INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Director
RFTH-West

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Dates of Conferences:

LEGEND:

Taxpayer =

Operator =

Investor 1 =

Investor 2 =

X =

Electric Company =

Licensor =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

Month1 =

Month2 =

Month3 =

Month4 =

Year1 =

Year2 =

Year3 =

Year4 =

Year5 =

Year6 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

r =

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t =

u =

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w =

x =

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aa =

bb =

cc =

dd =

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gg =

hh =

ii =

jj =

kk =

ll =

mm =

nn =

oo =

pp =

qq =

rr =

ss =

tt =

uu =

vv =

ww =

xx =

ISSUE(S):

Whether X and Investor 2 may claim "refined coal" tax credits under § 45(e)(8) based on the transaction at issue?

CONCLUSION(S):

Neither X nor Investor 2 may claim refined coal tax credits from this transaction which was structured, insofar as the participation of X and Investor 2 were concerned, solely to facilitate the prohibited purchase of refined coal tax credits.[1]

FACTS:

Taxpayer is a limited liability company classified as a partnership for Federal tax purposes. Taxpayer owns and operates two refined coal facilities. As depicted in the diagram below, the Taxpayer had three owners during the years at issue: Operator, Investor 1, and Investor 2 (we refer to Investor 1 and Investor 2 collectively herein as "Investors"). Operator is a Subchapter C corporation that owns a% of Taxpayer. Operator also owns b% of Investor 1, which is a limited liability company classified as a partnership for federal tax purposes; X is a limited liability company classified as an association for federal tax purposes that owns the remaining c% of Investor 1 through a disregarded entity. Investor 1 owns d% of Taxpayer, and Investor 2, a Subchapter C corporation, owns the remaining e%.

[1] Because we conclude that the Investors engaged in the prohibited purchase of tax benefits, we do not reach the issue posed to us of whether the Investors are bona fide partners in Taxpayer, or whether Taxpayer is a bona fide partnership. Consequently, our later references in this memorandum to "partner" or "partnership" are for convenience only and we do not intend our use of the terms to create any inference regarding their accuracy for federal income tax purposes. We also do not reach the issue posed to us concerning whether the transaction(s) entered into by the taxpayer lack economic substance pursuant to § 7701(o) or the common law economic substance doctrine.

A. Formation of Taxpayer and Construction of the Facilities

In Month1 of Year1, prior to the entrance of X and Investor 2 into the transaction, Operator formed Taxpayer as a limited liability company and remained its sole owner (both directly and indirectly) during the construction of the facilities and execution of the operative contracts detailed below. Also on or about Month1 of Year1, Operator, through Taxpayer, entered into a ten-year site lease at a de minimis rental rate of $f per month with Electric Company that was coterminous with the availability of the § 45 refined coal tax credit. Operator then designed, engineered, developed, and constructed two refined coal facilities for Taxpayer on its leased site (

). Operator designed the facilities to use a proprietary coal-refining process (the "Technology"), which it licensed from Licensor, a partnership in which Operator owned a g% interest and of which Operator was the managing member. Under the terms of Operator's license, it was obligated to make royalty payments to Licensor of h cents per ton of refined coal it produced during the first three years of production; thereafter, the royalty payment increased to the greater of i cents per ton or j% of the available § 45 tax credits per ton. The license expired upon termination of the availability of § 45 credits.

After constructing the facilities, Operator contributed them to Taxpayer, k% directly in exchange for a direct k% interest in Taxpayer, and d% through Investor 1--at that time its wholly-owned and disregarded entity--by assigning d% of the facilities to Investor 1 and then causing Investor 1 to contribute the fractional share of the facilities to Taxpayer in exchange for a d% interest in Taxpayer. Operator then caused Taxpayer to enter into the following agreements, all of which terminated when the availability of the § 45 credit ceased:

1. Technology Sub-License. Operator sublicensed its rights to use the Technology to Taxpayer for the duration of the § 45 credit's availability (the "Sub-License"). The terms of the Sub-License call for Taxpayer to make royalty payments to Operator as it uses the Technology to refine coal. The payment amounts vary depending primarily not on the value of the coal refined using the technology but on the value of the credit to Taxpayer; the payment formula in the agreement specifies that the royalty is equal to the excess of l cents per dollar of § 45 credit over all other capital and operating costs that Taxpayer incurred, not to exceed a total price of m cents per dollar of § 45 credit and not to be less than the minimum royalty that Operator owed to Licensor under its license agreement (i.e., h cents per ton, i cents per ton, or j% of the available § 45 credits per ton, depending on surrounding circumstances).

