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Client Alert

Tax Practice Group

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IRS Rejects Investors' Claim for Refined Coal Credits in Technical Advice

In Technical Advice Memorandum 2017-29-020 (July 21, 2017) (the "TAM"), the IRS denied claims by two tax equity investors (the "Investors" or each an "Investor") for renewable energy tax credits on grounds that the transaction was structured solely to facilitate the purchase of tax credits. The Investors claimed credits under section 45(e)(8) of the Internal Revenue Code (the "Code"), which provides a credit for production of certain refined coal over a ten-year period. The credits at issue were derived from the production of refined coal at two production facilities owned by a joint venture in which the Investors purchased interests. The TAM suggests that the IRS is reviewing renewable energy investments with a heightened level of scrutiny.

The TAM is puzzling—not so much in the result reached as in the articulation of the principle relied on to reach the result. As is discussed in more detail below, the IRS found that the transaction constituted an illegal sale of tax credits. The availability of Code section 45 tax credits to investors normally turns on the investors being valid partners for U.S. federal tax purposes and the arrangement furthering the purpose for which the credit was enacted—here the production of refined coal. Thus, normally, a conclusion that credits were "illegally sold" is the punchline that follows a finding based on legal principle, for example, that a taxpayer is not a partner (*see Historic Boardwalk Hall LLC v. Commissioner* [1]). *But* in the TAM, the IRS specifically denied finding that the Investors were not partners, the entity was not a partnership, or pre-tax profit potential was required, despite analyzing the transaction based on factors that would be common to those findings. The TAM raises questions about whether the IRS has minted a new tax common law principle and, if so, how it differs from the *Culbertson* test[2] and the economic substance test. Perhaps it is merely a new version of substance-over-form.

Background Facts

An operator designed and constructed two refined coal facilities, which the operator contributed to a wholly-owned limited liability company. The Investors, which were corporations for U.S. federal tax purposes, then purchased interests in the limited liability company (the "Joint Venture"). Thereafter, the Joint Venture constituted a partnership for U.S. federal tax purposes. The operator retained an ownership interest in the Joint Venture.

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The purchase prices paid by the Investors approximated each Investor's proportionate share of the operator's total capital costs attributable to the two facilities. The Joint Venture's operating agreement (the "Operating Agreement") obligated each of the three members to contribute a pro rata share of ongoing operating expenses as the Joint Venture incurred those expenses. The TAM describes this ongoing contribution obligation as a "pay-as-you-go" structure under which the members' contribution obligations were reduced "substantially" whenever the joint venture was not producing coal and thus not producing Code section 45 credits. The Operating Agreement allocated all partnership tax items (including credits) among the three owners on a pro rata basis. One of the Investors negotiated a liquidated damages provision, which required the operator to buy out that Investor if certain conditions were met. One of those conditions was an event causing the unavailability of the Code section 45 credit.

The Joint Venture entered into several agreements each of which was coterminous with the ten-year period in which the Code section 45 credit would be available. Pursuant to a sub-license agreement, the operator sub-licensed its rights to use proprietary technology in the facilities to the Joint Venture. Under that agreement, the Joint Venture made royalty payments to the operator. The amount of those payments was based on the value of the Code section 45 credits produced by the facilities. In addition, the Joint Venture entered into an agreement to purchase feedstock coal from an electric company at cost (the "Supply Agreement"). That same electric company also agreed to purchase refined coal from the Joint Venture (the "Sale Agreement") at a price that was discounted from the price paid under the Supply Agreement.

According to the TAM, the Joint Venture's operations did not meet expectations. On a number of occasions, the Joint Venture halted production for several months at a time. In its fifth year of operation, the Joint Venture stopped production permanently. Despite that subpar performance, the Investors received "very substantial tax benefits" well in excess of the Investors' capital contributions. These tax benefits were attributable to the Code section 45 tax credits, as well as tax losses and depreciation. Both Investors exited the investment in the fifth year of production by selling their interests in the Joint Venture back to the operator. The operator bought out one Investor pursuant to a negotiated agreement, and the other Investor exercised its liquidated damages provision.

IRS Analysis

The IRS concluded that neither of the Investors was entitled to claim the Code section 45 tax credits. It cited *Historic Boardwalk* for the proposition that the parties "facilitated the improper sale of section 45 tax credits" to the Investors. In *Historic Boardwalk*, the Third Circuit ruled that an investor was not a *bona fide* partner for U.S. federal tax purposes because the agreements governing that transaction ensured that the investor would receive Code section 47 rehabilitation tax credits and a preferred return without any meaningful downside risk or upside potential with respect to the underlying economic venture. But the TAM expressly declined to reach the issue of whether the Investors were *bona fide* partners or whether the Taxpayer was a *bona fide* partnership. Instead, the TAM began its analysis with the assumption that "taxpayers may not sell federal tax benefits." The TAM cited *Historic Boardwalk* for that proposition, but that is not a legal principle and was not the basis of the holding by the Third Circuit.[3] The TAM then analyzed whether the substance of the transaction resulted in a sale of tax credits. According to the IRS, the parties similarly created an arrangement that significantly limited the Investors' risk of loss and possibility of gain on the underlying coal production activities. The IRS focused especially on the Supply Agreement and the Sale Agreement. Those agreements guaranteed that the Joint Venture (and indirectly the Investors) would incur small, limited losses from the discounted sales of refined coal to the electric company, and would not receive any benefit from a favorable change in the market for coal. Investors benefited from increased sales of refined coal only through the receipt of additional Code section 45 tax credits. Because the Investors only benefited from Code section 45 credits, and only had to contribute capital when they got such credits, the IRS viewed the Investors' capital contributions, in substance, as fees paid to purchase tax credits.

Insights

The IRS explains in the TAM that it concluded the Investors engaged in a "prohibited purchase of tax benefits" rather than deciding whether the Investors were *bona fide* tax partners, whether the joint venture was a valid tax partnership, or whether the arrangement had economic substance. Thus, the IRS appears to have taken the position that tax credits can be denied based solely on a finding that investors "purchased" tax credits without having to decide whether, for U.S. federal tax purposes, investors are partners, the venture is a partnership, or the transaction has economic substance. It is not obvious why the IRS took that approach. Perhaps the Service was mindful of Congress's goal of encouraging investment in refined coal production and had concerns about certain taxpayer-favorable language in the Technical Explanation to section 7701(o).[4] Or perhaps it boldly represents the assertion of a new common law tax principle to deny tax benefits where non-tax substance is lacking. One practical follow-on question would be whether such a finding would suggest the imposition of the accuracy-related penalty under Code section 6662(b)(6), applicable when the economic substance doctrine, or a similar doctrine, denies tax benefits. Presumably, it would not.

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[1] 694 F.3d 425 (3rd Cir. 2012), *rev'g and remanding*, 136 TC 1 (2011).
[2] *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949) (stating that a partnership exists when two or more parties in good faith and acting with a business purpose intend to join together in the present conduct of an enterprise).
[3] *Historic Boardwalk*, 694 F.3d at 462-63 (The Third Circuit noted in *dicta* that "the IRS has challenged" the "prohibited sale of tax benefits." But the Court's holding rested solidly on *Culbertson* and whether the taxpayer was a *bona fide* partner for tax purposes).
[4] Joint Committee on Taxation Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination with the "Patient Protection and Affordable Care Act", JCX-18-10, March 21, 2010, at 152 (stating that "it is not intended that a tax credit . . . be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage.").