Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Section 45K - Credit for Fuel Produced from a Nonconventional Source

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent .

ISSUES

(1) For purposes of § 45K[1] of the Internal Revenue Code, is gas collected from landfills that is not energy-production grade a "qualified fuel"?

(2) What equipment is necessary to qualify for production of landfill gas?

(3) Is ownership of the equipment producing the landfill gas necessary for the production to be attributable to the taxpayer?

(4) What constitutes a "sale" for purposes of § 45K?

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[1] Section 45K, as redesignated by the Energy Tax Incentives Act of 2005, P.L. 109-58, applies generally to tax years ending after December 31, 2005. For tax years ending prior to that date, § 29 applies. The analysis given below with respect to § 45K applies equally to § 29 except where noted. Section 29 was not part of the general business credit under § 38 and no carryback or carryforward of unused credit was available.

(5) Will § 53 permit a corporate minimum tax credit carryover of an acquired C corporation to be used to reduce the tax liability of shareholders of an S corporation that acquired the C corporation?

CONCLUSIONS

(1) For purposes of § 45K, a “qualified fuel” must be energy-production grade. Therefore, gas collected from landfills must be energy-production grade, or pipeline grade methane in order for the sale of such gas to qualify for the § 45K credit.

(2) All equipment necessary to produce energy-production grade fuel from landfill gas must have been placed in service by the applicable date in order for the gas produced to qualify for the credit.

(3) The taxpayer must have an ownership interest in the equipment producing the landfill gas for the production to be attributable to the taxpayer.

(4) A sale is any transfer to an unrelated person, within the meaning of § 45K(d)(7).

(5) Section 53 does not permit a corporate minimum tax credit carryover of an acquired C corporation to be used to reduce the tax liability of shareholders of an S corporation that acquired the C corporation.

FACTS

The promoters created a multi-tiered partnership structure in which the top-tier entity allegedly produces and sells landfill gas, generating tax credits for the production of fuel from a nonconventional source as provided in § 45K. An alternative energy development company allegedly leases from landfill owners the right to extract methane gas from landfill sites. The top-tier entity leases these extraction rights from the development company in exchange for a gas sales agreement under which the company agrees to purchase (at an agreed-upon price) from the top-tier entity any methane extracted, provided that the entity must extract a minimum amount. Credits allegedly generated by this activity flow down to the investor partners.

In many cases the gas collected from the landfills was not of energy-production grade and was simply flared off.

LAW AND ANALYSIS

Section 45K/29/44D – The Credit for Producing Fuel from a Nonconventional Source

Section 45K(a) provides a production credit for fuel produced from a nonconventional source of $3 (adjusted for inflation)[2] multiplied by the barrel-of-oil equivalent of qualified fuels sold by the taxpayer to an unrelated person, the production of which is attributable to the taxpayer.

Section 45K(c)(1)(ii) defines “qualified fuel” to include gas produced from biomass, including fuels used as feedstocks.

Section 45K(c)(3) defines “biomass” as any organic material other than oil and natural gas (or any product thereof) and coal (including lignite) or any product thereof.

Section 45K(d)(3) provides that, in the case of a property or facility in which more than one person has an interest, production from the property or facility (as the case may be) shall be allocated among such persons in proportion to their respective interests in the gross sales from such property or facility.

Section 45K(d)(5) provides that the term “barrel-of-oil equivalent” with respect to any fuel means that amount of such fuel that has a Btu content of 5.8 million.

Section 45K(d)(7) provides that persons shall be related to each other if such persons would be treated as a single employer under the regulations prescribed under § 52(b). In the case of a corporation which is a member or an affiliated group of corporations filing a consolidated return, such corporation shall be treated as selling qualified fuels to an unrelated person if such fuels are sold to such a person by another member of such group.

Under § 45K(f), the credit applies to fuel produced from biomass if the facility was placed in service before July 1, 1998, pursuant to a binding contract in effect before January 1, 1997. In the case of a facility originally placed in service after December 31, 1992, the fuel must have been sold before January 1, 2008.[3]

The credit for the production of fuel from a nonconventional source was first enacted as § 44D as part of the Crude Oil Windfall Profit Tax Act of 1980 (COWPTA), Pub. L. No. 96-223. The Senate Finance Committee described the reasons for the credit as follows:

> The committee believes that a tax credit for the production of energy from alternative sources will encourage the development of these resources by decreasing the cost of their production relative to the price of imported oil.

[2] The Service publishes a notice describing the inflation adjustment every year, most recently Notice 2009-32, 2009-17 I.R.B. 865.

[3] In the case of a facility originally placed in service prior to January 1, 1993, the fuel must have been sold before January 1, 2003.

> These alternative energy sources typically involve new technologies, and some subsidy is needed to encourage these industries to develop to the stage where they can be competitive with conventional fuels. The information gained from the initial efforts at producing these energy sources will be of benefit to the entire economy. …
>
> If the credit leads to the development of these alternative sources, it will make a major contribution to reducing our dependence on imported energy.

S. Rep. No. 394, 96th Cong., 1st Sess. 87 (1979), 1980-3 C.B. 131, 205. The Conference Report confirms that "[t]he conference agreement adopts a modified version of the Senate amendment." H.R. Rep. No. 817, 96th Cong., 2d Sess. 139, 1980-3 C.B. 245, 299. Section 44D was redesignated as section 29 by section 471(c) of the Deficit Reduction Act of 1984, Pub. L. 98-369, 1984-3 C.B. (Vol. 1) 334. Section 29 was redesignated as § 45K by section 1322 of the Energy Policy Act of 2005, Pub. L. 109-58. Neither the redesignation of § 44D as § 29 in 1984 nor the later redesignation of § 29 as § 45K changed the fundamental purpose of the production credit, to decrease the cost of the production of fuels produced from nonconventional sources so those fuels could compete with conventional fuels.

Issue (1)

Initially, gas produced from a landfill may constitute a qualified fuel inasmuch as it is produced from biomass, within the meaning of § 45K(c)(3). However, that does not mean that any substance gathered at a landfill constitutes a qualified fuel, and that its sale gives rise to the § 45K credit. To determine whether gas collected from landfills must be energy-production grade in order to be a "qualified fuel" within the meaning of § 45K, we look to the purpose of the credit as well as to the actual statute. The intent of Congress in enacting the credit for the production of fuel from a nonconventional source was to decrease the production costs of fuels from nonconventional sources as compared to conventional fuels to equalize the price of those fuels in the marketplace and to promote the development of nonconventional sources. Development of these nonconventional sources was intended to reduce the United States' dependence on imported sources of energy. Only a substance sold for use as a fuel satisfies the intent of this provision.

Section 45K provides a credit for the production of qualified *fuel*, defined to include gas produced from biomass. While the term "fuel" is not defined in the statute, the dictionary definition is "[a] material such as wood, coal, gas, or oil burned to produce heat or power." The American Heritage Dictionary of the English Language, Fourth Edition (2004). For a substance, here landfill gas, to be a fuel, it must be of sufficient purity to be burned to produce heat or power, or for use as a feedstock, i.e. pipeline quality methane. Prior to the point in the processing of the gas when the gas is refined to pipeline quality methane. it is not yet a qualified fuel. See generally, Murphy Oil USA v. United States, 81 F.Supp 2d 942 (W. D. Ark. 1999) (The excise tax under

§ 4661 on propylene was due when the taxpayer reached refinery grade propylene; prior to that point, the substance was an intermediate hydrocarbon stream and no tax was due on its sale.). Thus, until the gas is refined to pipeline quality methane, it is not a qualified fuel within the meaning of § 45K and the sale of such gas does not give rise to a credit under § 45K.

Issue (2)

In order to qualify for the § 45K credit, qualified fuel produced from biomass must be produced in a facility that was placed in service before July 1, 1998, pursuant to a binding contract in effect before January 1, 1997. Thus, it is important to know what constitutes the facility. Section 45K does not define facility. The definition of facility depends on the type of qualified fuel produced at the facility. For the recovery and refining of landfill gas, the facility is any machinery and equipment necessary to produce (or gather), filter, compress, and measure the gas. For the sale of the substance at issue here to give rise to a credit under § 45K, all equipment described above must have been placed in service prior to July 1, 1998, pursuant to a binding contract in effect before January 1, 1997.

Issue (3)

Section 45K(a) provides a production credit for fuel produced from a nonconventional source of $3 multiplied by the barrel-of-oil equivalent of qualified fuels sold by the taxpayer to an unrelated person, the production of which is attributable to the taxpayer. Section 45K(d)(3) clarifies that "attributable to the taxpayer" means, in the case of a property or facility in which more than one person has an interest, production from the property or facility (as the case may be) shall be allocated among such persons in proportion to their respective interests in the gross sales from such property or facility.

