




SIGNED this 10th day of August, 2020.


BENJAMIN A. KAHN
UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
WINSTON-SALEM DIVISION

In re:)
)
North Carolina Tobacco) Case No. 17-51077
International, LLC,)
)
Debtor.) Chapter 7

**ORDER GRANTING TRUSTEE'S MOTION TO DETERMINE
THAT THE ESTATE SHOULD NOT REMIT PASS-THROUGH
TAXES ON BEHALF OF OUT-OF-STATE MEMBERS**

This matter is before the Court on the Motion to Determine that the Estate Should Not Remit Pass-Through Taxes on Behalf of Out-of-State Members (the "Motion") filed by the chapter 7 trustee, John Paul H. Cournoyer ("Trustee"). ECF No. 325. For the reasons set forth herein, the Court will grant the Motion.

Jurisdiction and Authority

The Court has jurisdiction over the subject matter of this proceeding under 28 U.S.C. § 1334. Under 28 U.S.C. § 157(a), the United States District Court for the Middle District of North Carolina has referred this case and this proceeding to this Court by its Local Rule 83.11. This is a statutorily core proceeding

under 28 U.S.C. § 157(b)(1), (b)(2)(A), (b)(2)(B), and (b)(2)(O). Section 505 of title 11 authorizes the Court to hear and decide a disputed tax claim so long as the liability of the taxpayer has not been previously adjudicated in a federal district court, tax court, or claims court. In re DeCoro USA, Ltd, 2013 WL 950572 (Bankr. M.D.N.C. 2013); In re Gossman, 206 B.R. 264 (Bankr. N.D. Ga. 1997); In re Starnes, 159 B.R. 748, 749 (Bankr. W.D.N.C. 1993) ("A bankruptcy court generally has the authority to determine a debtor's tax liability and such a proceeding is a core proceeding.").

Procedural History

Debtor North Carolina Tobacco International, LLC, commenced this case by filing a voluntary petition for relief under chapter 11 of title 11 on October 10, 2017. On October 20, 2017, the Court appointed John A. Northen as the chapter 11 trustee. ECF No. 51. On January 10, 2018, the Court converted this case to a case under chapter 7 and appointed John Paul H. Cournoyer as the chapter 7 trustee. ECF No 174.

Trustee filed this Motion, requesting that the Court find that Debtor is not liable for income taxes attributable to the sale of certain tangible assets under 11 U.S.C. §§ 105, 346, 505, and 726. ECF No. 325. The Court scheduled a telephonic hearing, at which only Trustee appeared. The Court found that Trustee's service of the Motion on the North Carolina Department of Revenue

(the "Department") did not comply with Rule 7004(b)(6), directed Trustee to re-serve the Motion on the Department, and continued the hearing.

Trustee thereafter filed a supplemental certificate of service evidencing proper service on the Department. ECF No. 328. The Department filed a Response to the Motion (the "Response"), ECF No. 332, arguing that Debtor is responsible for filing tax returns and paying income tax liability for non-resident members under N.C. Gen. Stat. § 105-154(d). As of the date of this Order, the Department has not filed a proof of claim or a request for allowance of an administrative expense.

The Court conducted a second telephonic hearing on the Motion. ECF No. 333. At the hearing, Trustee appeared; Ronald D. Williams, II, North Carolina Assistant Attorney General, appeared on behalf of the Department; and Robert Price appeared on behalf of the Bankruptcy Administrator. Id. At the conclusion of the hearing, the Court took the Motion under advisement, and allowed the parties to submit supplemental briefs within seven days. Trustee timely filed his Supporting Brief, ECF No. 334, and the Department timely filed its Supplemental Response in Opposition to the Motion (the "Supplemental Response"). ECF No. 335. The Motion is ripe for determination.

Factual Background

Debtor is a Missouri limited liability company ("LLC"), which manufactured tobacco products in East Bend, North Carolina. Debtor's principal place of business is in North Carolina. Debtor had four members: Samuel Kim, Ken Hauser, Ed Van Deventer, and Robert Dotson. ECF No. 154 at 43. According to annual reports filed with the North Carolina Secretary of State, Kim and Van Deventer reside in California and Missouri, respectively. ECF No. 27-7. With the Court's approval, Trustee has sold certain tangible assets of Debtor. See, e.g., ECF Nos. 263, 300, and 313.