2. (Unrefined) Coal Supply Agreement. Taxpayer entered into a 10-year agreement with Electric Company to purchase feedstock coal from Electric Company at terms approximating Electric Company's average cost of acquiring the coal from third-party vendors.

3. Refined Coal Sale Agreement. Taxpayer entered into a separate 10-year agreement with Electric Company to sell refined coal back to Electric Company at a rate equal to n cents per ton less than the rate at which Taxpayer purchased the coal under the Feedstock Coal Supply Agreement. Electric Company had the right, however, to discontinue further purchases of refined coal in the event it had operational concerns with burning refined coal. According to Taxpayer's representation, it was these operational concerns that required Taxpayer to discount the refined coal below cost in order to compensate the Electric Company for the increased risk to its boilers resulting from its use of the refined coal (but see footnote 4 below).

B. Acquisition of Interests by X and Investor 2

1. Taxpayer's Operating Agreement and Member Interest Purchase Agreements

As stated above, Operator formed Taxpayer in late Month1 of Year1 and was its sole owner (k% held directly by Operator and d% held indirectly through Operator's f% interest in Investor 1) until X's and Investor 2's purchases of interests in Investor 1 and Taxpayer, respectively. In Month2 of Year2, X acquired an indirect interest in Taxpayer by purchasing c% of Operator's interest in Investor 1 which, in turn, owned d% of Taxpayer. Operator retained the remaining b% interest in Investor 1. See Section B.2 below for more detail on X's acquisition of its interest. Investor 2 acquired a e% direct interest in Taxpayer by purchasing it out of the k% interest in Taxpayer that Operator owned directly, leaving Operator with a a% direct interest in Taxpayer. Thus, at that point, Operator owned a o% interest in Taxpayer (a% directly and p% indirectly through

its b% ownership of Investor 1), X indirectly owned q% of Taxpayer through its c% ownership of Investor 1, and Investor 2 directly owned the remaining e% interest in Taxpayer.

The separate membership interest purchase agreements that X and Investor 2 entered into with Operator set their purchase prices approximately equal to a proportionate share of Operator's total capital costs of constructing and installing the refined coal production facilities, though the information submitted to us does not specify what portion of the costs relates to construction versus installation of the facilities. X's purchase price for a c% interest in Investor 1 was $r, which represented s% of Operator's costs. Investor 2's purchase price for a e% interest in Taxpayer was $t, which represented u% of Operator's construction and installation costs, plus an ongoing "finder's fee" to Operator equal to v cents per each dollar of credit allocated to Investor 2. Consequently, X's and Investor 2's membership interest purchase prices (paid to Operator for interests in Investor 1 and Taxpayer, respectively) were, in large part, reimbursements of their proportionate share of Operator's costs for constructing and installing the refined coal production facility.

Under the terms of Taxpayer's Operating Agreement, each of its members was obligated to contribute its pro rata share of Taxpayer's ongoing operating expenses as Taxpayer incurred them, regardless of whether Taxpayer's facility was in operation and producing refined coal. Taxpayer allocated all items of income, gain, loss, deduction, and credit (including the § 45 credit) pro rata among its members. The Operating Agreement specifies that Taxpayer's members' intention is for their capital contributions not to exceed l cents per dollar of § 45 refined coal credit. The Operating Agreement also specifies that the members have no right to a return of their capital contributions (but see below for X's right to liquidated damages). The members share rights to decision-making for Taxpayer, including the handling of tax audits and financial matters.

