Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: December 3, 2015

to: , Team Manager
( )

Attn: , Team Coordinator
( )

from: Associate Area Counsel ( )
(Large Business & International)

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subject: Section 45 Refined Coal Credit
Taxpayer:
TIN:
Tax Period:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. Whether ( ) investment in ( ) constitutes a bona fide partnership interest under the test established by Commissioner v. Culbertson, 337 U.S. 733 (1949) and Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012), such that ( ) is entitled to the Section 45 refined coal credit.

CONCLUSIONS

1. After considering the facts and circumstances surrounding investment in , we believe that is not a bona fide partner in because, due to the agreements and conduct of the parties, the lack of significant downside risk

and the lack of significant upside potential, does not hold a meaningful stake in the success or failure of .

FACTS

is in the Compliance Assurance Process (CAP) program. Its tax return is currently under a CAP examination. During that tax year, was the sole owner of , a single member LLC that elected to be treated as a corporation. During , invested through in an entity that claims is a partnership. The entity is .

was formed on as a limited liability company. , at (Amended LLC Agreement). Upon its formation on , was wholly owned by ( ). Id. is a wholly owned subsidiary of ( ). was formed to own and operate a facility for the production of refined coal as defined by I.R.C. § 45(c)(7) that would be located at the power plant owned by (Utility). Amended LLC Agreement, at . By the terms of the Amended LLC Agreement, it will continue until , unless earlier terminated under applicable provisions. Id. at .

Prior to investment in , provided a document to . The document is titled (Promotional Material). is the 100% owner of , as mentioned above. The Promotional Material stated that "up to [a] % ownership interest is available for sale in ", " , as the producer and seller of the refined coal, should be entitled to receive production tax credits" and will "allocate [the tax credits] to the owners of the company on a pro rata basis." Promotional Material, at .

The following statements from the Investor Highlights and Risk Mitigation portions of the Promotional Material speak to commercial and tax risks that a potential investor would be protected against:

Further, the Promotional Material included an Investor Benefits Schedule, showing projected capital contributions and tax benefits of a % interest in .

The Investor Benefits Schedule shows expected costs to of $ with total after-tax benefits of $ [1] and net after-tax cash flow of $.[2]

Purchase of Membership Interest in

ultimately determined it would enter into a transaction regarding the refined coal facility at the power plant. To make the investment, created a wholly owned subsidiary called . Effective , the members of were:

In an email dated , admits that all the investors in are direct or indirect investors in :

and are all indirect owners of through a company called which owns % of . is a disregarded LLC owned by . is also a % owner of .

During the summer of , [ ] purchased the interests of , , and . As such, at year end , was owned % by , % by [ ], and % by , and % by .

[1] Calculated as follows:

Tax credits	$
Taxable loss	$
x Tax rate @ 35%	
Taxable loss benefits	$
Total tax benefits	$

[2] $ - $ = $

On , , , and [3] executed a document titled (Purchase Agreement) under which purportedly sold % of its interest in to . was allocated a % interest in income (including gross income and receipts from the sale of refined coal), gain, loss, deduction, and credits, including tax credits. Purchase Agreement, at . was to pay a purchase price consisting of an initial payment, quarterly fixed payments, and quarterly variable payments. The initial payment paid by was $. Id. at .

The quarterly fixed payment dates began with the first payment due on , and are scheduled to continue with the last payment due on . Id. at Schedule . The fixed payments total $ and bear an interest rate of % per annum. Id. at . Schedule of the Purchase Agreement details the dates and amounts of each monthly fixed payment. The Purchase Agreement states:

Id. at (emphasis added). Additionally, the quarterly capital contributions are limited, in the aggregate, to the excess of the estimated tonnage amount[4] for an investor for a quarter over the sum of the fixed payment actually made by that investor for that quarter and the amortization amount for the initial payment for that quarter. Amended LLC Agreement, at .

is also expected to make quarterly variable payments, the amounts of which are determined by the number of tons of refined coal produced, taking into consideration the fixed payments and capital contribution.[5] Purchase Agreement, at

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[3] is included as a party to the agreement solely for the purposes of

[4] The "tonnage amount", with respect to any quarter, is the product of

Purchase Agreement, at .

[5] Each variable payment is the amount equal to

. According to a spreadsheet calculating the projected losses and tax benefits provided from to the Revenue Agent, it is expected that will make variable payments totaling $ between and .

In addition to the initial payment, quarterly fixed payments, and quarterly variable payments, is required to make quarterly capital contributions. Purchase Agreement, at ; Amended LLC Agreement, at . initial capital contribution totaled $. Amended LLC Agreement, at Exhibit .

must direct , as manager, to prepare and deliver an "Operations Report" on or before the day after the end of each quarter. Purchase Agreement, at . The Operations Report sets forth the following information:

Purchase Agreement, at .

