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In this installment of From the SALT Minds, Ely and Long explore a recent North Carolina Business Court ruling, now on appeal to the state's supreme court, that illustrates the tension between tax policy as established by elected officials and the implementation (or not) of that policy by state tax authorities in the context of allocable tax credits.

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One of the worst nightmares of state industrial recruiters is to see media articles about the aggressive audit activities of their own state tax authority, with titles announcing the state and its tax administrator are "shaking business confidence"[1] in the state, improperly auditing tax credits,[2] rejecting legitimate tax credits,[3] and sending "mixed messages on clean energy."[4] It's even worse when their own state chamber of commerce writes and publishes a letter of concern to the governor, complaining about the alleged overreach of the North Carolina Department of Revenue in auditing taxpayers claiming the North Carolina renewable energy (RE) tax credit. That letter was signed by more than 150 businesses and business owners.[5] It's worse yet when a reputable firm that structures federal and state tax credit partnerships around the country is angry enough to sue the DOR for "declaratory relief and damages arising from constitutional violations," including the alleged destruction of its business in that state.[6]

To set the stage, this case involves North Carolina Farm Bureau Mutual Insurance Company Inc. and several other insurance companies that invested in syndicated tax credit partnerships through which their capital was

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[1] Zachery Eanes, "Solar Farm Investors Say State's Tax Collector Is Shaking Business Confidence in NC," *The Charlotte Observer*, Dec. 10, 2020.

[2] Darren Sweeney, "NC Solar, Business Advocates Blast State Audit of Renewable Energy Tax Credits," S&P Global, Feb. 12, 2021.

[3] Don Carrington, "Is Cooper's Revenue Department Rejecting Legitimate Tax Credits?" *The Carolina Journal*, Aug. 6, 2019.

[4] "Our Opinion: The State Sends Mixed Messages on Clean Energy," *Greensboro News & Record*, Oct. 7, 2019.

[5] News Release, "NC Chamber Weighs in on Renewable Credits to Protect Investor Confidence," (Jan. 22, 2021).

[6] *Monarch Tax Credits LLC v. North Carolina Department of Revenue*, Case No. 19-CVS-12647, 2021 NCBC 6 (N.C. Super. Ct. Jan. 25, 2021).

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invested in renewable energy projects in the state.[7] The RE credit was enacted in 1999 (although other renewable energy credits existed as early as 1977) and was expanded in 2009 to apply against the state's insurance premium tax, until the credit sunset in 2016. One would think that the legislators' expansion of the RE credit statute in 2009 to specifically include the insurance premium tax would make it clear to the DOR that the General Assembly remained enthusiastic and supportive about the value of these tax credits and wished to attract more capital to the state. That amendment in essence reaffirmed the stated goal of "promot[ing] the development of renewable energy and energy efficiency" and "encourag[ing] private investment in renewable energy and energy efficiency."[8] And that statute went hand in hand with section 105-269.15, which expressly authorizes partnerships (including multimember LLCs classified as partnerships for federal tax purposes) to claim the RE credit and several other credits and to pass through the credit to their partners/members.[9]

As mentioned below, there is a provision in the U.S. Constitution and in most, if not all, state constitutions called the separation of powers clause. Article I, section 6 of the North Carolina Constitution provides: "The Legislative, Executive, and Supreme Judicial Powers of the State Government shall be forever separate and distinct from each other." Article II, section 23, and Article V of the North Carolina Constitution grant the power to make laws exclusively to the General Assembly. Conversely, the DOR is charged with administering the state's tax laws.[10]

The North Carolina DOR is not the first, nor will it be the last, tax authority to disfavor tax credits being parceled out via passthrough entities to investors whose primary — or perhaps exclusive — reason for investing in so-called syndicated partnerships is to receive the after-tax benefit of the credit. In this instance, the benefit took the form of the now-expired RE tax credit. As here, the objections by taxing authorities to these common structures usually center around technical arguments about whether there was a true or bona fide partnership and whether the investor was a true partner. However, the DOR didn't always believe that the syndicated investment structures were subject to this line of attack — not formally announced until a 2018 notice — as evidenced by its issuance and publication of several corporate tax private letter rulings (CPLRs) before 2016, approving the types of partnership structures used by investors to benefit from the RE credit.[11]

The about-face by the DOR from initially blessing then disallowing the allocation of RE credits on audit (several years after the credit sunset) was met with stiff opposition from the business community, and there were no fewer than six amicus briefs filed with the Business Court in favor of the taxpayer. In our opinion, the most persuasive brief was filed by the North Carolina Chamber's Legal Institute. The principal author was the indefatigable professor Richard D. Pomp — himself no fan of tax incentives. An excerpt stated:

> This closely watched case squarely presents a question implicating North Carolina's business climate. Namely, whether investors can rely on a promise by the North Carolina General Assembly. . . . to offer tax credits in exchange for the capital investments and renewable energy. In December of 2020, more than one hundred fifty North Carolina-based organizations and leaders publicly stated their dismay with the approach taken by the Department of Revenue . . . in this matter [referring to the above-mentioned letter to the governor].

