# Office of Chief Counsel
# Internal Revenue Service
# Memorandum

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subject: Refined Coal Partnerships

**Issue**

Since issuing TAM 201729020, July 21, 2017, the IRS Office of Chief Counsel has received several requests for clarification as to the treatment of refined coal credit transactions and the eligibility of participants therein to claim the § 45 tax credit. In response to these requests, this memorandum sets forth some general guidelines for analyzing refined coal credit transactions.

**Background**

Enactment of the Refined Coal Tax Credit

Congress enacted § 45 of the Code as part of the Energy Policy Act of 1992 to provide a credit for electricity produced from certain renewable resources. In general, for any tax year, a credit is available for electricity produced from qualified energy resources at a qualified facility during the ten-year period beginning on the date the facility is originally placed in service and sold to an unrelated person.

By 2004, Congress recognized that the credit for the production of synthetic fuels from coal under former § 29 had been interpreted to include fuels that were merely chemical changes to coal that did not necessarily enhance the environmental performance of the feedstock coal.[1] To incentivize the production of fuel from coal that achieved significant environmental improvements, Congress amended § 45 as part of the American Jobs Creation Act of 2004 (AJCA) to allow certain producers of refined coal to qualify for the renewable energy production credit. Under § 45(e)(8)(A), the credit is $4.375 (adjusted for inflation) per ton of qualified refined coal (i) produced by the taxpayer at a refined coal production facility during the 10-year period beginning on the date the facility was originally placed in service, and (ii) sold by the taxpayer to an unrelated person during the 10-year period. Section 45(c)(7) defines "refined coal" as a fuel which meets certain formal and functional requirements. In order to constitute refined coal, the burning of the refined coal must result in the reduction of at least 20% of the emissions of nitrogen oxide and at least 40% of the emissions of either sulfur dioxide or mercury released as compared to burning the feedstock coal. Section 45(d)(8)(B) defines a refined coal production facility as a facility producing refined coal that is placed in service after the date of the enactment of the AJCA (October 22, 2004) and before January 1, 2012.

Transaction Structures for Refining Coal

To engage in the production of refined coal, an entity must have sufficient resources to develop or acquire the technology for the refining process, and to acquire and operate the physical coal refining facilities. While a single, well-funded entity could carry out these functions on its own, in cases of limited capital or expertise, more than one party may participate in a refined coal venture. In this case, a basic structure would be for the owner of the coal-refining technology (i.e. the developer) and one or more investors to enter into a joint venture, to which the developer would contribute its technology and the investors would contribute capital. The joint venture would operate one or more coal-refining facilities and each member of the joint venture would fully participate in the risks and rewards of the operation of those coal-refining facilities as well as the ability to exploit the coal-refining technology in future transactions.

Since the refined coal tax credit's enactment, however, the refined coal industry has developed a structure (the "common structure") that places several limits on the risks to the investors. In the common structure, developers organize a venture limited to a single facility and bring in investors to help fund the activity, but only for the duration of the 10-year credit period. The investor usually participates by purchasing an interest in a partnership that claims eligibility for the refined coal credit.[2] This partnership then enters into various agreements with terms that are co-extensive with the 10-year credit

[1] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05), May 2005, at 335-36.
[2] The refined coal credit is allowed for qualified refined coal produced and sold to an unrelated person by the taxpayer, without regard to whether the taxpayer owns the refined coal production facility in which the refined coal is produced. Accordingly, a taxpayer that leases or operates a facility owned by another person may claim the credit for refined coal that the taxpayer produces in the facility. Notice 2010-54, 2010-40 I.R.B. 403, § 5.01.

period. These 10-year agreements typically include (i) an agreement to purchase raw coal from a utility and then resell the refined coal back to the utility, (ii) a lease with the utility for the property on which the facility is located, and (iii) a license to exploit the refining technology. The presence of these terms in the common structure may be due to an interest on the part of investors in obtaining the tax credits coupled with a lack of investor interest in being exposed to the risks and rewards associated with owning and exploiting the technology to refine coal.

In the common structure, the agreements to purchase feedstock coal and sell refined coal typically guarantee a loss to the seller. Because utilities can generally meet current federal and state pollution standards with current technology, they may have little incentive to pay a premium for refined coal. To induce a utility to use refined coal in its operations, a coal refiner may structure a transaction to benefit the utility economically by selling the refined coal to the utility at a price below the price the refiner pays to the utility for the raw feedstock coal, or by paying the utility some sort of fee, thereby generating an economic loss to the refiner.[3] In the course of the coal refining, the refiner incurs additional expenses to refine the raw coal that increases the loss on the sale of refined coal. In many of the refined coal credit transactions the IRS is aware of, the coal purchase and sale agreements are fixed in price for the full 10-year term with no right to renegotiate, even if more stringent emissions standards were enacted that could greatly enhance the value of refined coal. The lack of a provision allowing such a renegotiation may reflect the relative bargaining power of the refined coal facility operators vis-à-vis utilities.