The Operations Report is final and binding on and and serves as the basis for determining variable payment for the applicable quarter. Id. If , in good faith, asserts that the Operations Report does not accurately reflect the

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. Purchase Agreement, at .

information and calculations, or that the information in the Report is untrue, incomplete or misleading, and such dispute is not resolved by the time the payment is due, must pay the undisputed portion. Id. at . The parties must then hire an accounting firm to resolve the dispute. Id.

As alluded to above, is also responsible for calculating and delivering to a statement showing the sum of the aggregate "tonnage amount" for the preceding fiscal year using information on actual sales by to unrelated persons of refined coal. calculates the "annual adjustment amount" which is the actual tonnage amount for each quarter (computed as set forth in footnote 4), reduced by the sum of:

Id. at .

If the annual adjustment amount is a positive amount, such amount is added to variable payment. If the annual adjustment is a negative amount, such amount is set off and applied against the variable payment, and any excess will be credited to future variable payments. Id.

While the schedule itself was not provided, the Purchase Agreement includes Initial Payment Amortization as a defined term. Id. at 4. Further, the purchase price section reflects the manner in which the Initial Payment Amortization bears on the computation of the variable payment. From the definition, the initial payment is amortized over the first of production.

Tax Event

If a "tax event" occurs and is continuing, and a member or members holding at least a % membership interest in deliver notice to that they wish to suspend production of refined coal, must provide a notice of suspension to the Utility within . Amended LLC Agreement, at . must exercise commercially reasonable efforts to negotiate with the Utility. Id. If, within days following delivery of the notice to Utility, the Utility and members cannot reach an agreement, and a member or members holding at least a % membership interest in deliver notice to that they wish to terminate the Agreement[6], must

[6] In short, the Agreement is among , Utility and , and provides the terms and obligations for the parties for the sale of the refined coal eligible for tax credits.

cause to provide notice to the Utility of termination of the Agreement. Amended LLC Agreement, at .

A "tax event" is defined as:

Id. at .

Additionally, the Amended LLC Agreement provides "

" Id. at . The member is then obligated to provide with and "

" Amended

LLC Agreement, at .

Indemnification

The Purchase Agreement includes an indemnification agreement under which will indemnify for losses resulting from or arising out of certain events including breach of any representations or warranties of under transaction agreements. Purchase Agreement, at . If an indemnified loss is with respect to tax credits or tax deductions allocated to , is obligated to indemnify with respect to (i) tax credits or deductions that are attributable to a quarter for which met its obligations to make fixed payments, variable payments and capital contributions and (ii) tax credits or deductions that would have been allocated to and would have been attributable to a period for which met its obligations to make fixed payments, variable payments and capital contributions, but that are not able to be claimed on tax returns, provided

Id. at .

(Coal Purchase Agreement) and (Supply Agreement)

The Coal Purchase Agreement, dated , provides that must pay Utility a combination of (i) $ cash, (b) a secured promissory note in the amount of $ and a (iii) security agreement for Utility's existing inventory. Coal Purchase Agreement, at .

Under the Supply Agreement, generally, Utility is to purchase from all of Utility's refined coal fuel requirements for its power plant. is permitted to sell any refined coal it produces that is not purchased by Utility to third parties. To the extent Utility's requirements for coal-based fuel at its power plant are not fully satisfied by product produced by , will sell unrefined coal to Utility that has available to it.

Under the Coal Purchase Agreement and the Supply Agreement, the sales price of refined coal sold to Utility is equal to the purchase price of the feedstock coal purchases from Utility.

Among the provisions triggering indemnification under the Purchase Agreement are the operator's breach of section (Redetermination Testing and Procedures) or (Refined Coal Specifications) of the Operating and Maintenance Agreement or the operator's breach "

" Purchase Agreement, at .

Dissolution and Winding Up

term commenced on and shall continue until . Amended LLC Agreement, at . On , or earlier if an Event of Dissolution occurs, , as manager, shall have the option to purchase the facility from at fair market value. Id. at . All of assets are to be liquidated. Id. at . If members holding at least % of the outstanding membership interests cannot agree on who to appoint as liquidators, shall act as liquidator. Id. Further, assets are to be distributed *pro rata* to the members in accordance with the capital balance in their capital accounts. Id. at . If 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 or any other member. Id. at .

At issue in this case is whether investment in constitutes a bona fide partnership interest under Federal tax law. If is not a bona fide partner in , cannot allocate the refined-coal tax credit, or any other tax benefits, to , as investment does not constitute the purchase of a membership interest, but rather a purchase of the tax credit.

LAW AND ANALYSIS

Section 45 provides a tax credit for electricity produced from certain renewable resources. In addition to the credit for production of electricity from renewable resources, section 45 provides a tax credit for the production of refined coal. Section 45(e)(8). In general, refined coal is a fuel that is produced from coal or high carbon fly ash, is sold by the taxpayer with a reasonable expectation that it will be used to produce steam, and is certified by the taxpayer as resulting in a qualified emission reduction. Section 45(c)(7)(A). A qualified emission reduction is "a reduction of at least 20 percent of the emissions of either sulfur dioxide or mercury released when burning the refined coal . . . as compared to the emissions released when burning the feedstock coal or comparable coal." Section 45(c)(7)(B).

The amount of the refined coal tax credit is determined by the number of tons of qualified refined coal produced by the taxpayer. See section 45(e)(8)(A). To qualify for the credit, refined coal must be produced by the taxpayer at a refined coal production facility as defined by section 45(d)(8) during the 10-year period[7] beginning on the date the facility was originally placed in service. Section 45(e)(8)(A). Refined coal must be sold by the taxpayer to an unrelated person during the 10-year credit period and the taxable year in which the credit is claimed. Id.

Investment in Does Not Constitute a Bona Fide Partnership Interest

Here, the Service is not challenging whether is producing refined coal as described in section 45(c)(7). Rather, the question is whether investment in constitutes a bona fide partnership interest under applicable case law.

In Commissioner v. Culbertson, the Supreme Court set forth the test for determining whether an interest in an entity constitutes a partnership interest. 337 U.S. 733 (1949). "A partnership is . . . an organization for the production of income to which each partner contributes one or both of the ingredients of income – capital or services." 337 U.S. at 740 (citation omitted); see also Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 226 (1985) (explaining that partners "pool their assets and labor for the joint production of profit," and that "[t]o the extent that a partner's profit from a transaction is assured without regard to the success or failure of the joint undertaking, there is not the requisite joint profit motive"). The question of whether a partnership exists for income tax purposes turns on:

> whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Culbertson, 337 U.S. at 742. Thus, state of mind is determinative of the question whether a partnership has been formed as between the parties. Id. at 742-43.

The Culbertson test "turns on the fair, objective characterization of the interest in question upon consideration of all the circumstances." TIFD III-E, Inc. v. United States, 459 F.3d 220, 232 (2d Cir. 2006) (hereinafter "Castle Harbour"). The following factors, none of which is conclusive, may be considered by the courts:

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> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

Luna v. Commissioner, 42 T.C. 1067, 1077-78 (1964).

In applying the Culbertson test, courts "are compelled to look not so much at the labels used by the partnership but at true facts and circumstances." Id. at 241. "In essence, to be a bona fide partner for tax purposes, a party must have a 'meaningful stake in the success or failure' of the enterprise." Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425, 449 (3d Cir. 2012) (quoting Castle Harbour, 459 F.3d at 231)).

Four cases are informative on whether an interest constitutes a partnership interest. The first case is the Castle Harbour case. In Castle Harbour, the United States Court of Appeals for the Second Circuit was called upon to determine whether foreign banks were partners in a partnership. 459 F.3d at 223. In that case, two Dutch banks invested in Castle Harbour, the partnership. Castle Harbour, 459 F.3d at 223. The other partner was TIFD III-E, Inc., a General Electric Capital Corporation subsidiary. Id. The banks were not liable for taxes in the United States and, under the partnership's Operating Agreement, were allocated "98% of the 'Operating Income,' which comprises the great majority of the partnership's income." Id. However, the operating income vastly exceeded the amount actually received by the banks because the amount was "drastically reduced by huge depreciation deductions which the IRS would not recognize, as the assets in question had already been fully depreciated." Id. The effect of the partnership allocations to the banks "was to shelter most of the partnership's income from taxation and redirect that income tax-free to [TIFD III-E, Inc.]." Id. The payments the banks were actually to receive was the reimbursement of their initial investment with an annual rate of return.

In Castle Harbour, the Service issued notices of Final Partnership Administrative Adjustments providing for reallocation of Castle Harbour's income from the banks to TIFD III-E, Inc. Id. at 223-24. The Service's reallocation was a result of rejecting the partnership's treatment of the banks as partners and finding that the banks' investment

was in substance a secured loan. Id. The Service advanced two arguments. First, the Service argued that the transaction was a sham. Id. at 224. Second, the Service argued that the interest of the banks was not "a bona fide equity partnership participation because the banks had no meaningful stake in the success or failure of the partnership." Id.

In addressing the Service's contention that the banks were not bona fide equity partners, the court applied the Culbertson test. In doing so, the court focused on whether the banks' interests had the prevailing character of debt or equity. Id. at 232. If the interests were debt, the banks would not be placed at the risk of the business and would not be considered partners. In its analysis, the court looked at: the banks' share in the upside potential of the partnership; whether the banks were the recipients of a promise by Castle Harbour to pay a sum certain; whether the banks' interest were subordinated to general creditors of the partnership; the banks' rights to enforce payment of principal and interest; management rights; labels used by the parties; the banks' right to a fixed percentage in interest payable regardless of the partnership's income or lack thereof; the reasonableness of expectation of payment; and the use to which the invested funds were put by the partnership and whether payment to the banks can only be paid out of future profits. Id. at 233-40. Based on its application of these factors, the court held that the banks' interests were in the nature of a secured loan and, for tax purposes, were not bona fide equity participation. Id. at 241.

The second case is Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, 639 F.3d 129 (4th Cir. 2011). In that case, the United States Court of Appeals for the Fourth Circuit overturned the Tax Court by ruling that a purported partnership's allocations of Virginia state tax credits to certain purported partners constituted sales of the state tax credits pursuant to I.R.C. § 707. Id. at 137. The court made its ruling "[a]ssuming, without deciding that a 'bona fide' partnership existed." Id. Although the court did not conduct a Culbertson analysis, it looked to similar factors. Specifically, the court, in addressing the Tax Court's holding, considered whether the purported partners had entrepreneurial risk. Id. at 144-46.

In Virginia Historic Tax Credit, the court considered the risks identified by the Tax Court: the developers would not complete their projects on time; the Virginia administrative agency would not be satisfied with the rehabilitation and the developers would not receive the credits; the Virginia administrative agency would revoke the credits and recapture them in later years; at the partnership level there could be liability for improper construction, mismanagement, or fraud; there could be fraud by another investor; retroactive changes in the law could happen; and there could be litigation in general. Id. at 145. The court stated that "[s]everal facts point to the conclusion that there was no true entrepreneurial risk faced by [purported partners]." Id.

The court noted that: purported partners were promised a fixed rate on return rather than a share in partnership profits; the partnerships assigned each purported partner a very small partnership interest and told purported partners to expect no

material allocations of income, gain, loss, or deduction; purported partners were secured against losing their contributions by the promise of a refund if the promised tax credits did not materialize; and the partnerships hedged against the possibility of insolvency by only contributing to completed projects. Based on the above, the court found "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" and ruled that the transaction constituted the sale of the state tax credit. Id. at 145-46.

The third and most applicable case is Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012). In Historic Boardwalk, the United States Court of Appeals for the Third Circuit was called upon to determine whether a purported partner in Historic Boardwalk Hall, LLC (HBH), the partnership, was a bona fide partner for tax purposes. Id. at 429. At issue in Historic Boardwalk was whether Pitney Bowes, Inc. (PB) was a bona fide partner in HBH such that PB can be allocated section 47 historic rehabilitation tax credits.

In Historic Boardwalk, the New Jersey Sports and Exposition Authority (NJSEA), a state agency, was tasked with restoring the East Hall, an historic landmark. Id. at 428-29. In the case of the section 47 historic rehabilitation tax credit, the credit is only available to the owners of property and therefore the Code does not permit the credits to be sold. Id. at 430. Because NJSEA was a tax-exempt entity, it could not benefit from the credit unless it was able to monetize it through the involvement of a tax-equity investor. Id. at 433.

After learning about the tax-equity-investor market, NJSEA formed the partnership and sold a membership interest to PB. Id. at 429. The partnership was designed so that PB could be allocated the tax credits generated from the rehabilitation of East Hall. Id. Upon investing in the partnership, PB was to receive 99.9 percent of all partnership items and a guarantee of tax benefits, including depreciation deductions and tax credits, and a 3-percent return on its investment. Id. at 436. Although PB was to receive 99.9-percent of the partnership's income, the partnership was structured such that PB would never benefit from its investment in excess of the tax credits and deductions and the 3-percent return. Id. at 459-60. In addition, the structure guaranteed that PB would benefit in the amount of projected tax credits and deductions and would receive the 3 percent return. Id. at 455-59.

In evaluating whether PB had a bona fide partnership interest in HBH, the court applied the Culbertson test noting that "to be a bona fide partner for tax purposes, a party must have a 'meaningful stake in the success or failure' of the enterprise." Historic Boardwalk, 694 F.3d at 449 (quoting Castle Harbour, 459 F.3d at 231). The court then used Castle Harbour and Virginia Historic to guide its analysis.

The court, citing Castle Harbour, stated that "whether a purported partner had a meaningful stake in the success or failure of the partnership . . . goes to the core of the ultimate determination of whether the parties intend to join together in the present

conduct of the enterprise." Historic Boardwalk, 694 F.3d at 454 (internal quotations and citations omitted). The court found Castle Harbour's analysis that the banks' indicia of equity participation was illusory or insignificant and Virginia Historic's conclusion that the purported investors did not face entrepreneurial risks of partnership operations to be highly relevant to the question of whether HBH was a partnership in which PB had a true interest in profit and loss. Id. at 454. In its analysis, the court focused on an assessment of risk from PB's participation. Id. at 455. Specifically, the court focused on PB's downside risk and upside potential and the form and substance of PB's investment. Id. at 455-63.

The court found that PB had no meaningful downside risk. In so finding, the court focused on three facts. First, any risk that PB would not receive credits in an amount at least equivalent to installments it had made was non-existent because under its agreements PB was not required to make installment contributions to the partnership until NJSEA had verified that it had achieved a level of progress on the renovation that would generate enough credits to at least equal the sum of the installment plus all prior capital contributions made by PB. Id. at 455. While PB did not have the contractual right to "compel [the partnership] to repay all or any part of its capital contribution [in the event that the anticipated credits were not generated,] PB had an even more secure deal. Even before PB made an installment contribution, it knew it would receive at least that amount in return." Id. at 456 (internal quotations and citations omitted).

Second, PB had a Tax Benefits Guaranty that eliminated risk of the Service disallowing the credits. Under the Guaranty, NJSEA agreed to pay PB the amount of tax credits disallowed, penalties and interest, and up to $75,000 in legal and administrative expenses incurred in connection with a Service challenge. Id.

Third, the court noted that PB did not have any risk that it would not receive all of its bargained-for tax credits due to the risk that the renovations would not be completed because the project was fully funded before PB entered into any agreement to contribute to the partnership. Id. at 456-57. Thus, the court determined that "PB was not subject to any legally significant risk that the renovations would falter. Historic Boardwalk, 694 F.3d at 457. Based on its analysis of these three risk items, the court determined that "PB bore no meaningful risk in joining [the partnership], as it would have had it acquired a bona fide partnership interest . . . [because] the parties agreed to shield PB's 'investment' from any meaningful risk." Id. at 457, 459.

The court continued its analysis by finding that PB also had no meaningful upside potential. The court noted that "'[w]hether [a putative partner] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise.'" Historic Boardwalk, 694 F.3d at 459 (quoting Culbertson, 337 U.S. at 747). The court noted that, although PB's 99.9-percent interest created the impression that it had a chance to share in potential profits of the partnership, in reality, PB would only benefit after numerous payments are made from the partnership to NJSEA. Id. Even the partnership's own "fantastically inaccurate" financial projections "forecasted no

residual cash flow available for distribution" to PB through 2042. Id. at 459-60. Furthermore, even if there were an upside, NJSEA and PB had put and call options under which NJSEA could exercise its option and cut PB out by paying a purchase price unrelated to the fair market value of PB's membership interest. Id. at 460. This ensured that PB would never receive any economic benefits from the partnership and constituted compelling evidence that PB was not a bona fide partner in HBH. Id. After considering PB's lack of upside potential, the court addressed the form and substance of the transaction.

In discussing the form and substance of PB's investment, the court stated that "'the sharp eyes of the law' require more from parties than just putting the 'habiliments of a partnership whenever it advantages them to be treated as partners underneath.'" Historic Boardwalk, 694 F.3d at 461 (quoting Culbertson, 337 U.S. at 754 (Frankfurter, J., concurring)). After looking past the outward appearance of a partnership, the court, for the same reasons that it determined that PB lacked both entrepreneurial risk and upside potential, determined that PB is not a bona fide partner in HBH. In looking at the substance of the transaction, rather than the form, the court stated that "[r]ecruiting teams of lawyers, accountants, and tax consultants does not mean that a partnership, with all its tax credit gold, can be conjured from a zero-risk investment." Id. at 462.

Although the court rejected PB's claim that it is a partner in HBH, the court "reached its conclusion mindful of Congress's goal of encouraging rehabilitation of historic buildings." Id. The court noted that the tax credits were not under attack; rather, the prohibited sale of tax credits was what was at issue. Id. at 462-63.

The fourth and most recent case is Chemtech Royalty Assocs. v. Commissioner, 766 F.3d 453 (5th Cir. 2014). In 1992, Dow Chemical Company ("Dow") decided to pursue a tax shelter promoted by Goldman Sachs called Special Limited Investment Partnerships ("SLIPs"). Id. at 455-56. Dow selected 73 patents to contribute to this partnership. Id. at 456. The patents were valued at approximately $867 million, and 71 out of 73 of the patents had a zero tax basis. Id. Through its subsidiaries, Dow formed Chemtech as a Delaware limited partnership and contributed the 73 patents, $110 million and all the stock of a pre-existing shell corporation owned by Dow. Id.

Five foreign banks invested a total of $100 million as limited partners in Chemtech. Id. In October 1993, Dow's domestic subsidiary owned 81% of Chemtech, its foreign subsidiary owned 1% as general partner, and the foreign banks owned 18%. Id. Chemtech operated from April 1993 through June 1998. Id. at 457. Its primary source of income was the royalty payments from Dow. Id. Dow and the foreign banks entered into a variety of agreements governing the transaction, under which Dow continued to use the patents it had contributed to Chemtech, continued to bear responsibility for all costs related to the patents, and indemnified the foreign banks against any liabilities arising from the patents. Chemtech allocated substantially all of its income to the tax-indifferent foreign banks in the form of a priority return, but only a fraction to Dow. Id. at 457-58. At the same time, Dow took deductions for the royalty

payments it made to Chemtech. Upon Chemtech's liquidation, the banks received a return of their capital plus a premium provided for in the partnership agreement.

After terminating Chemtech, Dow embarked on a similar transaction, this time involving the depreciable property of one of its Louisiana chemical plants ("Chemtech II"). Id. As in the first transaction, Dow utilized a subsidiary – the Dow Chemical Delaware Corporation ("DCDC"). Id. In June 1998, DCDC contributed the Louisiana plant and the stock of a shell subsidiary to Chemtech II. Id. Dow entered into a lease with Chemtech II for use of the Louisiana plant; under the lease, Dow retained responsibility for all expenses of the plant and was required to pay rent regardless of its use of the plant. Id. RBDC, Inc., a U.S. affiliate of Rabo Merchant Bank N.V., purchased a limited interest in Chemtech II for $200 million. Id. At this point, Chemtech II was owned 20.45% by RBDC, 73.18% by DCDC, and 6.37% by the general partner. Chemtech II allocated a portion of Dow's lease payments to RBDC as a priority return, but allocated all of the depreciation deductions associated with the plant to Dow. Once the plant assets were fully depreciated, RBDC withdrew from the partnership and the partnership liquidated shortly thereafter.

Citing Culbertson, Commissioner v. Tower, 327 U.S. 280 (1946), and Southgate Master Fund, LLC ex rel. Montgomery Capital Advisors, LLC, v. United States, 659 F.3d 466 (5th Cir. 2011), the Fifth Circuit pointed out that "parties, to form a valid partnership, must have two separate intents: (1) the intent to act in good faith for some genuine business purpose and (2) the intent to be partners, demonstrated by an intent to share 'the profits and losses.'" Id. at 461. The court focused on "whether Dow had the intent to share in the profits and losses with the foreign banks." In doing so, the court found: (1) "the transactions were structured to ensure that Dow paid the foreign banks a fixed annual return on their investment" regardless of the venture's success or lack thereof; (2) Dow agreed to bear "all non-insignificant risks" and the agreements ensured that Dow would not lose the banks' initial investment; (3) the foreign banks did not meaningfully share in any upside – the record suggested that Dow and other parties did not consider the patents to be profitable, and even if they did, the agreements "allocated only 1% of the increased value of a [patent] to all of the foreign banks *collectively*." Id. at 463-64 (emphasis in original). Finding that Dow lacked the intent to share the profits and losses of the Chemtech transactions, the court held the partnerships were not bona fide. Id. at 464-65.

In light of the four cases discussed above and in our application of the Culbertson test, we must focus on whether is a bona fide partner in . Specifically, we must focus on whether has entrepreneurial risk and upside potential separate from its allocated tax credits or whether investment in is in substance the prohibited sale of tax benefits. Pertinent factors are discussed below.

Agreements and the Conduct of the Parties in Execution of its Provisions

In form, and agreements appear to support the contention that interest in constitutes a bona fide partnership interest. Under the Purchase Agreement, purportedly purchased a % interest in from and is allocated % of income (including gross income and receipts from the sale of refined coal), losses, deductions, and credits, including tax credits. Although the structure of the agreements supports treating as a bona fide partner, we must "look not so much at the labels used by the partnership but at true facts and circumstances." Castle Harbour, 459 F.3d at 241.

Contributions of the Parties

Future Payment Obligation

Here, entered into discussions with Utility in , and the facility began producing refined coal in of that year. formed on . Amended LLC Agreement ( ), at . After , the facility continued production of refined coal pursuant to a series of additional agreements with . Thus, the facility was producing refined coal prior to investment in . On , purportedly sold a % interest in to in exchange for a current payment of $ and future payments consisting of variable and fixed monthly payments.

Although is obligated to make the future payments, the obligation is contingent on the numbers of tons of refined coal produced, taking into consideration the fixed payments and capital contribution. The variable payments and quarterly capital contributions are only required if generates enough tons of refined coal. Furthermore, fixed payment obligations are non-recourse against and and their affiliates, so that breach of the obligation can only be satisfied out of interest in .

Because purported capital contributions are largely to be made in the future and only in relation to the amount of refined coal, and by extension tax credits generated, we believe that the payments are in exchange for tax benefits and do not constitute capital contributions in substance. Since contributions are largely protected by the payment terms, this factor supports finding that is not a bona fide partner in . Historic Boardwalk, 694 F.3d at 455-56.

Indemnification Agreement and Amended LLC Agreement

The indemnification agreement in the Purchase Agreement and the Amended LLC Agreement may protect contributions in the event that tax credits and deductions are disallowed. The indemnification agreement lists four situations under which will indemnify . These include breach of any representations or warranties of under transaction agreements, the breach or violation of any of the covenants and agreements of under transaction agreements, a breach under the Operating and Maintenance Agreement, and liabilities of and its affiliates.

The indemnification provision goes on to state that if an indemnified loss is with respect to tax credits or tax deductions allocated to , is obligated to indemnify with respect to tax credits or deductions that are attributable to a month for which met its obligations to make payments and capital contributions. Read alone, could argue that the indemnification provision may limit indemnification of lost tax credits and deductions to losses related to operational issues. However, the Amended LLC agreement further indicates that is to be indemnified for disallowed tax credits and deductions.

The Amended LLC Agreement states that any member, including , is obligated to inform in the event that the IRS commences any audit or proceeding with respect to, inter alia, tax credits. The Agreement further states that, if a "tax event" – which is defined in the Agreement as – occurs, the members with at least a % interest may deliver notice that they wish to suspend production of refined coal. Notably, is the only member with at least a % interest and, as a result, the sole member that is able to suspend production by itself.[8] Other members would have to combine their membership interests to meet the % threshold. We believe that these two provisions, the indemnification agreement and the language from the Amended LLC Agreement, operate to protect contributions in the event that tax credits or deductions are disallowed and support a finding that is not a bona fide partner in . What is not clear, however, is the means by which could recover its initial $ investment in case of a cessation of production prior to the end of the Initial Payment Amortization period for a reason other than one meeting the definition of a tax event.

Statements of the Parties

The promotional information provided to by indicates that the parties were interested in the generation and allocation of tax benefits, not in undertaking a joint endeavor to operate a profitable refined coal facility. The Promotional Material's main focus in the Executive Summary is the tax credits, thus making clear that the primary benefit of investment is to receive the allocated tax credits from .

The Promotional Material's discussion of the Investor Highlights, Risk Mitigation and the included Investor Benefits Schedule also show that the parties were interested in the generation and allocation of tax benefits. The Investor Highlights include almost guaranteed financial benefits, *e.g.*, " " and the investors are not expected to be "out-of-pocket" after . The Investor Benefits Schedule was not based on an

[8] A chart entitled "Comparison of Members' Risk of Loss and Potential for Profit", contrasting those circumstances under which and the other members of held the same potential for profit and risk of loss from those where risk was less than that of other members is included as an attachment hereto.

expectation of profit from the production and sale of refined coal. Instead, the Schedule focused on "
" Promotional Material, at (emphasis added). Per the Schedule, the tax benefits equal $; thus, $ less taxable loss of $ = $ total net after-tax cash flow.

Additionally, a "tax event" includes "

" Amended LLC Agreement, at . Because the tax credit would be eliminated by a finding that investment in is not a partnership interest, it appears that such a finding would constitute a tax event as defined by the Amended LLC Agreement.

The parties' statements in the Promotional Material and the Amended LLC Agreement strongly indicate that was paying for tax benefits, and was not undertaking a joint endeavor to operate a profitable refined coal facility.

Relationship of the Parties

The relationship of the parties is akin to that of buyer and seller of refined coal tax credits. , a % interest holder in after it sold its interest to and the other members, is unable to use the tax benefits[9]; thus, the way it benefits is through the payments from the investors. Thus, is not only the seller of its membership interest, it is also essentially the seller of the near certain right to future tax credits.

As mentioned, the Promotional Material actually quantifies the amount that a potential investor would pay for tax credits. In the Investor Benefits Schedule, currently projected section 45 tax credits equal $. Absent the tax benefits of the investment, the investor could have expected a loss.

The operation of the refined coal facility further shows that the relationship of the parties is not one of parties undertaking a joint endeavor to operate a profitable refined coal facility. Under the agreements between the parties, *e.g.*,
(Sale Agreement), Utility is the operator of the facility running it on a day-to-day basis. In fact, neither nor is even mentioned in the Sale Agreement or the Operating and Maintenance Agreement. Although is sent quarterly (Reports), primarily for purposes of calculating the quarterly variable payments and quarterly capital contributions, is not involved in the management and decision-making regarding the production facility. Based on the above, we believe

[9] Even if retained an interest in it would be unable to use the tax benefits because section 45(e)(8)(A)(ii)(I) requires that the refined coal be sold to an unrelated person, and since wholly owns , they are related parties.

that the relationship of the parties supports finding that is not a bona fide partner in .

Lacks Significant Downside Risk

"[W]hether a purported partner had a meaningful stake in the success or failure of the partnership . . . goes to the core of the ultimate determination of whether the parties intend to join together in the present conduct of the enterprise." Historic Boardwalk, 694 F.3d at 454 (internal quotations and citations omitted). We believe that an analysis of investment in shows that lacks significant downside risk.

Indemnification Agreement

The Purchase Agreement between , and includes an indemnification agreement under which will indemnify for "any and all" losses resulting from or arising out of certain events including breach of any representations or warranties of under transaction agreements and, under certain circumstances, tax credits and deductions.

Payment Structure

In addition to the protection against risk in the indemnification agreement, also lacked significant downside risk due to the payment structure. In Historic Boardwalk, the court noted that PB was not required to make installment contributions to HBH until NJSEA had verified that it had achieved a level of progress that would generate enough credits to at least equal the sum of the installment plus all prior capital contributions made by PB. 694 F.3d at 455. This payment arrangement protected PB from risks that the tax credit may not materialize.

Similarly, will not make variable payments unless it has assurances that enough refined coal was produced. With respect to the quarterly variable payments, the amount of each payment is equal to

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. Purchase Agreement, at . In other words, the variable payments are determined by the number of tons of refined coal produced, taking into consideration the fixed payments

10

and capital contribution. The variable payments are determined by the number of tons of refined coal produced, taking into consideration the fixed payments and capital contribution.

Further, Report, final and binding on all parties, serves as the basis for determining variable payment for the applicable quarter. This Report, like the variable payments themselves, contains substantial information related to refined coal production. Likewise, statement showing the "annual adjustment amount", also used to compute quarterly variable payment, is based on the "tonnage amount", i.e.

Purchase Agreement, at .[11]

In other words, if does not produce enough refined coal to generate the requisite amount of credit, does not have an obligation to make variable payments. variable payments are wholly contingent on production of refined coal.

Additionally, the fixed payments are nonrecourse to , and are only recoverable against assets. Thus, the fixed payment obligation is only enforceable against interest in , without other recourse to . Moreover, since has the ability to exit the transaction if it does not make the "fixed payment," that obligation is not truly fixed.

Tax Event

In addition to being able to limit payments if tax credits are not generated, is also excused from making payments in the event a "tax event" occurs. If a defined "tax event" occurs, , by itself, can suspend further production of refined coal, and after , can fully terminate production. Amended LLC Agreement, at . Additionally, , id. at , so is able to exercise its suspension and termination rights early, and does not risk suffering losses from the anticipated tax benefits of investment in .

The agreements in this case provide significant protections against risk of loss. Based on the above, we believe that is largely protected from downside risk, which weighs in favor of finding that is not a bona fide partner in .

Lacks Any Pre-Tax Upside Potential

[11] Tonnage amount =

"'Whether [a putative partner] is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise.'" Historic Boardwalk, 694 F.3d at 459 (quoting Culbertson, 337 U.S. at 747). Although % interest in creates the impression that it will share in potential profits of the partnership, no pre-tax operational profits are projected or, in fact, possible, without a premium in the refined coal selling price over the feedstock purchase price. The Investor Benefits Schedule in the Promotional Material indicates that the only gains over the -year period are in the form of tax credits. Based on this projection, could not have any reasonable expectation of a pre-tax profit[12]. Thus, we do not believe that has a reasonable expectation of realizing any pre-tax upside potential from its investment in . This weighs in favor of finding that is not a bona fide partner in .

Additionally, under the Coal Purchase Agreement and the Supply Agreement, the sales price of refined coal sold to Utility is equal to the purchase price of the feedstock coal purchases from Utility. Because there is no mark-up on the refined coal sold by to Utility, there is no possible return on investment aside from tax credits.

and

and can be analogized to NJSEA in Historic Boardwalk. NJSEA entered into various rehabilitation contracts before even attempting to find a partner, and had assurances that the project was fully funded before PB purportedly invested in the partnership. Historic Boardwalk, 694 F.3d at 433-34. NJSEA's request for proposal provided that the tax credits would be marketed to potential investors. Id. at 434. In essence, NJSEA fashioned a transaction in which an investor would have no risk.

Likewise, created a transaction in which passive investors would have little to no risk. Like the confidential offering memorandum in Historic Boardwalk, Promotional Material highlights the lack of risk to potential investors. The Promotional Material boasts that "

" and "

" Like PB in Historic Boardwalk, knew that it would bear no meaningful risk "as it would have had it acquired a bona fide partnership interest." Id. at 457.

Additionally, "in form PB had the potential to receive the fair market value of its interest if either NJSEA exercised its [c]all [o]ption or PB exercised its [p]ut [o]ption, [but] in reality, PB could never expect to share in any upside." Id. at 460. Thus, the court determined that PB would never receive economic benefits from this transaction as

[12] Several agreements, based on their terms or the Schedules attached thereto, self-terminate after years.

NJSEA had actual control over the income and the purposes it was used. Id. (internal quotations and citations omitted).

Similarly, maintains significant control regarding the reacquisition of assets at the end of the term. If members holding at least % of the outstanding membership interests cannot agree on who to appoint as liquidators, acts as liquidator. is permitted to purchase the facility from if it so chooses. Further, assets are to be distributed *pro rata* to the members, but, if 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 or any other member. As a result, 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 lacks sufficient assets at the end of the term. Thus, it appears has upside potential whereas the other investors, including , do not.

Conclusion

After considering the facts and circumstances surrounding investment in , we believe that, due to the lack of upside potential and the limited chance of downside risk, is not a bona fide partner in . Thus, purported % interest in actually belongs to .

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views. Please call at if you have any further questions.

Associate Area Counsel
(Large Business & International)

By: _____

Attorney ( )
(Large Business & International)

Attachment: Comparison of Members' Risk of Loss and Potential for Profit.