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Delaware: NOL limitation violates state's Uniformity Clause; possible refund opportunities

The Delaware Superior Court (New Castle County) held that the Division of Revenue's longstanding practice of limiting a corporate taxpayer's net operating losses (NOLs) to the amount of NOLs claimed on the taxpayer's federal consolidated return violates the state's Uniformity Clause.

The case is: *Verisign, Inc. v. Director of Revenue*, C.A. No. N19C-08-093 JRJ (Del. Super. Ct. December 17, 2020). Read the [decision](#) [PDF 445 KB]

KPMG observation

As a result of this decision, taxpayers that would have been able to use NOLs but for the NOL limitation rule need to consider whether to file a claim for refund of corporate income tax.

Background

Under Delaware law, corporations are required to file returns on a separate-company basis and must compute stand-alone federal taxable income on a federal pro forma return as if the corporation had filed on a separate-company basis for federal purposes. If a Delaware corporate taxpayer claims a consolidated NOL deduction on its federal consolidated return, it can claim an NOL deduction on its Delaware return by taking the following steps:

- First, the taxpayer must "compute its NOL on a separate-company basis under the IRC."
- Second, pursuant to the Delaware Division of Revenue's policy, the taxpayer must "limit that separate company NOL to the consolidated NOL deduction of the federal consolidated group of which the [corporation] is a member." According to the state's audit manual, this step is not required if every member of the federal consolidated group files a Delaware separate entity return.

In the instant case, the taxpayer filed federal consolidated returns with its affiliates. From the 2005 to 2013 tax years (the years at issue), the taxpayer generated approximately \$2.89 billion in NOLs on a separate-company basis, and these amounts were carried over to the 2014, 2015, and 2016 tax years to reduce the company's federal taxable income to zero.

On audit, the Division of Revenue limited the amount of the taxpayer's NOL deductions in tax years 2015 and 2016 to the amount of the taxpayer group's consolidated NOL deductions for those years. The group's consolidated NOL deductions totaled to \$39 million and \$2 million in tax years 2015 and 2016, respectively. The allowable NOLs, accordingly, would be significantly less than the taxpayer's federal taxable income so that the taxpayer had positive pro forma federal (and therefore Delaware) taxable income. The taxpayer challenged application of the NOL limitation rule.

Court's decision

The court first rejected the taxpayer's assertion that the Division's policy with respect to the consolidated group limitation was inconsistent with Delaware law. In a previous decision, *Cluett, Peabody, & Co. v. Director of Revenue*, the court had sustained the Division's disallowance of the taxpayers NOLs on the basis that they were extinguished for the tax year at issue because the taxpayer filed consolidated returns at the federal level. The court in *Cluett* determined that the Division's application of the policy—which included consulting the group's consolidated federal returns—was consistent with Delaware statute. In the instant case, the court, following *Cluett* as precedent, found that the Division's policy was consistent with Delaware law.

The court then turned to address—and again reject—the taxpayer's contention that the exception to the Division's policy for when all consolidated group members are Delaware filers was discriminatory. In the court's view, the policy's exception did not benefit Delaware corporations to the expense of non-Delaware corporations. As such, the court concluded that there was no Dormant Commerce Clause violation.

Finally, the court addressed whether the Division's policy violated the Delaware Constitution's Uniformity Clause—that is, the clause that provides that “[a]ll taxes shall be uniform upon the same class of subjects within the territorial limits of the authority levying the tax....” The taxpayer argued that the Division's policy divided a single group of taxpayers (Delaware corporate taxpayers) into two groups on the basis of their federal filing status (consolidated filers and separate filers) and then applied a limitation to one but not the other.

The court agreed and explained that this policy created two classes of Delaware taxpayers in violation of the Uniformity Clause, as interpreted by an earlier Delaware case. The court rejected the Division's argument that the classification was reasonable. Although there was precedent that a “reasonableness test” applies to determine whether classifications are impermissible under the Uniformity Clause, that test is generally applicable to instances when the classification was created by the Delaware General Assembly. In this instance, the policy was articulated by the Division, and there was no authority providing that the division's classification would be entitled to deference. Accordingly, the court concluded that the Division improperly limited the amount of the NOL that the taxpayer could claim on its Delaware return to the amount of the taxpayer group's consolidated NOL.

What's next?

At present, it is not known whether the Division will file an appeal. In the interim, taxpayers that would have been entitled to claim increased NOL deductions but for application of the NOL limitation rule need to weigh whether to file refund claims.

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