Tax Incentives, Economic Substance, and Partnership Validity: New Case Undercuts IRS Attacks

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The information throughout this article strongly supports the position that IRS challenges to tax incentives based on economic substance and/or partnership invalidity should be used sparingly, if at all.

Introduction

Some activities or investments simply do not yield enough financial benefit, alone, to attract private parties in a free market. Consequently, Congress often inserts itself, creating incentives, such as tax credits and deductions, to encourage parties to place money where they otherwise would not. Taxpayers, for their part, frequently establish partnerships to facilitate investment in the precise activities approved and promoted by Congress, which generate the tax incentives. Congress is happy about the redirection of funds to projects it deems worthy, taxpayers are happy about the increased return-on-investment, and the industries, geographic areas and/or individuals favored by the tax incentives are happy with the windfall. So, everyone is pleased, right? Wrong. The IRS is sometimes upset, claiming that taxpayers have somehow engaged in improper behavior and thus should lose the very tax inducements offered by Congress in the first place.

This article explains the economic substance doctrine in general, followed by its application to transactions involving tax incentives, charitable contributions, and partnerships. It then analyzes a recent decision, *Cross Refined Coal, LLC v. Commissioner,* which should have a profound, positive effect on taxpayers taking actions to access tax incentives created by Congress.[1]

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Economic Substance Doctrine in General

Congress enacts tax laws, and the IRS issues regulations and other forms of administrative guidance to implement them. The government is replete with tax experts, but even they cannot foresee everything when they are formulating the rules. Over time, insightful taxpayers take favorable positions that comport with the express letter of the rules, but perhaps not their supposed spirit. Some courts find it necessary, therefore, to "supplement" the law in an effort to deter "unintended consequences."[2] They do so by creating various judicial canons, among them the economic substance doctrine.

Codification

The economic substance doctrine remained solely an invention of the courts for many years. Things changed in 2010, though, when Congress passed the Health Care and Education Reconciliation Act.[3] That legislation "codified" the economic substance doctrine, meaning it transformed it from a theory created and applied by the courts into a specific provision in the Internal Revenue Code, Section 7701(o).

Why did Congress believe it necessary to codify the doctrine? The short answer is that things were a mess because of inconsistent rulings by different courts, at different levels, at different times. There was disagreement starting with the basics. Some courts applied a conjunctive test, holding that taxpayers must demonstrate that the transaction in question had economic substance (*i.e.,* the objective component) and a business purpose (i.e., the subjective component) in order to access tax benefits. Other courts believed that transactions should survive if either economic substance or a business purpose existed. Still other courts viewed economic substance and business purpose as just two additional factors to consider in analyzing a transaction. Finally, one court went so far as to question whether the economic substance doctrine might be invalid as a violation of the separation-of-powers requirement.[4]

Uniformity among the courts was also missing when it came to the type and amount of non-federal-income-tax benefits a taxpayer must show to demonstrate that a particular transaction had economic substance. For instance, various courts denied benefits on economic substance grounds in situations where the transaction lacked profit potential from the outset, had the possibility of yielding a profit but never achieved it, or featured only minimal risks to, and profit prospects for, taxpayers.[5]

Congress, not surprisingly, tried to frame the issue more diplomatically. It explained the following in enacting the law in 2010:

> A strictly rule-based tax system cannot efficiently prescribe the appropriate outcome of every conceivable transaction that might be devised and is, as a result, incapable of preventing all unintended consequences. Thus, many courts have long recognized the need to supplement the tax rules with anti-tax-avoidance standards, such as the economic substance doctrine, in order to assure the Congressional purpose is achieved . . . The Committee believes it is still desirable to provide greater clarity and uniformity in the application of the economic substance doctrine in order to improve its effectiveness at deterring unintended consequences.[6]

Codifying the economic substance doctrine is one thing, having it make an impact is another. Congress understood this; therefore, it fortified the penalty regime simultaneously with enacting Section 7701(o). Its rationale for doing so was straightforward: The IRS needed a "stronger penalty" to improve tax compliance and dissuade taxpayers from engaging in what it considered abusive transactions.[7]

Legal Standards

Section 7701(o) provides that, in the case of a transaction to which the economic substance doctrine applies, such transaction shall be treated as having economic substance if, and only if, (i) the transaction changes the taxpayer's economic position "in a meaningful way," apart from federal income tax effects, *and* (ii) the taxpayer has a "substantial purpose" for engaging in the transaction, apart from federal income tax effects.[8] Taxpayers, the IRS, and the courts often refer to these as the *objective* profit-potential test and the *subjective* non-federal-income-tax-purpose test. A transaction must meet both tests.[9]

The law does *not* define the key terms in quotes above. The legislative history provides some clarifications, though. It states that taxpayers can rely on factors *other than* profit potential to show that a particular transaction meets one or both of the two tests.[10] However, if a taxpayer relies on profit potential, the present value of the "reasonably expected" pre-tax profit needs to be "substantial" in comparison to the present value of the expected net tax benefits that would be allowed if the IRS were to respect the transaction.[11] The legislative history confirms that Section 7701(o) does *not* require a specific minimum return to satisfy the profit-potential test.[12]

Economic Substance and Tax Incentives

Many describe the economic substance doctrine as a two-part test, but it really has three parts, the first of which is foundational. Section 7701(o) begins with a critical limiting phrase. It indicates that taxpayers, the IRS, and the courts should not even reach the two-part test, unless the situation involves a "transaction to which the economic substance doctrine is relevant."[13] The sources discussed below indicate that the economic substance doctrine is *not* relevant to transactions designed to qualify for congressional tax incentives.

Legislative History

Congress left no doubt when it enacted Section 7701(o) that the economic substance doctrine should *not* apply where taxpayers engage in transactions in conformity with a specific tax incentive. The legislative history states the following on this critical issue:

> If the tax benefits [of a transaction] are clearly consistent with all applicable provisions of the Code and the purposes of such provisions, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the

> treatment fails the economic substance doctrine as defined in this provision. [14]

The Joint Committee on Taxation expanded on the notion. It explained the following about the inapplicability of the economic substance doctrine to situations where taxpayers are acting in accordance with the wishes of Congress:

> If the realization of the tax benefits of a transaction is consistent with the Congressional purpose or plan that the tax benefits were designed by Congress to effectuate, it is not intended that such tax benefits be disallowed. See, e.g., Treas. Reg. § 1.269-2, stating that characteristic in which an amount otherwise constituting a deduction, credit, or other allowance is not available are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in light of the basic purpose or plan which the deduction, credit, or other allowance was designed by Congress to effectuate. *Thus*, for example, it is not intended that a tax credit (e.g., Section 42 (low-income housing credit), Section 45 (production tax credit), Section 45D (new market tax credit), Section 47 (rehabilitation credit), Section 48 (energy credit), etc.) be disallowed in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit [or deduction or other allowance] was intended to encourage.[15]

