taxnotes® state

Volume 106, Number 12 ■ December 19, 2022

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Reprinted from *Tax Notes State*, December 19, 2022, p. 1125

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Is North Carolina's Renewable Energy Tax Credit Saga Reaching Its End?

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In this article, Nelson reviews North Carolina's ongoing effort to claw back its renewable energy tax credits.

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Since 2019 North Carolina taxpayers have been embroiled in litigation over the state's former renewable energy tax credit program. In the latest twist in this saga, the North Carolina Business Court has issued an important decision confirming that the Department of Revenue cannot deprive an administrative law judge of jurisdiction in a contested tax case by withdrawing the agency action that is the subject of the dispute. The case, which has important implications for future tax appeals, is just the most recent development in a controversy that involves hundreds of taxpayers and hundreds of millions of dollars of tax credits.

The Renewable Energy Tax Credit Program

Integon[1] is one of a series of cases involving the tax credit program now working their way through the North Carolina courts. The program began in 1999 when the General Assembly enacted a tax credit for purchasing, leasing, or constructing renewable energy property. The credit was equal to 35 percent of the cost of the property and could be claimed against the income tax or the franchise tax. A credit was generated when renewable energy property was placed in service but was required to be taken in five annual installments. If the renewable energy property was damaged, taken out of service, or removed from the state, any remaining installments were forfeited.[2] The program expired in 2016.

The tax credit statute also provided that when a partnership constructed, purchased, or leased renewable energy property, the partnership could qualify for the credits and pass them through to its partners through partnership allocations.[3] This facilitated the pooling of capital required for most large-scale projects.

The recession that followed the subprime mortgage crisis of 2007 reduced business profits and thus the utility of income tax credits. This curtailed the flow of tax credit money into renewable energy projects. The General Assembly responded by expanding the credit program in 2009 to permit the credits to be taken against the insurance company gross premiums tax, a tax that is not dependent on profitability.[4] The insurance industry responded generously, becoming a major source of financing for the renewable energy sector.[5]

During most of the life of the tax credit program, the DOR was generally supportive. For instance, it issued numerous private letter rulings over the years blessing a variety of common

[1] *North Carolina Department of Revenue v. Integon National Insurance Co.*, 21 CVS 14395 (N.C. Bus. Ct. Nov. 22, 2022).

[2] N.C. Gen. Stat. section 105-129.16A.

[3] *See* N.C. Gen. Stat. section 105-269.15.

[4] *See* 2009 N.C. Sess. Laws ch. 548 section 3.

[5] *See, e.g.*, North Carolina DOR, 2017 Economic Incentives Report.

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syndicated partnership structures. These rulings demonstrated that the DOR was aware of, and comfortable with, complicated but familiar structures that, among other things:

1. segregated the federal and state credits through lease or sale-leaseback arrangements;
2. separated syndications of the federal and state credits through parallel investment vehicles;
3. allocated the credits through multiple tiers of passthrough entities; and
4. segregated each annual credit installment through separate classes of interests or separate upper-tier entities for each installment.[6]

North Carolina's renewable energy tax credit program was a considerable success. Developers and syndicators created the financial infrastructure needed to marshal separate pools of investors interested in the state credits and the corresponding federal credits and to direct the investors' funds into large-scale projects. The total economic impact in North Carolina from clean energy project development, including renewable energy projects, between 2007 and 2016 was $19.9 billion, including $10 billion in clean energy development spending. Almost 90 percent of these renewable energy investments were made in North Carolina's most economically distressed counties, and clean energy development during this period supported 126,440 annual full-time equivalent jobs.[7] By 2017, shortly after the program expired, North Carolina ranked second in the country in solar capacity.[8]

DOR's First Reversal — The 2018 'Important Notice'

The first reversal in what had been the smooth path of the tax credit program came in 2017. In that year, after the program had expired, but while installments of previously generated credits were still being taken, the DOR began auditing syndicated tax credit investors and disallowing any credits taken in open years. The last three years of the tax credit's life were its most successful, and the total amounts at stake were consequently large, reaching potentially to hundreds of millions of dollars.

The DOR's audits followed a uniform pattern. The auditors first asserted that the partnerships in which the taxpayer invested were not bona fide partnerships because of a purported lack of upside potential and downside risk. Even if the partnerships were legitimate, the auditors claimed the credits had not been received through partnership allocations, as the statute required, but through disguised sales. This dramatic reversal of the DOR's policy culminated in a 2018 "Important Notice" warning taxpayers that the bona fide partnership and disguised sale concepts could be applied to disallow credits claimed through partnerships.[9] Of course, this warning was too late for renewable energy tax credit investors, since the program had expired two years before.

Under North Carolina's procedure for contesting a proposed assessment or refund denial, the taxpayer must file an objection to the proposed action and request review by the DOR. The department's decision on review is reflected in a Notice of Final Determination (NOFD). A taxpayer wishing to contest an NOFD must file a contested case petition with the state's Office of Administrative Hearings (OAH), a central panel tribunal with jurisdiction to hear a petition from any person aggrieved by almost any of the state's executive agencies. A taxpayer who loses at the OAH must pay the tax due (in an assessment case) and may then file a petition for judicial review with the North Carolina Business Court, a special division of the superior court charged with hearing complex business cases, including tax cases.[10]

The first two tax credit investors to have their cases heard at the OAH were an insurance company, the North Carolina Farm Bureau Mutual Insurance Co., and a married couple, John and Rebecca McCabe. Both taxpayers filed their

[6] *See, e.g.*, North Carolina DOR, Private Letter Rulings CPLR 2015-10, CPLR 2015-08, CPLR 2014-05, CPLR 2013-08, and CPLR 2012-05.

[7] *See* RTI International, "Economic Impact Analysis of Clean Energy Development in North Carolina — 2017 Update" (Oct. 2017).

[8] *See* Amanda Levin, "2017 Clean Energy by the Numbers: A State-by-State Look" Natural Resources Defense Council (Feb. 28, 2018).

[9] *See* North Carolina DOR, "Important Notice: Tax Credits Involving Partnerships" (2018).

[10] *See generally* N.C. Gen. Stat. section 105-241.11 et seq. (2022).

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petitions at the OAH in 2019 and both cases were assigned to the same ALJ. Both cases were extensively briefed and argued, including the submission of numerous expert reports by nationally prominent tax professors and practitioners. In both cases, the taxpayer and the DOR filed cross-motions for summary judgment. In both cases, without conducting a hearing, the ALJ issued decisions upholding the NOFD. The decision in *Farm Bureau* stated, without elaboration, that "based on the partnership structure, Farm Bureau's investment was not in the renewable energy property itself but rather in the credits that the property generated."[11] The decision in *McCabe* upheld the DOR's findings that the taxpayers were not partners in a bona fide partnership and that even if they were, they had engaged in a disguised sale, and added that the taxpayers had "purchased the renewable energy credits" in an actual sale transaction.[12]

Both taxpayers appealed the ALJ's decision to the business court. *Farm Bureau* was heard before Judge Adam Conrad on September 30, 2021, and *McCabe* was heard before the same judge on September 13, 2022. Decisions in both cases are pending. In addition to these taxpayer actions, one of the leading syndicators operating in North Carolina filed an action against the DOR for declaratory and other relief under North Carolina's Administrative Procedure Act. That action is also pending in the business court before Conrad.[13]

DOR's Second Reversal — *Fidelity Bank*

The audit reports issued to taxpayers and the 2018 Important Notice relied heavily, if not entirely, on federal tax law concepts. For instance, the audit reports reprinted the text of IRC section 707 and its supporting regulations for the disguised sale doctrine. The Important Notice cited *Boardwalk Hall*[14] for the bona fide partnership doctrine and *Virginia Historic*[15] for the disguised sale doctrine, even describing *Virginia Historic* as "controlling" for North Carolina taxpayers.

The issues briefed and argued in *Farm Bureau* and *McCabe* included the relevance of these federal tax authorities to the resolution of a state tax dispute. The leading precedent on the relevance of federal tax law to North Carolina tax cases is *Fidelity Bank*.[16] In that case, the North Carolina Supreme Court considered whether a corporation could exclude market discount earned on U.S. government bonds from its North Carolina income. The corporation had purchased U.S. bonds below face value and held them until maturity. Under IRC section 1276, market discount is treated as interest, and under state law, a taxpayer may subtract interest received on U.S. government obligations in calculating state net income.[17] The taxpayer in *Fidelity Bank* argued that because North Carolina uses federal taxable income "as determined under the Code" as the starting point for calculating state net income, the term "interest" in the North Carolina statute should be given its meaning under the code.

At the DOR's urging, however, the court held that "when the General Assembly intends to adopt provisions or definitions from other sources of law into a statute, it does so by *clear and specific reference*."[18] The court found that the General Assembly had never adopted the code's definition of interest. The court therefore relied on state law precedents to limit the meaning of the term to a series of periodic payments, thereby excluding market discount.[19]

The DOR's position on the applicability of federal tax law in the renewable energy tax credit cases thus directly contradicts the position it advocated successfully just two years earlier in *Fidelity Bank*. The 2018 Important Notice even stated that "North Carolina generally follows the Code, subject to statutory exceptions and

[11] *North Carolina Farm Bureau Mutual Insurance Co. v. North Carolina Department of Revenue*, 19 REV 00439 (N.C. OAH Aug. 17, 2020), final decision at 6.

[12] *McCabe v. North Carolina Department of Revenue*, 19 REV 06681 (N.C. OAH Mar. 30, 2021), final decision at 19.

[13] *See Monarch Tax Credits LLC v. North Carolina Department of Revenue*, 19 CVS 12647 (N.C. Bus. Ct. Sept. 26, 2019), petition for judicial review.

[14] *Historic Boardwalk Hall LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012).

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

[16] *Fidelity Bank v. North Carolina Department of Revenue*, 370 N.C. 10, 803 S.E.2d 142 (2017).

[17] *See* N.C. Gen. Stat. section 105-130.5.

[18] *Fidelity Bank*, 370 N.C. at 20-21 (emphasis added).

[19] *See Fidelity Bank*, 370 N.C. at 20. *See also* William W. Nelson, "The Application of Federal Tax Law in North Carolina Tax Cases," 98 *N.C. L. Rev.* No. F (Aug. 2020).

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definitional differences" and even cited *Fidelity Bank* for this proposition. *Fidelity Bank* in fact held exactly the reverse: that code provisions do *not* apply unless the legislature adopts them by a clear and specific reference.

DOR's Third Reversal — *Integon*

Integon National Insurance Co. was another insurance company that made large investments in syndicated solar projects after the 2009 expansion of the tax credit program. Integon received an NOFD disallowing its 2016 tax credit installment and contested the NOFD by filing a petition at the OAH. *Integon* was heard, not by the ALJ who decided *Farm Bureau* and *McCabe*, but by OAH's chief ALJ, Donald van der Vaart. A hearing on the parties' cross-motions for summary judgment was scheduled for September 13, 2021.

In its third and perhaps most dramatic reversal to date, the DOR, one day before the scheduled hearing, offered to withdraw the NOFD disallowing Integon's 2016 credit installment. The department offered no explanation for its about-face, but it presumably feared an adverse decision from the new ALJ, which might have implications, not only for *Farm Bureau* and *McCabe* pending in the business court, but also for the long line of similar cases still waiting to get to the OAH.

On the day of the hearing, the parties presented the ALJ with a joint proposed dismissal order, which included the statement that the DOR "did not dispute the Petitioner's position in this contested case."[20] The ALJ took the matter under advisement and directed the parties to submit supplemental briefs on the OAH's remaining jurisdiction. In response, the parties filed a joint statement explaining that the DOR had voluntarily and unilaterally withdrawn the 2016 NOFD and asking the ALJ to dismiss the matter with prejudice, as there was no longer any agency action in dispute.

Van der Vaart concluded that he retained jurisdiction over the matter and, in another dramatic move, granted the taxpayer's motion for summary judgment rather than issuing the proposed dismissal order. Van der Vaart noted the DOR's prior reversals of position. He described the change of policy announced in the 2018 Important Notice as having been made "inexplicably and perhaps whimsically," broadly interpreted as a polite euphemism for "arbitrary and capricious."[21] Citing the department's victory in *Fidelity Bank*, he also concluded that there was no "clear and specific reference" in the North Carolina tax statutes to the federal authorities upon which the DOR relied.[22] He also cited the statement in the proposed dismissal order that the DOR did not dispute Integon's position as an admission that Integon had acquired its credits lawfully through a partnership allocation and not through an impermissible purchase transaction.[23]

The DOR appealed van der Vaart's decision to the business court, where the taxpayer moved to dismiss on the ground that the department, having withdrawn its NOFD, could not have been aggrieved by the OAH decision. The DOR argued that although it had withdrawn the NOFD, it made no concession regarding the merits of the case. It meant only to end the controversy, not to concede it. Indeed, the department gave no indication that it would not continue to challenge Integon's post-2016 credit installments.

In its November 22, 2022, ruling, the business court, in a decision by Judge Julianna Earp, denied Integon's motion to dismiss. The court held that the DOR's statement in an order that was merely proposed did not constitute an admission on the merits and that the department was aggrieved by an OAH decision that included statements contrary to what it believed to be a correct interpretation of the law. The court therefore reversed the OAH decision granting summary judgment to Integon "to the extent it [was] based on a purported admission by the Department."[24] Earp did not find fault with van der Vaart's other conclusions of law, including his conclusions about the scope of *Fidelity Bank* and the inapplicability of the federal antiabuse doctrines.

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[20] *Integon National Insurance Co. v. North Carolina Department of Revenue*, 20 REV 01001 (N.C. OAH Sept. 23, 2021), final decision at 3.

[21] *Id.*

[22] *Id.* at 7.

[23] *Id.* at 3.

[24] *Integon National Insurance*, 21 CVS 14395, Order and Opinion at 21.

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Importantly, Earp agreed that the ALJ did not lose jurisdiction when the DOR withdrew the NOFD. Neither that withdrawal nor the parties' proposed joint dismissal order could "strip the tribunal of jurisdiction."[25] The decision thus confirms that the department lacks the unilateral power to "turn off" OAH jurisdiction in order to avoid adverse ALJ decisions, a power the DOR may have been all the more anxious to assert in light of the OAH's announcement in 2021 that it would no longer refuse to publish its tax decisions.

Although conceding that the ALJ was correct in asserting that he retained jurisdiction, Earp remanded the case to the OAH to consider the separate question whether the withdrawal of the NOFD rendered the controversy moot, and if it did not, to conduct a hearing on the parties' cross-motions for summary judgment. The parties had already briefed the mootness issue at the business court, and that briefing suggests that the hearing on remand will likely focus on the so-called exceptions to the mootness doctrine under which a matter is not considered moot if it is capable of repetition while evading review or if a party voluntary ceases the complained-of conduct.

Conclusion

The ordeal of the North Carolina renewable energy tax credit saga has been long, painful, and expensive for taxpayers, and the DOR's reversals of policy have been costly to the state's business reputation. The department's assault on syndicated tax credit partnerships has paralleled, and perhaps was inspired by, the IRS's challenge to the use of partnerships to allocate federal energy credits away from project sponsors and toward investors better positioned to use them. At bottom, both the state and federal challenges present the question whether a partnership transaction should be set aside as abusive when the tax benefits the partnership affords were benefits the legislature specifically intended to make available.

Shortly before the hearing in *McCabe*, the federal challenge reached its climax. On August 5 the D.C. Circuit Court issued its decision in *Cross*.[26] That case involved an IRS challenge to federal clean coal production credits claimed by an investor in a coal refining partnership. The IRS asserted that the partnership was not bona fide, because it was impossible for the taxpayer to earn a pretax profit. The IRS argued that the arrangement was merely a scheme to facilitate the prohibited monetizing of the federal credits. In its decision for the taxpayer, the D.C. Circuit reaffirmed the principle that an investor is not engaged in an abusive or sham transaction when he invests in a partnership to receive tax benefits the legislature offered to induce his investment. In this conclusion, *Cross* followed *Sacks*,[27] which held that "if the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. . . . That violates the principle that statutes ought to be construed in light of their purposes."[28]

The 90-day period for seeking Supreme Court review of the *Cross* decision ran out in November without the IRS taking action. The federal challenge is now over. North Carolina taxpayers are hoping for a similar end to their ordeal. ■

[25] *Id.* at 15.

[26] *Cross Refined Coal LLC v. Commissioner*, 45 F.4th 150 (D.C. Cir. 2022).

[27] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995).

[28] *Id.* at 992.

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