Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:
202-622-3120
Refer Reply To:
CC:PSI:7-PLR-121614-00
Date:
December 21, 2001

Re: Section 29 Request for a Ruling: Credit for Producing Fuel from a Nonconventional Source

LEGEND:

P	=
A	=
B	=
B1	=
B2	=
B3	=
B4	=
C1	=
C2	=
D	=
Date 1	=
Date 2	=
Date 3	=
F	=
G	=
H	=
I	=
J	=
K	=
V	=
W	=
State X	=
Y	=
Z	=

Dear :

This letter responds to a letter dated October 17, 2000 and subsequent correspondence, submitted on behalf of P by its authorized representative, requesting rulings under sections 29 and 702 of the Internal Revenue Code.

FACTS

The facts as represented by P and P's authorized representative are as follows:

P is a limited liability company formed for the purpose of acquiring, relocating and operating three separate facilities for the production of solid synthetic fuel from coal. Pursuant to the transactions described below, P has acquired and relocated two solid synthetic fuel facilities (Facilities) to the V and W sites.

P is classified as a partnership for federal income tax purposes. The members of P are A, B1, B2, B3 and B4. A holds a % ownership interest in P and is the managing member. B1, B2, B3 and B4 hold an aggregate % ownership interest in P and are the non-managing members.

A and B are corporations that are wholly-owned subsidiaries of C1. C1 is engaged in a number of businesses, directly and through affiliates, including investments in the energy sector. B1, B2, B3 and B4 are indirect wholly-owned subsidiaries of C2.

On Date 2, B sold its % non-managing ownership interest in P to affiliated corporations B1 (%), B2 (%), B3 (%) and B4 (%) for cash.

D entered into separate construction contracts on Date 3 with general contracting firms to build the Facilities. The construction contracts were for synthetic fuel production facilities for producing solid synthetic fuel that was a "qualified fuel" within the meaning of section 29(c)(1)(C). P has provided an opinion of counsel that each of the construction contracts was a legal, valid and binding obligation of D under applicable state laws prior to January 1, 1997. In addition, each of the construction contracts (i) provided for liquidated damages of at least five percent of the contract price, (ii) included a description of the Facility to be constructed, (iii) provided for a completion date and (iv) provided for a maximum price. P represents that each of the Facilities was placed in service within the meaning of section 29(g)(1)(A) before July 1, 1998.

As described in the ruling request and subsequent correspondence from P's authorized representative, each Facility consists of a high-speed mixer, a ribbon blender and two pellet mills. In the process by which synthetic fuel is produced in the Facilities, coal feedstock and a chemical reagent are mixed in the high-speed mixer and transported by gravity feed to the ribbon blender. The ribbon blender provides additional blending and then distributes the mixture to the two pellet mills for final processing and delivery to the finished product conveyor belt.

The coal-based synthetic fuel originally produced in the Facilities by D was not commercially viable. As a result, D began using different chemical reagents to produce more marketable synthetic fuels.

On Date 1, D sold the Facilities to P for a fixed dollar amount, paid in full in cash at closing. A and B, the members of P when P acquired the Facilities, made capital contributions in cash to P in accordance with their ownership interests in an amount required to acquire and relocate the Facilities. The members of P have made (and will continue to make) periodic cash capital contributions to P to pay its operating costs in accordance with their respective ownership interests.

P has entered into a number of auxiliary agreements with third parties in connection with the relocation and operation of the Facilities.

P contracted with F, an affiliate of D, to reassemble and install the Facilities at the site of V and the site of W both located in State X. V is owned by H and W is owned by I. H and I are wholly-owned subsidiaries of G. P has represented that, following the relocation, the fair market value of the original property of each Facility is more than 20% of the Facility's total fair market value (the cost of the new property plus the value of the original property). H and I have each granted a lease to P at the sites of V and W, respectively, to enable P to reassemble and operate one Facility at each of the two sites. Under each of the lease agreements, P agreed to pay H and I a fixed monthly rent and an additional rental amount based on the amount of synthetic fuel sold to third parties.

P has entered into separate coal feedstock supply agreements with J for each Facility. If J fails to deliver the coal feedstock it is required to deliver to P, P can purchase feedstock from other suppliers. J is a limited liability company classified as a partnership that is engaged in the business of buying and selling coal and other fuels. The partners of J are P and K, a wholly-owned subsidiary of G. K is the managing member and holds a Y ownership interest in J. P is the non-managing member and holds a Z ownership interest in J.

P has entered into synthetic fuel sales agreements with H and I for each Facility. Under these agreements, H and I have agreed to purchase a minimum amount of synthetic fuel produced at the Facilities from P each year. If H or I does not purchase the synthetic fuel it is obligated to purchase, P can sell the synthetic fuel to third parties. P has represented that all sales of synthetic fuel will be to unrelated persons.

