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D.C. Circuit: Partnership upheld as valid, despite IRS claims it never would have been profitable without refined-coal tax credits

The U.S. Court of Appeals for the District of Columbia Circuit today affirmed a decision of the U.S. Tax Court that the taxpayer (a limited liability company) was a bona fide partnership for tax purposes, despite IRS contentions that the taxpayer could never have made a profit without the tax credit for refined coal.

The D.C. Circuit agreed with the Tax Court that partnerships formed to conduct activity made profitable by tax credits nevertheless engage in legitimate business activity for tax purposes.

The case is: *Cross Refined Coal, LLC v. Commissioner*, No. 20-1015 (D.C. Cir. August 5, 2022). Read the D.C. Circuit's **decision** [PDF 208 KB]

Background

Congress enacted a tax credit to incentivize the production of refined coal that releases fewer emissions than unrefined coal. Shortly after Congress expanded the refined-coal tax credit, the taxpayer (LLC) was formed and entered into contracts to build and operate a coal-refining facility. Two other investors were recruited in the enterprise.

The taxpayer's business model made economic sense only by accounting for the tax credit. Considering (1) the operating expenses that were incurred to refine coal, (2) the losses sustained in buying and then re-selling the coal, and (3) the royalties paid to obtain the necessary technology, the taxpayer's operations inevitably would produce a pre-tax loss. The only opportunity to turn a profit was to claim a tax credit that exceeded these costs. Consistent with this tax-centric model, the taxpayer's agreements had 10-year terms matching the 10-year window during which it could generate tax credits pursuant to section 45(e)(8)(A)(i).

Between 2010 and 2013, all three members of the taxpayer LLC were actively involved in its operations. Each reviewed daily production reports, signed off on major decisions, and communicated regularly with the taxpayer's management. Each member also made monthly contributions to cover operating expenses such as payroll, health insurance, and materials.

Initially the taxpayer was profitable, but it endured two lengthy shutdowns that ultimately ended the partnership.

For the 2011 and 2012 tax years, the taxpayer claimed more than $25.8 million in refined-coal tax credits and $25.7 million in ordinary business losses. Because LLCs are taxed as partnerships, the taxpayer distributed the credits and losses among its three members proportionally.

In 2017, the IRS issued a notice of final partnership administrative adjustment based on findings that the taxpayer was not a partnership for federal tax purposes "because it was not formed to carry on a business or for the sharing of profits and losses," but instead "to facilitate the prohibited transaction of monetizing 'refined coal' tax credits."

The taxpayer filed a petition with the Tax Court which found that the taxpayer was a "bona fide partnership" because all three members made substantial contributions to it, participated in its management, and shared in its profits and losses. The IRS appealed.

D.C. Circuit

Today, the D.C. Circuit issued its decision affirming the Tax Court's findings that the taxpayer had satisfied the federal definition of a partnership. The appeals court held that partnerships formed to conduct activity made profitable by tax credits engage in legitimate business activity for tax purposes and further noted that all of the taxpayer's members shared in its profits and losses and thus had a meaningful stake in its success or failure.

In its decision, the D.C. Circuit distinguished situations when one putative partner is insulated from the upside and downside risks of the business, finding that in such instances, the partner's interest resembles that of a secured creditor, not an equity partner. See *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3d Cir. 2012) ("a partnership, with all its tax credit gold, can[not] be conjured from a zero-risk investment").

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