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Nov. 03, 1998

Taxpayer

Member A

Member B

Licensor
Facility

Contractor
Company A
Company B
Company C
District

Dear

This responds to a letter dated December 12, 1997, and additional correspondence, submitted on behalf of the Taxpayer by its authorized representative, requesting rulings under sections 29, 702, and 708 of the Internal Revenue Code relating to a facility for producing solid synthetic fuel from coal fines. The following eight rulings are requested: (1) Taxpayer, with the use of the enumerated process, will produce a "qualified fuel" within the meaning of section 29 (c)(1)(C); (2) Production from the Facility will be attributable to Taxpayer within the meaning of section 29(a)(2)(B); (3) Taxpayer 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; (4) Each of the contracts for construction of the Facility constitutes a "binding written contract" within the meaning of section 29(g)(1)(A); (5) The credit allowed under section 29 may be passed through to and allocated among all members of Taxpayer in accordance with the principles of section 702(a)(7); (6) A future termination of Taxpayer under section 708(b)(1)(B) will not preclude the new partnership from taking the section 29 credit for the production of the "qualified fuel" from the Facility that is sold to an

unrelated person; (7) Because the Facility was "placed in service" within the meaning of section 29(g)(1), the Facility will continue to be treated as placed in service before July 1, 1998, if sold to a new owner after that date; and (8) Because the Facility was "placed in service" prior to within the meaning of section 29(g)(1), relocation 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 provided the fair market value of the used property is more than 20 percent of the relocated Facility's total fair market value at the time of the relocation.

We understand the facts as presented by Taxpayer's authorized representative to be as follows:

Taxpayer is a limited liability company treated as a partnership for federal income tax purposes. Taxpayer currently has two members: Member A and Member B. The District Director for the District has audit jurisdiction over Taxpayer's partnership tax returns.

Taxpayer was formed to engage in the business of producing and selling a solid fuel from coal fines (the "Product") using a process licensed to the Taxpayer by the Licensor. Taxpayer has constructed, and will own and operate the Facility for producing the end product. The Facility is comprised of two production lines located within a single metal building. The Facility was constructed pursuant to entered into by the Licensor with the Contractor on Licensor assigned those contracts to Taxpayer as of Each of the construction contracts is valid under state law and does not limit the damages recoverable under the contract to an amount less than of the contract amount. Taxpayer represents that the Facility was placed in service before July 1, 1998.

The Facility was constructed and will be operated on property (the "Site") held under lease by Member B and subleased to the Taxpayer under a Sublease. Member B has entered into a Feedstock Supply Agreement to supply coal fines feedstock to the Facility. The coal fines feedstock will be supplied principally from Member B's coal preparation plant operations. Member B is installing a recovery circuit as part of its coal preparation plant to recover ultra-fine coal. The ultra-fine coal previously could not be recovered and was part of the waste stream discharge from the coal preparation plant. Depending upon volume requirements, Member B may blend the coal fines recovered from the recovery circuit with other coal fines and deliver the blended coal fines to the Facility as a feedstock.

The Taxpayer has entered into Sales Agency Agreements with the Companies A, B, and C. These companies act as coal sales agents, brokers, and marketers for both related companies and

unrelated third parties. Under the Sales Agency Agreements, Companies A, B, and C will use reasonable best efforts to market the end product on behalf of the Taxpayer to unrelated purchasers. Those sales may occur on the spot market or pursuant to long-term contracts presented to the Taxpayer by Companies A, B, and C and approved by the Taxpayer.

The process at the Facility utilizes styrene monomers that are acrylonitrile and polyvinyl alcohol and injection pressure to chemically change the coal fines (in this case, mostly waste coal fines) into a solid fuel. Once the coal fines have been collected, sized and cleaned or blended, the process consists of three sequential steps.

In the first step, the cleaned coal fines may have an emulsion surfactant used to remove undesirable compounds such as clay and silicates. Concentrated acid is then combined with the fines to produce fixed carbon receptor sites which allow for attachment of an epi-oxygen structure to carbon matrices.

The second step of the process uses a two-step chemical reaction to capture the carbon matrices into a cross linked epi-oxygen structure which is capable of withstanding the temperatures and handling associated with solid fuel uses. Two monomers freely attach to the receptor sites prepared in the first step as the catalysts used to derive the monomers evaporate. During this reaction, the monomers are co-polymerized and attached to the carbon component receptor sites. Coal fines are changed by covalently attaching a polymer at the modified carbon matrices of the coal fines and restructuring the resulting end product into a cross linked epi-oxygen type structure.

