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Pennsylvania Supreme Court Schedules Oral Argument in Bank Shares Tax Case

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The Pennsylvania Supreme Court has decided to hear oral argument in the *Lebanon Valley Farmers Bank* case[1], and has scheduled the argument for November 27. The decision in this case could result in either a big tax bill or a big refund opportunity for banks that have, in the past six years, been involved in a merger.

The *Lebanon Valley* case involves the Pennsylvania bank shares tax. The bank shares tax is based on a six-year average of a bank's equity. For a bank involved in a merger, the statute includes a combination provision that combines the pre-merger equity of the merged banks. But under the *First Union* case (which we won five years ago[2])—if a bank that is a bank-shares taxpayer (an "institution") merges with a bank that is not a bank-shares taxpayer (a "non-institution"), then the historical equity values are not combined. Instead, for pre-merger years, only the equity of the surviving bank is included in computing the six-year average.

The *Lebanon Valley* case was brought by a bank that is a bank-shares taxpayer that was involved in a merger with another in-state bank that was also a bank-shares taxpayer. Lebanon Valley wanted to exclude the equity value of the bank that did not survive the merger. Lebanon Valley argued that the merger of two in-state banks is treated less favorably than the merger of an out-of-state bank with an in-state bank, and that the different treatment violated the uniformity clause of the Pennsylvania constitution.

The Commonwealth Court agreed with Lebanon Valley that there is a constitutional problem with the statutory method of computing the bank shares tax base for banks engaging in merger transactions.[3] The court concluded that the statute "renders an artificially low tax base for only certain taxpayers" and "is unconstitutional and cannot be employed." The court further determined that the "averaging methodology … can be severed … when the taxable amount of shares results from the merger of an institution with a non-institution or an institution that has been in existence for fewer than six years …." Thus, the court agreed with the Department of Revenue's remedy that "***the institution resulting from the merger [between an in-state bank and an] … out-of-state bank must be treated as a new institution for purposes of computing the taxable amount of shares***."[4]

If the Commonwealth Court's decision stands, then any bank-shares taxpayer that has been involved in a merger in the past six years may be required to recompute its tax base for the years following the merger, by completely disregarding the equity of both of the merging banks for pre-merger years.

The Commonwealth Court ordered the Department of Revenue to provide meaningful backward-looking relief by either: (1) assessing additional tax against banks that were involved in mergers with out-of-state banks; (2) refunding tax paid by banks involved in in-state mergers; or (3) some combination of (1) and (2).

Lebanon Valley appealed the decision to the Pennsylvania Supreme Court, which has granted oral argument for November 27, 2012. The court has expressly limited the issue for argument (which it "restated for clarity") to "whether the Shares Tax violates the Uniformity Clause and, if so, which remedy is proper."

If you have questions about the impact of the *Lebanon Valley* case, please contact one of the authors or the Reed Smith attorney with whom you usually work. For more information on Reed Smith's Pennsylvania tax practice, visit www.reedsmith.com/patax.

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1. *Lebanon Valley Farmers Bank v. Commonwealth*, Docket 78 MAP 2011.
2. *First Union National Bank v. Commonwealth*, 587 Pa. 507 (2006).
3. *Lebanon Valley Farmers Bank v. Commonwealth*, 27 A.3d 288 (Pa. Cmwlth. 2011).
4. *Id*. at 298. (emphasis added).