Administrative Guidance

The IRS, like legislative history, has recognized that behavior by taxpayers, done in response to incentives granted by Congress, should not be punished. For example, an IRS memo issued in 2011 states that the economic substance doctrine likely is *not* applicable to a "transaction that generates targeted tax incentives and is, in form and substance, consistent with congressional intent in providing the incentives."[16] That same legal memo also tells Revenue Agents *not* to challenge economic substance if the transaction in question "involves tax credits (*e.g.*, low-income housing credits, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits."[17]

Even an IRS memo from 2022 granting Revenue Agents nearly full autonomy to make determinations about economic substance warns that certain transactions enjoy an exemption. It explains that, notwithstanding the long list of facts and circumstances that Revenue Agents should consider as part of their analysis, "the economic substance doctrine may *not* be appropriate if the transaction that generates targeted tax incentives is, in form and substance, consistent with congressional intent in providing the incentives."[18]

Judicial Support

Consistent with the language in legislative history and IRS memoranda, various cases have held that it is improper for the IRS to assert the economic substance doctrine in tax disputes focused on congressional incentives. Perhaps the most famous example is *Sacks v. Commissioner*, wherein the taxpayer invested in solar water heaters in reaction to a package of tax laws, enacted by Congress and the state of Arizona, which encouraged people to invest in wind, solar, geothermal, and other alternative-energy sources.[19] The taxpayer claimed depreciation and investment tax credits for solar units, and the IRS disallowed them on grounds that the transactions were shams.

The Tax Court initially ruled in favor of the IRS, but the Court of Appeals reversed. In concluding that the transactions were not shams, the Court of Appeals underscored the inapplicability of the economic substance doctrine and similar devices to situations involving congressional inducements, such as tax credits, deductions, etc. The Court of Appeals stated the following:

> Absence of pre-tax profitability does not show "whether the transaction had economic substance beyond the creation of tax benefits" where Congress has purposely used tax incentives to change investors' conduct. *Congress* and the Arizona legislature purposely skewed the neutrality of the tax system . . . If the [IRS] treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative [hand]. A tax advantage such as Congress awarded for alternative energy investments is intended to induce investments which otherwise would not have been made. Congress sought, in the 1977 energy package, of which the solar tax credits were a part, to increase the use of solar energy in U.S. homes and businesses. If the [IRS] were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them. The tax credits were intended to generate investments in alternative energy technologies that would not otherwise be made because of their low profitability. Yet the [IRS] in this case at bar proposes to use the reason Congress created the tax benefits as ground for denying them. That violates the principle that statutes

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[1] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22).

[2] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 295.

[3] Health Care and Education Reconciliation Act of 2010, Public Law No. 111-152 (March 31, 2010).

[4] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the Patient Protection and Affordable Care Act. JCX-19-10. March 21, 2010, pgs. 143-144; U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pgs. 291-294.

[5] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the Patient Protection and Affordable Care Act. JCX-19-10. March 21, 2010, pgs. 144-145; U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pgs. 291-294.

[6] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 295.

[7] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 303.

[8] Section 7701(o)(1); Section 7701(o)(5)(D). The rules apply to a transaction "or series of transactions."

> ought to be construed in light of their purpose.[20]

The IRS, unsurprisingly after its stinging loss, attempted to narrow the holding in *Sacks v. Commissioner* and diminish its use in other contexts.[21]

Economic Substance and Charitable Donations

One does not make the fundamental decision about applicability of the economic substance doctrine by looking to Section 7701(o), but rather by analyzing judicial precedent. Indeed, the law states that the determination of whether the economic substance doctrine pertains in the first place "shall be made in the same manner as if [Section 7701(o)] had never been enacted."[22] The information in this segment of the article strengthens the notion that the economic substance doctrine has no bearing on charitable donations, in general, and charitable donations of conservation easements, in particular.

Charitable Donations

Several cases over the years have held that the economic substance doctrine normally is *not* relevant to charitable donations. This serves as a foundation for the position that, when it comes to transactions involving charitable donations and corresponding tax deductions, the IRS and the courts should never even analyze (i) whether the transaction changes the taxpayer's economic position "in a meaningful way," apart from federal income tax effects, and (ii) whether the taxpayer has a "substantial purpose" for engaging in the transaction, apart from federal income tax effects.[23]

Skripak v. Commissioner - 1985

The taxpayers in *Skripak v. Commissioner* participated in a program whereby they executed a series of documents purporting to buy scholarly books for one-third their retail price, held the books long enough to create long-term capital gain property, donated the books to small rural public libraries, and claimed charitable donation deductions based on the retail price of the books, which was about three times higher than what the taxpayers had paid a short time earlier.[24]

The IRS audited, fully disallowed the claimed deductions, and imposed penalties. The IRS's primary theory was that the transaction in which the taxpayers engaged lacked economic substance, constituted a sham, and thus should be ignored for tax purposes. The Tax Court rejected the IRS's argument on the following grounds:

> [The IRS] spent a great deal of time attempting to show that [the taxpayers] were completely inexperienced in every aspect of the book business and that [they] had virtually no chance of realizing an economic profit from their alleged acquisition and disposition of the reprint books. The record abundantly established that to be the case. *Although* we accept the truth of these matters, we have made no express findings on these facts because they are not pertinent to our inquiry. The deduction for charitable contributions provided by Section 170 is a legislative subsidy for purely personal (as opposed to business) expenses of a taxpayer. Accordingly, doctrines such as business purpose and an objective of economic profit are of little, if any, significance in determining whether [the taxpayers] have made charitable gifts. We think that the various documents [executed by the taxpayers and third parties] in fact comport with the economic substance and reality of these transactions, and we conclude that [the taxpayers] did in fact own and contributed the books to the various libraries.[25]

The Tax Court expanded on its reasoning later in its Opinion, criticizing the IRS for its singular and rigid focus:

> [The IRS's] seeming obsession with the mechanics of these transactions as shams appears to be caused by the admitted tax-avoidance motivation of [the taxpayers]. *However*, as stated above, the deduction for charitable contributions was intended to provide a tax incentive for taxpayers to support charities. Consequently, a taxpayer's desire to avoid or eliminate taxes by contributing cash or property to charities cannot be used as a basis for disallowing the deduction for that charitable contribution.[26]

The Tax Court, dispelling any doubt, concluded its analysis of the IRS's primary attack by underscoring the need to accept the behavior encouraged by Congress in enacting Section 170:

> Under *Gregory v. Helvering*, so heavily relied upon by [the IRS], the determinative question is 'whether what was done, apart from the tax motive, was the thing which the statute intended.' Here . . . various qualified charitable donees received gifts of books belonging to [the taxpayers]. This is precisely the result intended by Section 170. [The taxpayers] owned the reprint books and made contributions of those books to the various libraries, and we hold that [the taxpayers] are entitled to deductions for their charitable contributions.[27]

Hunter v. Commissioner - 1986

The taxpayers in *Hunter v. Commissioner* learned of a tax-reduction program, promoted by Mr. Ackerman, involving the purchase of "limited edition

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[9] In the case of individual taxpayers, the two-part economic substance test applies only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income. *See* Section 7701(o)(5)(B).

