate taxpayers to carry forward NOLs for a 20-year period and apply those NOLs as deductions against taxable income generated in future years, subject to certain limitations.² The Tax Reform Code provides statutory caps on the amount of NOLs that may be deducted against taxable income in each particular year.³ For tax years beginning after 2006, the NOL caps are two-pronged, allowing the deduction of the greater of either a set dollar amount or a percentage of taxable income. For example, in 2007, the NOL deduction was capped at the greater of \$3 million or 12.5 percent of taxable income. Both the dollar amount and percentage limitation have since been increased; and, for years beginning after 2014, the current cap is the greater of \$5 million or 30 percent of taxable income.

The Commonwealth Court decision

The Commonwealth Court held that the NOL cap, as applied to Nextel for the 2007 tax year, violated the Uniformity Clause of Pennsylvania's Constitution,⁴ which provides that "[a]ll taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax...."⁵ As explained by the court, "the limitations of the [NOL] deduction provision, particularly the operation and effect of the \$3 million alternative cap, violated the Uniformity Clause."⁶ Further, the majority held that the "only practical" remedy for Nextel is to permit the company to reduce its 2007 taxable income to \$0, without regard to the NOL cap.⁷ In coming to its conclusion, the majority reasoned that the NOL cap treated taxpayers with taxable income in excess of the \$3 million cap (considered large taxpayers) differently than taxpayers with taxable income of \$3 million or less (considered small taxpayers) by allowing such small taxpayers to reduce their taxable income to \$0 while prohibiting large taxpayers from doing so.⁸ The majority held that this violated the Uniformity Clause by creating a classification based solely on income that is "unjust, arbitrary and illegal."⁹

The majority opinion concludes with a statement regarding the effect of the court's decision:

[W]e fully recognize that our decision in this case could be far-reaching. Nonetheless, our analysis and remedy is appropriately confined to the Commonwealth, Nextel, and the 2007 Tax Year. To the extent our

¹ *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth of Pennsylvania*, Commonwealth Court of Pennsylvania, Docket No. 98 F.R. 2012, slip op. at 11-21 (Nov. 23, 2015). A copy of the Commonwealth Court of Pennsylvania's decision is available [here](#). Nextel did not press a facial constitutional challenge of either the CNIT or the NOL deduction, but rather pursued an "as applied" challenge to the NOL cap's particular application to Nextel's CNIT in the 2007 tax year.

² 72 P.S. § 7401(3)4.(c)(2).

³ 72 P.S. § 7401(3)4.(c)(1).

⁴ *Nextel Communications*, slip op. at 17.

⁵ PA. CONST. art. VIII, § 1. The court explained the standard for determining whether a Uniformity Clause violation has occurred as follows: "While reasonable and practical classifications in tax legislation are justifiable and often permissible, when a method or formula for computing a tax will, in its operation or effect, produce arbitrary, unjust, or unreasonably discriminatory results, the uniformity requirement is violated." *Nextel Communications*, slip op. at 12, quoting *Clifton v. Allegheny Cnty.*, 969 A.2d 1197, 1211 (Pa. 2009).

⁶ *Nextel Communications*, slip op. at 17.

⁷ *Id.* at 21.

⁸ *Id.* at 14.

⁹ *Id.* at 14-18.

decision in this as-applied challenge calls into question the validity of the [NOL carryover] deduction provision in any other or even every other context, the General Assembly should be guided accordingly.¹⁰

Although the court specifically limited its decision as noted above, it would appear that the court's reasoning, if ultimately sustained, may potentially apply to other tax years and other taxpayers.

In a separate concurring and dissenting opinion, two judges agreed with the majority that the NOL cap violates the Uniformity Clause, but asserted that the appropriate remedy is to strike only the offending dollar-based portion of the cap, thus leaving the percentage-based portion of the cap in place.¹¹

Considerations

The Commonwealth may exercise its automatic right of appeal to the Pennsylvania Supreme Court or otherwise file exceptions to protest the decision within 30 days from the date the Commonwealth Court's decision is recorded. As of the release date of this alert, the Commonwealth has not appealed the matter or filed exceptions. Accordingly, the decision is not final. However, while this case remains pending, taxpayers who were previously in an NOL carryover position with income exceeding the statutory NOL cap may wish to consider filing CNIT refund claims in order to preserve their rights to refunds for open tax periods. Upon further appeal, the Pennsylvania Supreme Court could uphold or overturn the entire decision, or uphold the finding of a Constitutional violation but prescribe a different remedy, which may thus impact the application of NOL caps in tax periods subsequent to 2007.

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¹⁰ *Id.* at 21.

¹¹ *Nextel Communications*, Concurring and Dissenting Opinion, DRP slip op. at 1-5.