Some transactions, such as the one described in TAM 201729020, place yet further limits on risk (or reward) to the investor. For example, the transaction described in TAM 201729020 included an unusual licensing arrangement that paid above-market royalty rates to the technology's primary licensee and sublicensed the technology to the operating partnership using a royalty formula that effectively allocated virtually all economic benefit that might accrue from improvements in the technology over time to the developer. Transactions such as this one are problematic, as insulation from the entrepreneurial fortunes of a coal refining operation indicates that the investor is not truly an investor participating in a coal refining venture, but rather a mere purchaser of tax credits.

**Analysis of Refined Coal Section 45 Credit Transactions**

Congress added the § 45 credit for refined coal to incentivize its production. Because the owner of the technology necessary to refine coal may not want or be able to develop and operate one or more coal refining facilities on its own, it may opt to share the §45 credit by bringing outside equity investors into a transaction to provide capital for the

[3] This arrangement also locks in an economic profit to the utility, which is otherwise prohibited by section 45(e)(8) from sharing in the refined coal tax credit.

facility and participate in its operation. To the extent that those investors have a true entrepreneurial interest in that refined coal operation, they may properly claim their share of the § 45 tax credits generated by the activity. If the investors are insulated from the risks and rewards of the business, however, the transaction may be subject to challenge under a bona fide partner analysis, a prohibited sale of tax credits analysis, or an economic substance analysis.

Bona Fide Partner

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 the enterprise." *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).[4] In making this determination, courts "look not so much at the labels used by the partnership but at the true facts and circumstances" to determine whether a partner has a "meaningful stake in the success or failure" of the enterprise.[5]

In *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012), the court found that an investor in a § 47 historic rehabilitation tax credit partnership was not a bona fide partner under the *Culbertson* standard. The investor was not entitled to claim the rehabilitation credit for qualifying rehabilitation expenditures under § 47 because it was not exposed to any economic benefit or detriment of the partnership's enterprise. In the court's view, "because [the investor] lacked a meaningful stake in either the success or failure of [the partnership], it was not a bona fide partner." *Id*. at 455, 459. In reaching its conclusion disallowing the tax credits to the investor, the Third Circuit stated:

> Much of that evidence may give an "outward appearance of an arrangement to engage in a common enterprise." *Culbertson*, 337 U.S. at 752, 69 S.Ct. 1210 (Frankfurter, J., concurring). But "the sharp eyes of the law" require more from parties than just putting on the "habiliments of a partnership whenever it advantages them to be treated as partners underneath." *Id*. Indeed, *Culbertson* requires that a partner "*really and truly intend*[ ] to ... shar[e] in the profits and losses" of the enterprise, *id*. at 741, 69 S.Ct. 1210 (majority opinion) (emphasis added) (citation and internal quotation marks omitted), or, in other words, have a "meaningful stake in the success or failure" of the enterprise, *Castle Harbour*, 459 F.3d at 231. Looking past the outward appearance, HBH's cited evidence does not demonstrate such a meaningful stake…. [A]fter looking to the substance of the interests at play in this case, we conclude that, because PB lacked a meaningful stake in either the success or failure of HBH, it was not a bona fide partner.

[4] *See also Comm'r. v. Tower*, 327 U.S. 280 (1946);
[5] *TIFD III-E, Inc. v. United States*, 459 F.3d 220 (2d Cir. 2006).

694 F.3d at 461, 463.

FAA 20161101F concluded that an investor in a refined coal partnership did not hold a meaningful stake in the success or failure of the partnership. As a result, the investor was not entitled to the § 45 credit. The FAA noted that the investor lacked significant downside risk:

> [I]f [the partnership] does not produce enough refined coal to generate the requisite amount of credit, [the investor] does not have an obligation to make variable payments. [The investor]'s variable payments are wholly contingent on [the partnership]'s production of refined coal.
>
> Additionally, the fixed payments are nonrecourse to [the investor], and are only recoverable against [the partnership]'s assets. Thus, the fixed payment obligation is only enforceable against [the investor]'s interest in [the partnership], without other recourse to [the investor]. Moreover, since [the investor] has the ability to exit the transaction if it does not make the "fixed payment," that obligation is not truly fixed.

The FAA also noted that the investor lacked any pre-tax upside potential. Not only was the facility projected to generate pre-tax losses during its operation, the investor had no upside potential at the end of the transaction:

> Further, [the partnership]'s assets are to be distributed pro rata to the members, but, if [the partnership]'s assets, after the payment or discharge of the debts and liabilities, are insufficient to return the capital contributions of each member, such member has no recourse against [the partnership] or any other member. As a result, [the investor] and the other members lack upside potential at the dissolution stage, as it cannot even recover its capital contribution – and has no recourse to do so – if [the partnership] lacks sufficient assets at the end of the term.

The wind energy safe harbor in Rev. Proc. 2007-65, 2007-45 I.R.B. 967,[6] sets forth parameters for transactions in which the form will be respected for purposes of the tax credit's availability. Chief among these terms are a requirement that an investor make and maintain a minimum unconditional investment of 20% of its total fixed capital contributions plus reasonably anticipated contingent capital contributions, and a requirement that at least 75% of those total contributions be fixed in amount. The purpose of these requirements is to ensure that the investor has a meaningful economic

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[6] Rev. Proc. 2007-65 provides a safe harbor for structuring wind energy partnerships. If a partnership satisfies all the requirements of the safe harbor, the IRS will respect its allocation of § 45 credits. Rev. Proc. 2007-65 applies only to partners or partnerships with § 45 production tax credits from renewable resources from wind.

interest in the enterprise and is not simply making conditional investments to the extent that the partnership is able to allocate them tax credits (sometimes referred to as a "pay-as-you-go" or "PAYGO" structure), effectively purchasing the credits. The cost of generating electricity from wind is largely front-loaded, as the bulk of expenditures relate to the construction and development of the wind farm. Because wind is free, the cost of the facility once operational is minimal in relation to the upfront expenses. Thus, the investor's economic return – that is, independent of tax considerations – generally will increase or decrease depending on how the wind blows.

The economics of a refined coal operation are completely different. Refined coal facilities, unlike wind farms, are relatively inexpensive to construct and install. The upfront costs of these facilities are insignificant in relation to the substantial ongoing operational expenses relating to coal purchases, as well as technology licenses, rent, labor, etc. After making a relatively small upfront contribution to purchase its interest in a refined coal partnership or to construct the refined coal facility, an investor will contribute the bulk of its total investment over the life of the partnership to fund operational expenses. These expenses and contributions generally correlate with the generation of § 45 credits – the partnership will sell refined coal shortly after purchasing feedstock coal – resembling a PAYGO structure. Moreover, under the terms of a typical contract with a utility, the partnership will generate a loss on each ton of refined coal sold regardless of how many tons are sold. Thus, while the fixed upfront investment in a refined coal partnership represents real capital that an investor places at risk, the PAYGO-like nature of refined coal operations adds a sale-like component to the transaction and the economic realities of a typical utility contract limit the variability of an investor's economic return. Thus, an analysis of a refined coal transaction requires us to closely examine the other indicia of a partnership. An investor has to truly share in the risks and the rewards of the refined coal operation – in a manner comparable to a developer in a standalone refined coal operation – to be considered to have a meaningful economic interest in the enterprise.

Sale of Tax Credits

Except where expressly authorized by statute, taxpayers may not sell federal tax benefits. In *Historic Boardwalk Hall*, the Third Circuit noted that the purported partnership was in effect a mechanism for indirectly selling the § 47 rehabilitation credit:

> [i]t is the prohibited sale of tax credits, not the tax credit provision itself, that the IRS has challenged. Where the line lies between a defensible distribution of risk and reward in a partnership on the one hand and a form-over-substance violation of the tax laws on the other is not for us to say in the abstract. But, "[w]here, as here, we confront taxpayers who have taken a circuitous route to reach an end more easily accessible by a straightforward path, we look to the substance over form." *Southgate Master Fund*, 659 F.3d [466, 491 (5th Cir. 2011)]. (Emphasis added).

694 F.3d at 462-463. The court also noted that the "recovery of an equity investment in a partnership is dependent on the entrepreneurial risks of partnership operations, whereas… receipt of an asset purchased from a partnership is not." *Id*. at 453.[7]

In *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), the Fourth Circuit held that the allocation of state tax credits for historic rehabilitation by a partnership was properly treated as a sale of those credits. In this case, because the credits at issue were state (not federal) tax credits, the Fourth Circuit analyzed the transaction under the disguised sale rules of Treasury Regulations §§ 1.707-3 and 1.707-6. The investors in the partnership in this case received a fixed return on their investment, comprised entirely of tax credits rather than any share of partnership profits. If the tax credits were not available, the investors were entitled to a refund of their capital contributions. Noting that "there was no true entrepreneurial risk faced by investors" (*Id*. at 145), the court concluded:

> We find persuasive the Commissioner's contention that the only risk here was that faced by any advance purchaser who pays for an item with a promise of later delivery. It is not the risk of the entrepreneur who puts money into a venture with the hope that it might grow in amount but with the knowledge that it may well shrink.

639 F.3d at 145-146. *See also Route 231, LLC v. Commissioner*, 810 F.3d 247 (4th Cir. 2016); *SWF Real Estate LLC v. Commissioner*, T.C. Memo 2015-63 (2015).

In TAM 201729020, this office concluded that two partners in a partnership that produced refined coal were not entitled to claim the refined coal tax credit under § 45 because their participation amounted to no more than a purchase of the tax credits from the developer:

> The totality of facts and circumstances point to the conclusion that X and Investor 2 entered into the transaction with Taxpayer to purchase refined coal tax credits and other tax benefits, not to participate in a business in which Taxpayer would act as a producer of refined coal. All of Taxpayer's contract negotiations took place when Operator was its sole owner, and Operator negotiated these contracts to correlate contribution obligations to tax credit generation, as well as to eliminate any opportunity for Taxpayer to realize any meaningful risks or rewards from the sale of refined coal. As the Third Circuit made clear in Historic Boardwalk, when a partnership's contracts governing a tax credit-generating activity lie on the wrong side of "a defensible distribution of risk and reward," the substance of the transaction points to a "prohibited sale of tax credits." In this case,

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[7] *See also Friendship Dairies, Inc., v. C.I.R.*, 90 T.C. 1054 (1988); *Beck v. C.I.R.*, 85 T.C. 557 (1985); *Hines v. U.S.*, 912 F.2d 736 (4th Cir. 1990); *Rice's Toyota World, Inc., v. C.I.R.*, 752 F.2d 89 (4th Cir. 1985); and *Freesen v. C.I.R.*, 798 F.2d 195 (7th Cir. 1986).

> Taxpayer's various contracts carefully circumscribed the risk of unanticipated expenditures by X and Investor 2 while just as assuredly preventing them from enjoying any financial rewards from the coal refining activity. Therefore, the substance of this transaction, insofar as it concerns X and Investor 2, was nothing more or less than the purchase and sale of refined coal tax credits.

Economic Substance

The economic substance doctrine has been developed by the courts to deny tax benefits to taxpayers that engage in tax-motivated transactions that do not change the taxpayer's economic position in a meaningful way other than via those tax benefits.[8] In *ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), Colgate-Palmolive entered into a partnership that purchased certain securities and then sold them for cash and an installment note in a transaction designed to take advantage of the ratable basis rules for contingent debt under the § 453 regulations. The sale generated a significant capital gain upfront, which was primarily allocated to a foreign partner. Shortly thereafter, Colgate bought out the foreign partner, becoming a 99.9% partner in the partnership. The partnership then sold the installment note, generating a large capital loss.

In analyzing the transaction, the Third Circuit explained that "pursuant to Gregory [v. Helvering], we must 'look beyond the form of [the] transaction' to determine whether it has the 'economic substance that [its] form represents,' *Kirchman v. Commissioner*, 862 F.2d 1486, 1490 (11th Cir.1989), because regardless of its form, a transaction that is 'devoid of economic substance' must be disregarded for tax purposes and "cannot be the basis for a deductible loss." *Lerman*, 939 F.2d at 45; accord *United States v. Wexler*, 31 F.3d 117, 122 (3d Cir.1994)." 157 F.3d at 247. The court concluded:

> We find ample support in the record for the Tax Court's conclusion that ACM and its partners did not reasonably anticipate that its contingent installment sale would generate a pre-tax profit. Because ACM's acquisition and disposition of the Citicorp notes in a contingent installment exchange was without objective effect on ACM's net economic position or non-tax objectives, and because its investments in the Citicorp notes and LIBOR notes did not rationally serve ACM's professed non-tax objectives or afford ACM or its partners a reasonable prospect for pre-tax profit, we will affirm the Tax Court's determination that the contingent installment exchange transactions lacked economic substance and its resulting decision providing that the capital gain and loss at issue will not be recognized and thus disallowing deductions arising from the application of the contingent installment sale provisions and the ratable basis recovery rule.

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[8] *See, e.g., Gregory v. Helvering*, 293 U.S. 465 (1935); *Knetsch v. United States*, 346 U.S. 361 (1960); *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Coltec Industries, Inc., v. United States*, 454 F.3d 1340 (Fed. Cir. 2006).

*Id*. at 260.

While many economic substance doctrine cases have focused on the potential for pre-tax profit, some courts have acknowledged that where Congress has incentivized otherwise uneconomic activity, transactions entered into to engage in that activity may have economic substance despite a lack of such profit potential.

For example, in *Sacks v. Commissioner*, T.C. Memo. 1992-596, rev'd, 69 F.3d 982 (9th Cir. 1995), the Tax Court disallowed energy credits attributable to an investment in solar water heaters due to a lack of economic substance. The Ninth Circuit reversed that holding, concluding that the taxpayer had a business purpose and his transaction had economic substance, independent from the tax credits. Although the transaction was anticipated to produce a pre-tax loss, a significant rise or fall in energy prices could meaningfully change the taxpayer's economic position for better or worse. In addition, at the end of the transaction, the taxpayer would own solar water heaters that could be sold at a profit in certain circumstances. The court explained:

> Absence of pre-tax profitability does not show whether the transaction had economic substance beyond the creation of tax benefits…where Congress has purposely used tax incentives to change investors' conduct. Where a transaction has economic substance, it does not become a sham merely because it is likely to be unprofitable on a pre-tax basis.… If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made.

69 F.3d at 991-992.

Similarly, a lack of pre-tax profitability will not, by itself, prevent a refined coal credit transaction from satisfying either the pre-enactment economic substance doctrine or § 7701(o). In a refined coal credit transaction that is structured in such a way that it lacks the potential for pre-tax profit based on the purchase and sale prices for the coal, the IRS can look to factors similar to those the court relied on in *Sacks, where the court relied on the fact that the taxpayer's economic position could be meaningfully affected by a significant change in prices and* the fact that the taxpayer retained ownership rights in the property giving rise to the tax credit that extended beyond the tax credit period.

As part of the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) (the Act), Congress codified the economic substance doctrine in § 7701(o). That section provides that in the case of any transaction to which the economic substance doctrine is relevant, such transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[9]

The Joint Committee on Taxation's summary of the Act explains that, "[t]he determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if the provision had never been enacted. Thus the provision does not change present law standards in determining when to utilize an economic substance analysis."[10] An accompanying footnote that expands on that point helps in analyzing whether § 7701(o) applies to targeted tax credits. That footnote states:

> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. … Thus, for example, it is not intended that a tax credit (e.g., section 42 (low-income housing credit), *section 45 (production tax credit)*, section 45D (new markets tax credit), section 47 (rehabilitation credit), section 48 (energy credit), etc.) 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. (Emphasis added).

JCX-18-10, Footnote 344.

The Joint Committee summary indicates that the economic substance doctrine should not be applied to disallow the refined coal credit if the taxpayer is, *in form and substance*, undertaking the type of activity that the refined coal credit was intended to encourage. In the case of a standalone developer engaged in a refined coal operation, the developer typically will be considered to undertake the type of activity that the

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[9] Prior to the enactment of section 7701(o), the courts of appeal did not approach the economic substance doctrine with uniformity. Some courts adopted a "conjunctive" test, requiring the taxpayer to establish it had both a legitimate non-tax effect and a bona-fide non-tax business purpose, some adopted a "disjunctive" test requiring the taxpayer show either economic effect or bona-fide business purpose, while yet others performed a balancing approach or "flexible" analysis using both prongs as factors. *See United Parcel Service v. Commissioner*, 254 F.3d 1014, 1018 (11th Cir. 2001) (Conjunctive); *Rice's Toyota World v.Commissioner*, 752 F.2d 89 (4th Cir. 1985) (Disjunctive); *Sochin v. Commissioner*, 843 F.2d 351 (9th Cir. 1988) (Balancing); *Bank of New York v. Commissioner*, 801 F.3d 104, 115 (2d Cir. 2015) (Flexible). In addition, The First Circuit recently restated its reluctance to delve into the subjective motives of taxpayers, relying on only economic test to determine if there was a plan of tax avoidance. *Santander Holdings USA v. United States*, 844 F.3d 15, 21-22 (1st Cir. 2016).

[10] Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as Amended, in Combination With the "Patient Protection and Affordable Care Act", March 21, 2010, JCX-18-10, at 152. Notably, the Joint Committee report mentions *Sacks* in Footnote 306 of its description of pre-enactment "Present Law", indicating that Congress was aware that the economic substance doctrine was relevant in a targeted credit transaction. It should be noted, however, that the context for the Joint Committee's discussion relates to the enactment of §7701(o) as part of the Health Care and Reconciliation Act, prior to its amendment of unrelated provisions by the Senate.

refined coal credit was intended to encourage, in form and substance, because the developer typically is actively engaged in refining coal and selling it, not merely purchasing a tax credit generated by the sale of such coal. Because the developer is subject to the risks and rewards of the refined coal production activity, it is, in form and substance, engaging in the activity the credit was intended to encourage. In such a situation the economic substance doctrine should not be applied to disallow the credit.

The foregoing case is to be distinguished from a case in which an investor, in form, is engaging in the production of refined coal, but is not doing so in substance. For example, if the facts and circumstances indicate that the investor is insulated from the upside potential and downside risks of the activity, the investor may, in substance, be purchasing the credits. Congress could enact a transferable tax credit, as some states have done, and in that situation a purchaser of credits may be engaging, in form and substance, in activity that Congress intended to encourage.[11] But the refined coal credit is not a transferable credit, and an investor who, in substance, is purchasing the credit is not, in substance, engaging in the activity that the refined coal credit was intended to encourage. In such a case, the economic substance doctrine can be applied to disallow the credit.

Following this analytical framework, in the case of a multiparty refined coal transaction, we first look to whether the investor is engaged, in substance, in the activity the refined coal credit was intended to encourage – the activity of refining coal. In order to be engaged in that activity, a taxpayer must be exposed to the risks and rewards associated with the activity. If the investor is subject to such risks and rewards, it will be considered to undertake the type of activity that the refined coal credit was intended to encourage, in form and substance, and the economic substance doctrine should not be applied to disallow the credit. However, if the investor is insulated from risks and rewards associated with the refined coal operation, the investor is not, in substance, engaged in the activity of refining coal. In this situation, the investor is not, in form and substance, undertaking the type of activity that the refined coal credit was intended to encourage, and the economic substance doctrine may be applied to disallow the credit.

**Common Analytic Principles**

While each of these three lines of analysis is distinct from the others, a common thread runs through all of them: an investor must have an entrepreneurial interest in the underlying activity giving rise to the credit. That may involve the investor having a

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[11] While Congress has not expressly enacted transferable federal tax credits, the safe harbor leasing provisions enacted as part of the Economic Recovery Tax Act of 1981 (Pub. L. No. 97-34) allowed an owner of investment credit (ITC) property to elect to transfer federal tax ownership of the property (and the associated ITC) via a sale-leaseback or other similar arrangement without relinquishing the benefits and burdens of legal ownership. These provisions were replaced by the financing leasing rules as part of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248), which were in turn repealed by the Tax Reform Act of 1986 (Pub. L. No. 99-514)

meaningful stake in the success or failure of the partnership (Bona Fide Partner), the investor’s economic return having the potential for variability (Sale of Tax Credits), or the investor’s economic position changing in a meaningful way (Economic Substance). While these principles consider similar factors, they do so in furtherance of different policies and therefore may not lead to identical conclusions. For example, as a general matter, the standard for being treated as a partner in a partnership may be easier to meet in terms of the amount of required exposure to economic risk/reward than the standard that is appropriate to address concerns regarding the prohibited sale of tax credits. Under each approach, the analysis of a refined coal transaction is based on all the facts and circumstances of that transaction. A transaction will not be respected, and an investor may not claim § 45 tax credits, if the investor does not have an entrepreneurial interest in the coal-refining activity and is not subject to the risks and rewards of that activity.

The determination of whether an investor has a sufficient entrepreneurial interest in a coal-refining activity requires an analysis of the governing agreements between the investor and developer (and any related parties), including any side agreements and understandings, whether or not legally enforceable. Those agreements must provide for meaningful sharing of the economic returns of the activity; they must not insulate the investor against economic risks, whether anticipated or unanticipated at the time the agreements are entered into. In other words, those agreements must provide for substantial exposure of the investor to variability of the economic returns of the coal-refining activity, so that the investor’s economic return on its investment is dependent on the success or failure of the coal-refining activity. In addition, if the developer’s non-tax return from the activity (including any payments or other economic benefits to a party related to the developer) is largely contingent upon the allocation of tax credits to the investor, there is not a meaningful sharing of the economic returns of the activity.

Congress enacted the § 45 refined coal production tax credit to subsidize an activity that may not be currently profitable. Consequently, it is not essential that a refined coal credit transaction demonstrate a pre-tax profit potential in order for an investor to have an entrepreneurial interest in the underlying coal-refining activity giving rise to the credit. Further, as discussed above, the absence of a pre-tax profit in a refined coal transaction will not, by itself, demonstrate that the transaction lacks economic substance under § 7701(o) or the judicial economic substance doctrine.

<u>Analytic Framework for Transactions Utilizing the Common Structure</u>

The common structure poses an analytic challenge to finding an entrepreneurial interest on the part of the investor, primarily because all relevant agreements, including the license for the coal-refining technology, are coterminous with the § 45 credit period while the coal purchase and sale agreements are fixed in price to guarantee a loss on the sale of refined coal. These facts significantly differentiate the transaction from the one described in *Sacks*. Because the common structure insulates the investor from so much detriment and benefit, any additional insulation may make it difficult for an investor to demonstrate that it faces meaningful variability in its prospective return and that the return is dependent on the success or failure of the venture. In determining whether an investor succeeds in this demonstration, we must look to all the facts and circumstances to come to a conclusion, but we find certain factors to be particularly useful in making our determination. The weight to be given to any factor in a particular case depends upon the specific facts and circumstances of the case, keeping in mind that the ultimate test is whether the investor has an entrepreneurial interest in the venture with substantial exposure to the variability of the economic returns of the coal-refining activity.

The presence of the following factors[12] tends to support a conclusion that an investor faces meaningful entrepreneurial risk and reward:

1. The investor makes a significant upfront investment (for example, 20% of its total capital investment) in the coal-refining activity that is fixed, nonrefundable, non-contingent, and fully at risk. In addition, the investor's total investment in the coal-refining activity is predominantly (i.e., greater than 50%) fixed, nonrefundable, non-contingent, and fully at risk. For purposes of applying this factor, an investment will not be regarded as "nonrefundable" if the parties have a side agreement or understanding, whether or not legally enforceable, that the investor can exit the transaction on terms that approximate a refund of all or a significant portion of its investment. For purposes of applying this factor, the investor's total investment in the coal-refining activity (i) equals the total consideration paid by the investor in connection with the acquisition of its interest in the coal-refining activity and/or the acquisition or construction of the coal-refining facility by the coal-refining venture, and (ii) does not include contributions or payments made to fund operating expenses of the coal-refining activity.

2. Under the relevant agreements,[13] the fortunes of the venture and thus the investor will be impacted by changes in circumstances. For example, if there are increases or decreases in the cost of the coal-refining activity, the investor's economic return will increase or decrease in response to these changes. [14] Similarly, if the technology is improved during the transaction period, the investor will share meaningfully in the value of those improvements As another example,

[12] This list of factors is not intended to be exclusive.
[13] These include, but are not limited to, agreements between the developer and investor (and any related parties) and agreements between the coal-refining venture and third parties.
[14] The payment formula in the Sub-License agreement in TAM 201729020, by contrast, was structured so that the royalty paid to the developer would increase or decrease in response to non-royalty cost savings or increases of the partnership, respectively, thereby offsetting the effect of those cost savings or increases and insulating the investors from variability in their economic return.

the agreement between the coal refining partnership and the third-party refined coal purchaser gives the partnership the ability to renegotiate prices during the term of the agreements, so that the pricing arrangement can take into account changes in the market for refined coal, and the effect of these changes in price are reflected in the investor's economic return.

3. The venture takes steps that are reasonably available to minimize the economic losses of the activity, and thus of the investor, *e.g.*, by negotiating lower labor costs.

Conversely, the presence of the following factors[15] tends to support a conclusion that an investor does not face meaningful entrepreneurial risk or reward:

1. The investor does not make a significant upfront investment in the coal-refining activity. Alternatively, the investor's total investment in the coal-refining activity is predominantly refundable, not fully at risk, or otherwise contingent. For example, this factor would be demonstrated by the presence of a side agreement or understanding among the parties, whether or not legally enforceable, that the investor can exit the transaction on terms that approximate a full or partial refund of its investment. For purposes of applying this factor, the investor's total investment in the coal-refining activity (i) equals the total consideration paid by the investor in connection with the acquisition of its interest in the coal-refining activity and/or the acquisition or construction of the coal-refining facility by the coal-refining venture, and (ii) does not include contributions or payments made to fund operating expenses of the coal-refining activity.

2. The relevant agreements[16] restrict the potential for the venture to be impacted by changes in circumstances, thereby limiting the exposure of the investor to variability of the economic returns. For example, if there are increases or decreases in the cost of the coal-refining activity, the investor does not share meaningfully in those increases or decreases. Similarly, if the technology is improved during the transaction period, the investor does not share meaningfully in the value of those improvements, or the investor only shares in the value of those improvements upon the occurrence of unusual or unlikely circumstances or events. As another example, the agreements between the coal-refining partnership and the third-party purchaser prevent the partnership from

[15] This list of factors is not intended to be exclusive.
[16] These include, but are not limited to, agreements between the developer and investor (and any related parties) and agreements between the coal-refining venture and third parties.

renegotiating prices during the term of the agreements, regardless of any changes in the market for refined coal.

3. The investor's tax benefits are guaranteed in any way. For purposes of applying this factor, standard commercial guarantees and indemnities, such as third-party insurance against environmental or tax liabilities or developer performance guarantees, are not considered guarantees of the investor's tax benefits. Similarly, long-term contracts to sell refined coal do not constitute guarantees of the investor's tax benefits.

4. The venture does not take steps that are reasonably available to minimize the economic losses of the activity, and thus of the investor, *e.g.*, by negotiating lower labor costs. A venture does not take steps reasonably available to it to minimize the economic losses of the activity if it does not make reasonable efforts to minimize the prices it pays for its inputs.

**Example**

The following example describes a transaction that illustrates the principles set forth in this memorandum.

Facts

The investor and developer form a partnership to produce and sell refined coal to a utility for a period of ten years. The investor purchases its interest in the partnership in exchange for a fixed upfront payment of $2X, an unconditional obligation to pay an additional $1X within two years, and up to an additional $1X if certain refined coal production and sales targets (and corresponding tax credit targets) are met. The investor is not entitled to the return of any portion of these payments. The developer does not receive any additional compensation, either directly or indirectly, from the investor.

The partnership enters into purchase and sale agreements with the utility that provide for the partnership's purchase from the utility of feedstock coal and the sale by the partnership to the utility of refined coal that qualifies for the refined coal tax credit. Under these agreements, the sale price for the refined coal is less than the purchase price for the feedstock coal, so that the partnership is guaranteed a loss on the sale of the coal. These contracts terminate concurrently with the expiration of the ten-year credit period. The partnership also enters into a ten-year lease with the utility to house and operate its refined coal facility on the utility's premises. The utility has the right to terminate the contracts if the refined coal causes any damage to its boilers. The parties have no right during the terms of the contracts to renegotiate the purchase and sale prices of the feedstock and refined coal to take into account any changes in the market or process for refined coal. However, the parties may agree to extend the contracts beyond the initial ten-year period and renegotiate the prices of feedstock coal and refined coal going forward.

The partnership agreement between the developer and the investor provides that the parties are obligated to share all costs of the partnership's activities pro rata, and any income realized by the partnership or tax credits generated by the partnership are also allocated pro rata. Both the developer and the investor have the right to participate in major management decisions of the partnership. The partnership terminates automatically at the end of ten years, or sooner by mutual agreement of both partners. In the event of early termination, the partners are entitled to liquidating distributions in accordance with their positive capital account balances; no partner is entitled to any additional payment or compensation, nor is any partner guaranteed a minimum amount of tax credits or other tax benefits. Any assets held by the partnership at termination (including the refined coal facility) will be sold, and any gain or loss on such sale will be allocated among the partners pro rata and liquidating distributions will be made in accordance with each partner's positive capital account balance.

The partnership enters into a ten-year license agreement with an unrelated third party to use the third-party licensor's proprietary process to refine the coal it sells to the utility. The partnership makes royalty payments to the third-party licensor in exchange for the right to use the process in producing refined coal. The royalty payments are paid at a fixed rate on a per-ton basis of refined coal and are in line with current market royalty rates for similar coal-refining processes. Royalty payments are not dependent on the tax credits generated by the activity and the partnership makes no royalty payments if there is a halt in the refined coal production process. However, if improvements are made to the proprietary process during the term of the license so that the cost of the process decreases (for example, if a lesser amount of a certain chemical is needed as part of the process), any cost savings resulting from such process improvement will inure to the partnership rather than to the third-party licensor, and will be shared pro rata by the developer and the investor. Additionally, the cost of the refined coal chemicals is in line with market prices.

Analysis

In this example, the investor is subject to the risks and rewards of the underlying refined coal activity. Thus, the investor is entitled to claim its share of the § 45 tax credits generated by the activity. A substantial amount of its maximum total investment in the activity is paid upfront and a significant majority of its total investment is fully at risk. If the partnership is fully successful, the investor will receive its anticipated tax benefits. If the partnership or the third-party licensor is able to reduce the cost of the coal-refining process, the investor's nontax return will improve. If the partnership is unsuccessful, the investor will not be able to recoup its initial investment in the partnership or any additional costs it incurs to fund the partnership's operation or attempts to improve the operation of the facility. The investor and the developer share the risks and rewards of the activity proportionately. The economic position of each of them is comparable to that of a standalone developer.

Please call (202) 317-3100 if you have any further questions.