[10] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 298.

[11] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 298; Section 7701(o)(2)(A).

[12] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 298.

[13] Section 7701(o)(1).

[14] U.S. House of Representatives, Committee on the Budget. The Reconciliation Act of 2010. 111th Congress, 2nd Session, Report 111-443, Volume I, Division I, March 17, 2010, pg. 296 (emphasis added).

[15] U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions of the Reconciliation Act of 2010, as Amended, in Combination with the Patient Protection and Affordable Care Act. JCX-19-10. March 21, 2010, pg. 152, footnote 344 (emphasis added).

[16] LB&I-040711-015 (July 15, 2011).

[17] *Id.*

[18] LB&I-04-0422-0014 (April 22, 2022) (emphasis added).

[19] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995).

prints" and subsequent donation of such artwork to museums.[28] Apparently, Mr. Ackerman, through one of his entities, purchased a large number of prints from a gallery for a low price because the gallery had owned them for a long time, failed to sell them to gallery visitors, and now considered them "excess inventory." Mr. Ackerman bought the prints for one-sixth of their retail price, sold them to the taxpayers for one-third of their retail price, and soon thereafter assisted the taxpayers in donating the prints and claiming charitable deductions for their full retail price. The taxpayers expected a tax deduction equal to approximately three times the amount they paid Mr. Ackerman.

In terms of procedure, Mr. Ackerman displayed on a table the prints for sale, placed the prints selected by the taxpayers in a separate drawer featuring their name, insured the prints, paid to have the prints packaged and shipped to museums after safeguarding them for over one year, and had the donations made in the name of the taxpayers.

The IRS audited the taxpayers and claimed that they should get a charitable deduction of $0 for a long list of reasons, among them that the transactions were shams and lacked economic substance. The IRS believed that the taxpayers "merely purchased a tax deduction which promised a three-to-one write-off on their investment."[29]

The Tax Court swiftly rejected the IRS's contention, holding that the "tax-avoidance motive" of the taxpayers in making the charitable donations did not preclude allowance of a deduction. The Tax Court alluded to what it said the previous year, in *Skripak v. Commissioner,* about Congress enacting Section 170 to incentivize taxpayers to support charities and the IRS being unable to use a taxpayer's desire to reduce taxes by donating to charities as grounds for disallowing a deduction.[30]

Weitz v. Commissioner - 1989

The taxpayers in *Weitz v. Commissioner* participated in a program pursuant to which they pooled funds with several other investors, had their agent purchase medical equipment in their names at bankruptcy auctions for low prices from distressed sellers, stored such equipment for more than one year, donated the equipment to hospitals, and claimed charitable deductions based on the retail value of the equipment at that time of the donations.[31] The taxpayers expected a four-to-one return on their investment, even after paying the agent's commission.

The IRS raised a laundry list of arguments in an attempt to award the taxpayers a charitable deduction of $0, several of which involved economic substance in one fashion or another. For instance, the IRS suggested that the taxpayers failed to make a completed gift to the hospitals because they supposedly lacked donative intent. The problem, according to the IRS, was that the primary motivation of the taxpayers in acquiring and transferring the medical equipment to the hospitals was obtaining a tax deduction, not giving to charity. The Tax Court outright rejected this attack, explaining that the IRS was simply off base:

> Most of [the IRS's] argument that [the taxpayers] lacked generous and altruistic donative intent is irrelevant and ill conceived. *A* charitable contribution may be motivated by the basest and most selfish of purposes as long as the donor does not reasonably anticipate benefit from the donee in return. Although [the IRS] makes much of the fact that [the hospital] personnel chose the equipment which would be donated, there is no requirement that the donated property be unnecessary or useless to the donee. The record does not suggest that [the taxpayers] anticipated any benefit from [the hospital], the donee, in exchange for, or in response to, their contribution. Although we are not unmindful of the tax benefits [the taxpayers] received from the contribution, that is not pertinent to any analysis of donative intent. We conclude that [the taxpayers'] primary motivation in making the contribution was to donate equipment to the hospital without the expectation of any consideration from the donee, and that, therefore, [the taxpayers] were motivated by the intent needed to accomplish a charitable donation.[32]

The Tax Court, after dismissing other arguments advanced by the IRS, provided additional color regarding the inapplicability of the economic substance doctrine to situations involving charitable donations. It explained the following:

> Underlying each of [the IRS's] arguments is concern over the significant tax savings [the taxpayers] hoped to obtain as a result of their participation in the plan devised by [their agent and accountant]. [The taxpayers] and the other investors paid a relatively low price for the equipment which, at no cost or inconvenience to themselves, they stored for one year until they could donate it to [the hospital] and claim a charitable contribution deduction in an amount four times greater than their cash outlay. Nonetheless, [the taxpayers'] actions complied in every respect with statutory requirements. *As* we recently noted in *Skripak v. Commissioner,* Section 170 allows a deduction from tax with respect to donations to charitable institutions

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[20] *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995) (internal citations omitted) (emphasis added).

[21] General Counsel Memo 20124002F (Oct. 5, 2012), pg. 16 (maintaining that "the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving – or of a purported partnership engaged in – tax-favored activity finds no support apart from *Sacks*.")

[22] Section 7701(o)(5)(C).

[23] Section 7701(o)(1); Section 7701(o)(5)(D).

[24] *Skripak v. Commissioner*, 84 T.C. 285 (1985).

[25] *Skripak v. Commissioner*, 84 T.C. 285, 314-315 (1985) (emphasis added).

[26] *Skripak v. Commissioner*, 84 T.C. 285, 319 (1985) (emphasis added).

[27] *Skripak v. Commissioner*, 84 T.C. 285, 319-320 (1985) (internal citations omitted) (emphasis added).

[28] *Hunter v. Commissioner*, T.C. Memo 1986-308.

[29] *Hunter v. Commissioner*, T.C. Memo 1986-308. The IRS also raised the following additional arguments to support a full disallowance of the charitable donation deduction: (i) The taxpayers supposedly never owned the prints; (ii) The taxpayers did not satisfy the long-term holding requirement; and (iii) The activities of the taxpayers were substantially similar to those of commercial art dealers, such that the prints constituted ordinary income property instead of capital gain property.

[30] *Hunter v. Commissioner*, T.C. Memo 1986-308.

[31] *Weitz v. Commissioner*, T.C. Memo 1989-99.

[32] *Weitz v. Commissioner*, T.C. Memo 1989-99 (internal citation omitted) (emphasis added).

