Delaware Court Invalidates Division's NOL Limitation Policy

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In this installment of SeeSALT Digest, the authors explore the recent Delaware court decision of *Verisign* and what it means for taxpayers.

The Delaware Division of Revenue's decades-long policy limiting net operating loss deductions for members of federal consolidated groups hangs in the balance after a Delaware state court invalidated the policy on state constitutional grounds in *Verisign.*[1] The Delaware Supreme Court will hear the parties' cross-appeals. Although it is unclear right now whether the lower court's judgment will hold, there is good reason to think it may.

The Division's NOL Limitation Policy

A corporation must file a separate return for Delaware corporate income tax purposes whether it files a federal income tax return on a separate-company basis or as part of a consolidated group.[2] The corporation's federal taxable income is the starting point for computing its Delaware taxable income.[3] If the corporation filed a federal income tax return as part of a consolidated group, it must compute its federal taxable income, including deductions, on a separate-company basis as if it had filed a separate federal income tax return.[4]

The division has long required every corporation that files a federal consolidated group return to compute its NOL deduction for Delaware corporate income tax purposes in two steps. First, the corporation must compute its NOL deduction on a separate-company basis under the Internal Revenue Code of 1986, as amended. Second, the corporation's NOL deduction is then limited to the federal consolidated NOL deduction (the NOL Limitation Policy).

The NOL Limitation Policy does not apply if every member of the federal consolidated group filed a Delaware corporate income tax return.[5]

According to the director of revenue, the NOL Limitation Policy "has been in place for at least 30 years and, in any event, longer than any current employee of the Division can remember."[6] However, the NOL Limitation Policy is not set forth in a regulation, a published ruling, or even in the instructions to the Delaware corporate income tax return. From every indication, the policy resides only in the division's audit manual, which says, "If not all members file in Delaware, and taxpayer is attempting to utilize a previous NOL, DOR needs to ensure that the NOL amount does not exceed the consolidated amount of the current year NOL."[7]

Verisign Challenges the Division's NOL Limitation Policy

Verisign is a member of an affiliated group of corporations (the Verisign Group) that have elected to file a consolidated federal income tax return. The Verisign Group deducted a consolidated NOL on its federal consolidated returns for the 2015 and 2016 tax years. Verisign, for its part, generated NOLs on a separate-company basis between the 2005 and 2013 tax years. For Delaware corporate income tax purposes, Verisign carried over its separately computed NOLs into the 2015 and 2016 tax years, reducing its federal taxable income each year to zero. Verisign's separately computed NOL deduction in each tax year exceeded the federal consolidated NOL deduction of the Verisign Group.[8]

Under its NOL Limitation Policy, the division limited Verisign's separately computed NOL deduction for the 2015 and 2016 tax years to the federal consolidated NOL deduction taken by the Verisign Group, presumably because not every member of Verisign Group was a Delaware corporate income tax filer. The division's adjustment caused Verisign to have federal taxable income and, in turn, a Delaware corporate income tax liability each year. Verisign protested the resulting assessment, which the division denied, and then filed a petition with the Tax Appeal Board.[9]

Verisign removed the proceeding to the Delaware Superior Court, New Castle County. The parties filed cross-motions for summary judgment, with Verisign asserting that the NOL Limitation Policy was contrary to Delaware statute, discriminated against interstate commerce in violation of the commerce clause of the U.S. Constitution, and violated the uniformity clause of the Delaware Constitution.[10]

Court Finds the NOL Limitation Policy Is Consistent With Delaware Statute

The thrust of Verisign's statutory argument was that Delaware is a separate-return state and does not permit consolidated returns. Verisign argued that the Delaware Code does not incorporate the concept of a federal consolidated group NOL, which is a creature of the Treasury regulations, and therefore the NOL Limitation Policy violates Delaware statute.[11] The director responded that nothing in the Delaware Code prohibits the division from limiting a corporation's separately *computed* NOL to the NOL actually *recognized* on the federal consolidated return.[12] Furthermore, the director argued that the superior court confirmed in *Cluett*[13] that limiting an NOL deduction to the amount of NOLs available on the federal return is consistent with Delaware statute.[14]

The superior court agreed with the director that *Cluett* foreclosed Verisign's statutory claim.[15] *Cluett* concerned a merger between two members of a federal consolidated group. The successor corporation would have succeeded to the constituent corporation's NOL carryovers for federal income tax purposes but for the fact that the NOLs had been fully exhausted by the federal consolidated group as of the date of the merger. Nonetheless, the successor attempted to take the benefit of the NOL carryovers a second time in computing its federal taxable income for Delaware corporate income tax purposes. The superior court sustained the division's disallowance of the NOL deduction, noting that because federal taxable income is the starting point for computing Delaware taxable income, and the NOLs had already been exhausted at the time of the merger, the successor had no NOL carryovers to use in computing its federal taxable income on a separate-company basis.[16]