Trustee employed Lehman B. Pollard and the firm of Nelson & Company (the "Accountant") to assist Trustee with, inter alia, filing all necessary tax returns for the estate. ECF No. 315 and 316. In the Motion, Trustee alleges that the Accountant has informed him that "no tax basis may be claimed in the assets sold [by Trustee]." ECF No. 325 at 1. Trustee contends that he cannot claim a tax basis in these assets because Debtor failed to file certain pre-petition tax returns.¹ Id. at 1-2. Moreover, Trustee is "unwilling to prepare or sign pre-petition [tax] returns" because Trustee lacks adequate information concerning pre-petition transactions. Id. at 2.

¹ According to the Department, Debtor has not filed a tax return since 2015. ECF No. 335.

Because Trustee cannot claim a tax basis in the assets sold by Trustee, the asset sales generated taxable gains. And, due to Debtor's status as an LLC, Trustee asserts that the income taxes owed as a result of the asset sales "will not be payable at the entity level." Id. Instead, Trustee argues that the income tax liability will "pass[-]through to . . . Debtor's equity holders." Id.² Trustee alleges that, even though the tax obligations pass-through to Debtor's members, North Carolina law requires the manager of an LLC with a nonresident LLC member to file an informational return and pay the nonresident members' income tax on their behalf from any otherwise distributable share of profits of the LLC.³ Id. at 2-3. According to Trustee, payment of income

² The Department does not contest that Debtor is registered as an LLC and is treated as a partnership for federal income tax purposes. As such, for North Carolina income tax purposes, Debtor also is taxed as a partnership. See N.C. Gen. Stat. § 105-153.3(9) (defining an LLC as "Either a domestic limited liability company organized under Chapter 57D of the General Statutes or a foreign limited liability company authorized by that Chapter to transact business in this State that is classified for federal income tax purposes as a partnership. As applied to a limited liability company that is a partnership under this Part, the term "partner" means a member of the limited liability company."); N.C. Dep't of Revenue, Personal Taxes Bulletin, p. 51 (December 2019) ("Limited liability companies are subject to State taxation according to their classification for federal income tax purposes; therefore, if a limited liability company is classified as a partnership for federal income tax purposes, the company and its members are subject to tax to the same extent as a partnership and its partners and is required to file a North Carolina partnership return.").

³ It is undisputed that the income was derived from business conducted in North Carolina. North Carolina General Statute § 105-154(d) provides:

(d) Payment of Tax on Behalf of Nonresident Owner or Partner.--If a business conducted in this State is owned by a nonresident individual or by a partnership having one or more nonresident members, the manager of the business shall report information concerning the earnings of the business in this State, the distributive share of the income of each nonresident owner or partner, and any other information required by the Secretary. The

tax on behalf of Debtor's equity interest holders from the assets of the estate would constitute a distribution to the members ahead of the creditors of the LLC, and therefore would violate the distribution priorities mandated in 11 U.S.C. § 726. Under § 726, creditors must be paid prior to any distribution to equity holders.⁴ Therefore, Trustee argues that, to the extent N.C. Gen. Stat. § 105-154(d) purports to require payment of member taxes prior to distributions to creditors, it is preempted by the distribution scheme under § 726. Trustee further argues that regardless of the distribution scheme required by § 726 and any provisions of the North Carolina Limited Liability Company Act, N.C. Gen. Stat. § 57D-1-01 et seq., tax obligations of the members are prohibited from creating an obligation of the estate under 11 U.S.C. § 346.

Lastly, Trustee argues that N.C. Gen. Stat. § 105-154(d) does not create a tax at the entity level, but is merely a mechanism to facilitate the state's collection of taxes owed by a nonresident

distributive share of the income of each nonresident partner includes any guaranteed payments made to the partner. The manager of the business shall pay with the return the tax on each nonresident owner or partner's share of the income computed at the rate levied on individuals under G.S. 105-153.7. The business may deduct the payment for each nonresident owner or partner from the owner or partner's distributive share of the income of the business in this State.

N.C. Gen. Stat. § 105-154(d) (Aug. 1, 2019).

