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By Hand Delivery (Courier)

North Carolina Department of Revenue
c/o Secretary Ronald G. Penny
501 North Wilmington Street
Raleigh, NC 27604

RE: REQUEST FOR DECLARATORY RULINGS FROM THE NORTH CAROLINA
DEPARTMENT OF REVENUE PURSUANT TO N.C. GEN. STAT. § 150B-4

Dear Secretary Penny:

My colleague, Reed Hollander of Nelson Mullins Riley & Scarborough, LLP, and I represent Monarch Tax Credits, LLC, formerly known as State Tax Credit Exchange, LLC (“Monarch”). We are writing on behalf of Monarch to formally request declaratory rulings from the North Carolina Department of Revenue (“NCDOR”) pursuant to N.C. Gen. Stat. § 150B-4, as described more fully below.

I. Authority

The Administrative Procedure Act “establishes a uniform system of administrative rule making ... for agencies” which “confers procedural rights” on the public. N.C. Gen. Stat. § 150B-1(a) and (b). The only portion of that Act from which the Department of Revenue is exempted is “the notice and hearing requirements contained in Part 2 of Article 2A.” N.C. Gen. Stat. § 150B-1(d)(4).

That Act specifically provides for declaratory rulings of the type requested here to be issued by NCDOR. N.C. Gen. Stat. § 150B-4 provides in pertinent part:

On request of a person aggrieved, an agency shall issue a declaratory ruling as to the validity of a rule or as to the applicability to a given state of facts of a statute administered by the agency or of a rule or order of the agency.

Further, N.C. Gen. Stat. § 150B-2(1a) provides: “Agency” means “an agency or an officer in the executive branch of the government of this State and includes ... a department ... in the executive branch.” Further, a “rule” is broadly defined to include

“any agency regulation, standard, or statement of general applicability that implements or interprets an enactment of the General Assembly or Congress or a regulation adopted by a federal agency or that describes the procedure or practice requirements of an agency.” N.C. Gen. Stat. § 150B-2(8a).

This request regards the validity of a rule – namely, the September 10, 2018 “Important Notice: Tax Credits Involving Partnerships” (hereinafter, the “September 10 Notice”) (copy enclosed).

II. Background

Monarch is a Georgia limited liability company that facilitates investments in renewable energy, historic redevelopment, and mill restoration projects throughout North Carolina. The North Carolina General Assembly has enacted tax credit programs to encourage investment in projects based on political priorities, which projects otherwise would be economically unviable. Taxpayers complied with North Carolina’s renewable energy mandate and the legal requirements set forth by the General Assembly and NCDOR. NCDOR’s disallowance of these tax credits punishes taxpayers for accepting the General Assembly’s invitation to make investments in North Carolina by participating in a politically-identified priority and socially responsible initiative.

During the relevant time period, Monarch’s customers invested in these projects via Monarch-sponsored partnerships and expected to receive an allocation of state tax credits pursuant to North Carolina General Statutes Chapter 105 (“Chapter 105”) Articles 3B, 3D, 3H, and/or 3L. NCDOR has asserted standards and made statements interpreting enactments of the General Assembly in the September 10 Notice that have substantially harmed Monarch, including in its ability to receive investments and its relationships with its investors. For these reasons and others, Monarch is a party aggrieved entitled to make these requests.

The September 10 Notice asserts standards and makes statements that:

- (A) NCDOR should apply federal tax law partnership principles in determining whether investors’ interests are valid partnership interests and whether the investors can use the tax credits allocated to them;
- (B) Chapter 105 includes the consequences resulting from federal income tax treatment of “disguised sale” transactions under federal Internal Revenue Code (the “Code”) Section 707 and the regulations thereunder, and a disguise sale determination prevents credits from being allocated

to a taxpayer or from creating sufficient basis in the partnership necessary for a taxpayer to use the tax credits; and

- (C) Federal tax law decisions in *Historic Boardwalk Hall, LLC v. C.I.R.*, 694 F.3d 425 (3rd Cir. 2012) (“*Historic Boardwalk*”) and *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129, 145-46 (4th Cir. 2011) (“*Virginia Historic Tax Credits*”) are authoritative or controlling concerning when a North Carolina taxpayer can claim North Carolina renewable energy, mill redevelopment, or historic redevelopment tax credits.

Monarch views these positions as inconsistent with the constitution and laws of North Carolina. Accordingly, it requests the following declaratory rulings set forth in Section III below.