P entered into an agreement with F for the operation and maintenance of the Facilities. F is subject to the direction and control of P, which has the sole authority to set production levels and make other strategic decisions. F is paid a fixed fee (with adjustment for inflation) per ton of synthetic fuel produced. Any capital costs associated with the Facilities will be paid by P and must be authorized by P. P has entered into separate arrangements with suppliers of chemical reagents.

P has supplied a detailed description of the process employed at each Facility. P also has proposed that, from time to time, several alternative chemical reagents identified in P's submissions may be used in the process. As described, the Facilities and the process implemented in the Facilities, including the alternative chemical reagents, meet the requirements of Rev. Proc. 2001-34, 2001-22, I.R.B. 1293.

Recognized experts in coal and chemical analysis have performed numerous tests on the fuel produced from coal feedstock using the process, including the alternative chemical reagents, that will be used at the Facilities and have submitted multiple reports in which the experts conclude that significant chemical changes take place with the application of the process to the coal.

Under the limited liability company agreement of P, in general, all items of income, gain, loss, deduction, and credit, including the section 29 credit, of P are allocated, and any distributions made, in proportion to the members' ownership interests, % to A, % to B1, % to B2, % to B3 and % to B4.

RULING REQUESTS #1 & #2

Section 29(a) allows a credit for qualified fuels sold by the taxpayer to an unrelated person during the taxable year, the production of which is attributable to the taxpayer. The credit for the taxable year is an amount equal to $3.00 (adjusted for inflation) multiplied by the barrel-of-oil equivalent of qualified fuels sold.

Section 29(c)(1)(C) defines "qualified fuels" to include liquid, gaseous, or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

In Rev. Rul. 86-100, 1986-2 C.B. 3, the Internal Revenue Service ruled that the definition of the term "synthetic fuel" under section 48(1) and its regulations are relevant to the interpretation of the term under section 29(c)(1)(C). Former section 48(1)(3)(A)(iii) provided a credit for the cost of equipment used for converting an alternate substance into a <u>synthetic</u> liquid, gaseous, or <u>solid fuel</u>. Rev. Rul. 86-100 notes that both section 29 and former section 48(1) contain almost identical language and have the same overall congressional intent, namely to encourage energy conservation and aid development of domestic energy production. Under section 1.48-9(c)(5)(ii) of the Income Tax Regulations, a synthetic fuel is one that "differs significantly in chemical composition," as opposed to physical composition, from the alternate substance used to produce it. Coal is an alternate substance under section 1.48-9(c)(2)(i).

Based on the representations of P and P's authorized representative, including the preponderance of P's test results, we agree that the fuel to be produced in each Facility using the process and reagents described in P's ruling request and subsequent correspondence results in a significant chemical change to the coal, transforming the coal feedstock into a solid synthetic fuel from coal. Because P owns the Facilities and because F on behalf of P operates and maintains the Facilities, we conclude that P will be entitled to the section 29 credit for the production of the qualified fuel from the Facilities that is sold to an unrelated person.

RULING REQUEST #3

Sections 29(f)(1)(B) and (f)(2) provide that section 29 applies with respect to qualified fuels that are produced in a facility placed in service after December 31, 1979, and before January 1, 1993 and which are sold before January 1, 2003.

Section 29(g)(1) modifies section 29(f) in the case of a facility producing qualified fuels described in section 29(c)(1)(C). Section 29(g)(1)(A) provides that for purposes of section 29(f)(1)(B), a facility shall be treated as placed in service before January 1, 1993, if the facility is placed in service before July 1, 1998, pursuant to a binding written contract in effect before January 1, 1997. Section 29(g)(1)(B) provides that if the facility is originally placed in service after December 31, 1992, section 29(f)(2) shall be applied by substituting “January 1, 2008” for “January 1, 2003.”

A contract is binding only if it is enforceable under local law against a taxpayer, and does not limit damages to a specified amount, e.g., by use of a liquidated damages provision. A contract provision limiting damages to an amount equal to at least five percent of the total contract price, for example, should be treated as not limiting damages. Each of the construction contracts, executed prior to January 1, 1997, includes such essential features as a description of the facility to be constructed, a completion date, and a maximum price. P provided opinions of counsel that each of the construction contracts is binding under the applicable state law. Each of the construction contracts also provides for liquidated damages of at least five percent of the contract price. Therefore, we conclude that the Facilities were constructed pursuant to a binding written contract for purposes of section 29(g)(1)(A).

