STATE OF NORTH CAROLINA WAKE COUNTY	IN THE GENERAL COURT OF JUSTICE SUPERIOR COURT DIVISION 21 CVS 5724
JOHN M. MCCABE and REBECCA B. MCCABE, Petitioners, v. NORTH CAROLINA DEPARTMENT OF REVENUE, Respondent.	**ORDER AND OPINION ON PETITION FOR JUDICIAL REVIEW**

1. In this appeal, Petitioners John and Rebecca McCabe seek judicial review of an administrative decision that resulted in the disallowance of an income tax credit they claimed in 2014. Respondent North Carolina Department of Revenue ("Department") contends that disallowance is appropriate and seeks to affirm the judgment. The Department has also filed exceptions to certain evidentiary rulings made during the administrative proceeding.

2. For the following reasons, the Court **REVERSES** the decision of the Office of Administrative Hearings and **REMANDS** with instructions to grant summary judgment in favor of the McCabes. The Court also **OVERRULES** the Department's exceptions.

3. The Court notes that it is issuing this decision in tandem with its decision in a separate appeal brought by North Carolina Farm Bureau Mutual Insurance Company. Both cases involve similar factual circumstances and present nearly identical legal questions. *See N.C. Farm Bureau Mut. Ins. Co. v. N.C. Dep't of*

Revenue, No. 20 CVS 10244 (Wake Cnty.) (Order and Opinion located at ECF No. 103).

> *Brooks, Pierce, McLendon, Humphrey & Leonard, L.L.P, by James C Adams, II and Howard L. Williams, for Petitioners John M. and Rebecca B. McCabe.*
>
> *Joshua H. Stein, Attorney General of the State of North Carolina, by Perry J. Palaez, Special Deputy Attorney General, North Carolina Department of Justice, for Respondent North Carolina Department of Revenue.*[1]

Conrad, Judge.

I.
BACKGROUND

4. When reviewing a final decision in a contested tax case, the Court does not make findings of fact. The following background is intended only to provide context for the Court's analysis and ruling.

A. Statutory Background

5. As the Court explained in the companion *Farm Bureau* decision, North Carolina has long used tax credits to spur the advancement of renewable energy resources. There were once a dozen or more statutes granting tax credits for wind, solar, and similar energy facilities. In 1999, the General Assembly repealed and replaced this patchwork of laws with a unified statutory scheme for renewable energy tax credits. *See* 1999 N.C. Sess. Laws 342, Secs. 1, 2.

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[1] Perry J. Pelaez has since withdrawn as counsel for the Department. Taking his place are Ericka R. McDaniel, Assistant Attorney General, and M.A. Kelly Chambers, Senior Deputy Attorney General, both of the North Carolina Department of Justice.

6. Here's how the credit works. "A taxpayer that has constructed, purchased, or leased renewable energy property" is eligible to receive a credit "if the property is placed in service in this State during the taxable year." N.C.G.S. § 105-129.16A(a). The amount of the credit is "equal to thirty-five percent (35%) of the cost of the property" up to a cost of $2.5 million per installation. *Id.* § 105-129.16A(a), (c)(1). But when the property serves a "business purpose," the taxpayer may not take the credit all at one time. It is instead split into five annual "installments beginning with the taxable year in which the property is placed in service." *Id.* § 105-129.16A(a); *see also id.* § 105-129.16A(c)(1) (defining "business purpose"). Each successive installment is contingent. If the property is taken out of service during the five-year period, "the credit expires," and the taxpayer loses any installments that haven't accrued. *Id.* § 105-129.16A(b).

7. In practice, few taxpayers that qualify for this credit can directly take advantage of it. This is because builders and lessors of renewable energy installations are often limited liability companies or other entities treated as partnerships for tax purposes. *See, e.g.*, *id.* § 105-153.3(9), (13). A partnership does not pay tax and has no tax liability to offset with a credit. It is considered a pass-through entity: its income, losses, and other tax items are allocated among its partners who then report their shares of each on their tax returns.[2]

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[2] North Carolina allows partnerships to borrow from federal forms for use in the state partnership tax return, Form D-403. *See* 17 N.C. Admin. Code 6B.3501, 6B.3503(a). To fill out Form D-403, a partnership can import some information directly from the federal IRS Form 1065. Just as the federal Schedule K-1 sets out each partner's allocated share of tax items, the Schedule NC K-1 serves the same purpose on the state level. *See* 17 N.C. Admin. Code 6B.3503(b).

