Internal Revenue Service

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Department of the Treasury

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Person to Contact:

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Refer Reply To:
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Date:
APRIL 16, 2002

In Re:

LEGEND:

P	=
A	=
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D	=
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Date 1	=
Year 2	=
Date 3	=

Dear :

This letter responds to a letter dated December 10, 2001 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 and operating a facility (Facility) for the production of solid synthetic fuel from coal. P is classified as a partnership for federal income tax purposes. The members of P are A and B. A holds a 66 2/3% ownership interest in P and B holds a 33 1/3% ownership interest in P. P owns the Facility through its interest in C, a wholly owned limited liability company that is disregarded for federal income tax purposes.

A is a limited liability company that is classified as a partnership for federal income tax purposes. A is owned by D and D's wholly owned subsidiary, E. D is engaged in a number of businesses, directly and through affiliates, including investments in the energy sector.

B is a corporation engaged in the business of acquiring and developing various energy-related projects and investments. B owns its interest in P through its interest in F, a wholly owned limited liability company that is disregarded for federal income tax purposes. Before Date 3, F was owned by G and B. On Date 3, B acquired G's interest in F.

F built the Facility pursuant to a construction contract entered into before December 31, 1996 by H, which was assigned to F on Date 1. Based upon an opinion of counsel provided by P, as of December 31, 1996, the construction contract was a legal, valid and binding obligation of H under applicable state law, enforceable against H in accordance with its terms. In addition, the construction contract (i) did not limit the amount of damages that could be paid in the event of a default under the contract to any specific amount, (ii) included a description of the Facility to be constructed, (iii) provided for a completion date and (iv) specified the price for the Facility. P represents that the Facility was placed in service within the meaning of section 29(1)(A) before July 1, 1998.

As described in the ruling request and subsequent correspondence from P's authorized representative, the Facility consists of a pug mill and three roll briquetters. In the process (Process) by which synthetic fuel is produced in the Facility, coal feedstock and a chemical reagent are mixed thoroughly in the pug mill and transported to the briquetters. The mixture is gravity-fed into the three briquetters through one of three feed hoppers where final processing occurs.

In Year 2, F relocated and reassembled the Facility to the site of X located in State Y. P has represented that, following the relocation, the fair market value of the original property comprising the Facility was more than 20 percent of the Facility's total fair market value (the cost of the new property plus the value of the original property).

On Date 3, B (acting through F) conveyed the Facility to P (indirectly by transferring to P all of the interest in C) in exchange for a cash payment plus the issuance of a 33- 1/3% membership interest in P. The cash portion of the purchase price is subject to adjustment under certain circumstances. 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. A member may elect to produce less than its ownership interest share of synthetic fuel in which case its obligation to pay operating costs will be proportionately reduced.

P has entered into a number of auxiliary agreements with I, J, K, L and M, which are unrelated to P. I owns X and has granted to P an easement at the site of X to enable P to operate the Facility at that site. Under the easement, P has agreed to pay I a fixed monthly rent and an additional rental fee based on the amount of synthetic fuel sold to third parties. Pursuant to a feedstock supply agreement, I has agreed to sell coal feedstock to P. If I fails to deliver the coal feedstock it is required to deliver, P can purchase its feedstock from other suppliers.

P has entered into an agreement with J for the operation and maintenance of the Facility. P has the sole authority to set production levels and make other strategic decisions. P may remove J as operator for cause for breach of its obligations and without cause under certain circumstances. J is paid a fixed fee (adjusted for inflation) per ton of synthetic fuel produced. Any capital costs associated with the Facility will be paid by P and must be authorized by P. P, as owner of the Facility, is responsible for supplying feedstock and chemical reagent for the Facility. J will also provide material handling services to P pursuant to a separate agreement, for a fixed fee per ton, adjusted each year for inflation.

