

Harvesting Tax Credits Is Legitimate Business for Tax Purposes

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If the sole purpose of a partnership is to harvest tax credits, is that a legitimate business for tax purposes? According to the Tax Court and the D.C. Circuit Court of Appeals, yes. In *Refined Coal, LLC. V. Commissioner*, No. 20-1015, (D.C. Cir. August 5, 2022), the answer is a resounding yes. But first, some background.

In 2004, to stimulate the production of refined coal, which produces fewer emissions when burned, Congress created a tax credit for the production and sale of refined coal. But there was a catch – a producer could only receive the credit if it sold refined coal for 50% more than the market value of unrefined coal. Well, surprise, surprise, this went nowhere, so in 2008 Congress removed the 50% restriction and lo-and-behold, it worked.

To take advantage of this change (and resulting tax credit), AJG Coal, Inc. launched a coal-refining facility at a power plant on Santee Cooper in South Carolina. Under the agreement, AJG, through a subsidiary, signed a lease that allowed it to build a coal refining facility *inside* the power plant. Next, the subsidiary entered into an agreement with the power plant to buy unrefined coal from the power plant, refine it, and sell it back to the power plant at *\$.75 less per ton*. Finally, the sub entered an agreement with its parent to license the coal-refining technology.

Wait a minute; they are reselling refined coal to the company from which they bought it for less money!? How could this ever make good business sense? The answer? Tax credits. The only possible way this was only profitable was through the application of the tax credit for refined coal. And we are not talking peanuts here. AJG projected that the sub would realize a **\$140 million** after-tax profit over a ten-year period.

Sadly, profits were much less than projected. In fact, the project had several lengthy shutdowns. Finally, in 2012, Santee shut down the coal-refining operation because of insufficient demand for local power, which caused two of the partners to suffer \$ 2.9 million and \$700,000 after-tax losses, which they wrote off on their respective federal income tax returns.

Not so fast, the IRS said. To be a legitimate business, i.e., to write off expenses and losses, you must have a profit motive, and operating a business solely to harvest tax credits do not count, so the partnership was not a *bona fide* partnership; therefore, the losses are not deductible.

Au contraire mon frère said the Tax Court. Yes, harvesting tax credits is a legitimate business purpose, and if the business would not be profitable, but for the tax credits, that is okay. It is still a legitimate business. Not content with the Tax Court, the Service appealed to the D.C. Circuit Court.

The D.C. Circuit Court noted that due to special benefits the tax code affords partnerships, there is the ever-present temptation for an entity to appear as a partnership, even if it is not. The Court noted there are two requirements to be a partnership. The

first requirement is the partners must intend to carry-on business as a partnership, i.e., the business must be undertaken for profit or other legitimate nontax purposes. Factors examined include the duration of the partnership and the business rationale for forming a partnership. The Court observed, “Taxpayers that structure their dealing to receive tax benefits afforded by statute are entitled to those benefits, no matter their subjective motivations.”

The second requirement is the partners must intend to share in the profits or losses or both; that is, the partners’ interests must have the prevailing character of equity. If a partner is insulated from the upside and downside risks of the business, that partner looks more like a secured creditor, not a true partner.

Applying these factors, the D.C. Circuit Court found the partnership was a true partnership and dismissed the Service’s objection that the partnership had no pre-tax profit motive and, therefore, was not a true partnership. The Court noted a partnership’s pursuit of after-tax profit, even one only made possible by tax credits, is a legitimate business activity. Finally, the Court held that even transactions that are only profitable on a post-tax basis can still have a nontax business purpose. The decision by the D.C. Circuit Court was unanimous.

So, where does that leave us? Consider for a minute all the tax credits provided by the tax code. The *Refined Coal* decision confirms and affirms that a partnership organized solely to harvest tax credits is a legitimate business for tax purposes. The question is, what tax credits can your business harvest?

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