

PA Supreme Court Affirms that Fixed-Dollar Cap on Net Loss Deduction is Unconstitutional, But Holds that Percentage Cap is Valid

Overview

On October 18, 2017, the Supreme Court of Pennsylvania ("Supreme Court") issued a majority opinion in *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth of Pennsylvania*¹ in which it determined that the dollar cap limitation of Pennsylvania's net loss deduction provisions violated the Uniformity Clause of the Pennsylvania Constitution.² The Supreme Court remedied the constitutional violation by severing the dollar-based cap from the net loss statute, thus leaving the percentage of taxable income cap in place. The decision reverses the order of the Commonwealth Court of Pennsylvania ("Commonwealth Court"), which had directed the Pennsylvania Department of Revenue ("Department") to issue a refund to the taxpayer.

This Tax Alert summarizes the background of the case, the lower court and Supreme Court decisions, and provides taxpayer considerations.

Net Loss Carryover Deduction Cap & Lower Court Decision

Pennsylvania generally allows corporate taxpayers to carry forward net losses and apply those net losses as deductions against taxable income generated in future years, subject to certain limitations. The Tax Reform Code provides statutory caps on the amount of net losses that may be deducted against taxable income in each particular year.³ For tax years beginning after 2006, the net loss deduction caps are two pronged, allowing the deduction of the *greater of* either a set dollar amount or a percentage of taxable income.⁴ In its 2015 decision, the Commonwealth Court had determined that the net loss deduction, as applied to Nextel for the 2007 tax year (in which the net loss deduction was capped at the greater of \$3 million or 12.5 percent of taxable income), violated the Uniformity Clause of Pennsylvania's constitution – particularly, through the operation and effect of the \$3 million cap, which created a classification based solely on income.⁵ Further, the Commonwealth Court held that the "only practical" remedy for Nextel was to permit the company to reduce its 2007 taxable income to \$0, without regard to the net loss deduction cap.⁶

Supreme Court of Pennsylvania Decision

The Department filed an appeal with the Supreme Court, raising two issues: (1) whether the net loss cap violates the Uniformity Clause of the Pennsylvania constitution by capping the amount of net loss deduction a corporation can take based on its income, and (2) if so, whether severance of the \$3 million flat deduction cap is the appropriate remedy.⁷

In its decision, the Supreme Court affirmed the Commonwealth Court's holding that the net loss cap violates the Uniformity Clause by creating disparate tax obligations between two classes of similarly situated taxpayers

¹ Supreme Court of Pennsylvania, Docket No. 6 EAP 2016, slip op. (Oct. 18, 2017), majority opinion available [here](#). Three Justices joined a concurring opinion, available [here](#).

² PA. CONST. art. VIII, § 1 ("All 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.").

³ 72 P.S. § 7401(3)4.(c)(1)-(2).

⁴ *Id.* For years beginning after 2014, the cap is the greater of \$5 million or 30 percent of taxable income.

⁵ *Nextel Commc'ns of the Mid-Atl., Inc. v. Commonwealth*, 129 A.3d 1, 9-11 (Pa. Commw. Ct. 2015). A copy of Deloitte's Tax Alert on this prior decision is available [here](#).

⁶ *Id.* at 13.

⁷ *Nextel Commc'ns of the Mid-Atl., Inc. v. Commonwealth*, Supreme Court of Pennsylvania, Docket No. 6 EAP 2016, slip op. at 9 (Oct. 18, 2017).

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based solely on the value of the property involved (*i.e.*, the amount of each class member's taxable income).⁸ The Supreme Court noted that such arbitrary and unreasonable classification is prohibited by the Uniformity Clause, and stated that "a taxing statute which classifies similarly situated taxpayers solely on the basis of their income, and thereby places differing tax burdens on each class as a result, is forbidden."⁹

The Supreme Court then considered the appropriate remedy, concluding that the dollar-based flat deduction creating the constitutional violation should be severed from the statute, while the remainder of the statute continues to operate as the legislature intended.¹⁰ The Supreme Court noted that the overall structure of the net loss deduction reflects the legislature's intent to balance the twin policy objectives of encouraging corporate investment and ensuring maintenance of the Commonwealth's financial health; thus, the Supreme Court determined that "the legislature's intent to have the [net loss deduction] jointly further both of these policy objectives can best be effectuated by severing from the [net loss deduction] the \$3 million flat deduction."¹¹ Regardless of the removal of the dollar-based cap provision, all corporations remain subject to the percentage-based cap of the net loss deduction against taxable income.

Taxpayer Considerations

The Supreme Court's decision¹² creates potential uncertainty for taxpayers, notably those taxpayers for which the elimination of the dollar-based deduction may create an unfavorable result. It should also be noted that legislation has been proposed that could raise the percentage cap to 35% of taxable income for taxable years beginning after December 31, 2017 and 40% of taxable income for taxable years beginning after December 31, 2018.¹³ Companies interested in this decision are strongly encouraged to discuss the potential implications of the holding with one of the contacts listed below.

Contacts:

If you have questions regarding this Supreme Court of Pennsylvania decision or other Pennsylvania tax matters, please contact any of the following Deloitte Tax professionals:

Kenn Stoops

Deloitte Tax LLP, Philadelphia
+1 215 299 5225
kstoops@deloitte.com

Todd Hyman

Deloitte Tax LLP, Philadelphia
+1 215 299 4539
thyman@deloitte.com

Ed Kenawell

Deloitte Tax LLP, Pittsburgh
+1 412 338 7884
ekenawell@deloitte.com

Steven Thompson

Deloitte Tax LLP, Philadelphia
+1 215 246 2463
stethompson@deloitte.com

Stacy Ip-Mo

Deloitte Tax LLP, Philadelphia
+1 215 246 2374
sipmo@deloitte.com

Bob Kovach

Deloitte Tax LLP, Pittsburgh
+1 412 338 7925
rkovach@deloitte.com

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⁸ *Id.* at 25-26, 29.

⁹ *Id.* at 25-27, 29 (citing *Mt. Airy #1, LLC v. Pennsylvania Department of Revenue*, 154 A.3d 268, 276 (Pa. 2016)).

¹⁰ *Nextel Commc'ns of the Mid-Atl., Inc. v. Commonwealth*, Supreme Court of Pennsylvania, Docket No. 6 EAP 2016, slip op. at 1-2, 36-37 (Oct. 18, 2017).

¹¹ *Id.* at 35-36.

¹² Generally, an application for reargument may be filed within 14 days after entry of the judgment (an option still potentially available as of the date of this Alert). Pa. Rules of Appellate Procedure, Rule 2542 (available at 210 Pa. Code § 2542).

¹³ H.B. 542, Gen. Assemb., Reg. Sess. (PA 2017-2018), available [here](#).