P has entered into synthetic fuel sales agreements with K and L, pursuant to which K and L have each agreed to purchase a minimum amount of synthetic fuel each year, subject to P's sole discretion to set the level of synthetic fuel sales. If either K or L 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. M will act as P's agent in arranging for sales of synthetic fuel to third parties pursuant to an agency agreement.

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

Recognized experts in coal combustion chemistry conducted numerous tests on the synthetic fuel produced from coal feedstock using the Process, including the alternative chemical reagents that may be used at the Facility. The experts have submitted multiple reports concluding that significant chemical changes take place with the application of the Process to the coal feedstock.

Under the limited liability company agreement of P, all items of income, gain, loss, deduction, and credit, including the section 29 credit, of P are generally allocated, and any distributions made, in proportion to the members' ownership interests, 66 2/3% to A and 33 1/3% to B. Income and section 29 credits arising from sales of synthetic fuel produced during a particular quarter, and deductions for operating costs incurred in such quarter, are allocated to the members in accordance with the ratio of their respective capital contributions to fund operating costs for that quarter.

The rulings requested by P are as follows:

(1) P, 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) The production of the qualified fuel from the Facility will be attributable solely to P, entitling P to the section 29 credit for the production of qualified fuel from the Facility that is sold to an unrelated person;

(3) The contract for the construction of the Facility constitutes a "binding written contract" within the meaning 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 under the principles of section 702(a)(7), in accordance with each member's interest in P at the time the section 29 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) The acquisition of the Facility by P will not affect the placed-in-service date of the Facility for purposes of section 29;

(6) Any termination of P under section 708(b)(1)(B) arising from sales or exchanges of interests in P will not preclude P as reconstituted from taking the section 29 credit for the production and sale of qualified fuel to unrelated persons; and

(7) 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 X 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.

RULING REQUESTS 1 AND 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 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 the Facility using the Process on the coal feedstock, including the use of alternative chemical reagents, will result in a significant chemical change in coal, transforming the coal feedstock into a solid synthetic fuel. Because P owns the Facility and because J on behalf of P operates and maintains the Facility, we conclude that 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 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 a “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 is 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 price. P provided an opinion of counsel that the construction contract is binding under the applicable state law. Neither the construction contract nor applicable state law limits damages for default to any specific amount. Therefore, we conclude that the Facility was 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 when used in Title 26, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term “person” will be construed to mean and include 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 Treasury Regulation 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* 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 members of P, in accordance with each member’s interest in P when the section 29 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 facilities 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. There is no such limitation on facilities for producing synthetic fuel from coal.

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, the acquisition of the Facility by P will not affect the placed-in-service date of the Facility for purposes of section 29. When property is placed in service is a factual determination, and we express no opinion on when the Facility was 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 will not preclude the reconstituted partnership from claiming the section 29 credit for the production and sale of synthetic fuel to unrelated persons.

RULING REQUEST 7

To qualify for the section 29 credit, the 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. 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, 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 X 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 Facility was placed in service.

CONCLUSIONS

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

(1) P, 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) The production of the qualified fuel from the Facility will be attributable solely to P, entitling P to the section 29 credit for the production of qualified fuel from the Facility that is sold to an unrelated person;

(3) The contract for the construction of the Facility constitutes a "binding written contract" within the meaning 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 principles of section 702(a)(7), in accordance with each member's interest in P at the time the section 29 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) The acquisition of the Facility by P will not affect the placed-in-service date of the Facility for purposes of section 29;

(6) Any termination of P under section 708(b)(1)(B) arising from sales or exchanges of interests in P will not preclude P as reconstituted from taking the section 29 credit for the production and sale of qualified fuel to unrelated persons; and

(7) 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 X 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. We express no opinion on when the Facility was 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 Facility was 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. 2002-1, 2002-1 I.R.B. 1. However, when the criteria in section 12.05 of Rev. Proc. 2002-1 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 Technician Reviewer, Branch 7
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:

Copy for section 6110 purposes