⁴ This distribution priority does not differ from the winding up of an LLC under North Carolina law. See N.C. Gen. Stat. §§ 57D-6-07(d) and 57D-6-08(2) (2014).

LLC member from distributions that otherwise would be payable to the nonresident member. Trustee first points to the title of the statute: "Payment of Tax on behalf of Nonresident Owner or Partner." (emphasis added). Trustee then cites the language of the statute, which states that "[t]he manager of the business shall pay with the return the tax on each nonresident owner or partner's share of the income computed at the rate levied on individuals under G.S. 105-153.7." (emphasis added). Trustee argues that this language demonstrates that the tax is on the nonresident's share of the partnerships income and payment made is for the benefit of the nonresident, but this provision does not purport to create a separate tax at the entity level. Instead, Trustee contends that this language merely places an obligation on the manager to report and pay the tax obligations of nonresident members, but nowhere purports to create an obligation of the entity to North Carolina.

In response, the Department argues that, contrary to traditional principles of flow through taxation, North Carolina has chosen to place the burden of reporting and paying income tax liability of nonresident partners on the manager of the partnership instead of the nonresident members. Based on Personal Tax Bulletins issued by the Department, the Department argues that the obligation to pay nonresident members' taxes itself creates a separate and distinct tax obligation on the partnership. And the

Department goes further. Without citing any statutory or secondary authority and conceding that the statute itself does not offer written guidance of any tax or other consequences to either the member or the partnership if the manager fails to comply, the Department argues that the business would be assessed for penalties, additional tax, and interest should it fail to pay the nonresident income tax. The Department analogizes this collection mechanism to a withholding tax, whereby traditionally, the partnership would be liable for the failure to remit taxes.

The Department contends there is no preemption issue because the state income tax owed by Debtor should be paid as an administrative expense under 11 U.S.C. § 503(b)(1)(B)(i), and it therefore fits under the priority rules set forth in 11 U.S.C. § 726. Finally, the Department argues that payment of the tax is not a distribution under the Bankruptcy Code, but a satisfaction of tax liability.

Discussion

To the extent that N.C. Gen. Stat. § 105-154 purports to impose a tax obligation against Debtor, it is preempted by the Internal Revenue Code ("IRC") and 11 U.S.C. § 346.⁵ Section 346

⁵ For the reasons set forth herein, the Department's argument that any tax under N.C. Gen. Stat. § 105-154 is entitled to priority under §§ 503 and 726 collapses into the analysis of whether such a tax is incurred by the estate. Section 503(b)(1)(B)(i) gives priority solely to a tax incurred by the estate. Hall v. U.S., 566 U.S. 506, 511-12 (2012) ("A tax 'incurred by the estate' is a tax for which the estate itself is liable."). Because the Court concludes that N.C. Gen. Stat. § 105-154 does not and cannot create a tax incurred by the estate,

"specifically sets forth and enumerates tax provisions relating to the treatment of state and local taxes and provides that the provisions of the Internal Revenue Code generally supersede any state and local rules." 3 Collier on Bankruptcy ("Collier") ¶ 346.01 (16th ed. 2020). The Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), 119 Stat. 186, "rewrote § 346 in its entirety to conform state and local income tax administration to the Internal Revenue Code of 1986." 2A Bankr. Service L. Ed. § 17:74 (July 2020). "Section 346 now expressly aligns its assignment of state or local taxes with the rules for federal taxes" Hall, 566 U.S. at 515. Section 346(a) addresses taxation in cases in which there is a separate taxable estate under the IRC; § 346(b) governs cases in which there is not a separate taxable estate; and § 346(c) specifically addresses the tax treatment of partnerships or entities treated as partnerships. Id. at 513-14.⁶

the Department is not entitled to an administrative expense under §§ 503 and 726.

⁶ Section 346(h) discusses the trustee's duty to withhold and remit taxes to state and local authorities. Section 346(h) provides:

The trustee shall withhold from any payment of claims for wages, salaries, commissions, dividends, interest, or other payments, or collect, any amount required to be withheld or collected under applicable State or local tax law, and shall pay such withheld or collected amount to the appropriate governmental unit at the time and in the manner required by such tax law, and with the same priority as the claim from which such amount was withheld or collected was paid.

There is no indication on the record that there will be any distributions to resident or nonresident members of the kind listed in 346(h) in this case.

"In corporate and partnership cases under chapter 7 or chapter 11 . . . a separate taxable estate, apart from the debtor, is not deemed to arise." In re Knobel, 167 B.R. 436, 443 n.17 (Bankr. W.D. Tex. 1994) (citing 26 U.S.C. §§ 1398 and 1399).⁷ Therefore, §§ 346(b) and (c) apply in this case. Section 346(b) provides:

Whenever the Internal Revenue Code of 1986 provides that no separate taxable estate shall be created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of an estate shall be taxed to or claimed by the debtor, such income, gain, loss, deductions, and credits shall be taxed to or claimed by the debtor under a State or local law imposing a tax on or measured by income and may not be taxed to or claimed by the estate. The trustee shall make such tax returns of income of corporations and of partnerships as are required under any State or local law, but with respect to partnerships, shall make such returns only to the extent such returns are also required to be made under such Code. The estate shall be liable for any tax imposed on such corporation or partnership, but not for any tax imposed on partners or members.

(emphasis added). In turn, § 346(c) provides:

With respect to a partnership or any entity treated as a partnership under a State or local law imposing a tax on or measured by income that is a debtor in a case under this title, any gain or loss resulting from a distribution of property from such partnership, or any distributive share of any income, gain, loss, deduction, or credit of a partner or member that is distributed, or considered distributed, from such partnership, after the

Therefore, 346(h) is inapplicable. To the extent that the Trustee proposes to make any such distribution to a member of the Debtor, the Trustee shall withhold any amounts required under § 105-154 for distribution to the Department.

⁷ With limited exceptions not applicable to this case, § 1398 of the IRC creates a separate, taxable estate only in cases under chapter 7 or chapter 11 in which the debtor is an individual. 26 U.S.C. § 1398(a). "Except in any case to which section 1398 applies, no separate taxable entity shall result from the commencement of a case under title 11 of the United States Code." 26 U.S.C. § 1399.

commencement of the case, is gain, loss, income, deduction, or credit, as the case may be, of the partner or member. . . .

Trustee asserts that North Carolina state taxation laws are preempted by § 346 and title 26 of the IRC, and the Court agrees. "Section 346 preempts state tax law in favor of specific provisions detailed in several subsections." In re Wilshire Courtyard, 729 F.3d 1279, 1285 (9th Cir. 2013) (discussing how § 346(j) preempts state law as provided by § 346(a)); see also Collier ¶ 346.01 ("Section 346 is . . . a clear example of the primacy of the federalism of the Bankruptcy Code.").

Under federal law, any taxes in this case are taxable to the members and are not imposed on the corporation or partnership. It is well settled that pass-through entities, such as LLCs like Debtor, are not subject to federal taxation at the entity level. As an LLC with more than one member, Debtor is treated as a partnership for federal taxation purposes unless it elects to be treated as a corporation. See 26 C.F.R. §§ 301.7701-1 (2011), 301.7701-2 (2019), and 301.7701-3 (2020). "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." 26 U.S.C. § 701. "Partnerships are not taxed at the entity level." Pridgen v. I.R.S., 2 Fed. App'x 264, 272 (4th Cir. 2001). Instead, "partners are taxed under a passthrough taxation system." Hillman

v. I.R.S., 263 F.3d 338, 339 n.2 (4th Cir. 2001). Under this system, “[a] partnership is not itself liable for the payment of income taxes; instead, partnerships operate as ‘pass-through’ entities and each partner must pay taxes on his or her allocated share of the partnership's income or loss.” Va. Historic Tax Credit Fund 2001 LP v. Comm’r, 639 F.3d 129, 137 (4th Cir. 2011). However, partnerships still are “required to submit annual informational returns to the IRS reporting income, gains, losses, and deductions.” Mellow Partners v. Comm’r, 890 F.3d 1070, 1072 (D.C. Cir. 2018).⁸ Therefore, “the partnership is merely a tax computing unit and is not a taxpayer or taxable entity.” Rogers v. Ill. Dep’t of Revenue, 75 N.E.3d 374, 379 (Ill. App. Ct. 2017) (quoting Randolph Prods. Co. v. Manning, 176 F.2d 190, 192 (3d Cir. 1949)). Income taxes of a pass-through entity like an LLC or S corporation are liabilities of that entity’s members. In re Carolina Internet, 2012 WL 2860024, at *3 (Bankr. W.D.N.C. 2012). “The filing of a bankruptcy case by the corporation does not alter its tax status or that of its shareholders.” Id. (citing Pants Rack, Inc. v. United States, 669 F.2d 198 (4th Cir. 1982); Mourad v. Comm’r, 387 F.3d 27 (1st Cir. 2004); Official Comm. of Unsecured Creditors of Forman Enters. v. Forman (In re Forman Enters.), 281 B.R. 600 (Bankr. W.D. Pa. 2002); Hanrahan v. Waltermann (In re

⁸ As trustee of Debtor’s chapter 7 estate, Trustee is responsible for filing a return on behalf of Debtor. 26 U.S.C. § 6012(b)(3).

Walterman Implement, Inc.), 2006 Bankr. LEXIS 921 (Bankr. N.D. Iowa May 22, 2006)).⁹

Having determined that any taxes were imposed solely on the nonresident members rather than the LLC under federal law, § 346(b) dictates the result in this case. That section expressly prohibits such taxes from being a liability of the estate. 11 U.S.C. § 346(b) ("The estate shall be liable for any tax imposed on such corporation or partnership, but not for any tax imposed on partners or members."). Furthermore, the North Carolina statutes and tax bulletins make it abundantly clear that the members at all times remain ultimately liable for the taxes, and the Department does not argue otherwise.¹⁰ Since the members are unquestionably liable

⁹ The Department argues that N.C. Gen. Stat. § 105-154(d) departs from these traditional principles and instead imposes an additional tax liability on the LLC for the nonresident members' distributive share of any income. Although nothing in the statute purports to impose such a tax on the LLC, the Court need not determine whether the North Carolina statute purports to separately tax the LLC solely for nonresident member income or gains because such a state level tax would be preempted by the provisions of § 346 and federal tax law.

¹⁰ Notably, § 105-154(d) only allows the nonresident owner to be reimbursed should an excess amount be overpaid by the manager to the North Carolina state government, providing "[t]he nonresident owner or partner may, on its own income tax return, request a refund of an overpayment made on its behalf by the manager of the business within the provisions of G.S. 105-241.6." (emphasis added). In fact, the North Carolina Personal Taxes Bulletin expressly prohibits the manager of an LLC from seeking such a refund on behalf of the LLC:

The manager of a partnership may not request a refund of an overpayment made on behalf of a nonresident owner or partner if the manager of the business has already filed the partnership return and paid the tax due. The nonresident owner or partner may, on its own income tax return, request a refund of an overpayment made on its behalf by the manager of the partnership within the provisions of G.S. 105-241.6. A nonresident individual partner who is not required to file a North Carolina individual income tax return pursuant to the provisions 17 NCAC 06B .3513 must file a North Carolina individual income tax return in order to receive a refund

for their respective tax obligations, the estate cannot also be liable. Section 346(b) expressly prohibits any dual tax obligation of the members and the estate, providing that the estate shall not be liable for any tax imposed on the members. For these reasons, the Court finds that the estate has no liability for the taxes imposed against the resident or non-resident members of the LLC.

NOW, THEREFORE, it is hereby ORDERED, ADJUDGED, and DECREED that Trustee's Motion is granted.

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of tax paid on the nonresident partner's behalf by the manager of the partnership.

N.C. Dep't of Revenue, Personal Taxes Bulletin, N.C. Dept. of Rev. 46 (Dec. 2019) <https://files.nc.gov/ncdor/documents/files/2019-Personal-Taxes-Bulletin.pdf>.

The Taxes Bulletin also makes clear that the obligation to file a North Carolina tax return ultimately falls on the member if the LLC does not file a return on the member's behalf. The Bulletin provides:

A nonresident individual partner is not required to file a North Carolina individual income tax return when the only income from North Carolina sources is the nonresident's share of income from a partnership doing business in North Carolina and the manager of the partnership has reported the income of the nonresident partner, including any guaranteed payments made to the partner, and has paid the tax due for the nonresident individual partner.

Id. at 48 (emphasis added). By negative implication, the nonresident individual must file a North Carolina individual income tax return if the manager does not report the income or does not pay the tax due.

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