The third step of the process uses shear force, heat, and pressure to react the derived product from the second step into a final shaped form which is convenient for use in solid fuel applications. The Facility will incorporate pellitizers to shape the end product. Shear forces in this step induce an exothermic reaction which is necessary to anneal the derived product into a consistent compound. Heat is used to drive off catalysts and moisture and render the derived end product into a hard, shaped structure that can be used as a solid fuel.

Taxpayer had numerous tests performed on the coal feedstock and the solid fuel to be produced in Taxpayer's Facility. Based on the preponderance of these tests, Taxpayer alleges that there is a significant difference in the chemical composition of the coal feedstock and the solid fuel. The polymeric binder, which consists of about to the British thermal units (Btus) of the end product, which is a solid fuel.

<u>RULING REQUEST #1</u>

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.

Section 29(d)(5) of the Code defines the term "barrel-of-oil equivalent" with respect to any fuel as that amount of the fuel that has a Btu content of 5.8 million; except that in the case of qualified fuels described in section 29(c)(1)(C), the Btu content must be determined without regard to any material from a source not described in section 29(c)(1)(C).

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 <u>synthetic</u> liquid, gaseous, or <u>solid fuel</u>. 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 the Taxpayer and the preponderance of Taxpayer's test results on the coal feedstock and the fuel to be produced, we agree that the fuel to be produced in Taxpayer's Facility using the enumerated process on the coal fines will result from a significant chemical change in coal, transforming the coal into a solid synthetic fuel from coal that is a qualified fuel.

<u>RULING REQUESTS #2 AND #3</u>

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.

Under section 7701(a)(14), "taxpayer" means any person subject to any internal revenue tax. Furthermore, section 7701(a)(1) provides that when used in title 26, where not

otherwise distinctly expressed or manifestly incompatible with the intent thereof, "person" will be construed to mean and include an individual, trust, estate, partnership, association, company, or corporation.

Taxpayer is the taxpayer for purposes of section 29(a)(2)(B) of the Code because a limited liability company such as Taxpayer may be treated for tax purposes as either a partnership or a corporation, either of which is a taxpayer under section 7701(a)(14). Taxpayer will own and operate the Facility and will be producing and selling the end product. All production of qualified fuels by the Facility therefore will be attributable to Taxpayer within the meaning of section 29(a)(2)(B).

Taxpayer has represented that all sales of end product made on behalf of Taxpayer by Companies A, B, and C will be sales to unrelated persons within the meaning of section 29(d)(7). Because production from the Facility will be attributable to Taxpayer, we conclude that Taxpayer will be entitled to the section 29 credit for the production of qualified fuel that is sold to an unrelated person.

RULING REQUEST #4

Section 29(f)(1)(B) and (f)(2) provide that section 29 applies with respect to qualified fuels which are produced in a facility place 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 contracts, executed include such essential features as a description of the facility to be constructed, a completion date, and a maximum price. It is represented that the contracts are binding under applicable law and that the contracts do not limit damages to an amount less than of the cost of the Facility. Therefore, each

of the contracts is a binding written contract for purposes of section 29(g)(1).

RULING REQUEST #5

Taxpayer also requested a ruling that, assuming the other requirements of section 29 are met, the sale of the end product by Taxpayer will entitle the members of Taxpayer to claim the section 29 credit in the year of sale.

Under section 7701(a)(14), "taxpayer" means any person subject to any internal revenue tax. Generally, under section 7701(a)(1), 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 regulation prescribed by the Secretary of the Treasury. Under section 1.702-1(a), the distributive share is determined as provided under 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 (1) the partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have 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, any allocations of the tax credits or tax credit recapture cannot have economic effect under section 1.704-1(b)(2)(ii)(b)(1), and so 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 the expenditure 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). The credit provided by section 29 is based on receipts from the sale of qualified fuels. Therefore, any allocation of the credit in proportion to the allocation of the receipts from the sale of the qualified fuel will be respected if the allocation of the receipts satisfies the substantial economic effect safe harbor or the allocation is consistent with the partners' interest in the partnership.

An allocation of a partnership item that has a corresponding economic benefit or burden is a valid allocation under section 704(b) if the allocation satisfies either (1) the substantial economic effect safe harbor of section 1.704-1(b)(2), or (2) the partner's interest in the partnership standard of section 1.704-1(b)(3). To satisfy the substantiality component of the substantial economic effect safe harbor, the economic effect of the allocation must be substantial under section 1.704-1(b)(2)(iii).

Under the provisions of section 1.704-1(b)(2)(iii), an allocation is not substantial if (1) the after-tax economic consequences (including the effect of the section 29 credit) of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax consequences that result from the allocation, the interaction of the allocation with the partner's tax attributes that are unrelated to the partnership is taken into account.

After applying the relevant law to the facts represented, we conclude that the section 29 credit attributable to Taxpayer may be allocated to its members in accordance with their interests in Taxpayer when the credit arises. For the section 29 credit, a member's interest in Taxpayer is determined based on a valid allocation of the receipts from the sale of the section 29 credit qualified fuel.

