

State Taxation of the *Pro Hac Vice* Lawyer

BY JERRY MEEK

In 2010 the NC State Bar amended its *Pro Hac Vice* Admission Registration Statement to require the out-of-state attorney to sign a statement verifying that he or she will report to the NC Department of Revenue any income earned in the case, “if required to do so by law.” The amendment prompts the obvious question: When will an out-of-state attorney be required to pay North Carolina income tax? And, relatedly, when should a North Carolina attorney be concerned about paying income tax in another state?

Both the Due Process Clause and the Commerce Clause limit a state’s ability to tax non-residents. As the United States Supreme Court held in *Complete Auto Transit, Inc. v. Brady*,¹ a state can tax non-residents only if the non-resident is engaged in an activity which has a “substantial nexus” with the taxing state, and if the tax imposed is “fairly apportioned” among the states.

For income tax purposes, it’s not clear what is required for “substantial nexus” to exist. In *Quill Corp. v. North Dakota*,² the US Supreme Court held—in the context of requiring a non-resident to collect sales taxes—that substantial nexus required physical presence in the taxing state. But in *A&F*

Trademark, Inc. v. North Carolina,³ the North Carolina Court of Appeals rejected the argument that the physical presence test applied to taxes other than sales taxes. According to our court of appeals, the existence of sufficient economic ties will subject a non-resident to income taxation in our state, even absent physical presence.

Often, the *pro hac vice* attorney will travel into our state in furtherance of the representation, thereby indisputably creating substantial nexus. When the non-resident attorney performs services without ever physically appearing in our state, there is a continuing dispute over whether or not North Carolina

has jurisdiction to impose an income tax. Notwithstanding this dispute, ultimately whether any tax is owed depends upon how any income generated from the representation is apportioned.

Each state, including North Carolina, has adopted legislation to implement the Constitution’s requirement for fair apportionment of multistate business income. The goal of apportionment statutes is to roughly approximate the income that can be said to be fairly related to the services provided by the respective states. In the context of multi-



state legal services, this is rarely the same as what the client actually paid for the services.

Under most statutes, states employ a three “factor” formula for apportioning the business income earned by multistate actors, including lawyers. Usually these formulas take into account the taxpayer’s property, payroll, and sales in each state, relative to the taxpayer’s total property, payroll, and sales. Different states apply different weights to these factors. North Carolina weighs the sales factor twice as heavily as either of the other two factors.

Since it is unlikely that a non-resident attorney appearing *pro hac vice* in North Carolina will own or rent any real or tangible personal property in our state, the property factor is likely to be zero. Similarly, since the non-resident attorney typically will not pay compensation in our state, the payroll factor is likely to be zero.⁴

As a result, the sales factor is of greatest concern to the non-resident attorney. The sales factor represents the gross revenue sourced to North Carolina, divided by the gross revenue from all states. Especially in the context of services revenue, the critical task is determining to what state the revenue should be sourced. Two main approaches have developed.

First, in states that have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), services revenue is attributed to the state in which the greater proportion of costs are incurred to perform the activities that give rise to the income. Second, in the 11 states which have adopted a market-based sourcing rule, services revenue is attributed to the state where the customer or client receives the benefit.

North Carolina employs a variation on the UDITPA approach. Services income is sourced to our state if the “income-producing activities are in this state.”⁵ This rather unhelpful rule is explained through guidance issued by the NC Department of Revenue, which provides that when services are performed across state lines, gross receipts for performing those services “shall be attributed to this state based upon the ratio which the time spent in performing such services in this state bears to the total time spent in performing such services everywhere.” Consequently, a non-resident lawyer who spends no time in North Carolina will owe no North Carolina tax, even if paid for appearing in a North Carolina action.

Let’s take a practical example. A nonresident lawyer is admitted *pro hac vice* in North Carolina. She has no real or tangible property in our state and pays no “compensation” within our state. The property and payroll factors are therefore zero. She is paid \$150,000 for 500 hours of work on the case. She spent 100 of those 500 hours in North Carolina. The numerator of the sales factor is therefore \$150,000 x [100/500], or \$30,000. Assuming that her gross receipts from all states during the year was \$600,000, the sales factor is \$30,000 / \$600,000, or 0.05.

To calculate the apportionment factor, all of the factors must be combined, with the sales factor weighted twice: $[0 + 0 + 0.05 + 0.05] / 4 = 0.025$. This apportionment factor is then multiplied by her net business income from all states to determine the income that must be reported in North Carolina. Thus, if her net business income for the year was \$320,000, the amount which must be reported to North Carolina is \$320,000 x 0.025, or \$8,000.

Fortunately, her home state will typically give her a credit for any tax she paid to North Carolina. She will in the end face a higher total tax burden only if her North Carolina tax bill is greater than her home state’s bill. Obviously, if her home state has no income tax, this burden can be significant.

A similar calculation results when a North Carolina lawyer performs legal services in a foreign state. But since the Supreme Court’s interpretation of the Commerce Clause gives the states considerable discretion when adopting apportionment formulas, differences abound. South Carolina, for example, adopts a single factor formula, under which only sales sourced to the state are considered in determining the tax. As a result of this diversity, apportionment formulas could overlap, resulting in double taxation of the same income. When a firm’s employees are physically present in another state, some states may even require the payment of payroll taxes.

Finally, if the non-resident attorney is a partner, member, or shareholder of a partnership, LLC, or S-corporation, must each partner, member, or shareholder file a tax return in North Carolina? Because the distributive share of each owner of a pass-through entity will include income apportioned to North Carolina, the answer is generally yes. Fortunately, North Carolina—along with most other states—permits the partnership,

LLC, or S-corporation to file a “composite return,” thereby paying the tax on behalf of all of the firm’s owners. This will avoid the administrative and compliance burdens associated with filing and processing multiple individual returns, often with little income to report. ■

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Endnotes

1. 430 U.S. 274 (1977).
2. 504 U.S. 298 (1992).
3. 167 N.C. App. 150 (2004).
4. This is true because, under N.C.G.S. § 105-130.4, compensation is considered “paid in this state” only if: (a) the individual’s service is performed entirely in North Carolina; (b) only an incidental amount of the service is performed in another state; or (c) the base of operations, or place from which the service is directed, is in our state. Typically, the *pro hac vice* attorney will perform a substantial (and therefore non-incidental) amount of the services in his or her home state—drafting pleadings, preparing or responding to written discovery, or preparing for depositions or trial.
5. N.C.G.S. § 105-130.4(l)(3)(c).

Animal Damages (cont.)

- Jack Russells in which a replacement for Laci could have been bought for less than \$350.
20. Consider, too, whether ordering the refunding of veterinary charges paid by the Sheras was a remedy sounding in breach of contract that was not available in their suit against state veterinary hospital under the North Carolina Tort Claims Act.
 21. *Heath v. Mosley*, 286 N.C. 197, 199, 209 S.E.2d 740, 742 (1974). Costs of repairs are some evidence of the decrease in value.
 22. *Givens v. Sellars*, 273 N.C. 44, 51, 159 S.E.2d 530, 536 (1968).
 23. *Kimes v. Grosser*, 126 Cal. Rptr. 3d 581 (App. 1911). See also *Burgess v. Shampooch Pet Industries*, 131 P.3d 1248 (Kan. App. 2006) (full amount of veterinary bills recoverable, although plainly in excess of replacement value, where 13-year-old dog had no market value).
 24. *Hyland v. Borass*, 719 A.2d 662, 664 (NJ App. Div. 1998). *Accord*, *Leith v. Frost*, 899 N.E.2d 635, 641 (Ill. App. 2008).
 25. *McDougall v. Lamm*, 48 A.3d 312, 324 (NJ 2012).
 26. *Brouseau v. Rosenthal*, 443 N.Y.S. 2d 285, 286 (Civ. Ct NY Cnty, 1980).