

**APPEALS
SETTLEMENT GUIDELINES**

INDUSTRY: Abusive Tax Avoidance Transactions

ISSUE: Methane Gas Project (IRC § 29 Credit),
Credit for Fuel from a Nonconventional Source (FNS)

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APPROVED:

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June 20, 2008
Date

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Date

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APPEALS SETTLEMENT GUIDELINES
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Based on a review of the issues proposed by Compliance and the protests filed by and on behalf of taxpayers in several live cases, Appeals' evaluation of the merits and the hazards of litigation with respect to the Methane Gas Project – IRC § 29 FNS Credit is as follows:

STATEMENT OF ISSUE

Whether credits claimed under IRC § 29 for the production and sale of a fuel from a nonconventional source should be disallowed.

COMPLIANCE POSITION

Taxpayers identified with this Project failed to acquire legitimate ownership interests in the methane gas facilities at issue. As a result, during the taxable year, the taxpayers did not sell to unrelated persons a qualified fuel, the production of which is attributable to the taxpayers. Consequently, the taxpayers are ineligible to claim credits under IRC § 29.

TAXPAYER POSITION

Taxpayers assert that they acquired, either directly or indirectly through partnerships, legitimate ownership or lessee interests in methane gas facilities located at various waste landfills that produce and sell qualified fuel to unrelated parties and, therefore, they are entitled to the credit provided under IRC § 29.

FACTUAL BACKGROUND

The promoters of this scheme sell interests in partnerships that purportedly have qualified credits under IRC § 29 to pass through to their partners to reduce or eliminate the partners' current tax liability. The promoters provided the taxpayers with engineering reports purporting to document the legitimacy of the landfills and the biomass fuel produced at facilities owned by the partnerships along with annual income statements and other documents, all of which appear to be very thorough, authoritative and legal.

In a typical arrangement, the taxpayer makes an initial payment for his/her partnership interest and signs a recourse note complete with interest charges for the remainder of the price. The assignor retains (1) any and all income generated by the landfill gas facility as a production fee payment for a period of nine years and (2) a vendor's lien on the assignee's (i.e., the taxpayer/partner's) share of the landfill gas facility for payment of the unpaid balance and interest.

While examining the taxpayers, Compliance made third-party contacts with the operators of the various landfills shown to be the sources of the claimed credits. Compliance continues to make such contacts as it examines additional partnerships. To date, all landfill owners and operators contacted by Compliance have responded that they have not transferred (by sale or lease) any interests in their landfills to the partnerships in question, nor have they contracted the rights to the IRC § 29 credits to the partnerships.

APPLICABLE LAW

In general, IRC § 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.¹ More specifically, IRC § 29(a) provides as a credit against tax for the taxable year an amount equal to (1) \$3 (adjusted for inflation) multiplied by (2) the barrel-of-oil equivalent of qualified fuels (A) sold by the taxpayer to an unrelated person during the taxable year, (B) the production of which is attributable to the taxpayer. Under IRC § 29(d)(5), a barrel-of-oil equivalent is the amount of fuel that has a Btu (British thermal unit) content of 5.8 million, generally the energy equivalent of one barrel of oil.

IRC § 29(c)(1)(B)(ii) defines the term “qualified fuels” to include gas produced from biomass. Under IRC § 29(c)(3), the term “biomass” means any organic material other than (A) oil and natural gas (or any product thereof), and (B) coal (including lignite) or any product thereof. The COWPTA Conference Report generally defines biomass as any organic substance other than oil, natural gas, or coal, or a product of oil, natural gas, or coal. Biomass includes waste, sewage, sludge, grain, wood, oceanic and terrestrial crops and crop residues, and waste products that have a market value. H.R. Conf. Rep. No. 817, 96th Cong, 2d Sess. 132 (1980), 1980-3 C.B. 245, 292.

IRC § 29(d)(3) defines the phrase “production attributable to the taxpayer” as meaning that, in the case of a property or facility in which more than one person has an interest, except to the extent provided in regulations prescribed by the Secretary, production from the property or facility (as the case may be) is allocated among such persons in proportion to their respective interests in the gross sales from such property or facility. While no regulations have been promulgated under IRC § 29, the COWPTA Senate Report states that, in the case of energy production from biomass, solid agricultural by-products, coal liquefaction and gasification, and qualifying processed wood, the credit would be based on the taxpayer's interest in the facility. S. Rep. No. 394, 96th Cong., 1st Sess. 89 (1979), 1980-3 C.B. 131, 207. Thus, production is generally attributable to a taxpayer based on the taxpayer's ownership interest in the facility.

Therefore, to be eligible to claim a credit under IRC § 29, all rights to operate the landfill gas collection systems at the landfill sites and all rights to the landfill gas produced at the landfill sites must belong to the taxpayer. That is to say, for the production of the

¹ IRC § 29 was originally designated as IRC § 44D by the Crude Oil Windfall Profit Tax Act of 1980 (“COWPTA”) and, subsequently, redesignated as IRC § 45K for taxable years beginning after December 31, 2005. See Pub. L. No. 96-233, 94 Stat. 229 (1980).

landfill gas to be attributable to the taxpayer for purposes of IRC § 29(a)(2)(B), a taxpayer must have the right to operate the landfill facility as a lessee or as an owner and must own the rights to the landfill gas produced at the landfill facility.