2. Investor 1's Operating Agreement and Member Interest Purchase Agreement

Operator formed Investor 1, a limited liability company, on Date1. On Date2, Operator entered into a membership interest purchase agreement to sell X a c% interest in Investor 1. On the same date, Investor 1 executed an agreement with X and Operator. The agreement specified similar contribution obligations and item allocations as Taxpayer's Operating Agreement described above. However, the agreement contained an additional provision that, in the event of a federal tax audit, Operator would place the royalty payments otherwise payable to it under the Sub-License into an escrow account to defray the costs of the audit.

X's membership interest purchase agreement in Investor 1 set a purchase price equal to a proportionate share of Operator's total capital costs of constructing and installing the refined coal production facilities. The membership interest purchase

agreement also included a liquidated damages provision under which Operator was obligated to purchase X's interest in Investor 1 at a price equal to the initial purchase price times the number of months remaining in the 10-year term divided by 120 (i.e. the total number of months in the term). The liquidated damages provision was triggered by any one of fifteen specified conditions, including conditions leading to unavailability of the § 45 credit or a period of uu months in which the actual or projected net cash expenses of Taxpayer would exceed l% of the credits generated by the respective entity during that period. X had the option to exercise its rights under the terms of the liquidated damages provision with respect to any refined coal facility owned by Taxpayer that met one of the fifteen enumerated conditions. If X exercised its right with respect to any individual facility, Operator would pay X damages equal to X's prorated purchase price described above that was attributable to that particular facility, and X would assign all of its indirect economic interest in that facility to Operator. If X exercised its right with respect to both refined coal facilities owned by Taxpayer, X would no longer hold an indirect economic interest in Taxpayer, leaving Investor 1 with one indirect owner in Taxpayer. In that event Investor 1 would presumably be treated as a single-member entity with respect to its ownership interest in Taxpayer and disregarded, leaving Taxpayer with two owners – Operator (both directly and indirectly through Investor 1) and Investor 2.

Although the liquidated damages provision would compensate X for a portion of its initial capital contribution to Investor 1, which in turn was used for Investor 1's initial capital contribution to Taxpayer, it would not compensate X for any ongoing contributions to cover Taxpayer's operating costs. Therefore, if conditions arose to trigger availability of the liquidated damages provision, X could cover some—but not all—of its economic losses by invoking its rights under the provision, or it could choose to remain in the partnership and bear the risk that its relatively small ongoing contributions would not be offset by anticipated tax benefits. Even this small risk was limited by the pay-as-you-go structure of Taxpayer's operations, which reduced its partners' contribution obligations substantially whenever Taxpayer was not producing refined coal and receiving the corresponding § 45 tax credit. We note that because the arrangements contractually guaranteed that Taxpayer would always incur additional financial losses even when the activity was producing refined coal, the only possible incentive for the Investors to make such additional capital contributions was the prospect of claiming additional tax benefits.

C. Operation of Taxpayer

Taxpayer's operations did not achieve its expectations. The facilities were idled from Month1 of Year2 to Month3 of Year3, and again from Month4 of Year4 until Year5, when the Taxpayer halted operations permanently. Over the w months of Taxpayer's existence, the facility was in operation for a total of x months. Despite projecting an estimated production of y million tons of refined coal per year, Taxpayer produced only z million tons in Year2, aa million tons in Year3, and bb million tons in Year4.

Nonetheless, the Investors enjoyed very substantial tax benefits (tax credits, losses, depreciation) well in excess of their capital contributions during those years. In Year3 alone, for example, Taxpayer reported $cc in tax deductions-- including a net loss of $dd on its sales of refined coal (revenue from refined coal sales of $ee less feedstock costs of $ff), royalty expenses under its sublicensing agreement of $gg, and other expenses of $hh (including $ii depreciation)—plus refined coal tax credits of $jj, the combination of which exceeded its partners' $kk in capital contributions.

Also noteworthy is the wide gap between the licensing and sub-licensing royalty payment amounts the parties made with respect to the Technology. In Year3, the terms of Taxpayer's Sub-License resulted in a $gg million royalty payment to Operator. Under the terms of Operator's license agreement with Licensor, however, Operator paid only $ll to Licensor, retaining the balance ($mm) for itself; stated differently, Operator paid Licensor h cents per ton of coal to use the Technology, but it received royalty payments of $nn per ton of coal under the Sub-License.

We also note that Taxpayer achieved some cost savings in Year6, after both X and Investor 2 were no longer participants in Taxpayer. In response to environmental concerns caused by the chemical used in Taxpayer's refining process, Electric Company obtained a permit to use a different chemical, which was less expensive than the one it had been using. The result of this change was a cost savings with respect to the chemical of a dollar per ton of coal (from $oo/ton to $pp/ton).

D. X and Investor 2 Exit the Transaction

Both X and Investor 2 exited Taxpayer in Year5. Investor 2 sold its interest back to Operator on Date3, pursuant to a negotiated agreement that included cancellation of one or more limited-recourse notes owed by Investor 2 to Operator for its purchase of an interest in another coal refining facility. X exercised its rights under the liquidated damages provision (under the condition regarding three consecutive months of excessive expenses) on Date4. On Date5, X sold its c% interest in Investor 1 to Operator.

LAW:

Section 45(e)(8) of the Internal Revenue Code provides that a producer of refined coal is eligible for a tax credit for qualified refined coal that the taxpayer (i) produces at a refined coal production facility during a ten-year period beginning on the date the facility is placed in service, and (ii) sells to an unrelated person during that ten-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.

Barring express statutory authorization, taxpayers may not sell federal tax benefits. For example, in Historic Boardwalk Hall, LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012), cert. denied, 133 S.Ct. 2734 (May 28, 2013), the Third Circuit considered whether an investor's interest in the success or failure of a partnership that incurred qualifying rehabilitation expenditures under § 47 was sufficiently meaningful for the investor to qualify as a partner in that partnership. The agreements governing the Historic Boardwalk Hall transaction ensured that the investor would receive the § 47 rehabilitation credits (or their cash equivalent) and a preferred return, with no potential for meaningful variability in the return from the partnership activity itself. As a result, the investor could look only to the purported tax benefits from the activity for a return of its investment.

In reaching its conclusion disallowing the tax credits to the investor, the Third Circuit stated,

> [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).

The lack of a potential for a meaningful return that could vary depending on whatever success the underlying activity might achieve meant that at the end of the straightforward path in Historic Boardwalk was an arrangement that, in substance, was merely a sale of tax benefits, and tax benefits alone. And, as the court noted, the sale of tax credits is prohibited. See also Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184, 207 (1983), aff'd., 752 F.2d 89 (4th Cir. 1985) ("Since petitioner was not making an actual investment in an asset, the transaction presents no opportunity other than for tax reduction. Because the cash down payment was not used to acquire an asset but was more akin to a fee to purchase tax savings, it too is excluded from basis").

ANALYSIS:

We begin by noting that monetization of tax credits is not an unprecedented practice in the refined coal industry.[2] It is also important to note that monetization of tax benefits is not necessarily prohibited in the context of a transaction that involves more than a sale of tax benefits. The facts in Taxpayer's case, however, demonstrate a plan to sell refined coal tax credits and other tax benefits, rather than a plan on the part of X and Investor 2 to become producers of refined coal through an investment in Taxpayer. Specifically, the transaction in this case provided significant pre-tax profits to both Operator (through the substantial markup on its Sub-License of the Technology to Taxpayer) and Electric Company (through site lease fees and a guaranteed profit on its sale of the feedstock coal for a higher price than its repurchase of the refined coal). In contrast, the arrangement made it highly unlikely that X and Investor 2 would derive any financial benefit, meaningful or otherwise, from the production of refined coal; to the extent any financial benefit did materialize, we see no evidence that the parties pursued the benefit intentionally, or that the remote possibility of a benefit played any role in the investors' decision to participate in the transaction. While that arrangement also guaranteed that X and Investor 2 would suffer small and carefully circumscribed losses of their capital contributions, we do not think those losses can be fairly characterized as losses attributable to the production of refined coal, because those losses were primarily dependent on the amount of tax credits produced rather than the economic consequences of an investment in a refined coal production activity. Consequently, we conclude that those contributions are more accurately described as fees paid to purchase tax credits for a relatively small upfront payment followed by additional payments only to the extent necessary to generate additional tax benefits. Rice's Toyota World, Inc. v. Commissioner, supra.