In the *Verisign* court's view, *Cluett* would have been decided differently if the court in that case had disagreed with the division's decision to refer to the federal consolidated group NOL. The *Verisign* court inferred from the absence of any disagreement that the *Cluett* court endorsed the division's policy of "consulting" the federal consolidated group NOL as being consistent with Delaware statute. Citing *Cluett* as precedent, the *Verisign* court concluded that the NOL Limitation Policy is consistent with Delaware statute.[17]

The Court Rejects Verisign's Commerce Clause Argument

Verisign contended that the NOL Limitation Policy violated the commerce clause of the U.S. Constitution because the division limits a corporation's separately computed NOL deduction to the federal consolidated group NOL deduction unless all the members of the federal consolidated group are Delaware corporate income tax filers. Verisign alleged that, consistent with the U.S. Supreme Court's opinion in *Fulton Corp.*,[18] conditioning a tax benefit (here, an NOL deduction in excess of the federal consolidated group NOL deduction) on in-state activity discriminates against interstate commerce on its face.[19]

The court rejected the comparison between the division's policy and the scheme struck down in *Fulton Corp.*[20] At issue in *Fulton Corp.* was North Carolina's intangibles tax on the fair market value of corporate stock owned by state residents.[21] Residents were entitled to a taxable percentage deduction equal to the issuing corporation's corporate income tax apportionment percentage.[22] As a result, the taxable percentage deduction increased if the issuing corporation conducted more of its business in state.[23] The U.S. Supreme Court held that North Carolina's regime facially discriminated against interstate commerce because it benefited corporations that engaged in in-state business and burdened corporations that engaged in interstate commerce.[24] The Court explained, "A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from playing their trades in interstate commerce."[25]

The *Verisign* court concluded that the NOL Limitation Policy, unlike North Carolina's intangibles tax scheme, does not amount to "economic protectionism — that is, regulatory measures designed to benefit in-state economic interests by burdening out-of-state competitors" — and therefore does not discriminate against interstate commerce.[26] The court's analysis is unfortunately short, but one can reasonably surmise that the court sought evidence of an *intent* to benefit in-state interests and burden out-of-state interests and, finding none, concluded

that the division's policy was meaningfully different from the overtly parochial measures the U.S. Supreme Court has routinely struck down under the commerce clause.

Although the court appears to have focused on the intent behind the NOL Limitation Policy, the U.S. Supreme Court held in *Oregon Waste Systems Inc.* that "the purpose of, or justification for, a law has no bearing on whether it is facially discriminatory."[27] The key question is whether the NOL Limitation Policy benefits in-state economic interests over out-of-state economic interests.[28] The NOL Limitation Policy permits a corporation to deduct its full separately computed NOL if all the members of its federal consolidated group do business in Delaware, but it limits the corporation's separately computed NOL deduction if any member of the federal consolidated group does not do business in Delaware.

On its face, the NOL Limitation Policy rewards corporations whose affiliates do business in Delaware and penalizes those whose affiliates do not. The policy appears to facially discriminate against interstate commerce. A state tax measure that discriminates against interstate commerce is "virtually per se invalid."[29] If the NOL Limitation Policy is in fact discriminatory, the division bears the burden of demonstrating that its policy "advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives,"[30] which is a difficult burden to meet.

The Court Invalidates the NOL Limitation Policy On Uniformity Grounds

Verisign also claimed that the NOL Limitation Policy violated the uniformity clause of the Delaware Constitution, which provides that "all taxes shall be uniform upon the same class of subjects within the territorial limits of the authority levying the tax, except as otherwise permitted."[31] Verisign would have been entitled to its full separately computed NOL deduction if it had filed a separate federal income tax return, rather than as part of a federal consolidated return. The disparate treatment between corporations that file separately or on a consolidated basis for federal income tax purposes, Verisign argued, violates the uniformity clause.[32]

The superior court agreed with Verisign.[33] The court explained that the division's policy divides a single group of corporate taxpayers into two different classes — those who filed federal consolidated returns and those who did not — and applies the NOL limitation to only the first class.[34] Addressing the director's position that the classification should nevertheless be sustained because it is "reasonable," the court acknowledged that the Delaware Supreme Court has articulated a "reasonableness test" (as the *Verisign* court described it) for determining whether a classification runs afoul of the uniformity clause.[35] The Delaware Supreme Court has explained that test, or standard of review, as follows:

> There is of course a presumption that the statute is constitutional. Legislatures have a wide discretion in the matter of classification for the purpose of taxation which the courts will not disturb unless the statute is clearly arbitrary. The existence of facts to support the classification of the legislature must be assumed if any set of facts can reasonably be conceived which will sustain such classification.[36]

Focusing on the above passage, the *Verisign* court said the "reasonableness test" is predicated on the notion that deference must be given to classifications created by the legislature and by its terms does not apply to

classifications created solely by an administrative agency. Because the classification created by the NOL Limitation Policy was created solely by the division, the court concluded that the division was not entitled to deference and the alleged "reasonableness" of the classification could not save it. The court held that the NOL Limitation Policy violated the uniformity clause and granted summary judgment for Verisign.[37]