8. Thus, when a partnership earns a renewable energy tax credit, the partners are the ones who claim it. A hybrid of state and federal law governs what the partners are allowed to claim. The starting point is N.C.G.S. § 105-269.15. Subsection (a) states that a partnership that qualifies for a credit "passes through to each of its partners the partner's distributive share of the credit." *Id.* § 105-269.15(a). Subsection (c) goes on to say that a "distributive share of an income tax credit shall be determined in accordance with sections 702 and 704 of the" Internal Revenue Code. *Id.* § 105-269.15(c). The scope of this reference to Code[3] sections 702 and 704 is central to the parties' dispute here.

9. Designed to be temporary, the statutory scheme for renewable energy tax credits carries a built-in sunset provision. As a result, renewable energy properties placed into service after 2017 are no longer eligible to earn the credit. *See id.* § 105-129.16A(e)–(g).

B. The McCabes' Investment

10. John and Rebecca McCabe are North Carolina residents. In 2014, they invested in several renewable energy projects in North Carolina through a partnership organized by Monarch Tax Credits, LLC. The McCabes then claimed a share of the tax credits generated by the projects on their joint income tax return. (*See* R.72302, R.72308–09.)[4]

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[3] In keeping with the North Carolina Revenue Act, the Court refers to the Internal Revenue Code simply as the "Code." *See* N.C.G.S. § 105-228.90(b)(7) (defining "Code" as "[t]he Internal Revenue Code as enacted as of May 1, 2020, including any provisions enacted as of that date that become effective either before or after that date").

[4] The Court refers to the McCabes jointly as "investors" and "partners" for simplicity. It is more accurate to say that John McCabe invested in the partnership as an individual and that

11. Monarch specializes in tax-equity financing across a variety of industries, including renewable energy, low-income housing, film projects, and historic rehabilitation. Put simply, this means that Monarch works with project developers to raise capital by marketing their surplus or unused tax credits to investors. (*See* R.66405.)

12. The events in this case involve solar energy projects sponsored by Ecoplexus, Inc. and FLS Energy, Inc. Seeking capital for the projects, the sponsors enlisted Monarch to find investors who would finance a portion of the cost—roughly 11% for EcoPlexus and 17% for FLS Energy—with the expectation of receiving in return allocations of tax credits generated by the projects. Much of the remaining cost was financed with debt. Recall that the amount of tax credit that a renewable energy property generates depends on its total cost (not its method of financing). *See* N.C.G.S. § 105-129.16A(a). Factoring in projected costs and the size of its investment, Monarch anticipated a ratio of $1 in credit for every 35 cents its investors contributed to EcoPlexus and $1 in credit for every 58 cents contributed to FLS Energy. This arrangement benefited the investors and sponsors alike: as one developer with FLS Energy testified, the "projects would not have been feasible" without the capital from Monarch's investors. (*See* R.66243, R.66406–08.)

13. Monarch created partnerships designed to route capital from investors to the sponsors and to return the tax credits generated by the projects to the investors.

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the McCabes together claimed a share of credit on their tax return as a married couple filing jointly. (*See* R.72308, R.72311.) The Court also refers to Monarch Tax Credits as "Monarch" throughout this opinion, though the parties often refer to it by its previous name, State Tax Credit Exchange, LLC.

The partnership structure is complex, comprising several tiers. In the top tier, the investors are partners in an entity called the Annual Fund. In the next tier down, the Annual Fund is a partner in another entity called the Master Fund. There are more tiers below that, with the Master Fund holding an interest in one or more partnerships connected to the project sponsors. At the bottom are the renewable energy projects. (*See, e.g.*, R.65411–75, R.65479–564, R.65568–731, R.66278–81, R.66297–36.)[5]

14. One advantage of this partnership structure for investors is the short-term commitment. As its name suggests, each Annual Fund is tied to a single tax year. This year-to-year framework runs in parallel with the statutory scheme, which requires taxpayers to take renewable energy tax credits in installments over five years. In effect, Monarch created a new Annual Fund each year to receive and allocate that year's installment of tax credits, along with any profits or losses. After doing so, the Annual Fund would exercise a put option and sell its interest in the Master Fund for $100.00, and a new Annual Fund for the next year would take its place. Each investor would be free to make a new contribution and become a partner in the new Annual Fund, or to step aside. (*See, e.g.*, R.66320, R.70335, R.72307, R.72311.)

