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Refer Reply To:
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Date:
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Dear

This letter responds to a letter dated September 24, 1999, 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:

Y formed a limited liability company, P, to engage in the transaction. P will be treated as a partnership for federal income tax purposes. The partners of P are Y and Z. Z is a wholly-owned subsidiary of Y. Y has complete and exclusive control of the management of P. Y has extensive experience in energy, coal, and related businesses.

P was formed by Y to purchase from A a synthetic fuel facility (the "Facility") that produces a solid synthetic fuel from coal (the "Product"). The Facility will produce the Product using a process licensed to P by A.

P purchased the Facility from A pursuant to a purchase agreement on Date 1. In consideration for the Facility (i) P made a cash payment of $W to A, (ii) P made a cash payment of $X to C in discharge of a portion of A's debt on the Facility, (iii) P assumed certain debt of A by executing a replacement promissory note in the amount of $Y to C, and (iv) P agreed to make a contingent cash payment to A of an additional amount up to $Z based on the Facility satisfying certain performance criteria on or before Date 6.

The Facility was constructed pursuant to a construction contract between A and B entered into on Date 2. The construction contract is for a synthetic fuel production facility consisting of a single production line for producing a solid synthetic fuel from coal using A's patented process. The construction contract provides a guaranteed maximum price and a completion date. The construction contract provides that any damages recoverable by B against A shall not be less than six percent of the total contract price. P provided an opinion of counsel that the construction contract constituted a binding written contract under applicable state laws prior to January 1, 1997, and at all times thereafter through the completion of the contract.

The Facility is skid mounted. The modular equipment, some of which is bolted onto concrete pads, can be unbolted, disassembled and readily moved to another site. Thus, the Facility can be moved to a new site to take advantage of a supply of coal or for other business reasons. The Facility's equipment includes (i) raw feed hoppers that move coal onto belt conveyors which feed the coal to the machinery for processing, (ii) a fluid binder storage tank, (iii) two binder pug mills that mix coal with binder and water, (iv) two pellet mills, machines that compact and extrude the combined material into pellets, and (v) a drying oven which reduces the moisture content of the pellets if necessary.

You have enumerated certain additions, changes, and repairs that will be made to the Facility but will not affect the licensed process or the equipment that implements the process. These additions, changes, and repairs will not increase the production output of the Facility. The cost of the additions, changes, and repairs is less than 20 percent of the total cost of the Facility (that is, purchase price plus cost of additions, changes, and repairs).

The Facility is currently located on property owned by F and leased to A under a site lease agreement. As part of the transaction, P assumed A's rights and obligations under the site lease agreement. P may cancel the site lease agreement by giving six months notice and by paying a cancellation fee to F.

P also assumed A's rights and obligations under an agreement with F for the supply of coal to the Facility and a sales agency agreement with F for the sale of the Product to unrelated purchasers. The coal supply agreement allows P to purchase coal from outside sources under certain circumstances. Pursuant to the sales agency agreement, F has arranged to sell the Product to certain nearby utilities.

P entered into an operation and maintenance agreement with A regarding the Facility. A's compensation will be a quarterly fee adjusted over time for inflation. P will pay all operating costs as set forth in the annual budget. In addition, any capital costs associated with the Facility will be paid by P, and must be authorized by P.

P entered into a license agreement with A granting to P the right to use A's technology, trade secrets, and other intellectual property for producing synthetic fuel from coal. P will pay A a royalty of a fixed dollar amount per ton of the Product produced and sold by P for use of the technology. The license agreement also provides that A will sell to P all of P's requirements of binder for the Facility. The price of the binder is A's cost to produce the binder plus a fixed amount.

P has supplied a detailed description of the process employed in the facility. 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.

A recognized expert in combustion, coal, and chemical analysis has performed numerous tests on the coal that will be used at the Facility and has submitted a report in which the expert concludes that significant chemical changes take place with the application of the process to the coal.

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 <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 P and P's authorized representative, including the preponderance of the test results, we agree that the fuel to be produced in P's Facility using the described process on the coal will result in a significant chemical change in coal, transforming the coal fines into a solid synthetic fuel from coal. Because P will own the Facility and operate and maintain the Facility through its agent, 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 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. The contract also provides that damages shall not be less than six percent of the total contract price. P provided an opinion of counsel that the contract is binding under applicable law. Therefore, the contract is a binding written contract for purposes of section 29(g)(1).

RULING REQUEST #4

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 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 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 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 the 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 #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).

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 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 first placed in service within the applicable dates. The placed-in-service deadlines contained in sections 29(f) and 29(g) focus on the facility, and not the owner of the facility. The legislative history of section 44D clearly shows that Congress wanted to encourage the production of new alternative fuels from facilities first placed in service after 1979, and not provide tax incentive for production capacity in service before 1980.

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

Accordingly, the determination of whether a facility has satisfied the placed-in-service deadline under either section 29(f)(1)(B) or 29(g)(1)(A) is made by reference to when the facility is first placed in service, not when the facility is transferred or sold to a different taxpayer. Therefore, if P's 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 #6

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.

Section 7701(a)(14) provides that "taxpayer" means any person subject to any internal revenue tax. Generally, under section 7701(a)(1), the term "person" includes an individual, a 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. Section 1.702-1(a) provides that 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 partners interest in the partnership (determined by taking into account all facts and circumstances) if (1) the partnership agreement does not provide as to 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.

Section 1.704-1(b)(4)(ii) provides that 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 credit recapture arises. If a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership tax 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 with respect to such 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 with respect to 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 allocated to the members of P in accordance with the members' interests in P when the credit arises. For the section 29 credit, a member's interest in P is determined based on a valid allocation of the receipts from the sale of the section 29 qualified fuel.

RULING REQUEST #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 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) P, with use of the enumerated process, 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 the qualified fuel from the Facility that is sold to an unrelated person;

(3) the contract for construction of the Facility constitutes a "binding written contract" within the meaning of section 29(g)(1)(A);

(4) if P's 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 the relocation or replacement (we express no opinion on when P's Facility was placed in service); and

(5) 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 (we express no opinion on when P's Facility was placed in service).

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

(7) 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 or the extent to which modification of the Facility or the process implemented in the Facility might result in a new placed in service date.

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, 2000-1 I.R.B. 4, 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 Technician Reviewer, Branch 7
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
Copy for section 6110 purposes