Key Takeaways

Verisign dealt a significant blow to the division's decades-old NOL Limitation Policy, potentially opening the door to refund claims for prior periods and more favorable treatment in future periods for corporate taxpayers that file as a part of a federal consolidated group. Verisign and the director recently filed cross-appeals in the Delaware Supreme Court, which means the NOL Limitation Policy may live to see another day — or not. The Delaware Supreme Court should reconsider Verisign's commerce clause claim. For now, taxpayers impacted by the NOL Limitation Policy may wish to consider filing protective refund claims while the appeal is pending.

FOOTNOTES

[1] *Verisign Inc. v. Director of Revenue*, No. N19C-08-093 JRJ, 2020 WL 7640107 (Del. Super. Ct. Dec. 17, 2020) (unpublished).

[2] Del. Code Ann. title 30, section 1903(a); Delaware Form 1100i, "Corporate Income Tax Return Instructions 2" (2019) (Return Instructions).

[3] Del. Code Ann. title 30, sections 1903(a), 1901(10).

[4] *See, e.g.*, Return Instructions, *supra* note 2, at 2.

[5] *Verisign*, 2020 WL 7640107 at *3 (citing parties' pretrial stipulation).

[6] Answering Brief in Opposition to Plaintiff Verisign Inc.'s Motion for Summary Judgment, *Verisign*, No. N19C-08-093 JRJ (Del. Super. Ct. Nov. 25, 2020) (Trans. ID. 66140938).

[7] Pre-Trial Stipulation and Order, para. 9, *Verisign*, No. N19C-08-093 JRJ (Del. Super. Ct. Nov. 12, 2020) (Trans. ID. 66105127).

[8] *Verisign*, 2020 WL 7640107 at *3.

[9] *Id.* at *3-4.

[10] *Id.* at *1-4.

[11] *Id.* at *5.

[12] *Id.*

[13] *Cluett, Peabody & Co. v. Director of Revenue*, No. 83A-JN-4, 1985 Del. Super. LEXIS 1089 (Del. Super. Ct. Jan. 22, 1985) (unpublished).

[14] *Verisign*, 2020 WL 7640107 at *5.

[15] *Id.*

[16] *Cluett*, 1985 Del. Super. LEXIS at *2-4. The taxpayer in *Cluett* stipulated that all of the subsidiary's NOLs had been used on the federal consolidated return and that for the tax year in question, there were no additional NOL carryovers to be used on the taxpayer's federal income tax return. *Id.* at *4.

[17] *Verisign*, 2020 WL 7640107 at *7.

[18] *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

[19] Plaintiff's Answering Brief to Defendant Director of Revenue's Motion for Summary Judgment at 23-24, *Verisign*, No. N19C-08-093 JRJ (Del. Super. Ct. Nov. 12, 2020) (Trans. ID. 66106134). Verisign separately asserted that even if the NOL Limitation Policy were upheld, the division's assessment would violate the foreign commerce clause of the U.S. Constitution by treating dividends from foreign subsidiaries worse than dividends from domestic subsidiaries. *E.g.*, Plaintiff's Opening Brief in Support of Its Motion for Summary Judgment at 30-33, *Verisign*, No. N19C-08-093 JRJ (Del. Super. Ct. Oct. 12, 2020) (Trans. ID. 66106053). The Delaware Superior Court did not reach this claim because it concluded that the NOL Limitation Policy violated the uniformity clause of the Delaware Constitution.

[20] *Verisign*, 2020 WL 7640107 at *8.

[21] *Fulton Corp.*, 516 U.S. at 327.

[22] *Id.* at 328.

[23] *Id.*

[24] *Id.* at 333, 346.

[25] *Id.* at 333.

[26] *Verisign*, 2020 WL 7640107 at *8 (quoting *Department of Revenue v. Davis*, 553 U.S. 328, 337-338 (2008)).

[27] *Oregon Waste Systems Inc. v. Department of Environmental Quality*, 511 U.S. 93, 100 (1994).

[28] *Id.* at 99.

[29] *Id.* at 101.

[30] *Id.*

[31] Del. Const. Article VIII, section 1.

[32] Plaintiff's Answering Brief to Defendant Director of Revenue's Motion for Summary Judgment at 22-23, *Verisign*, No. N19C-08-093 JRJ (Del. Super. Ct. Nov. 12, 2020) (Trans. ID. 66106134).

[33] *Verisign*, 2020 WL 7640107 at *10

[34] *Id.*

[35] *Id.*

[36] *Aetna Casualty & Surety Co. v. Smith*, 131 A.2d 168, 177 (1957) (internal citation omitted).

[37] *Verisign*, 2020 WL 7640107 at *10.

END FOOTNOTES

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