RULING REQUEST #4

Under section 7701(a)(14), the term “taxpayer” means any person subject to any internal revenue tax. Section 7701(a)(1) provides that the term “person” includes an individual, trust, estate, partnership, association, company, or corporation.
Section 702(a)(7) provides that each partner determines the partner’s income tax by taking into account separately the partner’s distributive share of the partnership’s other items of income, gain, loss, deduction, or credit to the extent provided by regulations prescribed by the Secretary. Under Treasury Regulation section 1.702-1(a), the distributive share is determined as provided in section 704 and section 1.704-1.
Section 704(a) provides that a partner’s distributive share of income, gain, loss, deduction, or credit is, except as otherwise provided in chapter 1 of subtitle A of Title 26, determined by the partnership agreement.

Section 704(b) provides that a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances) if (i) the partnership agreement does not provide for the partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) or (ii) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) lacks substantial economic effect.

Under section 1.704-1(b)(4)(ii), allocations of tax credits and tax credit recapture (except for section 38 property) are not reflected by adjustments to the partners' capital accounts. Thus, these allocations cannot have economic effect under section 1.704-1(b)(2)(ii)(b)(1), and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or tax credit recapture arises. If a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership taxable year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for the year, then the partners' interests in the partnership regarding the credit (or the cost giving rise to it) are in the same proportion as the partners' respective distributive shares of the loss or deduction (and adjustments). *See* Treasury Regulation section 1.704-1(b)(5), Example 11. Identical principles apply in determining the partners' interests in the partnership regarding tax credits that arise from receipts of the partnership (whether or not taxable).

Based on the information submitted and the representations made, we conclude that the section 29 credit attributable to P, both before and after its reconstitution, may be passed through to, and allocated to, the members of P in accordance with each member's interest in P when the credit arises. For the section 29 credit, a member's interest in P is determined based on a valid allocation of the receipts from the sale of the section 29 qualified fuel. We express no opinion, however, regarding how the members' interests in P are determined.

RULING REQUEST #5

The section 29 credit has always been a time sensitive credit in that eligibility for the credit is determined when facilities or wells producing qualified fuels are placed in service and when the qualifying fuels are produced and sold to unrelated persons. For example, the section 44D credit, as originally enacted in the Crude Oil Windfall Profit Tax Act of 1980, was generally available for the production and sale of alternative fuels after December 31, 1979, and before January 1, 2001, from Facility placed in service after December 31, 1979, and before January 1, 1990, on property which first began production after January 1, 1980.

The section 29 credit has been extended by Congress four times. The placed-in-service deadline and the period for claiming the section 29 credit were extended in the Technical and Miscellaneous Revenue Act of 1988 (1991 for placed in service), Omnibus Budget Reconciliation Act of 1990 (1993 for placed in service and 2003 for the end of the credit period), Energy Policy Act of 1992 (1997 for placed in service and 2007 for the end of the credit period), and Small Business Job Protection Act of 1996 (June 30, 1998, for placed in service).

It is clear from the legislative history of section 44D that Congress intended the credit to apply to facilities placed in service after 1979, and that the placed-in-service deadline in section 29(f)(1)(B) must be read as applying to when the facility is first placed in service within the applicable dates. The placed-in-service deadlines contained in sections 29(f) and 29(g) focus on the facility, and not the owner of the facility. The legislative history of section 44D clearly shows that Congress wanted to encourage the production of new alternative fuels from facilities first placed in service after 1979, and not provide tax incentive for production capacity in service before 1980.

Section 29(g)(2) demonstrates that Congress knows how to preclude transferees of facilities from claiming the section 29 credit. That provision provides that extension of the period for placing facilities in service after 1992 does not apply to any facility that produces coke or coke gas unless the original use of the facility commences with the taxpayer.

Accordingly, the determination of whether a facility has satisfied the placed-in-service deadline under either section 29(f)(1)(B) or 29(g)(1)(A) is made by reference to when the facility is first placed in service, not when the facility is transferred or sold to a different taxpayer. Therefore, if P's Facilities were "placed in service" prior to July 1, 1998 within the meaning of section 29(g)(1), the sale of the Facilities after June 30, 1998, will not result in a new placed in service date for the Facilities for purposes of section 29 for the new owner. When property is placed in service is a factual determination, and we express no opinion on when the Facilities were placed in service.

RULING REQUEST #6

Section 708(b)(1)(B) provides that a partnership shall be considered as terminated if within a twelve-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Section 1.708-1(b)(1)(iv) provides that if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. Section 1.708-1(b)(1)(iv) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after May 9, 1997.

As discussed above, the placed in service deadline in sections 29(f)(1)(B) and 29(g)(1)(A) must be read as applying to when the facility is first placed in service within the applicable dates. The placed-in-service deadlines contained in sections 29(f)(1)(B) and 29(g)(1)(A) focus on the facility, and not the taxpayer owning the facility.

Accordingly, the determination of whether a facility has satisfied the placed-in-service deadline under sections 29(f)(1)(B) and 29(g)(1)(A) is made by reference to when the facility is first placed in service, not when the facility is placed in service by a transferee taxpayer. Therefore, we conclude that any termination of P under section 708(b)(1)(B) arising from sales or exchanges of interests in P (including the termination of P arising from the sale by B of its % interest in P to B1, B2, B3 and B4) will not preclude the reconstituted partnership from claiming the section 29 credit on the production and sale of synthetic fuel to unrelated persons.

RULING REQUEST #7

To qualify for the section 29 credit, the Facilities must be placed in service before July 1, 1998, pursuant to a binding written contract in effect before January 1, 1997. While section 29 does not define "placed in service," the term has been defined for purposes of the deduction for depreciation and the investment tax credit. Property is "placed in service" in the taxable year the property is placed in a condition or state of readiness and availability for a specifically assigned function. Sections 1.167(a)–11(e)(1)(i) and 1.46-3(d)(1)(ii) of the Income Tax Regulations. "Placed in service" has consistently been construed as having the same meaning for purposes of the deduction for depreciation and the investment tax credit. See Rev. Rul. 76-256, 1976-2 C.B. 46.

Rev. Rul. 94-31, 1994-1 C.B. 16, concerns section 45, which provides a credit for electricity produced from certain renewable resources, including wind. The credit is based on the amount of electricity produced by the taxpayer at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service, and sold by the taxpayer to an unrelated person during the taxable year. Rev. Rul. 94-31 holds that, for purposes of section 45, a facility qualifies as originally placed in service even though it contains some used property, provided the fair market value of the used property is not more than 20 percent of the facility's total value (the cost of the new property plus the value of the used property).

Rev. Rul. 94-31 concerns a factual context similar to the present situation. Consistent with the holding in Rev. Rul. 94-31, for each of the Facilities, if the Facility was "placed in service" prior to July 1, 1998, within the meaning of section 29(g)(1), relocation of the Facility to the V or W site or other location after June 30, 1998, or replacement of parts of the Facility after that date, will not result in a new placed in service date for the Facility for purposes of section 29 provided the fair market value of the original property of the Facility is more than 20 percent of the Facility's total fair market value at the time of the relocation or replacement. When property is placed in service is a factual determination and we express no opinion on when the Facilities were placed in service.

CONCLUSIONS

Accordingly, based on the representations of P and P's authorized representative, we conclude as follows:

(1) P, both before and after its reconstitution, with the use of the process and the chemical reagents, will produce a "qualified fuel" within the meaning of section

29(c)(1)(C);

(2) Both before and after its reconstitution, the production of the qualified fuel from each of the Facilities will be attributable solely to P, entitling P to the section 29 credit for the production of qualified fuel from each Facility that is sold to an unrelated person;

(3) Each of the contracts for the construction of the Facilities constitutes a "binding written contract" in effect before January 1, 1997 for purposes of section 29(g)(1)(A);

(4) The section 29 credit attributable to P may be passed through to and allocated among the members of P in accordance with the members' interests in P when the credit arises. For the section 29 credit, a member's interest in P is determined based on a valid allocation of the receipts from the sale of the section 29 qualified fuel;

(5) If P's Facilities were "placed in service" prior to July 1, 1998 within the meaning of section 29(g)(1), the sale of the Facilities after June 30, 1998, will not result in a new placed in service date for the Facilities for purposes of section 29 for the new owner (we express no opinion on when P's Facilities were placed in service);

(6) Any termination of P under section 708(b)(1)(B) arising from sales or exchanges of interests in P (including the termination of P arising from the sale by B of its % interest in P to B1, B2, B3 and B4) will not preclude P as reconstituted from claiming the section 29 credit on the production and sale of synthetic fuel to unrelated persons; and

(7) For each of the Facilities, if the Facility was "placed in service" prior to July 1, 1998, within the meaning of section 29(g)(1), the relocation of the Facility to the V or W site or other location after June 30, 1998, or replacement of parts of the Facility after that date, will not result in a new placed in service date for the Facility for purposes of section 29 provided the fair market value of the original property of the Facility is more than 20% of the Facility's total fair market value at the time of the relocation or replacement. We express no opinion on when the Facilities were placed in service.

Except as specifically ruled upon above, we express no opinion concerning the federal income tax consequences of the transaction described above. Specifically, we express no opinion on when P's Facilities were placed in service or how the partners' interests in P are determined.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in this ruling. See section 12.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 46. However, when the criteria in section 12.05 of Rev. Proc. 2001-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to P's authorized representative.

Sincerely yours,
Joseph H. Makurath
Senior Technical Reviewer, Branch 7
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy for section 6110 purposes

cc: