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Department of the Treasury

Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:PSI:7-PLR-110852-00
Date:
December 21, 2001

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

LEGEND

P	=
X	=
Y	=
Z	=
A	=
B	=
C	=
D	=
Site E	=
Site F	=
State G	=
State H	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
$W	=
$X	=

Dear :

This letter responds to a letter dated May 25, 2000, and subsequent correspondence, submitted on behalf of P by its authorized representative, requesting rulings under section 29 of the Internal Revenue Code.

FACTS

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

P is a limited partnership that owns a synthetic fuel facility (Facility) designed to produce a solid synthetic fuel derived from coal feedstock. X, a limited partnership, owns a percent limited partner interest in P, Y owns a percent limited partner interest in P, and Z owns percent general partner interest in P. Pursuant to the transaction described below, A owns 66 percent limited partner interest in X and B owns a percent limited partner and 1 percent general partner interest in X. The partners 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.

Effective on Date 1, A acquired a percent limited partner interest in X from B. In consideration for the limited partner interest in X, B received (i) cash payments of $W (ii) fixed payment note in the principal amount of $X payable over time, and (iii) a contingent payment note based on section 29 credits allocated to A. B also granted to A the option to acquire an additional percent limited partner interest in X. A will make monthly contributions to X to fund its share of net operating and capital costs incurred by P. P represents that based on the expected production level of the Facility on Date 1, the net present value of the cash and the consideration payable to B under the fixed note will exceed 50 percent of the total consideration payable to B for the limited partner interests.

On Date 2, B entered into two separate construction contracts with D pursuant to which D agreed to provide the equipment and services necessary to construct, install, and place into service two facilities. On Date 3, D and B agreed to combine the two separate construction contracts to build a two-line facility rather than two one-line facilities. P represents that the decision was made to improve the operating efficiency of the Facilities and to reduce maintenance, rather than to increase the production output. The Facility includes moveable equipment designed to convert coal fines material into Synthetic Fuel. The construction contract provides for a fixed price and a completion date. The construction contract does not provide for the payment of liquidated damages. P has provided an opinion of counsel that the construction contract, as amended, constituted a binding written contract under applicable state laws prior to January 1, 1997.

The Facility was constructed at the Site F in State H, and was in control of X. P represents that the Facility was placed in service within the meaning of section 29(g)(1)(A) before July 1, 1998.

While the Facility was operational on Date 4, P represents that the poor quality of available coal feedstocks at the Site F reduced the profitability of synthetic fuel production. Following the difficulties encountered in obtaining sufficient coal fines in Site F, X discussed with Y moving the Facility to the Site E in State G. The Facility was disassembled and moved to the Site E, which is owned by Y. The test burns at Site E were successful, and X and Y decided to form P to pursue the further operation of the Facility.

X contributed the Facility to P pursuant to the limited partnership agreement entered into as of Date 5. Pursuant to the partnership agreement, P paid to B a fee for its services in developing the Facility and also reimbursed it for the costs incurred in moving, setting up, and operating the Facility for test purposes at the present location at Site E.

P entered into an agreement with C for the operation and maintenance of the Facility. C is subject to the direction and control of P, which has the sole authority to set production levels and make other strategic decisions. C is paid a fixed fee for general administration duties and a graduated fixed fee per ton of synthetic fuel produced for operation and management duties. P will pay all operating costs.

Pursuant to a coal feedstock supply agreement, Y has agreed to sell coal feedstock to P. If Y is unable to provide sufficient coal supply to satisfy P's requirements, P can purchase its feedstock from other suppliers. P also entered into a synthetic fuels sales agreement with Y where Y agreed to purchase a certain amount of the synthetic fuel produced at the Facility each year. P has represented that all sales of synthetic fuel will be to unrelated persons.

P has supplied a detailed description of the process employed in the Facility for the production of synthetic fuel. As described, the Facility and the process implemented in the Facility 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 using the process, including specified reagents, that will be used at the Facility and have submitted reports in which the experts conclude that significant chemical changes take place with the application of the process to the coal.

Under the limited partnership agreement of P, 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.

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(l) and its regulations are relevant to the interpretation of the term under section 29(c)(1)(C). Former section 48(l)(3)(A)(iii) provided a credit for the cost of equipment used for converting an alternate substance into a synthetic liquid, gaseous, or solid fuel. Rev. Rul. 86-100 notes that both section 29 and former section 48(l) 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 “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 test results submitted by P, we agree that the fuel produced in the Facility using the process and reagents described in P’s ruling request and subsequent correspondence will result in a significant chemical change to the coal, transforming the coal into a solid synthetic fuel from coal. Because P owns the Facility and operates and maintains the Facility through its agent, we conclude P will be entitled to the section 29 credit for the production of the qualified fuel from the Facility 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 which 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. The construction contract, 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. In addition, the contract does not limit damages to a specified amount. P provided an opinion of counsel that the contract is binding under applicable state law prior to January 1, 1997. Therefore, we conclude that the Facility was constructed pursuant to a binding written contract for purposes of section 29(g)(1)(A).

RULING REQUESTS #4 & #5

Sections 29(f)(1)(B) and (f)(2) of the Code provide that section 29 applies with respect to qualified fuels which 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) of the Code modifies section 29(f) in the case of a facility producing qualified fuels described in section 29(c)(1)(C), which qualified fuels include solid synthetic fuels produced from coal or lignite. Section 29(g)(1)(A) provides that for purposes of section 29(f)(1)(B), such a facility is to 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) is to be applied by substituting for the date therein January 1, 2008.

To qualify for the section 29 credit, P's Facility 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. Section 1.167(a)-11(e)(1)(i) and section 1.46-3(d)(1)(ii) of the 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, if P's Facility was "placed in service" prior to July 1, 1998, within the meaning of section 29(g)(1), relocation of P's Facility 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 section 29 if the fair market value of the original property is more than 20 percent of the Facility's total fair market value at the time of relocation or replacement. When property is placed in service is a factual determination, and we express no opinion on when P's Facility was placed in service.

RULING REQUEST #6

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 <u>first</u> 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 Facility was “placed in service” prior to July 1, 1998 within the meaning of section 29(g)(1), the sale of the Facility after June 30, 1998, will not result in a new placed in service date for the Facility 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 P’s Facility was placed in service.

RULING REQUEST #7

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 may be passed through to, and allocated to, the partners of P in accordance with each partner's interest in P when the credit arises. For the section 29 credit, a partner'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 what constitutes a valid allocation.

RULING REQUEST #8

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 a termination of P under section 708(b)(1)(B) will not preclude the reconstituted partnership from claiming the section 29 credit on the production and sale of synthetic fuel to unrelated persons.

CONCLUSIONS

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

(1) The synthetic fuel produced by the Facility is a solid synthetic fuel produced from coal feedstock and constitutes a “qualified fuel” as defined in section 29(c)(1)(C);

(2) The production of the qualified fuel from the Facility will be attributable solely to P, entitling P to the section 29 credit for qualified fuel sold to unrelated persons;

(3) The contract for construction of the Facility constitutes a “binding written contract” in effect before January 1, 1997 for purposes of section 29 (g)(1)(A);

(4) If the Facility was “placed in service” prior to July 1, 1998 within the meaning of section 29(g)(1), relocation of the Facility 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 is more than 20 percent of the Facility’s total fair market value at the time of relocation or replacement (we express no opinion on when P’s Facility was placed in service);

(5) The Facility is “placed in service” for purposes of section 29(g)(1) on the date the

Facility was first placed in a condition or state of readiness and availability to produce qualified fuel, as provided in Regulations sections 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i) (we express no opinion on when the Facility was placed in service);

(6) If the Facility was “placed in service” prior to July 1, 1998 within the meaning of section 29(g)(1), the sale of the Facility after June 30, 1998, will not result in a new placed in service date for the Facility for purposes of section 29 for the new owner (we express no opinion on when P’s Facility was placed in service);

(7) The section 29 credit attributable to P may be allocated to the partners of P in accordance with the partners’ interests in P when the credit arises. For the section 29 credit, a partner’s interest in P is determined based on a valid allocation of the receipts from the sale of the section 29 qualified fuel; and

(8) A termination of P under section 708(b)(1)(B) will not preclude the reconstituted partnership from claiming the section 29 credit on the production and sale of synthetic fuel to unrelated persons.

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 Facility was placed in service for purposes of section 29.

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.

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: