

**IN THE SUPREME COURT OF PENNSYLVANIA
EASTERN DISTRICT**

No. 6 EAP 2016

NEXTEL COMMUNICATIONS OF THE MID-ATLANTIC, INC.,

Appellee

v.

COMMONWEALTH OF PENNSYLVANIA,

Appellant

**AMICUS BRIEF OF PENNSYLVANIA BUSINESS COUNCIL,
GREATER PHILADELPHIA CHAMBER OF COMMERCE, AND
GREATER PITTSBURGH CHAMBER OF COMMERCE
IN FAVOR OF APPELLEE**

**Appeal from the Orders of the Commonwealth Court of Pennsylvania
entered on November 23, 2015 and December 30, 2015 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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SUMMARY OF ARGUMENT

Pennsylvania law allows corporations to carry forward losses generated in prior years to offset income earned in later years. For smaller taxpayers, this produces a fair result: a taxpayer with a \$3 million loss one year followed by \$3 million of income the subsequent year may deduct the loss against its income and pay no tax. However, a larger taxpayer otherwise identical except that it had \$30 million of losses followed by \$30 million of income would pay tax in the year of income, because of Pennsylvania's net loss deduction cap. The cap, which limited the net loss deduction in 2007 to the larger of \$3 million or 12.5% of taxable income, only affects larger taxpayers with income in excess of \$3 million.

In 2007, over 19,000 smaller taxpayers were able to utilize their net losses to reduce their income to zero and pay no tax. In the same year, over 200 larger taxpayers had net losses that could have offset their income. However, because of Pennsylvania's net loss cap, those 200 larger taxpayers were required to pay tax in the year of income. Nextel, and many members of the Amici, are among the 200 taxpayers whose net losses were limited by the cap.

This distinction between larger and smaller taxpayers violates the Uniformity Clause of the Pennsylvania Constitution. Further, the distinction discourages investment and risk-taking and makes Pennsylvania's business climate

less competitive. Thus, the Commonwealth Court's unanimous decision¹ that the net loss cap violates Pennsylvania's constitution must be affirmed.

¹ *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth*, 129 A.3d 1 (2015).

STATEMENT OF AMICUS'S INTEREST

The Pennsylvania Business Council is a policy organization, which comprises over 100 substantial businesses throughout the Commonwealth. It is the organization formed by the merger of the Business Roundtable and Pennsylvanians for Effective Government. Its membership includes the Greater Philadelphia Chamber of Commerce and the Greater Pittsburgh Chamber of Commerce (collectively, the "Amici").

The Amici envision a Commonwealth in which residents enjoy a very high quality of life in sustainable communities, where those who are seeking employment find high quality jobs with good compensation, and where those who invest their capital and hard work can grow firms that flourish and are profitable.

The net loss cap interferes with those goals. The cap singles out large corporate taxpayers. It singles them out and discourages them from making capital investments for the future. The cap singles them out and discourages risk taking. The cap singles them out and discourages them from conducting research and development. The cap singles out large corporations and discourages them from profitable, long-term decision making. The cap thereby makes Pennsylvania a less competitive place to do business.

ARGUMENT

If a small taxpayer has a \$3 million loss in Year 1 and \$3 million of income in Year 2, that taxpayer, economically speaking, has no income.² Under Pennsylvania law, that taxpayer may deduct the \$3 million loss in full against the \$3 million of income and pay no tax. Contrast that with a larger taxpayer, with larger swings in profit and loss—for example, \$30 million loss in Year 1 and \$30 million income in Year 2. That larger taxpayer, like the smaller taxpayer, has no economic income. But because of Pennsylvania’s net loss cap, that taxpayer will pay well over \$2 million of tax because its net loss deduction in Year 2 is capped at \$3.75 million.³ Thus, because a large taxpayer in this situation pays an income tax, yet has no income, it has an effective tax rate of “infinity.”⁴ Importantly, from a constitutional perspective, the “larger” taxpayer pays tax simply because it is larger and has greater swings in income and loss.

² See Expert Report of Professor Edward J. McCaffery attached to R.R. 19a, S/F ¶ 25 (Ex. G), hereinafter McCaffery Aff., ¶ 9(b).

³ In 2007, the net loss deduction is the greater of 12.5% of taxable income or \$3,000,000. 72 P.S. § 7401(3)(4)(c)(1)(A)(II). The tax would be approximately \$2.625 million: \$30 million of income, less \$3.75 million net loss deduction = \$26.25 million of taxable income x 9.99% rate. See McCaffery Aff., R.R. 19a, S/F ¶ 25 (Ex. G) at ¶ 9(d).

⁴ See McCaffery Aff., R.R. 19a, S/F ¶ 25 (Ex. G) at ¶ 14.

As the Commonwealth Court noted, in 2007 alone, there were 19,303 taxpayers that are like the “small” taxpayers described in this example.⁵ They had income that was completely offset by prior-year losses. They paid no tax. Meanwhile, in the same year, there were 234 taxpayers that had prior-year losses that could have entirely offset their current-year income.⁶ If they were treated like the smaller taxpayers, they would have paid no tax. Yet they paid tax merely because they were larger and their swings in income and loss were greater than \$3 million. Indeed, as the Commonwealth Court noted, “[t]he only factor that distinguishes between these two classes of taxpayers . . . is the amount of taxable income in the 2007 Tax Year.”⁷ Nextel fits into this minority of larger taxpayers. So do many members of the Amici. Small taxpayers avoid tax because they are small; large taxpayers—including many of our members—pay tax solely because they are large.

This distinction is prohibited by our state Constitution. In Pennsylvania, if the legislature imposes an income tax, all taxpayers must pay the tax, regardless of their size. The only exceptions allowed are exceptions explicitly provided in the Constitution. For example, our Constitution was amended so that truly poor

⁵ *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth*, 129 A.3d 1, 4 (2015).

⁶ *Id.*

⁷ *Nextel*, 129 A.3d at 8.

individuals may avoid the income tax.⁸ There is, however, no such “poverty” amendment for corporate taxation. Corporations that earn \$3 million or less are not “poor”; there is no poverty amendment for them. Yet the record shows that over 19,000 corporations paid no tax whatsoever simply because they earned \$3 million or less and could fully deduct their net losses. Meanwhile, about 200 similarly situated corporations paid substantial tax simply because they could not deduct their losses in full because they had greater than \$3 million of income. The Commonwealth Court held that this distinction “illustrates the injustice and inequality that must result from such special legislation.”⁹

The Department may argue that the disparity is unintentional, or it is so technical that it does not violate the Uniformity Clause.¹⁰ This brief by the Amici will rebut those arguments, and argue that the disparity is not a harmless technical violation of the Uniformity Clause. Instead, it is intentional, and has the actual effect of discouraging investment, discouraging risk-taking, and making Pennsylvania less competitive.

⁸ PA. CONST. art. VIII, § 2(b)(ii) (Proposal No. 5, 1968).

⁹ *Nextel*, 129 A.3d at 10 (quoting *In re Cope’s Estate*, 43 A. 79, 81 (1899)).

¹⁰ *Columbia Gas Transmission Corp. v. Commonwealth*, 468 Pa. 145, 151 (1976) (“taxation is not a matter of science, and perfect uniformity or absolute equality is not required . . .”).

I. THE CAP DISCRIMINATES BY DESIGN.

The record in this case shows that the vast majority of corporations with net losses fall into the category of “small” corporations. Indeed, 19,000 corporations—fully 98% of all corporations with net losses—fall into this category.¹¹ Those corporations are completely unaffected by the net loss cap because of their size. By comparison, only about 200 corporations—less than 2% of all corporations with net losses—are affected by the cap. Thus, by exempting the majority of corporations from the cap, the legislature was able to raise revenue from the minority, yet avoid the political opposition of the majority.¹²

The Amici comprise many corporations that fall in this minority. The legislature has designed the cap in a way that splits the corporate business community into “large” and “small” factions. Specifically, “the General Assembly has favored taxpayers whose property (i.e. taxable income) is valued at \$3 million or less.”¹³ It has thereby been able to substantially reduce the political opposition to the cap. In that way, the legislature has been able to meet its revenue goals from “large” corporations and avoid the political debate that would occur if it tried to raise the revenue from all corporations. The purpose of the Uniformity Clause is to

¹¹ *Nextel*, 129 A.3d at 8.

¹² The Uniformity Clause “prevent[s] a majority from teaming up on a minority, measured in terms of level of income alone.” *McCaffery Aff.*, R.R. 19a, S/F ¶ 25 (Ex. G) at ¶ 20.

¹³ *Nextel*, 129 A.3d at 10.

prevent those kinds of large-versus-small factions.¹⁴ For that reason alone, the cap must fall.

II. THE CAP SINGLES OUT LARGER CORPORATIONS AND DISCOURAGES THEM FROM INVESTMENT, RISK-TAKING, AND LONG-TERM THINKING.

It is axiomatic that taxation is “not a matter of science.”¹⁵ Yet tax rules are technical.¹⁶ A uniformity violation that causes true harm may be obscured by these technicalities.¹⁷ The Amici assure the Court that the disparate treatment of large companies is more than just a mere technicality. In this section of our brief, we will show the Court that the net loss cap causes real harm; it affects real business decisions made by larger corporations in the Commonwealth.

The reason for the net loss deduction is simple. Income tax is computed based on an annual accounting period.¹⁸ The problem is that most good business

¹⁴ McCaffery Aff. R.R. 19a, S/F ¶ 25 (Ex. G) at ¶ 22 (Pennsylvania’s tax uniformity clause “has many impressive features, including the avoidance of class warfare.”).

¹⁵ *Columbia Gas Transmission Corp.*, 468 Pa. at 151

¹⁶ See *Ewing v. U.S.*, 914 F.2d 499, 501 (4th Cir. 1990) (“tax laws are technical and, for the most part, are to be accordingly interpreted.”) citing *Lewyt Corp. v. Comm’r*, 349 U.S. 237, 240 (1955); *Brafman v. United States*, 384 F.2d 863, 867-68 (5th Cir. 1967); *Richardson v. Smith*, 301 F.2d 305, 306 (3d Cir. 1962) (“taxation . . . must be played strictly in accordance with the rules”), *cert. den.*, 371 U.S. 820 (1962).

¹⁷ Indeed, the cap itself is a needless technicality. McCaffery Aff. ¶ 22 (“This helps to illustrate one of the many virtues of Pennsylvania’s tax uniformity clause—it keeps things simple and fair.”).

¹⁸ See Internal Revenue Code § 441(a) (“Taxable income shall be computed on the basis of the taxpayer’s taxable year.”).

investments take longer than a year to produce results.¹⁹ As the following discussion points out, the net loss cap singles out large corporations and discourages them from engaging in exactly the kind of long-term decision making that they should be engaging in.

A. The net loss cap singles out large corporations and discourages them from conducting research and development.

Companies can spend years on research and development before a product is developed.²⁰ Those companies often incur significant losses during the early research years, with the expectation that those investments will turn into income in later years.²¹ Pennsylvania's net loss cap singles out large companies and discourages them from conducting research because, in Pennsylvania, the losses caused by the research expenses incurred in the early years will not be freely

¹⁹ See, e.g., Peter Kennedy, *What's Driving the Global Strategies of U.S. Companies?*, STRATEGY & LEADERSHIP, Nov.-Dec. 1996, at 48 ("When it comes to generating a 20 percent ROI, the average timeline is 4.3 years" according to a survey of executives at 113 US corporations.); Joseph G. Morone, *Technology and Competitive Advantage – The Role of General Management*, RESEARCH AND TECH. MGMT., Mar.-Apr. 1993, at 16 ("The four major product innovations that shaped GE Plastics took an average of six years to break even after they reached the marketplace . . . Cellular telephones took close to 15 years of development and \$150 million of investment before the first sales were made, and the business lost \$50 million in its first year.")

²⁰ See, e.g., Julie Tennyson, *Tax Incentives for the Biotechnology Industry: Should Tennessee Offer Sales Tax Exemptions and Net Operating Loss Extensions?*, 70 TENN. L. REV. 567, 567 (2003) ("Product development within the biotechnology industry . . . can take as much as ten to fifteen years for a single product.").

²¹ See, e.g., Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 2, Accounting for Research and Development Costs* ¶ 43 (Oct. 1974) ("The economic resources of a particular enterprise are generally regarded as those scarce resources for which there is an expectation of future benefits to the enterprise either through use or sale." Emphasis in the original.)

deductible against the income that is generated in the later years when the research pays off.

B. The net loss cap singles out large corporations and discourages them from making major capital investments.

Companies confront decisions to make major capital investments. They decide whether to hire employees, build a plant, expand a plant, or purchase new equipment.²² Those investments involve incurring significant expenditures up front, often causing the company to generate losses.²³ The expectation is that the investment will pay off in the long run.²⁴

Pennsylvania's net loss cap singles out large companies and discourages them from making those investments because the losses caused by the early-year expenditures cannot be freely deducted when the investment pays off. Indeed, some major projects can only be accomplished by large companies. Therefore, the net loss cap has an especially pernicious impact on investment in the Commonwealth.

²² See generally Mousumi Bhattacharya & Kathleen K. Wheatley, *Organizational Risk and Capital Investments: A Longitudinal Examination of Performance Effects and Moderating Contexts*, J. MANAGERIAL ISSUES, Spring 2006, at 62-83.

²³ *Id.*

²⁴ *Id.*

C. The net loss cap singles out large corporations and discourages them from entering and investing in cyclical industries.

Many important industries in Pennsylvania are cyclical. Energy,²⁵ transportation,²⁶ construction,²⁷ and financial services industries²⁸ are known for their economic ups and downs. Without a net loss system, companies that invest in these cyclical industries would pay more tax on the same amount of economic income compared with companies that invest in more stable industries.²⁹ The net loss deduction permits “a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than a year.”³⁰ The cap on net losses singles out large corporations and discourages them from entering or investing in cyclical industries.³¹

²⁵ See, e.g., Chee-Chong Teo et. al., *An Application of Master Schedule Smoothing and Planned Lead Time Control*, PRODUCTION AND OPERATIONS MGMT., Mar.-Apr. 2012, at 212 (“the company had experienced a sudden surge in demand due to the global increase in demand for energy. However, given the cyclical nature of the industry, the firm was hesitant to invest heavily in expanding its capacity because this could result in over-capacity during the trough of the cycle.”)

²⁶ See S. Rep. No. 87-2041 (1962) (explaining the need for a net loss deduction for companies in the transportation industry).

²⁷ Lucia F. Dunn & Ida A. Mirzaie, *Turns in Consumer Confidence: An Information Advantage Linked to Manufacturing*, ECON. INQUIRY, Apr. 2006 at 347 (naming construction and financial services as two examples of cyclical industries.)

²⁸ *Id.*

²⁹ See *Libson Shops v. Koehler*, 353 U.S. 382, 386 (1957).

³⁰ *Id.*

³¹ *McCaffery Aff.*, R.R. 19a, S/F ¶ 25 (Ex. G) at ¶ 18 (“Any taxpayer who is limited by the NOL Cap . . . faces a different, non-uniform tax rate than a corporate taxpayer not so limited.”).

D. The net loss cap singles out large corporations and discourages them from taking risks and entering new markets.

The net loss deduction serves to encourage investment in new ventures, because early losses can be deducted as soon as the enterprise becomes profitable.³² In other words, the net loss deduction helps investors that take risks—the kinds of risks that result in breakthrough products and industries. Consider a company choosing between a high-risk, high-reward project, and a low-risk, low-reward project. In Pennsylvania, the net loss cap singles out large corporations and skews them away from the high-risk, high reward projects because, if the project pays off, the losses from the early years cannot offset the income in the later years.³³ Indeed, as described earlier, in Pennsylvania, a large company may be subject to Pennsylvania income tax even if a venture produces no economic income when measured over multiple years. In this way, the net loss cap discourages large corporations from taking business risks that may result in the next blockbuster product. The net loss cap, as applied to larger businesses, singles them out and discourages them from making investments in new ventures, new products, or new markets.

³² See *United States v. Foster Lumber Co.*, 429 U.S. 32, 42-43 (1976) (net loss deductions “stimulate enterprise and investment, particularly in new businesses or risky ventures where early losses can be carried forward to future more prosperous years.”).

³³ See *Id.*

CONCLUSION

The net loss cap is unconstitutional because it singles out larger companies. This is not a mere technicality that causes no harm. To the contrary, the unconstitutional cap discourages research, capital investment, and risk-taking. This court should follow the Commonwealth Court's decision, and the century of case law preceding it, and strike the cap so that all corporations—large and small—are treated the same.

Respectfully submitted,



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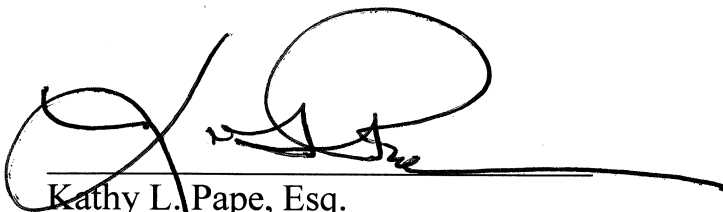
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