By way of further background, NCDOR’s conduct surrounding the September 10 Notice violates the mandate of North Carolina Constitution Article V, Section 1 that “[t]he power of taxation shall be exercised in a just and equitable manner.” Specifically, Monarch contends that NCDOR has acted with secrecy and undue delay when it possesses knowledge that its actions and failures to take action are substantially injuring Monarch’s business operations.

Beginning in January 2018, investors in Monarch-sponsored partnerships for certain projects began receiving audit notices from NCDOR for tax years 2014 to 2016. The focus of the audits were the investments in the various tax credit projects in North Carolina through Monarch-sponsored partnerships. The Information Document Requests (“IDRs”) associated with the audits were substantially similar. Monarch assisted the investors in responding to these audits and provided everything NCDOR requested on a timely – if not expedited – basis. Monarch also requested a meeting with NCDOR to address the agency’s supposed concerns and to attempt to resolve the audits in a mutually agreeable manner, even though NCDOR’s audits lacked a proper factual or legal foundation.

An initial meeting, held in May 2018, was attended by NCDOR representatives Ronald Penny (Secretary), Ken Wright (Legislative Liaison), Anthony Edwards (Assistant Secretary for Tax Administration), Eileen Sinclair (Administrative Assistant) and Jocelyn Andrews (Chief Operating Officer and Assistant Secretary for Tax Compliance), along with George Strobel, Nelson Freeman, and Ed Turlington representing Monarch. At this meeting, Monarch asked NCDOR’s representatives to explain the agency’s position regarding any claimed problems with the tax credits or the Monarch-sponsored partnership structure. NCDOR’s representatives declined to respond substantively or to explain NCDOR’s positions, but they did agree to a

second meeting. NCDOR's representatives specifically indicated that Monarch and NCDOR could discuss resolution at this second meeting.

A second meeting, held in July 2018, was attended by different NCDOR representatives, namely Alan Woodard (Director of Audit and Examinations), Rick Gilbert (Assistant Director for Interstate Audit), David Simmons, Lara Rose Eileen Sinclair (Administrative Assistant), and Ken Wright (Legislative Liaison). Monarch's attendees included George Strobel, Howard Williams, Nelson Freeman, and Craig Hoffman. At this second meeting, NCDOR's personnel commenced an interrogation of Monarch's attendees while refusing to discuss a resolution, as previously promised. NCDOR also refused to explain its position regarding any claimed problems with the tax credits or the Monarch-sponsored partnership structure, which was inconsistent with the Private Letter Rulings ("PLRs") issued by NCDOR in 2013 and NCDOR guidance issued in 2014. Moreover, NCDOR refused to answer any questions.

At a third meeting, NCDOR representatives stated that NCDOR had no inclination to enter into any settlement at that time.

Monarch consistently and repeatedly requested meetings to try to resolve the supposed issues with NCDOR or, at a minimum, to understand its position, but NCDOR has repeatedly declined to hold such a meeting or to engage in such substantive discussions. Notwithstanding that the September 10 Notice resulted in significant and substantial business losses to Monarch, NCDOR continued to delay the audits and claimed that it needed further information to better understand the situation when, in fact, it did not. NCDOR also consistently and repeatedly rejected Monarch's pleas to render a final decision and place it before an administrative law judge early in 2018 so that there could be a ruling on the lawfulness of NCDOR's apparent rejection of the credits, such that Monarch would possibly still have time to obtain investors in 2018. It appears that NCDOR delayed and drew out the audit process to deter third-party investments in Monarch's structures in 2018 and 2019, causing further losses to Monarch.

III. Declaratory Ruling Request

Consistent with our analysis below, and with reference to the September 10 Notice, pursuant to N.C. Gen. Stat. § 150B-4, Monarch seeks declaratory rulings that:

- (1) NCDOR lacks constitutional and statutory authority to adopt the Code's provisions concerning the validity of partnership interests for purposes of determining North Carolina state income tax;

- (2) Chapter 105 does not incorporate the Code's provisions concerning the validity of partnership interests for purposes of determining North Carolina state income tax;
- (3) Chapter 105 incorporates North Carolina state law principles concerning the validity of partnership interests for purposes of determining North Carolina state income tax;
- (4) Chapter 105 does not expressly adopt or incorporate Code Section 707 or 761;
- (5) Chapter 105 does not impliedly adopt or incorporate Code Section 707 or 761;
- (6) Chapter 105 does not include any provisions addressing so-called "disguised sales";
- (7) *Historic Boardwalk* is not binding authority concerning whether, for North Carolina state income tax purposes, a North Carolina taxpayer possesses a valid partnership interest in a partnership or may claim tax credits under Chapter 105;
- (8) *Virginia Historic Tax Credits* is not binding authority concerning whether, for North Carolina state income tax purposes, a North Carolina taxpayer possesses a valid partnership interest in a partnership, has engaged in a disguised sale, or may claim tax credits under Chapter 105;
- (9) The determination of whether a valid partnership interest exists for North Carolina state income tax purposes depends solely upon application of North Carolina's statutory and common law concerning partnerships and business organizations;
- (10) North Carolina's statutory and common law concerning partnerships and business organizations applies to Chapter 105's provisions governing partnerships and business organizations; and
- (11) For North Carolina income tax purposes, the rulings set out in Private Letter Rulings CPLR 2013-04B and CPLR 2013-05B are not subject to Code Section 707, *Historic Boardwalk*, or *Virginia Historic Tax Credits* or other supposedly governing principles of federal tax law concerning whether a bona fide partnership interest exists.

IV. Analysis

The North Carolina General Assembly possesses the exclusive power to make state tax law. N.C. Const. Art. I, § 23. The General Assembly has done so by enacting Chapter 105. N.C. Gen. Stat. § 105-1, *et. seq.* The General Assembly has delegated to NCDOR only the power to interpret the tax laws promulgated by the General Assembly. N.C. Gen. Stat. § 105-264. NCDOR's limited role exists not only as a matter of legislative mandate, but also as a matter of constitutional imperative. N.C. Const. Art. II, § 1. ("The legislative power of the State shall be vested in the General Assembly."); N.C. Const. Art. I, § 6 ("The legislative, executive, and supreme judicial powers of the State government shall be forever separate and distinct from each other."). Both the General Assembly and NCDOR are bound by the North Carolina Constitution's mandate that "[t]he power of taxation shall be exercised in a just and equitable manner, for public purposes only, and shall never be surrendered, suspended, or contracted away." N.C. Const. Art. V, § 2(1). The positions stated in NCDOR's September 10 Notice violate these constitutional and statutory protections.

Federal tax law is irrelevant to the determination of whether a valid partnership exists for purposes of Chapter 105. The general rule is that, without a "[c]lear and specific reference" in Chapter 105 invoking the Code, the Code has no application in determining taxable income in North Carolina. *Fidelity Bank v. N.C. Dep't of Revenue*, 370 N.C. 10, 20 (2017). In *Fidelity*, NCDOR argued that the Revenue Act was not "a wholesale adoption of all Code provisions and definitions" in an effort to prevent a taxpayer from using Code principles to conform the federal tax treatment of market discount income as deductible interest because the state tax provision contained no language evidencing legislative intent to require state law to mirror federal law. NCDOR is not a lawmaking body and cannot arrogate to itself legislative power to adopt federal tax law when it serves to increase taxes but reject federal tax law when it would reduce taxes.

Chapter 105 makes "clear and specific" references to only two Code provisions addressing federal partnership taxation principles, as follows:

- (a) Qualification. - A partnership that engages in an activity that is eligible for a tax credit qualifies for the credit as an entity and then passes through to each of its partners the partner's distributive share of the credit for which the partnership entity qualifies. Maximum dollar limits and other limitations that apply in determining the amount of a tax credit available to a taxpayer apply to the same extent in determining the amount of a tax credit for

which the partnership entity qualifies, with one exception. The exception is a limitation that the tax credit cannot exceed the amount of tax imposed on the taxpayer.

(b) Allowance of Credit to Partner. - A partner's distributive share of an income tax credit passed through by a partnership is allowed to the partner only to the extent the partner would have qualified for the credit if the partner stood in the position of the partnership. All limitations on an income tax credit apply to each partner to the extent of the partner's distributive share of the credit, except that a corporate partner's distributive share of an individual income tax credit is allowed as a corporation income tax credit to the extent the corporate partner could have qualified for a corporation income tax credit if it stood in the position of the partnership. All limitations on an income tax credit apply to the sum of the credit passed through to the partner plus the credit for which the partner qualifies directly.

(c) Determination of Distributive Share. - A partner's distributive share of an income tax credit shall be determined in accordance with **sections 702 and 704 of the Code**.

N.C. Gen. Stat. § 105-269.15 (emphasis added).