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[5] This is a simplified summary of a more complex organizational chart. (*See, e.g.*, R.72305–07.) For clarity and readability, the Court refers to the partnerships as Annual Fund and Master Fund as a shorthand in place of their much lengthier proper names. Also, although this case concerns only state tax credits, the projects at issue generated federal tax credits as well. A parallel chain of partnerships was created to facilitate allocations of the federal tax credits to other investors.

15. The McCabes chose to invest in the Annual Fund for 2014 after learning about it from their accountant and sometime investment advisor. Monarch gave the McCabes several agreements that set forth the fund's details, including that its primary purpose was to invest in renewable energy properties and that the pool of available tax credits would depend on the amount invested and other factors. Monarch also noted that the actual amount of credit generated by the projects might fall short of what was anticipated and that there were legislative and regulatory risks associated with the investment. The investment materials stated that the Annual Fund might cover a credit shortfall out of its reserves but was under no obligation to do so. (*See* R.66364, R.66372–75, R.70061, R.70094–109, R.70110–39.)

16. In December 2014, the McCabes bought a .3166842% membership interest in the Annual Fund. They made an initial capital contribution of $8,640.00—or 30 percent of the total contribution—at that time. In April 2015, the Annual Fund then allocated to the McCabes their pro rata share of tax items, including $36,000 in tax credit and $14,192 in losses. After receiving their K-1 schedule, the McCabes paid the remaining $20,160 to the Annual Fund to complete their total investment contribution of $28,800. In total, the Annual Fund for 2014 contributed over $6,000,000 in capital to the underlying projects. (*See*, R.64890, R.64893–94, R.66243, R.66407, R.70061, R.72310–11.)

17. The McCabes claimed their share of credit and losses on their 2014 tax returns. Because they could not offset more than 50% of their North Carolina income tax liability with tax credit, the McCabes claimed less than their full allocation from

the Annual Fund ($30,464) in 2014. Because the unused credit carried forward, the McCabes were able to claim allocated losses and the credit remaining from 2014 on their 2015 tax return. (*See* R.72311–12.)

18. In July 2015, the 2014 Annual Fund exercised its put option and redeemed its interest in the Master Fund for $100.00. After exercising this put option, the 2014 Annual Fund retained only a nominal interest in the Master Fund. In 2015, despite its nominal interest in the Master Fund, the 2014 Annual Fund still allocated $11,614 in losses to McCabe along with $3 of interest income. (*See* R.62875, R.64897, R.72311.)

C. Procedural History

19. At the beginning of 2018, the Department notified the McCabes that their 2014 tax return was subject to an audit. (*See* R.72313.)

20. While the audit was pending, the Department issued an "Important Notice: Tax Credits Involving Partnerships." The stated purpose of the Important Notice was "to assist in evaluating the validity and potential amount of" a partner's distributive share of a tax credit earned by a pass-through entity. To that end, the Department referred taxpayers to federal law, citing the link "to sections 702 and 704 of the Code" in N.C.G.S. § 105-269.15. In the Department's words, a "person not qualifying as a partner under federal income tax [law] would not qualify for allocation of a credit" under state law. Similarly, the Department cautioned that some transfers of tax credits may be viewed as disguised sales under Code section 707, which would

prevent the "credits from being allocated to a taxpayer under section 704." (R.65034–36.)[6]

21. In November 2018, the Department issued a proposed assessment based on the Official Auditor's report that disallowed the McCabes' claimed share of tax credit. The McCabes then requested a Departmental review. (*See* R.72313.)

22. Following its review, the Department upheld the proposed assessment. Tracking its guidance in the Important Notice, the Department reasoned that section 105-269.15(c)'s reference to Code sections 702 and 704 incorporates the federal bona fide partnership and disguised sale doctrines. Applying these doctrines, the Department first concluded that the McCabes were not bona fide partners in the Annual Fund because any upside potential from the underlying renewable energy projects would not go to them, guaranty agreements ensured that they would face no downside risk, and the substance of the transaction was not an investment in a true partnership. (*See* R.63541–44 (citing, *e.g.*, *Historic Boardwalk Hall v. Comm'r*, 694 F.3d 425 (3rd Cir. 2012)).)

23. In addition, the Department concluded that even if the McCabes were bona fide partners, allocating a share of tax credit to them in return for their investment

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[6] In the years before the Important Notice, the Department issued many Private Letter Rulings ("PLRs") concerning section 105-269.15. The McCabes argue that the Department blessed Monarch's partnership structure in these PLRs and reversed course in the Important Notice. The Department, on the other hand, argues that its interpretation has remained consistent throughout and notes that the McCabes never requested a PLR. After reviewing the PLRs, the Court concludes that they have little relevance to the questions presented. *See* N.C.G.S. § 105-264.2(a) ("A written determination is applicable only to the individual taxpayer addressed and as such has no precedential value except to the taxpayer to whom the determination is issued.").

amounted to a disguised sale. The Department reasoned that the McCabes' investment was tied directly to the amount of credit they expected to receive, which was reasonably certain at the time of the investment; that they had a contractual right to the expected share of credit; that the amount of credit due was secured against shortfall or recapture; that their interest in the partnership was disproportionate to their share of the profits; and that they had no further obligation to the partnership after receiving their share of the credit. The Department also relied on its finding that the McCabes faced no entrepreneurial risk. (*See* R.63544–47 (citing *Va. Historic Tax Credit Fund 2001 LP v. Comm'r*, 639 F.3d 129 (4th Cir. 2011)).)

24. The McCabes filed a timely petition for a contested case hearing in the Office of Administrative Hearings. The parties filed numerous motions, including cross-motions for summary judgment, cross-motions to exclude expert witness testimony, and the McCabes' motion to supplement the record on summary judgment. The presiding Administrative Law Judge ("ALJ") denied the McCabes' motion to supplement the record and granted in part the cross-motions to exclude expert testimony. (*See* R.64367–68, R.64390–92, R.64404–5.)

25. In a Final Decision, the ALJ granted the Department's motion for summary judgment and denied the McCabes' motion. Among other things, the ALJ observed that the McCabes' investments mirrored the "partnership structure commonly used throughout the United States for renewable energy tax equity financing projects under federal and various state laws." Even so, the ALJ held that this partnership

structure is unlawful in North Carolina "because this State does not allow renewable energy tax credits to be bought or sold." Reasoning that "the McCabes purchased the renewable energy credits to offset their state income tax liability," the ALJ concluded that their claimed allocation of credit must be disallowed. (R.62788, R.62791.)

26. Moreover, the ALJ agreed with the Department that state law "treats the allocation of tax credits by partnerships in the same fashion as federal law." The ALJ concluded that the McCabes were not bona fide partners under federal law because the partnerships at issue "lacked a non-tax business purpose" and because their "cash-for-credit transactions were not, in substance, partnership investments." Assuming that the McCabes were bona fide partners, the ALJ further concluded that their "purchase of the renewable energy credits amounted to a 'disguised sale' under Code § 707(a) and cannot be included in the calculation of a partner's distributive share as set forth in Code § 704(b)." (R.62788, R.62791.)

27. Having concluded that the McCabes could not claim a share of tax credit in any amount, the ALJ had no need to decide whether they adequately substantiated their claim or whether the claimed allocation of credit was correctly calculated. (*See* R.62791.)

28. Following the Final Decision, the McCabes paid the assessment and then petitioned for judicial review in this Court. The Department, in turn, has filed exceptions relating to the admissibility of expert testimony offered by the McCabes. (*See* Pet., ECF No. 3; Resp. to Pet., ECF No. 13.)

29. These matters are ripe for determination.

II.
LEGAL STANDARD

30. In reviewing an agency's final decision, this Court "acts in the capacity of an appellate court," and "the substantive nature of each assignment of error dictates the standard of review." *N.C. Dep't of Env't & Nat. Res. v. Carroll*, 358 N.C. 649, 658, 662 (2004). The Court reviews de novo an order granting summary judgment. *Midrex Techs. v. N.C. Dep't of Revenue*, 369 N.C. 250, 257 (2016); *see also* N.C.G.S. § 150B-51(b)(4), (c). This means that the Court "considers the matter anew and freely substitutes its own judgment for" the agency's. *Midrex*, 369 N.C. at 257 (cleaned up) (quoting *Carroll*, 358 N.C. at 660). But the scope of review is limited to "the final decision and the official record." N.C.G.S. § 150B-51(c).

31. "In reviewing a final decision allowing . . . summary judgment, the court may enter any order allowed by . . . Rule 56" of the North Carolina Rules of Civil Procedure. *Id.* § 150B-51(d). Thus, summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that any party is entitled to a judgment as a matter of law." N.C. R. Civ. P. 56(c). The Court views the evidence in the light most favorable to the nonmoving party and draws all inferences in its favor. *See, e.g.*, *DeWitt v. Eveready Battery Co.*, 355 N.C. 672, 682 (2002); *N.C. Farm Bureau Mut. Ins. Co. v. Sadler*, 365 N.C. 178, 182 (2011).

32. The moving party has the initial, procedural "burden of establishing that there is no triable issue of material fact," which may be accomplished "by proving that an essential element of the opposing party's claim is nonexistent, or by showing

through discovery that the opposing party cannot produce evidence to support an essential element of his claim." *DeWitt*, 355 N.C. at 681 (citations and quotation marks omitted). If the moving party carries this burden, then "the burden shifts to the nonmoving party to produce a forecast of evidence demonstrating that the nonmoving party will be able to make out at least a prima facie case at trial." *Id.* at 681–82 (cleaned up).

33. The taxpayer retains the substantive "burden of proving eligibility for a credit and the amount of the credit." N.C.G.S. § 105-129.18. And the "proposed assessment of the Secretary [of Revenue] is presumed to be correct." *Id.* § 105-241.9(a).

III.
ANALYSIS

34. The McCabes seek to reverse the judgment below and restore the tax credits that they claimed for tax year 2014. The Department argues that the judgment should be affirmed for the reasons stated by the ALJ and on alternative grounds that the ALJ did not reach.

35. The Court will begin by addressing disputes concerning, first, whether the McCabes unlawfully bought a share of a tax credit as a matter of state law and, second, whether their entitlement to claim a share of the credit depends on the application of certain federal tax doctrines. Then, the Court will address the amount of credit the McCabes may claim, if entitled to do so. Last, the Court will address the parties' evidentiary disputes.

A. Actual Sale

36. The ALJ disallowed the McCabes' claimed tax credit for several reasons. The first stated reason is that the McCabes "purchased the renewable energy credits to offset their State income tax liability," which "is unlawful in North Carolina." (R.62791.)

37. The McCabes contend that this was error. In their view, the ALJ treated the disputed transaction as an "actual sale" of tax credit when, in reality, it involved the sale of an interest in a partnership that carried with it various rights, including the right to receive pro rata shares of income, loss, and credit generated by the partnership.

38. Indeed, there is no serious dispute about the form of the transaction. The undisputed evidence shows that the McCabes claimed a share of tax credit received in the form of a partnership allocation, not in the form of a sale. The Department acknowledges as much. Accordingly, there is no basis to disallow the McCabes' claim on the ground that it arose from an "actual sale" of credit.

39. Even so, the Department argues that the judgment must be affirmed because the McCabes' use of the partnership form concealed what was in substance a sale of credit. In support, the Department points to Monarch's marketing materials, which often describe its business as buying and selling tax credits. The Department also cites two North Carolina appellate decisions, neither of which involves section 105-269.15 or tax credits more generally.

40. The Court is not persuaded. To be sure, there are times when courts must "look beyond the corporate facade and to substance rather than form," so as to ensure

that the tax laws will not " 'be evaded through technicalities.' " *Good Will Distribs. (N.), Inc. v. Currie*, 251 N.C. 120, 126 (1959) (quoting *Indus. Cotton Mills Co. v. Comm'r*, 61 F.2d 291, 293 (4th Cir. 1932)). But the scope of that principle is not well developed within our State's case law, and rarely should a court cast aside a lawfully formed partnership as a tax-manipulative sham.

41. Caution is warranted here. This is, at root, a statutory question, and the Court is bound to respect the General Assembly's wishes. To encourage the development of renewable energy resources, the General Assembly offered tax credits as incentives. Its detailed statutory scheme established not only the criteria that a partnership must meet to qualify to receive a tax credit, *see* N.C.G.S. § 105-269.15, but also the structure by which the partnership "passes through to each of its partners the partner's distributive share of the credit," *id.* § 105-269.15(a). There is little room for judicial meddling if a transaction checks these boxes. As one federal court recently observed, "it's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance." *Summa Holdings, Inc. v. Comm'r*, 848 F.3d 779, 787 (6th Cir. 2017).

42. The McCabes' claim checks the boxes. It is undisputed that each underlying renewable energy project legitimately qualified for a tax credit under section 105-129.16A. It is also undisputed that the McCabes acquired a membership interest in a limited liability company. For tax purposes, that makes the McCabes partners in a partnership. There is no statutory basis to disallow tax credits legitimately earned by a partnership and then passed through to its partners.

43. Yes, it might be necessary to put up judicial guardrails if there were evidence of fraud or a sham transaction. But there isn't. These transactions were real, not fake. The McCabes invested real money in real renewable energy properties that were placed in service and that generated tax credits. Their investment mattered too: according to one of the project sponsors, the properties "would not have been feasible" without the contributions from investors in Monarch's tiered partnerships. (R.66243.) Moreover, nothing suggests that the McCabes obtained an illusory partnership interest. They had meaningful rights—including rights to share in profits and losses—established through operating agreements and other organizational documents. (*See, e.g.*, R.70094–109, R.70110–39.) And to boot, the McCabes' investments involved exactly the kind of economic activity that the General Assembly deemed socially desirable and sought to encourage with tax credits.

44. Accordingly, the undisputed evidence does not show that the McCabes purchased a renewable energy tax credit or that their partnership transaction was "unlawful" under state law. It was error to disallow the claimed share of credit for that reason.

45. The Department also advances distinct but highly similar arguments based on federal tax doctrines, which it contends have been incorporated into section 105-269.15. The Court now turns to these arguments.

B. Federal Doctrines

46. As secondary grounds for disallowing the McCabes' share of credit, the ALJ relied on two federal tax doctrines. The ALJ concluded that the McCabes were not bona fide partners under federal law. In addition, the ALJ concluded that, even if

the McCabes were bona fide partners, their transactions were impermissible disguised sales under Code section 707, thus necessitating the exclusion of the partnership's tax credit from their distributive share of tax items.

47. The McCabes contend that neither federal doctrine is part of North Carolina law and that the ALJ therefore erred in relying on them. The Department contends that the General Assembly incorporated both doctrines into North Carolina law by stating that "a distributive share of an income tax credit shall be determined in accordance with sections 702 and 704 of the" Code. N.C.G.S. § 105-269.15(c).

48. The Court thoroughly addressed these interpretative questions in the companion *Farm Bureau* decision and concluded that the General Assembly did not intend to adopt federal laws on bona fide partnerships and disguised sales into section 105-269.15(c). This conclusion applies with equal force here. Rather than repeat the discussion in *Farm Bureau* in full, the Court incorporates it by reference. *See generally N.C. Farm Bureau Mut. Ins. Co. v. N.C. Dep't of Revenue*, No. 20 CVS 10244 (Wake Cnty.) (ECF No. 103 at ¶¶ 40–79).

49. By way of summary, it will suffice to note 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.' " *Fidelity Bank v. N.C. Dep't of Revenue*, 370 N.C. 10, 19 (2017) (quoting *Lutz Indus. v. Dixie Home Stores*, 242 N.C. 332, 340 (1955)). Section 105-269.15(c) contains no reference to federal definitions of partner and partnership or to Code section 707 and disguised sales. The only reference to federal law is instead to Code sections 702 and 704, but these two sections deal with

the mechanics of calculating a partner's distributive share of tax items, such as income, losses, and credit. *See* 26 U.S.C. §§ 702, 704. It is for that purpose—determining a distributive share, not determining partnership status or determining whether to treat a transaction as a disguised sale—that section 105-269.15(c) points to Code sections 702 and 704.

50. Had the General Assembly intended to adopt these federal doctrines, it would have incorporated them into section 105-269.15 by clear and specific reference. It did not. Consequently, the Department's contention that the McCabes are not bona fide partners and that their transactions were disguised sales is misplaced.

51. In addition, the Department has not argued or shown that the McCabes do not qualify as partners under state law. As the Court explained in *Farm Bureau*, the text and context of section 105-269.15(c) show an intent to use the terms partner and partnership as defined in an analogous part of the Revenue Act governing individual income tax. *See* N.C.G.S. § 105-153.3(9), (13) (defining "partnership" to include "a limited liability company" and "partner" to include "a member of the limited liability company"). It is uncontested that the McCabes—as members in the Annual Fund—are members of a limited liability company. Accordingly, the Court concludes, based on the undisputed evidence, that the McCabes are partners in the sense meant by section 105-269.15 and thus are entitled to claim a distributive share of tax credits.[7]

[7] It is perhaps worth noting that the Department has not argued or shown whether the federal government has applied either doctrine to the McCabes' partnership transactions.

C. The Amount of the McCabes' Distributive Share

52. Next, the Court considers whether the McCabes have carried their burden to show the amount of credit that they are entitled to claim. The ALJ noted the parties' disputes on this point but chose not to decide them, having concluded that the McCabes could not claim a distributive share in any amount. Because the record is complete and because the parties have presented their disputes on appeal, the Court concludes that it is proper to decide them now and that a remand to the Office of Administrative Hearings to calculate the amount would be inefficient and wasteful.

53. One dispute involves the substantiation requirement in N.C.G.S. § 105-129.18. This statute requires a taxpayer who claims a credit to "provide any information required by the Secretary of Revenue" and to "maintain and make available for inspection by the Secretary of Revenue any records the Secretary considers necessary to determine and verify the amount of the credit to which the taxpayer is entitled." N.C.G.S. § 105-129.18. The penalty for noncompliance is disallowance of the claimed credit: "The burden of proving eligibility for a credit and the amount of the credit rests upon the taxpayer, and no credit may be allowed to a taxpayer that fails to maintain adequate records or to make them available upon inspection." *Id.*

54. The McCabes argue that they complied with the substantiation requirement. They contend that the only materials required by the Department were the partnership agreements, which were produced. (*See* R.66245; *see also* R.66720–21.) This contention is supported by the Department's stipulation that the McCabes maintained all records that they had received and provided them to the Department.

(*See* R.72313.) Additionally, the Department testified that it was not aware of any requested document that had not been provided. (*See* R.66755.)

55. The Department's response is inscrutable. What information does the Secretary require to substantiate a claim for a tax credit? What records does the Secretary consider necessary to determine and verify the amount of the claimed credit? Did the McCabes fail to maintain these records or to make them available for inspection? The Department doesn't say. Its conclusory, one-paragraph argument cites no evidence and offers no reasonable basis to conclude that the McCabes failed to comply with section 105-129.18.

56. A second dispute is whether the McCabes complied with Code section 704, as incorporated into section 105-269.15(c). Code section 704 has two potentially applicable subsections. Subsection (a) states a default rule that a distributive share shall "be determined by the partnership agreement." 26 U.S.C. § 704(a). Subsection (b), on the other hand, states that a distributive share "shall be determined in accordance with the partner's interest in the partnership" when the partnership agreement is silent or when the allocation at issue "does not have substantial economic effect." *Id.* § 704(b).

57. It is undisputed that the McCabes received a pro rata allocation of credit from the partnership. That is, the McCabes hold a .3166842% membership interest in the Annual Fund, and the $36,000.00 in credit they received amounts to .3166842% of the total credit held by the fund and distributed to all partners. (*See* R.64890, R.72311.) This allocation is consistent with the terms of the Annual Fund's operating

agreement. (*See* R.66307–10.) Thus, according to the McCabes, their claimed allocation complies with section 704—no matter which subsection applies—because it follows the partnership agreement and aligns with their interest in the partnership.

58. The Department argues that section 704(b) controls and that the amount of credit allocated to the McCabes is not consistent with their interest in the partnership. The basis for this argument is that the McCabes' credit allocation exceeds their capital contribution to the partnership due to the way the underlying renewable energy projects were financed. In a nutshell, the financing included a mix of investor contributions and recourse debt. Each project qualified to receive a tax credit in an amount based on its total cost without regard to the source of financing or the ratio of capital to debt financing. As a result, each project generated more in tax credit than it received in investor contributions.

59. According to the Department, this means that the McCabes received a benefit from the projects' use of debt financing that is not reflected in their partnership interest and their claimed allocation of credit. But at no point does the Department explain how debt financing affects interests in a partnership. It cites no case, regulation, or statute on the subject. Nor does it say how the law applies in this case—that is, what share of credit the McCabes are entitled to claim once debt financing is considered. The Department's brief also runs afoul of the Business Court Rules by incorporating its "brief below," (DOR Op. Br. 52–53, ECF No. 54), in lieu of citing evidence in the record.

