

Cancellation of Indebtedness as Income under Pennsylvania Law, Part II.

My initial post on *Marshall v. Commonwealth*, No. 933 F.R. 2008 (Pa. Commw. Jan. 3, 2012) summarized the facts surrounding Mr. Marshall's tax problem and outlined the issues he raised.

In a nutshell, Mr. Marshall invested \$140,000 in a real estate limited partnership in 1985; the partnership investment was a total loss. Mr. Marshall was assessed with approximately \$165,000 in Pennsylvania income tax based upon the theory that he had income of over \$3.9 million arising from the cancellation of partnership indebtedness, which occurred when the partnership's lender foreclosed on its real estate. After administrative proceedings, the assessment was largely upheld, and Mr. Marshall filed a petition for review in the Commonwealth Court, raising a series of statutory and constitutional challenges to the assessment.

Despite compelling equities, Mr. Marshall lost on every issue, although he did convince Judge Patricia McCullough and Judge Robert Simpson, who dissented. This post will focus on the Court's disposition of the constitutional issues that Marshall raised, and a future post will then focus on the Court's statutory analysis.

The majority opinion began its analysis with two constitutional issues that Mr. Marshall raised: specifically, he challenged the imposition of the tax on him as a violation of the commerce clause and of the due process clause of the United States Constitution.

On the commerce clause, the majority concluded that Mr. Marshall waived his argument, noting that he had focused his brief on the fact that he lacked minimum contacts with Pennsylvania and that the Supreme Court of the United States had held in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992) that minimum contacts was not the test to be applied under the commerce clause. *Marshall*, slip op. at 6. While I have not had the opportunity to read the briefs, treating this issue as waived strikes me as a very unfair result. From the excerpt of the brief that the majority cites, it is clear that Marshall's lawyers argued that he did not reside in or conduct business in Pennsylvania, and physical presence remains the central question in assessing whether a taxpayer has a sufficient nexus to the taxing state for the imposition of the tax to satisfy analysis under the dormant commerce clause. *Quill*, 504 U.S. at 314-18. In *Quill*, an out of state vendor challenged the imposition of a sales and use tax upon it under the commerce clause and the due process clause; the vendor won its commerce clause challenge because it lacked a physical presence in the taxing state. Since his lawyers argued that Marshall lacked a physical presence in Pennsylvania, the fact that they also argued that he lacked minimum contacts (the due process standard) should not have resulted in a waiver of his commerce clause challenge.

On the due process clause, the majority held that Marshall's decision to invest in a limited partnership which was set up for the sole purpose of investing in real property in Pennsylvania was sufficient to give him minimum contacts with the state. Slip op. at 7-9. This result appears correct; it is certainly consistent with *Quill*, where the Supreme Court held that imposition of a sales and use tax did not violate the due process rights of a vendor who lacked a physical presence in the taxing state.

Marshall also attacked the tax assessment as imposing disparate treatment on out-of-state taxpayers, which raised issues under the commerce clause and equal protection clause of the United States Constitution, and under the uniformity clause of the Pennsylvania Constitution. The gist of his argument was straight-forward: Pennsylvania residents who invested in the partnership were permitted to offset any taxable gain from the cancellation of the partnership's indebtedness with the loss from their investment in the partnership. Marshall, however, as a non-resident, was not permitted the same ability to offset, which meant that he paid eleven times the tax of a Pennsylvania resident.

The majority rejected this argument, reasoning that Marshall's partnership interest was intangible property which must be sourced outside the Commonwealth for non-residents to satisfy the commerce clause. *Marshall*, slip op. at 48-49. This is technically correct, but nonetheless seems too facile: the commerce clause limits the power of a state to impose a tax, not to recognize a loss. If Pennsylvania is going to tax a non-resident partner on income that he receives from a partnership's Pennsylvania property, fairness would seem to suggest that he be permitted to offset losses associated with that investment for the purpose of calculating the amount of his income. Judge McCullough's dissenting opinion makes the same basic point, and concludes that Marshall had raised a legitimate claim under the uniformity clause of the Pennsylvania Constitution.

Jim Malone is a tax lawyer based in Philadelphia. © 2012, MALONE LLC.