Notably, this provision does not define the term partnership by reference to the Code, nor does it invoke the Code's provisions concerning when federal tax law treats a partnership interest as valid. Instead, Section 269.15 incorporates only two provisions of the Code – Sections 702 and 704 – for purposes of determining how to calculate a partner's distributive share. There is no indication in Section 269.15, or otherwise in Chapter 105, that the General Assembly intended for NCDOR to deviate from North Carolina law governing business entities to determine the existence of a valid partnership interest. *See, e.g.,* N.C. Gen. Stat. § 105-153.3(13) (defining partnership); *id.* § 59-36 (same). Further, no Code provisions other than Sections 702 and 704 are adopted in Section 269.15.

NCDOR lacks the authority to adopt the Third Circuit's analysis in *Historic Boardwalk* as North Carolina law or to rely upon it as persuasive authority concerning whether a partnership interest is valid under North Carolina law. The General Assembly has not adopted *Historic Boardwalk*; it is a case that does not apply

North Carolina law or correspond to any provision of North Carolina law, and decisions of the federal Third Circuit Court of Appeals are not binding in North Carolina or outside of the Third Circuit.

The foregoing analysis also governs NCDOR's invocation of Code Section 707, which sets out federal tax law governing disguised sales. Chapter 105 does not incorporate Section 707 and NCDOR has no authority to engage in the legislative function of adopting Section 707 as a provision of North Carolina tax law.

NCDOR similarly lacks the authority to adopt *Virginia Historic Tax Credits* as binding on North Carolina taxpayers. NCDOR's basis for invoking *Virginia Historic Tax Credits* is its analysis of federal Tax Code Section 707. But, as Section 707 does not apply to North Carolina state taxes, neither does *Virginia Historic Tax Credits*. More generally, *Virginia Historic Tax Credits* interprets federal tax law and does not govern whether an investor can claim North Carolina state tax credits. *Virginia Historic Tax Credits* did not answer the question of whether the investors at issue in that case could claim state historic tax credits for purposes of state taxation.

Assuming arguendo that *Virginia Historic Tax Credits* has any applicability to North Carolina state tax credits, NCDOR has misconstrued the decision. The case addresses whether the recipient of a contribution must recognize federal income from a transfer, not the allowance or disallowance of state tax credits. *Virginia Historic Tax Credits*, 639 F3d at 146, n.20. It provides no basis for disallowing tax credits claimed by Monarch's investors.

The September 10 Notice also inaccurately describes federal law by cherry-picking cases without the context and evolution of the economic substance doctrine now codified in Section 7701(o). Federal case law, along with Congressional codification of the economic substance doctrine, make clear that a pre-tax profit is not required for a government sanctioned tax credit. *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995). Moreover, federal case law makes clear that the taxpayers at issue would be partners under federal law.

The September 10 Notice also creates confusion concerning NCDOR's position on Private Letter Rulings CPLR 2013-04B and CPLR 2013-05B. The Private Letter Rulings do not reference Code Section 707, *Historic Boardwalk*, or *Virginia Historic Tax Credits* or other supposedly governing principles of federal tax law concerning whether a bona fide partnership interest exists. NCDOR needs to clarify that the rulings set out in Private Letter Rulings CPLR 2013-04B and CPLR 2013-05B are not subject to any federal law principles not specifically recited therein.

North Carolina Department of Revenue
August 1, 2019
Page 9

V. CONCLUSION

We appreciate your attention to this request and look forward to hearing from you within the time provided by N.C. Gen. Stat. § 150B-4(a1). Please feel free to contact us should you have any questions.

Warm regards,



Joseph S. Dowdy

cc:

By Hand Delivery (Courier) and email

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NCDOR

NORTH
CAROLINA
DEPARTMENT
OF REVENUE

IMPORTANT NOTICE: TAX CREDITS INVOLVING PARTNERSHIPS

The Department has recently received inquiries regarding the requirements for claiming North Carolina tax credits, particularly with regard to credits claimed in connection with a taxpayer's transactions with a partnership (or other flow-through entity). While each individual situation should be evaluated with the assistance of tax advisors knowledgeable in both tax credits and partnership tax rules, this notice provides sources of information to assist in evaluating the validity and potential amount of the respective tax credit. These sources are not intended to be an exhaustive list of relevant available information and should not be relied on as such.

North Carolina and Federal Tax Statutes

Credits against North Carolina tax are generally contained in Articles 3A through 3L of Chapter 105 of the General Statutes. With a few exceptions, most of these credits have expired. However, for credits or installments of credits still in effect, N.C. Gen. Stat. §§ 105-228.90 and 105-269.15 provide relevant definitions and guidance for a taxpayer claiming a credit through a transaction with a partnership. Some of these statutes require an understanding of federal income tax partnership and basis rules.