A. X and Investor 2's Only Meaningful Return is from Tax Benefits

1. X and Investor 2's Return From Their Investment in Taxpayer Could Not Vary Regardless of the Success or Failure of the Refined Coal Production Activity

The parties in this case structured the governing contracts to produce little more than tax benefits commensurate with X and Investor 2's regular and ongoing contributions—significantly curtailing any potential for them to benefit from the success of the refined coal production activity, while simultaneously limiting the risks of the failure of that activity.[3] The feedstock coal supply and refined coal sale agreements

[2]

[3] It is important to note that we do not take the position that investors must have the potential for a pre-tax profit from the refining activity in order to claim the credit. Cf. Sacks v. Commissioner, 69 F.3d 982 (9th

locked in a fixed and guaranteed loss to Taxpayer (and indirectly to X and Investor 2) of n cents per ton of refined coal sold to Electric Company for the entire duration of the availability of the § 45 credit. As a result, a favorable change in the market value of refined coal could never benefit X and Investor 2 in any way. Taxpayer argues that Electric Company's concern about the safety of using refined coal in its boilers meant that Taxpayer had no choice but to sell the refined coal at a loss.[4] Taxpayer explained that Electric Company was under no obligation to use refined coal to generate electricity, and that their goal in doing so was to reduce fuel costs and provide certainty with respect to those costs going forward. Coupled with the safety concerns, Taxpayer argues that these factors provided Electric Company with sufficient leverage at the time the contracts were entered into to lock in the discount over their full 10-year term, thereby guaranteeing a fixed loss per ton of coal to Taxpayer without regard to the value of that coal. While operational concerns may explain the initial discounted sale price for refined coal, we question whether Taxpayer would have been able to, or whether they even attempted to, negotiate for a price adjustment at some point during the term of the

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Cir. 1995) (the taxpayer's activity was not expected to generate a pre-tax profit but the taxpayer's economic fortunes, wholly apart from the tax benefits, would rise and fall with the success of the business, and therefore his enterprise had economic substance). Congress enacted § 45(e)(8) to incentivize an activity that might not otherwise be profitable without the tax credits. Therefore, a pre-tax profit cannot be a condition of claiming that benefit. That does not mean, however, that a genuine producer within the meaning of § 45(e)(8) does not need to have a meaningful financial interest in the underlying production activity. For example, a taxpayer might reasonably anticipate incurring a financial loss in a tax-subsidized activity when tax incentives are not taken into account. Nevertheless, a taxpayer that has a genuine interest in the activity will strive to maximize its opportunity for whatever financial return is possible from the activity and to minimize its financial loss in order to increase its overall gain when tax incentives are taken into account. In other words, it has a meaningful financial stake in the success or failure of the activity apart from the tax benefits. Contrast that with X and Investor 2 in this case who are indifferent to the financial prospects of the production activity (aside from the tax benefits) because their investment in Taxpayer provided such limited likelihood of any meaningful variation in financial return from the underlying coal refining activity that we find it implausible that the outside chance of variability was played any role in their decision to invest. As a consequence, it is more accurate to characterize X and Investor 2 as merely observers of an activity engaged in by others.

[4] While we base our response on the agreed facts as submitted by the Taxpayer and the IRS, we note that those initial facts appear to have changed shortly after Taxpayer began operations.

contract if the operational concerns giving rise to the discount might have been substantially reduced or eliminated early on in the transaction. Presumably, after the Electric Company had burned refined coal for a reasonable period of time (assuming the initial use was successful), its operational concerns would have been reduced significantly. In addition, as noted above, Electric Company already had the right throughout the duration of the Refined Coal Purchase Agreement to stop purchasing refined coal at any time it had operational concerns. It seems reasonable to us that the ability to save n cents per ton of refined coal during an initial period of the contract, coupled with a smaller discount that still provided them with a below-market fuel source, may have been sufficient inducement for Electric Company to agree to a price adjustment at some point during the term of the contract after their operational concerns had been addressed.