> even when the donation is carefully contrived to comply with the requirements of the applicable rules and regulations. [The taxpayers'] actions have been planned and executed to assure that their donation of medical equipment to [the hospital] would come within the definition of a deductible charitable contribution and all of the steps necessary to accomplish that goal have been effectuated. [The taxpayers] cannot be penalized for being careful.[33]

Weintrob v. Commissioner – 1990

The taxpayers in *Weintrob v. Commissioner* were partners in a limited partnership that pooled investor money, purchased unimproved land, allowed the partners to "withdraw" land from the partnership in proportion to their capital account ratios, donate such land to charity, and claim charitable donation deductions that far exceeded the amount of money invested.[34]

The IRS disallowed the deductions on several grounds, one of which was the supposed lack of economic substance. The IRS maintained, as it had in several other cases mentioned above, that the only purpose for the series of transactions culminating in donations was to secure tax benefits for the partners.

The Tax Court first noted that it had previously rejected a similar challenge by the IRS in *Skripak*. Consistent with that earlier decision, the Tax Court in Weintrob ruled that the taxpayers "parted with their own funds as the result of which the various qualified charitable organizations received finished gravesites [and] such being the case [the taxpayers] made substantive donations for which they are entitled to deductions" under Section 170.[35]

RERI Holdings I, LLC v. Commissioner - 2014

The taxpayer in *RERI Holdings, LLC v. Commission* was a limited liability company, with multiple members, treated as a partnership for federal tax purposes.[36] The partnership donated to a university complete ownership of another partnership, which held certain real property. The partnership claimed a charitable donation deduction of approximately $33 million. The IRS suggested that the deduction should be $0 because the relevant transaction was a sham, lacked economic substance, and thus should be ignored for tax purposes.

The taxpayer filed a Motion for Partial Summary Judgment with the Tax Court, asking it to declare from the outset that the sham-transaction doctrine and economic substance doctrine do not apply when determining whether a taxpayer's contribution to charity triggers a deduction under Section 170. The taxpayer relied heavily on *Skripak*. It also noted another case, this one involving the donation of a fa[ccedil]ade easement and a cash endowment, wherein the Tax Court observed the following: "It is true the taxpayer hoped to obtain a charitable deduction for her gifts, but this would not come from the recipient of the gift. It would not be a *quid pro quo*. If the motivation to receive a tax benefit deprived a gift of its charitable nature under Section 170, virtually no charitable gifts would be deductible."[37]

For its part, the IRS principally turned to *Ford v. Commissioner*.[38] In that case, the taxpayer was a limited partner in a partnership, which owned real property. The partnership decided to donate the property to a university. At that time, the fair market value of the property was $600,000, but it had a tax basis of $0 in the hands of the partnership because it had been fully depreciated already. Consequently, if the partnership had *directly* donated the property to the university, its charitable contribution deduction would have been $0. In an effort to avoid this unfavorable tax result, the following transactions occurred: A new corporation was formed, the partnership transferred the property to the corporation in exchange for 100 percent of its stock, the partnership then donated the stock (instead of the property itself) to the university, the partnership claimed a charitable donation deduction of $600,000, and the members of the partnership benefitted from their pro-rata share of the deduction. The corporation did not conduct any business while the partnership owned it, and its only asset was the property. The Tax Court held in Ford v. Commissioner that (i) the transfer of the property by the partnership to the corporation was done solely for purposes of obtaining a tax deduction for the partners, (ii) the corporation was a sham, acted solely as a conduit, and lacked economic substance, and (iii) as a result, the partnership, not the corporation, made the charitable donation to the university.

The Tax Court explained that *Skripak* and similar cases concerned taxpayers who bought tangible personal property at distress prices for the sole purpose of later contributing such property to a charity. In those cases, the Tax Court held that the absence of any non-tax motives for entering into the transactions was not an obstacle to the taxpayers claiming the charitable deductions.

The Tax Court then noted that the situation in *Ford was distinct from that in Skripak.*The former case did not fea-

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[33] *Id.*

[34] *Weintrob v. Commissioner*, T.C. Memo 1990-513.

[35] *Id.*.

[36] *RERI Holdings I, LLC v. Commissioner*, T.C. Memo 2014-60.

[37] *RERI Holdings I, LLC v. Commissioner*, T.C. Memo 2014-60 (referencing *Scheidelman v. Commissioner*, 862 F.3d 189, 200 (2nd Cir. 2012)).

[38] *RERI Holdings I, LLC v. Commissioner*, T.C. Memo 2014-60 (referencing *Ford v. Commissioner*, T.C. Memo 1983-556).

[39] Tax Reform Act of 1969, Public Law No. 91-17, Section 201 (1969); U. S. House of Representatives, Tax Reform Act of 1969, 91st Congress, 1st Session, Report No. 91-782 (Dec. 21, 1969); *See also* Tax Reform Act of 1976, Public Law No. 94-455, Section 2124(e) (1976); *See also* Tax Reduction and Simplification Act of 1977, Public Law No. 95-30, Section 309 (1977). Notably, the IRS first recognized tax deductions for charitable contributions of partial interests in real property several years earlier, in 1964. *See* Rev. Rul. 64-205.

[40] Tax Treatment Extension Act, Public Law No. 96-541, Section 6(a) (1980); U.S. Senate, Tax Treatment Extension Action of 1980, 96th Congress, 2d Session, Report No. 96-1007 (Sept. 30, 1980).

[41] U.S. Joint Committee on Taxation. Description of S. 1675 (Public Land Acquisition Alternatives Act of 1983). JCX-1-84, Feb. 4, 1984, pg. 10 (statement by Senator Malcolm Wallop) (emphasis added).

[42] U.S. Joint Committee on Taxation. Description of S. 1675 (Public Land Acquisition Alternatives Act of 1983). JCX-1-84, Feb. 4, 1984, pg. 15 (statement by President of the Conservation Foundation).

[43] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295.

ture the direct purchase and subsequent donation of property by a taxpayer; rather, it involved the formation by the taxpayer of an entity, the corporation, in order to carry out the transactions and achieve the desired tax results. The Tax Court summarized the issue in Ford as follows: "[W]hether the formation of a corporate shell should be respected for federal tax purposes where the sole purpose of the corporation was to enable the taxpayers (and others similarly situated) to obtain a charitable contribution deduction that would otherwise have been unavailable to them." Importantly, the Tax Court clarified that it disregarded the corporation in *Ford* because it lacked economic substance, but it did not disallow the charitable deduction altogether. It simply recharacterized the transaction from the donation of corporate stock to the direct donation by the partnership of the land.

The Tax Court noted that the IRS made several "clear" contentions in its opposition to the Motion for Partial Summary Judgment. These included that the partnership was a sham, the transactions lacked economic substance, and those sorts of judicial principles can serve to disallow charitable contribution deductions when the benefits claimed are inconsistent with the legislative goals underlying Section 170. However, the Tax Court was puzzled as to why, exactly, the IRS was advancing some of its attacks. The Tax Court exhibited its befuddlement with the IRS's overall strategy by offering various rhetorical questions. First, the Tax Court pondered why the IRS wished to prove that the partnership should be disregarded because it supposedly was not formed to carry out a business venture? The biting question by the Tax Court was "so what?" Ignoring the partnership would result in a direct purchase and donation of property by the members of the partnership, and this scenario would render a charitable deduction for the partners pursuant to *Skripak*. Second, the Tax Court asked what would occur if it determined, consistent with the IRS's contentions, that the transactions in question lacked a non-tax purpose? Again, the inquiry by the Tax Court was "so what?" Citing Skripak and other cases addressed in this article, the Tax Court challenged the IRS as follows: "Have we not said sufficiently that gifts to charity need have no economic substance beyond the mere gift?" The Tax Court concluded that the IRS had not adequately explained how its assertions, even if true, would affect the entitlement of the partners of the partnership to a charitable deduction.

Charitable Donations of Conservation Easements

Congress has offered tax incentives, in the form of deductions, for donations of partial interests in real property for more than five decades, starting in 1969.[39] Congress codified this notion as Section 170(h) in 1980, thereby specifically providing tax incentives to taxpayers for donating conservation easements.[40] Four years after enacting Section 170(h), members of Congress introduced legislation to sweeten the pot, so to speak. They wanted to expand the tax rewards for protecting land, mindful of increasing development pressures and decreasing federal budgets earmarked for land acquisition. A hearing about the proposed legislation left no doubt that Congress was incentivizing private land preservation, and the motivation of the donors was linked to tax benefits:

> The message could not be clearer – if we are to tackle the task of preserving many of these precious resources in light of current pressures for development and the competition for funds, we have to identify and enact tools to accomplish this task. I believe that [the proposed legislation] contains such an opportunity. Building on the broad principles found in [Section 170(h)], which provides for the deductibility of contributions of partial interest in real property, we have sought with [the proposed legislation] to put together a variety of tax incentives to further encourage the sale and contribution of significant natural areas. Those principles which I believe must remain intact as we seek viable alternatives to encourage and promote tax motivated transfers of scenic lands and wildlife habitat, contemplate that tax benefits are provided only with regard to carefully defined natural areas.[41]

The proposed legislation and corresponding hearing in 1984 were the culmination of various workshops on land management and acquisition alternatives led by members of Congress. According to congressional testimony, such workshops rendered the following conclusions about tax policy. First, it was in the national interest to encourage land conservation through private donations and public appropriations. Second, the practice of conserving property "should be made more profitable to landowners via the provision of tax incentives." Third, there is a need "to provide new tax benefits to stimulate land conservation by private property owners."[42]

Economic Substance and Partnership Validity

The IRS has attempted for decades to challenge partnerships under various theories, including that the entities are

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[44] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295, pg. 21.

[45] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295, pg. 32.

[46] *Id.*

[47] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295, pgs. 33-34 (emphasis added).

[48] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295, pg. 37 (citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584 (1978) (emphasis added)).

[49] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295, pg. 38.

[50] *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, T.C. Memo 2009-295, pg. 42. On appeal, the court did not question the issue of partnership validity, but ruled that the transactions were "disguised sales." *See Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011).

[51] *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425 (3rd Cir. 2012), *rev'g* 136 T.C. 1 (2011).

[52] *Historic Boardwalk Hall, LLC v. Commissioner*, 694 F.3d 425, 463 (3rd Cir. 2012), *rev'g* 136 T.C. 1 (2011).

[53] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22).

[54] Section 45(c)(7)(A).

[55] Section 45(d)(8); Section 45(e)(3).

[56] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 4.

[57] *Id.*

[58] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 5.

not really partnerships and, even if they were, they lack economic substance because they have no business purpose or pre-tax profit potential. The results have been mixed when it comes to attacks on partnerships formed for purposes of obtaining legislative tax incentives, but the most recent case, examined below, strongly favors taxpayers.

Earlier Victory for Taxpayers

In *Virginia Historic Tax Credit Fund 2001, LP v. Commissioner*, the IRS challenged a syndicated partnership, or fund, which was formed to enable a state historic tax credit program.[43] The IRS alleged, among other things, that the relevant entity was not a partnership for federal tax purposes because "the investors did not intend to join together for any business purpose other than the sale of state tax credits."[44] The Tax Court, after examining all the pertinent objective factors, concluded that the investors intended to become partners in order to pool their capital in a diversified group of developer partnerships for purposes of obtaining state tax credits.[45]

The Tax Court then addressed the related contention by the IRS, which was that the investors were not partners regardless of their intent because they lacked a valid business purpose, and the substance of the transactions did not match their form.[46] The Tax Court reasoned as follows with respect to the first sub-issue; that is, whether a business purpose existed:

> [E]ach investor was entitled under the partnership agreements to a share of any profits generated by the partnerships had there been any. *The* parties agree, however, that the partnerships did not expect to make a profit in the literal sense, but instead offered a net economic gain to investors based on their reduced state income tax. Virginia enacted the Virginia Program, in large part, because investment in historic preservation generally would not otherwise be made due to low profitability. The investors understood that the same lack of profitability that required state legislative actions would result in little to no profit to developer partnerships and the [partnerships at issue]. Their participation in the Virginia Program despite this understanding should not, in itself, bar a finding of business purpose.[47]

The Tax Court next addressed the second sub-issue, which was whether individuals obtaining tax credits by investing through partnerships (*i.e.*, the form of the transactions) undermined the substance. The Tax Court held in favor of the taxpayer again. It referred to the Supreme Court precedent stating that the IRS and courts should honor the relationships between parties where there is a "genuine multi-party transaction with economic substance that is *compelled or encouraged by regulatory or business realities*, is imbued with federal tax-independent considerations, and is not shaped solely by federal tax avoidance."[48] After evaluating the facts in the case, particularly the logic behind employing partnerships as investment vehicles, the Tax Court held that the use of partnerships was not a mere formality used for federal tax avoidance, but rather the structure was "compelled by the realities of public policy programs, generally, and the Virginia Program, in particular."[49]

In summary, the Tax Court held that the entity in question was a partnership for federal tax purposes, it had a valid business purpose, and the substance of the transactions between the investors and the partnership were capital contributions followed by allocation of credits, not simple "sales" of tax credits.[50]

Earlier Victory for the IRS

In *Historic Boardwalk Hall, LLC v. Commissioner*, the Third Circuit Court of Appeals held that an investor was not a bona fide partner for federal income tax purposes, and thus was not entitled to receive an allocation of historic rehabilitation credits from the partnership.[51] The primary reason for this decision was that the investor was guaranteed full reimbursement of its investment if it did not receive the anticipated tax credits. This, concluded the Court of Appeals, meant that the investor did not incur any risks and did not adequately participate in the financial upside or downside of the partnership's business, such that it was not a "bona fide partner."[52]

Newest Case

The most recent case, decided in 2022, is *Cross Refined Coal, LLC v. Commissioner*.[53]

Summary of Key Facts

The case focused on the refined-coal tax credit, found in Section 45, which incentivizes production of cleaner-burning coal.[54] The law specifically states that, if more than one person has an ownership interest in a refined-coal production facility, then the tax credits "shall be allocated among such persons" in accordance with the size of their interests.[55]

A company ("AJG") began developing coal-refining technology and making plans to launch a production facility in South Carolina. To accomplish this, AJG formed a limited liability company treated as a partnership ("Cross"). It entered into three key contracts: (i) A lease

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[59] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pg. 8.

[60] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 12-13.

[61] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 13-14.

[62] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pg. 15.

[63] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pg. 27 (emphasis added).

[64] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 39-42.

[65] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 43-44.

[66] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 44-45.

[67] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 45-51.

[68] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pg. 52.

[69] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pg. 53.

[70] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pgs. 53-54.

[71] *Cross Refined Coal, LLC v. Commissioner*, Tax Ct. No. 19502-17, Bench Opinion, 8/29/19, pg. 55.

[72] Section 6110(k)(3); Section 6110(b)(1)(A). The Tax Court issues three main types of decisions, namely, T.C. Opinions, T.C. Memorandum Opinions, and T.C. Summary Opinions. Only the first

with a utility company that generated electricity by burning coal ("Santee"); (ii) A purchase-and-sale agreement with Santee, pursuant to which Cross would buy raw coal from Santee, refine it, and then sell it back to Santee for 75 cents *less* per ton, thereby triggering a loss for Cross on the resale; and (iii) a sub-license agreement with AJG for use of its technology.

The Court of Appeals recognized the inevitable financial outcome of this arrangement. It explained that, after taking into account the property lease payments, expenses to refine the coal, losses on the resale to Santee, and royalties for the technology, Cross's "business model made economic sense only by accounting for the tax credit," its "operations inevitably would produce a pre-tax loss," and the "sole opportunity to turn a profit was to claim a tax credit that exceeded [all the] costs."[56]

AJG recruited two other members in 2010, subsidiaries of Fidelity Investments ("Fidelity") and Schneider Electric ("Schneider"). Together, they invested in several production facilities. Adding two members benefitted AJG in various ways. For instance, it could diversify its investment over a larger number of projects to reduce its overall risk, collect useful data from multiple facilities, not exceed its ceiling on fossil fuel investments, and allow the two new members to claim the tax credits immediately, while AJG carried them forward to future years. Fidelity purchased a 51 percent interest in Cross for $4 million, contributed another $1 million to cover initial operating expenses of Cross, and invested additional amounts to allow production of refined coal at other facilities. Fidelity's purchase agreement featured a liquidated-damages provision, which allowed Fidelity to essentially get out of the deal and recoup a prorated portion of its investment if Cross failed to meet certain performance goals. For its part, Schneider purchased a 25 percent interest in Cross for $1.8 million, provided $564,000 for operating expenses, and invested even more to enable production at other facilities. Schneider's purchase agreement did not contain a liquidated-damages provision.[57]

AJG, Fidelity and Schneider were all "actively involved" in the operations of Cross. They reviewed daily production reports, made major decisions, communicated regularly on management issues, and paid monthly sums to cover operating expenses, such as payroll, insurance, and materials.[58]

The operation was profitable, but not nearly to the extent initially envisioned, largely because of two extended and unanticipated shutdowns of the facility. Consequently, both Fidelity and Schneider exited Cross in 2013. The former received about $2.5 million in liquidated damages, while the latter accepted $25,000 from AJG for its ownership interest.

Cross claimed over $25 million in refined-coal tax credits on its Forms 1065 for 2011 and 2012, as well as significant business losses. Cross, as a partnership, distributed the credits and losses among AJG, Fidelity and Schneider in accordance with their ownership percentages.

The IRS audited. In its final notice, the IRS argued that Cross was not truly a partnership for federal tax purposes because AJG did not form it to carry on a business and share in profits and losses, but rather to facilitate "the prohibited transaction of monetizing refined coal tax credits." The IRS contended that only AJG, and not Fidelity and Schneider, could claim the credits. Cross disputed the IRS's final notice by initiating litigation in Tax Court.

Analysis by the Tax Court

The Tax Court indicated that its task was to decide whether Cross was a partnership for federal tax purposes, and if so, whether Fidelity and Schneider were bona fide partners therein.[59]

The Tax Court began by acknowledging that the coal-refining operation was, in a vacuum, unprofitable for Cross. It explained Cross's situation in the following manner:

> For the producer [Cross], the economics began with a multi-million-dollar investment and an inevitable before-tax loss every year of the operation. The coal must ultimately be sold at a discount in order to induce the utility [Santee] to assume the risk of buying and using the refined coal. Thus, the producer's best-case scenario would involve a before-tax loss for each ton of refined coal sold, and the more successful the producer in producing and selling refined coal to the utility, the greater that before-tax loss would be.[60]

The Tax Court went on to describe several risks facing Cross. These included (i) the "real risk" that Santee would purchase no refined coal or a reduced amount thanks to its ability to use raw coal when it chose, (ii) the possibility of suspended production resulting from permitting, environmental, or other problems, and (iii) reputational and legal damages if lawsuits arose from violations of federal or state laws.[61] The Tax Court then summarized the financial realities for Cross, along with the fundamental role of the tax credit.

> The producer's incentive to undertake these risks and to incur an inevitable before-tax loss was the tax credits . . . that Section 45 awarded for the production and sale of the refined coal. Without those tax credits, there was no economic reason for the producer

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type, called a "published" opinion, generally constitutes binding precedent for Tax Court purposes. *See* Section 7463(b); *Nico v. Commissioner,* 67 T.C. 647, 654 (1977) (stating that "we consider neither Revenue Rulings nor Memorandum Opinions of this Court to be controlling precedent"); *Huffman v. Commissioner*, 126 TC 322, 350 (confirming that "memorandum opinions are not binding"); James S. Halpern, What Has the Tax Court Been Doing? An Updated, Tax Notes 1277 (May 30, 2016) (explaining that the "official position of the Tax Court appears to be that, with respect to memorandum opinions, we are not bound by the doctrine of stare decisis").

[73] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22).

[74] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pgs. 10-11.

[75] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 12 (internal citations and punctuation omitted).

[76] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 12.

[77] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 14.

[78] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 15.

[79] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pgs. 18-19.

[80] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 16.

> to buy high and sell low, *i.e.,* to purchase coal, incur additional cost to refine it, and then sell it not at a profit but at a discount. Without the tax credits as an incentive to the producer, the utility would not have an occasion to use refined coal and thereby reduce its harmful emissions.[62]

The Tax Court also viewed the situation from the perspective of Fidelity and Schneider. It explained that they had to pay AJG a so-called finder's fee and a portion of the license for its coal-refining technology. The Tax Court then underscored the financial dependence:

> But for Fidelity and Schneider, because they did not hold any interest in the royalties for the technology, the Section 45 tax credits were the [only] source of economic return for the operation. Without the credits, the operation would have always necessarily been a losing proposition for all three members because of the discount on the sale of the refund coal to Santee.[63]

Partnership Status – Contributions, Profits, Risks

The Tax Court then turned to the first issue; that is, whether Cross was a partnership for federal tax purposes. The IRS argued that AJG, Fidelity and Schneider did not have a business purpose. In support of its position, the IRS focused on three factors: The contributions to Cross made by the members, whether the members shared in the profits, and whether the members shared in the losses. The Tax Court's analysis of the three factors is below.

Recalling the multi-million dollar initial contributions, followed by regular payments of significant operating expenses, the Tax Court quickly dispensed with the IRS's challenge to member contributions.[64]

The Tax Court also rejected the IRS's criticism about profits. The IRS suggested that the increase in tax credits resulting from the boost in sales of unprofitable refined coal did not constitute profit sharing. The Tax Court highlighted several deficiencies and flaws in the IRS's logic:

> This is true as far as it goes, since the agreed-upon discount for sales of refined coal will assure a loss on the sale of every ton of coal refined. But it deliberately disregards the obvious economic reality of the situation: The members do share in increased profit, *i.e.,* after-tax profit, because of the Section 45 credits that are a necessary predicate for the entire arrangement. The [IRS] disregards the credit because he looks for the deal to justify itself in pre-tax terms, finding an abuse where a deal is undertaken only for tax benefits. There are indeed abusive situations in which the tax law will disregard transactions that lack substance apart from tax manipulations, but this is not such a circumstance.[65]

Citing *Sacks v. Commissioner*, the famous case in the Ninth Circuit Court of Appeals addressing tax incentives, the Tax Court augmented its criticism of the lack-of-profitability theory floated by the IRS.

> It is therefore insufficient to say . . . that there was no opportunity for Fidelity or Schneider to earn any pre-tax profit before or after the expiration year of the tax credits in 2019. That was certainly true; and, again, in some circumstances the lack of opportunity for pre-tax profit could indeed be evidence of lack of real business purpose or intent; but here the partners deliberately and conscientiously pursued the economic goal that Congress incentivized them to seek; that is, an after-tax (and after-tax-credit) profit. On the facts of this case and given the nature and purpose of Section 45, we look to the post-tax profits that the members anticipated, and we hold that they did indeed share in the profits of the arrangement.[66]

Finally, the Tax Court devoted several pages to explaining various risks of loss that existed, how all the members in Cross were exposed to such risks, and why the situation involving Cross was distinguishable from that in the earlier case, *Historic Boardwalk*.[67]

Supposed Sale of Tax Credits

The IRS, in addition to questioning the classification of Cross as a partnership, urged the Tax Court to rule that AJG was simply "selling" tax credits to Fidelity and Schneider. The Tax Court declined to do so, making the following initial observation:

> It is true that the credits were a critical feature of the arrangement, that no rational actor would have invested in the refined coal facility without the credits, [and] that the parties took every necessary effort to assure their obtaining of the credits. It is also true that their communications speak of obtaining of the credits as the desired outcome, and that some of their communications used "purchasing" or "selling" the credits as shorthand for entering into or acting under the contracts into which they had entered. There may be circumstances in which such facts might undermine the existence of a bona partnership, but this is not the case here.[68]

The Tax Court then explained that, unlike other cases, *Cross Refined Coal featured* "obviously real transactions" with parties that were "substantially involved in the activity," and did not consist of mere "paper transactions."[69] The Tax Court added to these observations, with references to legislative incentives, investor motives, and economic substance:

> Congress created the refined coal credit for the purpose of incentivizing the refined coal activity; it did so because the market, unassisted by credits, was not producing refined coal on the scale that Congress thought beneficial. Congress manifestly decided that, if refined coal was to be produced in sufficient quantity, money beyond that which the market would offer would need to be added to the mix. The intended result of the credit was that investors, knowing they could obtain the credits, made decisions to produce refined coal – decisions that they did not make and would not make unless they could be sure that they would receive the credits.

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[81] *Cross Refined Coal, LLC v. Commissioner*, 130 AFTR 2d 2022-5092 (CA Dist. Col. 8/5/22), pg. 17.

[82] *Id.*

[83] Rev. Proc. 2019-3, Section 3.02(2).

[84] Notice 2017-10, Section 1; Internal Revenue Service. Conservation Easement Audit Technique Guide. Publication 5464 (Rev. 11-2020), pgs. 69-72; *See also* Nathan J. Richman. "Future Easement Charges Could Pivot on Economic Substance Questions," 2020 Tax Notes Today Federal 19-4 (Jan. 29, 2021) (quoting senior IRS officials as saying that "future cases could hinge on the whole picture of transactions misrepresenting their economic substance.")

[85] *See* LMSB-4-0910-024 (Sept. 14, 2020), Tax Analysts Doc. No. 2020-20089; LB&I-040711-105 (July 15, 2011); Notice 2014-58.

[86] LB&I-04-0422-0014 (April 22, 2022) (emphasis added).

> And rational investors, having made that decision, would of course work to assure that they maintained the right to receive those credits. Without the credits, the refined coal activity was a losing proposition; but that fact cannot mean that the activity, undertaken by someone who gains claiming the credits, lacks economic substance; rather, that fact is the reason for the credits.[70]

Bona Fide Partners – Debt versus Equity

The IRS claimed that the investments by Fidelity and Schneider resembled debt (*i.e.*, loans to Cross) more than equity (i.e., capital contributions to Cross), such that they were not partners in Cross. The Tax Court gave this final theory little credence. It said that the only aspect of the case that had "any remote arguable relation" to debt was the liquidated-damages provision in the agreement with Fidelity, which allowed it to recoup a portion of its initial investment if Cross failed to surpass certain milestones. The Tax Court explained that the IRS's contention "collapses with only a little more consideration" because a liquidated-damages provision does not constitute an unconditional promise to pay and it does not contemplate an interest component. The Tax Court concluded that the contributions by Fidelity and Schneider were clearly equity.[71]

Analysis by the Court of Appeals

The decision by the Tax Court in *Cross Refined Coal* came in the form of an Order, otherwise known as a Bench Opinion. Importantly, Bench Opinions do not constitute legal precedent, such that other taxpayers, favored by the Tax Court's analysis, might not have been able to cite it as authoritative.[72] The IRS, therefore, could have just internally disagreed with the outcome, licked its proverbial wounds, and hoped for a better result in the next case. Did the IRS adopt this strategy and required restraint? No, it elevated the matter to the Court of Appeals instead. The gamble did not pay off for the IRS, as the Court of Appeals affirmed the earlier decision by the Tax Court, even strengthening it in certain regards.[73]

Partnership Status – Profits

The Court of Appeals ruled that the Tax Court correctly determined that AJG, Fidelity and Schneider intended to jointly conduct a business. The Court of Appeals noted that AJG had several legitimate, non-tax reasons for forming Cross and recruiting Fidelity and Schneider. It also explained that there was "nothing untoward" about AJG seeking partners that could immediately utilize the tax credits. Indeed, the Court of Appeals explained that low-tax entities, like AJG, frequently dangle the prospect of quick tax credits in order to lure high-tax entities, like Fidelity and Schneider, into a partnership. The Court of Appeals further underscored that all three entities actively participated in day-to-day operations, they contributed funds to cover expenses in proportion to their ownership interests, and they remained partners for several years, even during two unprofitable shutdowns of the production facility. Finally, the Court of Appeals highlighted that the provision granting the tax credit, Section 45, expressly contemplates multiple owners of a facility.[74]

The Court of Appeals then turned to the IRS's principal complaint, namely, that Cross supposedly did not pursue business activity to generate a pre-tax profit. The IRS maintained that an absence of pre-tax profit was fatal to achieving partnership status. The Court of Appeals, like the Tax Court before it, strongly disagreed. It explained the following:

> As a general matter, a partnership's pursuit of after-tax profit can be a legitimate business activity for partners to carry on together. This is especially true in the context of tax incentives, which exist precisely to encourage activity that would not otherwise be profitable. The production of refined coal illustrates this point: Congress recognized its environmental benefits, but, as the Tax Court explained, refiners must sell it at a discount in order to induce the utility to assume the risk of buying and using it. Thus, Cross did not simply engage in wasteful activity, which is typical of sham partnerships that merely manufacture tax losses. Rather, Cross engaged in business activity with a practical economic effect, the production of cleaner-burning refined coal, which Congress specifically sought to encourage.[75]

The Court of Appeals emphasized that it was not alone in its thought process. For instance, the Ninth Circuit Court of Appeals, in issuing its earlier decision in *Sacks v. Commissioner,* held that "taxpayers may legitimately conduct business activity that Congress has deliberately made profitable through statutory tax incentives, and may do so with no hope of a pre-tax profit."[76]

Interestingly, the Court of Appeals concluded its analysis by admonishing the IRS for attacking a partnership when the partners could have accomplished the same thing independently. The Court of Appeals, using the IRS's own words against it, noted the following:

> Even the [IRS] ultimately recognizes that an enterprise profitable only on a post-tax basis can have a valid business purpose. [The IRS] acknowledges that Cross would have had a legitimate business purpose had AJG alone operated it, even with no potential for pre-tax profit. But if only one entity could validly seek after-tax profit through Cross, there is no reason why three partners could not validly pursue the same objective.[77]

Risks, Economic Substance, Sale of Credits

With respect to sharing in the risks, the Court of Appeals acknowledged that the parties took certain actions designed to mitigate potential downsides to their investments. For instance, Fidelity negotiated a liquidated-damages provision, and Cross's sub-license agreement regarding technology was structured to safeguard Fidelity and Schneider from fluctuations in costs. The Court of Appeals concluded that such realities did not convert capital contributions into loans, and the outcomes for the partners largely depended on the amount of coal refined. The three parties, therefore, were bona fide partners.[78]

The Court of Appeals conceded that Fidelity and Schneider would not be considered partners if their risks were so trivial or so remote as to make them indifferent to the success or failure of Cross's coal-refining operations. However, these two parties faced "significant downside risks," had "much skin in the game," lacked a guaranteed return on their investment, and enjoyed no special tax-credit allocations.[79]

The Court of Appeals next addressed an alternative argument by the IRS, which was that even if Fidelity and Schneider had downside risks, they were insufficient in comparison to the tax benefits to support partner status. The IRS tried to use cases involving the economic substance doctrine as grounds for this contention. Such cases compared the magnitude of tax benefits and non-tax benefits to determine whether a particular transaction had a business purpose. The IRS suggested that the logic and reasoning from those non-partnership cases should apply to cases, like *Cross Refined Coal*, centered on the validity of an entity claiming to be a partnership. The IRS pointed out that, on one hand, Fidelity invested about $4 million and Schneider about $3 million, taking into account the initial contributions, normal operating expenses, and extraordinary expenses during the two shutdowns of the production facility, and subtracting the liquidated-damages that Fidelity received upon departure from Cross. On the other hand, applying the best-case scenario contemplating full coal production for 10 years, Fidelity and Schneider expected to enjoy a total of $105 million in after-tax profits. The IRS concluded that such a large "imbalance" between actual risks and potential rewards proves that Fidelity and Schneider "bought tax credits" from Cross instead of becoming true equity partners in Cross.[80]

The Court of Appeals rejected the IRS's theory because of the inapplicability of economic substance cases to the situation at hand: "Congress recognized the environmental benefits of cleaner coal and provided tax incentives that it deemed appropriate as a result [so] we cannot ignore tax consequences in assessing the legitimacy of the encouraged activity."[81]

For the sake of argument, the Court of Appeals indulged the IRS, evaluating whether comparing the amount of capital placed at risk to the anticipated tax benefits in the best-case scenario would justify transforming Fidelity and Schneider into non-partners. The Court of Appeals refused to side with the IRS, even after framing the issue in the manner most favorable to it:

> [T]he production of refined coal is a legitimate business activity that Congress sought to make profitable through tax incentives, including for partnerships. Without more, high after-tax profit margins suggest only that the tax credit is a generous one, not that the entities obtaining them are something other than a legitimate partnership. In this case, for example, nobody doubts that AJG could benefit from the tax credit, no matter how small its investment or how large its tax-driven profits. Fidelity and Schneider were no less eligible to reap the rewards of Congress's generosity.[82]

Conclusion

Observe three realities. First, many taxpayers contemplating transactions involving tax incentives and partnerships would like to obtain advance approval from the IRS in the form of a Private Letter Ruling. The problem is that the IRS declines to rule on several critical issues, including whether an alleged partnership is valid, a person is a partner, the economic substance doctrine applies to a particular transaction, or such transaction has a bona fide business purpose.[83] Second, as part of its many "compliance campaigns" in recent years, the IRS announced its plan to challenge various transactions involving tax incentives. It has encouraged its personnel to question the validity of entities claiming partnership status and to apply the substance-over-form, step-transaction, sham-transaction, and economic substance doctrines.[84] Third, since the economic substance doctrine was codified way back in 2010, Revenue Agents had to acquire executive approval *before* they challenged a tax benefit based on economic substance and before they asserted corresponding penalties.[85] This completely changed in 2022, when the IRS issued a memorandum declaring that, going forward, Revenue Agents could rely solely on their own judgment in broaching economic substance, and "[e]xecutive approval is *not* required."[86]

The information throughout this article strongly supports the position that IRS challenges to tax incentives based on economic substance and/or partnership invalidity should be used sparingly, if at all. Nevertheless, from the three realities enumerated above, taxpayers can anticipate that the IRS will maintain its attacks. Taxpayers involved in transactions featuring tax credits, deductions or other congressional incentives, therefore, should hire experienced tax defense counsel and prepare for the inevitable. ●