60. Accordingly, the Court concludes that there are no genuine issues of material fact concerning the amount of credit the McCabes are entitled to claim. The McCabes have offered unrebutted arguments and evidence to show that they substantiated their claim as required by section 105-129.18 and to show that their claim is consistent with their interest in the partnership as required by Code section 704. The McCabes are entitled to an allocation of $36,000 in tax credit and are entitled to use that credit to offset up to 50% of their 2014 income tax liability.

D. Evidentiary Disputes

61. Each side contends that the ALJ erred in ruling on certain evidentiary issues.

62. First, the ALJ denied the McCabes' motion to supplement the record following the hearing on the parties' cross-motions for summary judgment. The McCabes contend that this was an abuse of discretion because the proffered evidence addressed questions raised by the ALJ at the hearing. As the ALJ observed, though, the time to submit evidence relating to the cross-motions was before the hearing, not after. The Court cannot say that the ALJ's decision to deny the motion to supplement as untimely was "manifestly unsupported by reason, or could not be the product of a reasoned decision." *Terry's Floor Fashions, Inc. v. Crown Gen. Contractors, Inc.*, 184 N.C. App. 1, 17 (2007) (citation and quotation marks omitted).

63. Second, the ALJ excluded expert opinion testimony—from both the McCabes' experts and the Department's—concerning the scope of state law and the General Assembly's legislative intent. The McCabes agree with that decision

generally but argue that the ALJ went too far, excluding parts of three expert reports that merely referred to state law or legislative policies.

64. An ALJ's ruling on the admissibility of expert testimony is reviewed for an abuse of discretion. *See, e.g.*, *Stark v. N.C. Dep't of Env't & Nat. Res.*, 224 N.C. App. 491, 500–01 (2012). "The burden is on the appellant not only to show error, but also to enable the Court to see that he was prejudiced and that a different result would have likely ensued had the error not occurred." *Hasty v. Turner*, 53 N.C. App. 746, 750 (1981); *see also N.C. Dep't of Transp. v. Mission Battleground Park, DST*, 370 N.C. 477, 483 (2017) (observing that complaining party must show whether exclusion of expert testimony "was prejudicial or harmless"); *Ingram v. Henderson Cnty. Hosp. Corp.*, 259 N.C. App. 266, 285 (2018) (finding no abuse of discretion when party could not "demonstrate prejudice" from exclusion of expert testimony).

65. After careful review, the Court concludes that any error in the ALJ's evidentiary ruling, if one exists, was harmless. In the McCabes' own words, most of the disputed portions of the expert reports concern background context and rote recitations of law. The McCabes do not identify any prejudice or explain what difference it would have made had the ALJ admitted these aspects of the reports.

66. Third, the ALJ denied the Department's motion to exclude the reports and testimony of the McCabes' experts in their entirety. The Department filed exceptions to this decision, which is subject to review for abuse of discretion. The Department has the burden "to show both error and that [it] was prejudiced by" the admission of the evidence. *State v. Gappins*, 320 N.C. 64, 68 (1987).

67. Citing only its "brief below," the Department contends that the McCabes' expert reports "are no different from legal briefs." (DOR Op. Br. 60.) This does not fairly raise the issue on appeal. The attempt to incorporate arguments made below violates the Business Court Rules that set out word limits for briefs (which the Court enlarged in this case) and that require parties to cite supporting materials with specificity. Indeed, the Department does not describe the experts' opinions individually, point to representative passages in any of their reports, or cite relevant pages or paragraphs. Although the Department advanced more comprehensive arguments in its reply brief, those arguments are untimely. *See, e.g.*, *State v. Triplett*, 258 N.C. App. 144, 147 (2018) ("[A] reply brief is not an avenue to correct the deficiencies contained in the original brief." (citations and quotation marks omitted)); *Larsen v. Black Diamond French Truffles, Inc.*, 241 N.C. App. 74, 78–79 (2015) (same). Moreover, any error was harmless—the Department does not mention prejudice or show that it was prejudiced by the ALJ's decision. Accordingly, the Department has not met its burden to show an abuse of discretion. Its exceptions are overruled.

IV.
CONCLUSION

68. For all these reasons, the Court **GRANTS** the McCabes' Petition, **VACATES** the Final Decision, and **REMANDS** with direction to **GRANT** summary judgment in favor of the McCabes. The Court further **OVERRULES** the Department's exceptions to ALJ's denial of its motions to exclude.

SO ORDERED, this the 3rd day of April, 2023.

/s/ Adam M. Conrad
Adam M. Conrad
Special Superior Court Judge
for Complex Business Cases