We do note that the number of electric utilities available to purchase refined coal was limited, . Therefore, an offer by Taxpayer to share a portion of the value of the tax benefits with Electric Company (which could not otherwise earn those benefits itself due to the unrelated purchaser restriction in § 45(e)(8)(A)(ii)(I)) through a re-purchase price advantage, fees, or other similar arrangements was no doubt helpful in encouraging Electric Company to participate in the transaction.[5] However, we also note that the only parties to the transaction that did not receive an anticipated financial benefit[6] from the activity were X and Investor 2. Operator, which negotiated the terms of the transaction with Electric Company and with what was at the time its wholly owned disregarded entity, Taxpayer, received a markup on its Sub-License to Taxpayer of $qq per ton of coal refined and sold to Electric Company, and Electric Company received site lease payments and a profit of n cents per ton of coal sold and repurchased under the terms of the coal supply and repurchase agreements.

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[6] We note that Taxpayer did recognize some cost savings from changing chemicals used in the coal refining process to comply with environmental requirements, but, as we state below, this change was neither anticipated nor voluntary, and therefore not likely to have been part of the expected return for the investors prior to the transaction.

Taxpayer argues that Operator, X, and Investor 2 all had unlimited upside potential at the time the partnership was formed. First, Taxpayer argues that to the extent Taxpayer was able to manage operating costs (by improving the production process to reduce the amount of additives needed, negotiating for reduced labor costs, etc.), Operator, X, and Investor 2 would each enhance their pre-tax return. In addition, Taxpayer asserts that upon the expiration of the contracts with Electric Company, Taxpayer could negotiate a new contract with Electric Company on more favorable terms; after ten years of experience, the refined coal product would be a known commodity and the risks of using it as a feedstock may disappear[7], or Electric Company could have a greater need for refined coal due to heightened environmental regulatory standards. Alternatively, at the end of ten years, Taxpayer could relocate the facility to a new utility and enter into a contract with that utility on more favorable terms. Finally, Taxpayer points out that Taxpayer could sell the facility, in which case Operator, X, and Investor 2 would share the proceeds of the sale pro rata. As we explain below, these arguments do not withstand scrutiny.

First, Taxpayer vastly overstates its potential for cost reduction. Under any scenario, Taxpayer was always obligated to sell its product at a predetermined loss to Electric Company, and was always obligated to pay Operator a mark-up on its use of the Technology. Taxpayer's royalty payments and discounts on the sale of refined coal over the life of the partnership totaled $rr, at rates that were not subject to variation. By contrast, Taxpayer's total cash expenses, exclusive of these contractually-guaranteed expenses, totaled $ss during that same period, and it appears very unlikely that Taxpayer had a realistic possibility of reducing many of those costs. It seems improbable that insurance premiums or utility costs, for example, would decrease by any significant amount (rather than increase) over time. We acknowledge that Taxpayer could fine-tune its production process to reduce the amount of chemical additives needed, thereby reducing its costs, and that Taxpayer did in fact succeed in changing its chemical use and reducing its costs in a year subsequent to the participation of Investor 1 and Investor 2. However, the necessity of obtaining a new permit to implement any change and the attendant risks of the permitting process make it unlikely the parties would have changed chemicals absent the circumstances that actually unfolded in Taxpayer's case—that is, a requirement imposed by a regulator to address environmental concerns. Furthermore, under the payment formula in the Sub-License royalty agreement between Taxpayer and Operator, those cost savings would simply result in increasing the royalty payments to Operator until they reached the m cents per dollar of credit cap, lessening considerably the likelihood that the Investors would benefit from any reasonably foreseeable cost savings. Although Taxpayer argues that the royalty payment cap would allow it to share in cost savings, under the

[7] We note that despite Taxpayer's professed optimism about the potential for an increase in the value of refined coal, Taxpayer did not insist on a price adjustment clause in the Refined Coal Sale Agreement that would have allowed Taxpayer to share in any such increase in value during the term of the transaction.

formula in the Sub-License, based on Taxpayer's projections, non-royalty operating costs would have had to decrease by a substantial percentage in order for the cost savings to begin to inure to the benefit of the Investors rather than merely increase the royalty payable to Operator.[8] Taxpayer's own cost projections show that cost savings of this magnitude were not anticipated. More generally, the royalty formula made it unlikely that that reasonably foreseeable decreases or increases in operating costs (excluding the royalty) would affect the amount of losses flowing through to the Investors.[9]