In determining which party has the right to operate a biomass facility located at a landfill, the following criteria are to be considered:

1. Whether the taxpayer will bear the cost of operating and maintaining the facility;
2. Whether the taxpayer will bear the cost of property taxes imposed on the facility;
3. Whether the taxpayer will bear the risk of loss associated with the operation of the facility;
4. Whether the taxpayer will have legal title to the facility;
5. Whether the taxpayer will have the right to receive all of the income generated from the operation of the facility;
6. Whether the taxpayer will have the right to operate or control the operation of the facility; and
7. Whether the taxpayer will have the right to any appreciation in value in the facility.

See Priv. Ltr. Rul. 9841019 (July 8, 1998); Priv. Ltr. Rul. 9725044 (June 20, 1997).

If an individual taxpayer is a partner in a partnership that purports to hold an ownership interest in a biomass fuel facility, such partnership must demonstrate that it is entitled to the benefits and bears the burdens of ownership for tax purposes. If an individual taxpayer is a partner in a partnership that purports to have a leasehold interest in a biomass fuel facility, the partnership will have to show that the rights, obligations, and risks of the purported lessor and lessee resemble those of a traditional lease relationship. See *BB&T v. United States*, No. 07-1777 (4th Cir. Apr. 29, 2008).

An IRC § 29 credit attributable to a partnership must be allocated to the partners in accordance with the partners' interests in the partnership when the credit arises. See Treas. Reg. § 1.704-1(b)(4)(ii). Regulations § 1.704-1(b)(4)(ii) provides that allocations of tax credits and tax credit recapture (except for IRC § 38 property) are not reflected by adjustments to the partners' capital accounts. Thus, these allocations cannot have economic effect under Regulations § 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 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 with respect to 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 Treas. Reg. § 1.704-1(b)(5), Ex. 11. Regulations § 1.704-1(b)(4)(ii) further provides that identical principles apply in determining the partners' interests in

the partnership regarding tax credits, such as the credit under IRC § 29, that arise from receipts of the partnership (whether or not taxable).

Additional eligibility requirements for the IRC § 29 credit include:

- Written Binding Contract Requirement— IRC § 29(g)(1) extends the IRC § 29 credit to certain qualified fuels if the facility producing the fuel is placed in service after 1992 and before July 1, 1998, pursuant to a binding written contract in effect before January 1, 1997. IRC § 29 does not define the term “facility,” however.

A written contract to acquire or construct a “facility” for producing qualified fuels will satisfy the written binding contract requirement under IRC § 29(g)(1).

- Placed-in-Service Requirement—To qualify for the IRC § 29 credit on qualified fuels sold through the year 2007 under IRC § 29(g)(1)(B), the facility must be placed in service before July 1, 1998. IRC § 29 does not describe when property is treated as placed in service; however, the term is defined for purposes of the investment tax credit and depreciation deductions. For example, Regulations § 1.46-3(d)(1)(ii) provides that property is considered placed in service in the taxable year in which the property is first placed in a condition or state of readiness and availability for a specifically assigned function. Regulations § 1.46-3(d)(2) provides examples of when property is considered in a condition or state of readiness and availability for a specifically assigned function within the meaning of Regulations § 1.46-3(d)(1)(ii). Such examples include where “equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects.” Treas. Reg. 1.46-3(d)(2). See Regulations § 1.167(a)-11(e)(1)(i) for the meaning of “placed in service” for depreciation. The term “placed in service” has consistently been construed as having the same meaning for purposes of the investment tax credit and depreciation deductions. See, e.g., Rev. Rul. 76-256, 1976-2 C.B. 46; Rev. Rul. 76-428, 1976-2 C.B. 47; Wilkison v. Commissioner, T.C. Memo 1988-386.

The determination of whether a landfill gas facility has satisfied the placed-in-service deadline under either IRC § 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.

DISCUSSION

Protests filed on behalf of the taxpayers identified under the Methane Gas Project have inadequately supported taxpayers’ positions with respect to the credits claimed due, at least in part, to an apparent lack of backing from the promoters. Most importantly, at the Appeals conferences, the taxpayers’ representatives have consistently failed to provide adequate documentation of the partnerships’ ownership or lease interests in the landfill gas facilities. In fact, we found that every claimed qualified facility turned out to be unqualified as to the taxpayer at issue. (In each case, although the facility

sometimes actually existed, neither the taxpayers nor the related partnerships had any ownership interest in the facility.)

Accordingly, during the taxable year, taxpayers associated with the Methane Gas Project did not sell to unrelated persons a qualified fuel, the production of which is attributable to the taxpayers, as required by IRC § 29(a)(2)(B) and § 29(d)(3). Therefore, the taxpayers are ineligible to claim credits under IRC § 29.

SETTLEMENT GUIDELINES

Based on the foregoing, we have concluded that no credit should be allowed under IRC § 29 for the taxpayers identified under the Methane Gas Project. This is a factual determination based on the finding that these taxpayers do not hold any ownership interests in qualified fuel facilities.

Appeals Officers or other personnel requiring further guidance should contact Technical Guidance Coordinator Barry C. Noller at 716-270-2459.