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[7] *North Carolina Farm Bureau Mutual Insurance Co. Inc. v. North Carolina Department of Revenue*, Case No. 20-CVS-10244, 2023 WL 2754645 (N.C. Super. Ct. Apr. 3, 2023); *see also McCabe v. North Carolina Department of Revenue*, Case No. 21-CVS-5724, 2023 WL 2754635 (N.C. Super. Ct. Apr. 3, 2023).

[8] N.C. Gen. Stat. section 62-2(a)(10)c.

[9] For a detailed analysis of the lead ruling, see William W. Nelson, "Major Taxpayer Win in North Carolina Renewable Energy Tax Credit Dispute," *Tax Notes State*, May 8, 2023, p. 497.

[10] *See, e.g., Burgess v. Your House of Raleigh Inc.*, 388 S.E.2d 124, 137 (N.C. 1990) ("The primary rule of construction of a statute is to ascertain the intent of the legislature and to carry out such intention to the fullest extent.") (citation omitted).

[11] *See* CPLRs 2010-08R, 2012-05, 2012-10, 2013-04B, 2013-05B, 2013-07, 2013-18, 2014-05, 2014-07, 2014-09, 2015-01, 2015-02, 2015-05, 2015-10, 2015-11, and 2015-12. In CPLR 2015-08, the DOR first qualified its ruling on the investors being treated as partners for federal income tax purposes.

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> The DOR's action, resulting in a bait and switch, violates the North Carolina Constitution's separation of powers principles, obliterates the Legislature's intent in adopting the credits, and violates deep seated, fundamental norms of fairness, reliance, and finality. If the DOR's blatant disregard of the Legislature's will is allowed to stand, North Carolina cannot guarantee future investors that their reliance interests will be protected. Investors will be warned that they heed North Carolina law at their own risk. The damage to the North Carolina business climate, so carefully cultivated over time, is obvious, and will result in the Legislature's loss of tools needed for economic development.[12]

The DOR argues that section 105-269.15 incorporates federal definitions of partner and partnership, which depart from the definitions used in other parts of the state's Revenue Act. The Business Court firmly rejected that interpretation, writing:

> The Department worries that this interpretation elevates form over substance and invites abuse. Its concern is exaggerated. North Carolina courts are far from powerless when faced with abuse of the corporate form. . . . *This isn't that kind of case. The transactions at issue were real, not fictitious, and they involved exactly the kind of economic activity that the General Assembly deemed socially desirable and sought to encourage with tax credits.* Farm Bureau contributed millions of dollars to support renewal energy properties — properties that were, in fact, placed in service and that did, in fact, qualify to receive tax credits. Yes, its goal in joining the Annual Funds was undoubtably to obtain tax benefits, which would be suspect if the activity that generated the tax benefits lacked substance or was otherwise a sham. Again, though, the renewable energy properties in this case were real and qualified for tax credits. *Pursuing real economic ends for tax-related reasons is legitimate.*[13]

Moreover, the Business Court opined that "even if the Department's interpretation were correct, it would not be entitled to summary judgment. Federal courts do not lightly set aside *de jure* partnerships as shams."[14] That case involved an unsuccessful IRS challenge to the validity of a multitier LLC used to market refined coal production tax credits to investors.[15] The court cited *Cross Refined Coal* multiple times, including for the proposition that a "partnership's pursuit of after-tax profit can be a legitimate business activity for partners to carry on together. This is especially true in the context of tax incentives, which exist precisely to encourage activities that would not otherwise be profitable."[16] The court also rejected the DOR's disguised sale argument, writing: "If the General Assembly had intended to adopt a law as complex and well-defined as the disguised sale rule, it would have used clear, specific language to do so. It did neither."[17]

In the face of clear legislative intent, multiple reenactments of the RE tax credit statute, numerous published CPLRs approving multitier partnership structures, and the Business Court's thorough ruling, the DOR's decision to appeal that ruling to the North Carolina Supreme Court is surprising. One would think that Gov. Roy Cooper (D) (perhaps at the behest of his own economic development agency) might intervene here, and hopefully he soon will. ■

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[12]Brief of Amicus North Carolina Chamber Legal Institute at 4, *North Carolina Farm Bureau Mutual Insurance Co.*, Case No. 20-CVS-10244 (filed Jan. 25, 2021).

[13]*North Carolina Farm Bureau Mutual Insurance Co.*, Case No. 20-CVS-10244, at para. 51-52 (emphasis supplied).

[14]*Id.* at para 55 (citing *Cross Refined Coal LLC v. Commissioner of Internal Revenue*, 45 F.4th 150, 156 (D.C. Cir. 2022)).

[15]*See* IRC section 45.

[16]*North Carolina Farm Bureau Mutual Insurance Co.*, Case No. 20-CVS-10244, at para. 58.

[17]*Id.* at para. 71.

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