RULING REQUESTS #6 AND #7

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 or 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.

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, 1990, on property which first began production after January 1, 1980. The section 44D credit for qualifying processed wood was available only as to production and sales from facilities first placed in service in calendar years 1980 and 1981. As to production from those facilities, the credit was available for production and sales before either October 1, 1983, or 3 years from the date that the facility was first place in service, whichever came later. The section 44D credit for steam from solid agricultural byproducts was available only for production and use before January 1, 1985, in facilities placed in service after December 31, 1979. In addition, there was a special rule for post-1979 increases in production capacity or replacement of facilities <u>first placed in service</u> before 1980. Such production capacity increases or replacements were treated as facilities first placed in service after 1979. H.R. Conf. Rep. No. 817, 96th Cong., 2d Sess. 139-41 (1980), 1980-3 C.B. 299-301.

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 2008 for the end of the credit period), and Small Business Job Protection Act of 1996 (June 30, 1998, for placed in service).

If section 29(f)(1)(B) were read as requiring facilities producing qualified fuels to be placed in service by the taxpayer, facilities placed in service before 1980 that are sold or transferred to a new taxpayer after 1979 would not entitle the purchaser/transferee to claim the section 29 credit. 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 <u>first</u> placed in service, not when the facility is transferred or sold to a different taxpayer. Therefore, although a section 708(b)(1)(B) termination of Taxpayer would result in a deemed transfer of assets to a new partnership, this technical termination of the partnership and formation of a new partnership would not affect when the facility is placed in service for purposes of section 29. A future termination of Taxpayer under section 708(b)(1)(B) will not preclude the new partnership from taking the section 29 credit for the production of the qualified fuel from the facility that is sold to an unrelated person. In as much as the Facility was "placed in service" prior to as represented by Taxpayer, the Facility will continue to be treated as placed in service before July 1, 1998, for purposes of section 29 if sold to a new owner after such date.

<u>RULING REQUEST #8</u>

To qualify for the section 29 credit, Taxpayer'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. Sections 1.167(a)-11(e)(1)(i) and 1.46-3(d)(1)(ii). "Placed in service" has consistently been construed as having the same meaning for purposes of the deduction for depreciation and the investment tax credit. <u>See</u> 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 section 45 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, the relocation of Taxpayer's Facility after June 30, 1998, will not prevent the relocated facility from continuing to be treated as originally placed in service prior to July 1, 1998, for purposes of section 29 provided the fair market value of the used property is more than 20 percent of the relocated facility's total fair market value at the time of the relocation.

CONCLUSIONS

Accordingly, based on the representations of the Taxpayer and the Taxpayer's representative and the facts as we understand them, we rule as follows:

1. Taxpayer, with use of the enumerated process, will produce a "qualified fuel" within the meaning of section 29(c)(1)(C) of the Code.

2. Production of qualified fuel from the Facility will be attributable to Taxpayer within the meaning of section 29(a)(2)(B) of the Code.

3. Taxpayer 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.

4. Each of the contracts for construction of the Facility constitute a "binding written contract" within the meaning of section 29(g)(1)(A).

5. The credit allowed under section 29 may be passed through to and allocated among all the members of Taxpayer in accordance with the principles of section 702(a)(7).

6. A future termination of Taxpayer under section 708(b)(1)(B) will not preclude the new partnership from taking the section 29 credit for the production of the qualified fuel from the facility that is sold to an unrelated person.

7. Because the Facility was "placed in service" within the meaning of section 29(g)(1), the Facility will continue to be treated as placed in service before July 1, 1998, if sold to a new owner after such date.

8. Because the Facility was "placed in service" within the meaning of section 29(g)(1), relocation 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 provided the fair market value of the used property is more than 20 percent of the relocated Facility's total fair market value at the time of the relocation.

No opinion is expressed concerning the consequences of the above described facts under any other provision of the Code or regulations. Specifically, no opinion is expressed concerning the proper characterization of any payments made by Taxpayer to Member A or Member B.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that this ruling 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 been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent any such regulations are inconsistent with any conclusions in this ruling. See section 12.04 of Rev. Proc. 98-1, 1998-1 I.R.B. 7. However, when the criteria of section 12.05 of Rev. Proc. 98-1 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, a copy of this letter is being sent to the Taxpayer's authorized representative. A copy of this letter should be attached to Taxpayer's partnership federal income tax return for the first taxable year that Taxpayer claims the section 29 credit for the qualified fuel produced in the Facility and sold to an unrelated person.

Sincerely yours,

HAROLD E. BURGHART
Assistant to the Chief,
Branch 6
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)