Congress addressed this issue in the original Senate report. It states:

> Taxpayers would be entitled to the credit in proportion to their ownership interest in the facility or the production. In the case of production from shale, geopressured brine, coal seams, Devonian shale, and tar sands, the credit would be based on the taxpayer's economic interest in the property (within the meaning of Code Sec. 613(a)). The production attributable to the taxpayer for any tax year would be equal to an amount which bears the same ratio to total production from the property for that year as the amount of the taxpayer's gross income from the property, on account of that production, bears to the aggregate gross income from the property of all persons having an economic interest in the property. In the case of energy production from biomass, solid agricultural by-products, coal liquification and gasification, and qualifying processed wood, the credit would be based on the taxpayer's interest in the facility.

S. Rep. No. 394, infra, 1980-3 C.B. 131, at 206.

To illustrate the Senate report, in Rev. Rul. 93-46, 1993-2 C.B. 3, in a case arising under then-section 29, the Service considered a situation in which the fee interest owner entered into a mineral lease with a third party, assigning all operating rights but retaining a royalty interest. The gas produced was a qualified fuel when extracted. After analyzing the regulations under §§ 611 and 614, the Service determined that, under those regulations, both the royalty and operating interests constituted economic interests in the production and concluded that both were entitled to claim their shares of the credit as determined by their allocable share of the production. Similarly, in Rev. Rul. 94-48, 1994-2 C.B. 3, the Service held that the owner of a net profits interest in a mineral property that produced qualified fuel was entitled to a share of the credit under a formula provided therein. Both of these cases concern situations in which the taxpayer had an economic interest in the property, which is the source of the qualified fuel. In this case, however, the source of the qualified fuel is the facility in which the gas is gathered, filtered, compressed, and measured and in order for production to be attributable to the taxpayer, the taxpayer must have an economic interest in the facility. It is not necessary that the taxpayer operate the equipment in order for production from the facility to be attributable to the taxpayer. The economic interest of the taxpayer can be a leasehold interest or an outright ownership interest but it must have economic substance. Whether an interest has economic substance or lacks economic substance is an issue of fact to be resolved based on all the facts and circumstances.

Issue (4)

Section 45K(a) provides a credit for fuel produced from a nonconventional source and sold by the taxpayer to an unrelated person, the production of which is attributable to the taxpayer. Section 45K does not further define “sale” except to require that the sale be to an unrelated party. Thus, any transfer to an unrelated person, as defined in § 45K(d)(7), qualifies as a sale. Whether there is an actual transfer of the fuel is a matter of fact that must be determined by examining all of the facts and circumstances. Ownership of the fuel must be transferred in fact. In answer to your request regarding whether designation of a point in a pipeline as the point at which the fuel is considered sold, fuel can be sold in place so designation of the arrival of the fuel at a particular point in a pipeline as the time that sale occurs does not violate § 45K if the fuel is actually transferred at that time.

Issue (5)

The field has essentially asked whether § 53 would permit a corporate minimum tax credit carryover of an acquired C corporation to be used to reduce the tax liability of shareholders of an S corporation that acquired the C corporation.

A corporate taxpayer that is subject to the AMT may indefinitely carryforward its unused minimum tax credits. In addition, pursuant to § 381(c)(25), the minimum tax credits pass to an acquiring corporation in a transaction under § 381(a).

The taxpayer correctly asserts that, for the years involved, the amount of unused credits under former § 29 may, under certain circumstances, increase the corporation's minimum tax credit pursuant to §§ 53(b) and 53(d)(1)(B)(iii) (note that there are no facts for us to determine whether the aforementioned circumstances are present here). However, the argument the taxpayer is making that the acquiring S corporation's shareholders are permitted to use the acquired C corporation's minimum tax credit carryforwards seems to us to be totally without merit. Except for minimum tax credits of an acquired corporation that are available to the acquiring corporation pursuant to a transaction under § 381(a), the only taxpayer that may claim a minimum tax credit under § 53 is the taxpayer that incurred the alternative minimum tax liability. We understand that the possible application of the provisions of Subchapter K to this situation are being considered separately.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views. Please call if you have any further questions regarding issues 1, 2, 3, and 4. For questions regarding issue 5, please call

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