Moreover, per Taxpayer's pre-transaction financial models, the parties were projecting that the cost of chemical additives used in the production process would increase by tt percent per year over the ten-year life of the contracts. Although the benefit of hindsight shows chemical costs could in fact decrease, Taxpayer has put forward no evidence that the parties gave any consideration to the possibility, let alone likelihood, of a decrease at the time they entered into the transaction. We are also unpersuaded that Taxpayer's ability to renegotiate labor costs after a uu-year period (with vv days' notice) was viewed by Taxpayer or its investors as a meaningful source of potential cost reduction; although Taxpayer has shown that at least one competitor with lower contract labor costs entered the market, Taxpayer presented no evidence that it ever contemplated or expected a reduction in labor costs when creating its financial projections. Furthermore, Taxpayer never actually renegotiated labor costs, even once it ostensibly had the ability to do so, suggesting that any potential for labor cost savings was illusory. The reality is that all of the parties (Investors, Electric Company, and Licensor) had a profitable agreement (including tax credits) that fixed the costs and profit over ten years using the agreements to each claim a portion of the refined coal tax credit while providing an acceptable return for each party, and there was little incentive given the profitability of the transaction to re-open contractual negotiations among the parties or seek adjustments that would require the review and consent of all of the parties to the transaction.

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[8] For example, based on the projections included in of Investor 1, which was included as Exhibit D of the submission for this memorandum, entitled "Estimated Year2 Operating Results for Investor 1," non-operating expenses would have had to decrease by more than h% before the royalty cap was reached.

[9] As a result of the royalty formula, non-royalty costs would have had to increase by a substantial percentage in order for the minimum royalty to apply. Cost increases up to that level would simply result in an offsetting reduction in royalty payments. For example, based on the projections included in of Investor 1, which was included as Exhibit D of the submission, entitled "Estimated Year2 Operating Results for Investor 1", as well as the projections provided to Investor 2 before its investment that were included in Exhibit J of the submission, entitled "Licensor Section 45 Project Financial Model for Implementation at Taxpayer Plant," concerning projected increases in non-royalty operating costs, non-royalty costs would have had to increase between n% and l% in order for the minimum royalty to apply.

Second, we find implausible Taxpayer's claim that it could have entered into a new and more favorable contract, either with Electric Company or a new utility, after the Sub-License, the land lease and the § 45 credit period expire. At that point, Taxpayer would own nothing more than a 10-year-old facility with no rights to use the Technology to refine coal and no right to keep the facility on Electric Company's property. Also at that point, because there is no longer any need to sell refined coal to an unrelated party to satisfy the requirements of § 45(e)(8), Operator and Operator's parent company (which manages and owns g% of Licensor) would appear to have little incentive to negotiate favorable terms with Taxpayer (and indirectly with X and Investor 2). Assuming that refined coal by that point would have sufficient value to justify an investment without the § 45 tax credit subsidy, Operator could obtain its own license from Licensor and refine and sell coal directly to a utility, whether Electric Company or a different utility, or the utility could license the Technology and refine coal itself. Operator would have no economic incentive to include X or Investor 2 in this new contractual arrangement. Operator is the managing member of Licensor, which owns the Technology, and would have no incentive to share the potential for a genuine pre-tax profit it may receive from royalty payments on a new Technology sub-license. Taxpayer argued that an already-built (and therefore permitted) facility is a genuine asset, the possession of which confers at least some bargaining power on Taxpayer to enter into a new contract with the utility. The permitting process for building a coal refining facility is fraught with uncertainty and can involve costly hurdles, as regulators may use that process to impose other regulatory requirements on the permit applicant wholly unrelated to the refining of coal. Some utilities may be willing to continue to operate the existing refined coal facility after the 10-year credit period and contracts expire rather than reopen their permits. We note, however, that Taxpayer's bargaining power due to owning a permitted facility remains limited; the facility is located on the utility's land, the viability of refined coal as a profitable product remains speculative without the tax credit or more stringent environmental emission control regulations, and Taxpayer would bear the costs of dismantling the facility if it cannot sell it.

Finally, although Taxpayer is correct that upon the sale of the facility the proceeds would be shared pro rata among Operator, X, and Investor 2, the proceeds are unlikely to amount to a sum that is significant relative to the parties' investment. Coal refining facilities generally consist of relatively inexpensive and readily replaceable equipment, such as conveyer belts for raw feedstock coal, mixers where chemicals are added, return conveyer belts for the refined coal, etc. At the end of the contracts with Electric Company, the facility would have had ten years of wear and tear and a corresponding decline in value and it would be sitting on land for which the lease had expired. Therefore, it strains credulity to suggest that Electric Company, Operator, or any other purchaser would be willing to pay more for the used facility than its original cost to Operator. Plus, if Taxpayer sought to sell the facility to any purchaser other than Electric Company, it would face the added cost of dismantling the facility and re-installation at another site. Thus, assuming a purchaser could be found, any amount of

possible profit on this transaction would not be meaningful compared to the substantial purported tax benefits that X and Investor 2 seek to obtain through this arrangement.

In short, this is not a case in which the potential for a return on X and Investor 2's contributions could vary meaningfully based on the degree of success or failure in producing refined coal. Instead, from the perspective of X and Investor 2, this transaction was structured solely to generate tax benefits. Ironically, in fact, under this arrangement increased sales of refined coal had the perverse effect of decreasing X's and Investor 2's overall financial return. Of course, neither X nor Investor 2 objected to this arrangement because increased sales of refined coal produced the one thing that the X and Investor 2 wanted, and the only thing they could receive from the transaction—tax benefits.

2. Limitations on Risks from Production of Refined Coal

The parties structured the governing contracts to strictly circumscribe the Investors' exposure to unanticipated losses, another strong indication that their intent was to purchase tax benefits, not to participate in a refined coal production venture. The terms of the Operating Agreement, the site lease, and the Technology Sub-License all limited Taxpayer's operating costs significantly at any time the tax credit was not available to offset the partners' contributions; despite the facility being idled ww% of the time, the expenses attributable to those time periods during which the facility was idle totaled only xx% of the total operating expenses over the life of Taxpayer. In addition, like the coal supply and sale agreements, these agreements were all coterminous with the duration of the credit's availability, guaranteeing that the Investors would not be obligated to fund the expense of refining coal unless they were assured of the availability of an offsetting credit. Although X and Investor 2 continued to make contributions during a period when the facility was idled, they did not do so in an effort to earn additional revenue—again, they had no non-tax financial stake in whether refined coal was actually produced—they made additional contributions only in the hope of additional tax benefits if the facility began production again. Thus, those payments were simply additional fees paid for future tax benefits. Moreover, X's liquidated damages provision provided an effective refund right to X on a prorated portion of its initial investment should the anticipated credits not materialize, and Investor 2's payment of the bulk of its initial investment with limited recourse debt rather than cash also mitigated its exposure to genuine financial risk. Thus, neither X nor Investor 2 committed capital to the business of producing refined coal. They invested instead only in tax benefits, and had no meaningful expectation of risks or rewards from the production activity.

B. Substance of the Transaction

We recognize that our conclusion in this case may seem at odds with the fact that the activity that Congress intended to incentivize did take place, as refined coal was

produced. However, if we assume—without concluding—that the transaction between Electric Company and Taxpayer amounted to a genuine sale of refined coal to an unrelated party, we find that X and Investor 2 did not participate directly or indirectly in the production and sale of refined coal. 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, 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.[10]

In sum, we conclude that the parties structured a financial transaction in which Taxpayer facilitated the improper sale of § 45 tax credits to X and Investor 2. Further, we reserve for further consideration the possibility that the transaction between Electric Company and Taxpayer did not amount to a genuine sale of refined coal to an unrelated party. Accordingly, neither X nor Investor 2 is entitled to claim the tax credits arising from Taxpayer's activity.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the Taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. An earlier version of this Technical Advice Memorandum, dated February 10, 2017 (TAM-136522-15), was revoked prior to its publication.

[10] Operator's parent company, in fact, describes the Investors' capital contributions as