The Internal Revenue Code ("Code") provides guidance for the formation of bona fide partnership arrangements and allocation of partnership items to taxpayers. North Carolina generally follows the Code, subject to statutory exceptions and definitional differences.¹ In certain instances, North Carolina law or Chapter 105 directly references the Code. For example, N.C. Gen. Stat. § 105-269.15 specifically refers to sections 702 and 704 of the Code. In addition, this statute further references a "partner's distributive share," terms explained in sections 702 and 704.

It is the Department's position that relevant statutes in Chapter 105 include consequences resulting from federal income tax treatment of transactions generally known as "disguised sales" pursuant to section 707 of the Code and the regulations thereunder. Thus, a "disguised sale" determination prevents tax credits from being allocated to a taxpayer under section 704 or from creating sufficient basis in the partnership necessary for a taxpayer to use the tax credits.

Furthermore, the Department believes the termination of a partnership under section 708(b)(1)(B) of the Code, occurring prior to the repeal of section 708(b)(1)(B), are also

¹ See, e.g., *The Fidelity Bank v. North Carolina Department of Revenue*, 803 S.E. 2d 142 (2017).

applicable. Thus, a partnership that terminated under section 708(b)(1)(B) would lose its allocable credits at the time of the section 708(b)(1)(B) transaction.

Federal Case Law

Several U.S. Circuit Courts of Appeals, as well as the Tax Court, have addressed federal income tax issues that are relevant for North Carolina tax credits claimed by partnerships and taxpayers. Notably, Virginia Historic Tax Credit² provides an analysis of disguised sale transactions involving state tax credits, and Historic Boardwalk³ discusses bona fide partner and partnership arrangements.

Because Virginia Historic Tax Credit is a Fourth Circuit Court of Appeals decision, the case is controlling for North Carolina. In a Private Letter Ruling, the Department has specifically stated its position that a person not qualifying as a partner under federal income tax would not qualify for allocation of a credit.⁴

North Carolina Private Letter Rulings

The Department has issued private letter rulings on the use of partnerships with various credits. Rulings from 2010 forward have been redacted and made publicly available at the direction of the General Assembly. These rulings, redacted pursuant to N.C. Gen. Stat. § 105-264.2(c), are available at:

<https://www.ncdor.gov/taxes/corporate-income-franchise-tax/determinations/corporate/written-determinations-corporate-tax>

Taxpayers should be aware that private letter rulings are only binding with respect to the requesting party, address only the specific rulings requested, and based only on the facts as presented. Accordingly, they should not be viewed as a blanket guarantee that all the criteria for claiming the credit have been met, including the party receiving the ruling.

Conclusion

In response to the inquiries received, the Department suggests that taxpayers review the above referenced materials, as well as information available from other sources, and discuss with their tax advisors the impact on the availability and amount of credits available for use against North Carolina tax liabilities. In addition, a taxpayer may request a private letter ruling through the Department's Written Determination policy, available at:

² *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011).

³ *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), *cert. denied*, 133 S.Ct. 2734 (2013).

⁴ CPLR 2013-09R (August 13, 2013).

<https://www.ncdor.gov/taxes/corporate-income-tax-information/corporate-income-franchise-and-insurance-tax-bulletins/determinations/written-determinations>

After reviewing the above information, if taxpayers or tax advisors believe the amount of tax credits claimed on original returns are incorrect, they may file amended returns with the Department. If the amended return reflects additional tax due, the taxpayer will avoid a late-payment penalty if the additional tax reflected on the amended return is paid when the amended return is filed. If the amended return reflects additional tax due but some or all of the additional tax is not paid when the amended return is filed, the unpaid tax is subject to applicable penalties. In addition, statutory interest accrues on tax not paid by the original due date of the tax return. Taxpayers that owe additional North Carolina income tax may request a waiver of penalties resulting from the underpayment of tax attributable to such income within the provisions of the Department's penalty waiver policy available at:

<https://www.ncdor.gov/documents/penalty-waiver-policy>

To the extent there is any change to a statute or regulation, or new case law subsequent to the date of this notice, the provisions in this important notice may be superseded or voided. To the extent that any provisions in any other notice, directive, technical bulletin, or published guidance regarding the subject of this notice and issued prior to this notice conflict with this important notice, the provisions contained in this important notice supersede the previous guidance.