Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Contact Person:

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Telephone Number:

In Reference to:

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Date:

OCT 21 1998

A =

B =

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P =

X =

Y =

Z =

Dear

This letter responds to a letter dated April 13, 1998, and subsequent correspondence, submitted on behalf of P by its authorized representative, requesting rulings under sections 29, 702, and 708 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 treated as a partnership for federal income tax purposes. P currently has two members X and Y. P was formed for the purpose of producing solid synthetic fuel from coal fines.

A, B, and C each entered into a separate contract on December 31, 1996, for the construction of a facility to produce solid synthetic fuel from coal fines using Z's process. (The process is described below.) All three construction contracts have been assigned to P. The construction contracts are valid under state law and each provides for liquidated damages of at least five percent of the cost of the facility. Each construction contract also includes a description of the facility to be constructed, a completion date, and a maximum price.

P will own the facilities, and X will manage the facilities.

P will enter into a licensing agreement with Z to use Z's two stage process to produce solid synthetic fuel from coal fines. Upon the delivery of clean coal fines to the site of the facilities, the coal fines are sized and introduced into the mixing stage of the process. At this first stage, the coal fines are blended in a mixer/conditioner with a proprietary combination of co-reagents, consisting of a petroleum-based, liquid binder and a dry, inorganic mineral additive (collectively, the Binder Material). The petroleum-based binder is a high viscosity, liquid binder that contains oxygen-deficient, aliphatic molecules and is introduced at elevated temperatures of up to 400 degrees Fahrenheit. The inorganic mineral additive is introduced in the form of a dry powder and can serve as either a catalyst or a co-reactant, increasing the reaction rate or the extent of the reaction.

In the second stage of the process, the mixture of coal fines and the Binder Material is introduced via a volumetric metering device into the roll pelletizer and subjected to pressure of up to 3,000 pounds per square inch. The combination of the mixing process, the heat from the Binder Material, and the pressure from the roll pelletizer results in the formation of a high-density, solid synthetic fuel.

P has determined that the inorganic mineral component of the Binder Material is not required and that the petroleum-based, liquid binder component of the Binder Material can be delivered in the form of an emulsion; that is, a mixture of the petroleum-based, liquid binder and water, with one or more surfactants to facilitate and stabilize dispersion. By introducing the petroleum-based, liquid binder in the form of an emulsion, the binder handling temperatures can be reduced significantly (to approximately 150 degrees Fahrenheit), thereby reducing operating costs and potential safety risks associated with the process. In addition, by introducing the petroleum-based, liquid binder as an emulsion, the binder is more evenly mixed with the coal feedstock prior ro briquetting, thereby increasing the quality of the solid synthetic fuel.

P conducted numerous tests on the fuel produced from coal fines using both the Binder Material and the emulsified form of the petroleum-based, liquid binder (without the inorganic mineral additive). By the preponderance of these tests' results, P and P's representative represent that there was a significant chemical change in the coal fines making up the fuel.

P will sell the solid synthetic fuel on the spot market to unrelated persons.

The facilities are designed to facilitate relocation in the event that coal fines become unavailable at the present location.

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 "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 P's facilities using the enumerated process on the coal fines will result from a significant chemical change in coal, transforming the coal fines into a solid synthetic fuel from coal. Because P will own the facilities and X will manage the facilities, we conclude that P will be entitled to the section 29 credit for the production of the qualified fuel from the facilities that is sold to an unrelated person.

RULING REQUEST #3

Section 29(d)(5) defines "barrel-of-oil equivalent" with respect to any fuel as that amount of the fuel which has a Btu content of 5.8 million; except that in the case of qualified

14

fuels described in section 29(c)(1)(C), the Btu content shall be determined without regard to any material from a source not described in section 29(c)(1)(C). Section 29(d)(6) defines "barrel" to mean 42 United States gallons.

As required by section 29(d)(5), the Btu content of the qualified fuel produced and sold by P must be determined without regard to any material other than coal. This means that the Btu content of the qualified fuel attributable to any binder must be disregarded for purposes of calculating the section 29 credit.

RULING REQUEST #4

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. Each of the construction contracts, 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. It is represented that the construction contracts are binding under applicable law and that each contract provides for liquidated damages of at least five percent of the cost of the facility. Therefore, the construction contracts are binding written contracts for purposes of section 29(g)(1).

RULING REQUEST #5

To qualify for the section 29 credit, P's facilities 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). "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, the relocation of any of P's facilities 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.

RULING REQUEST #6

P also requested a ruling that, assuming the other requirements of section 29 are met, the sale of the product by P will entitle the members of P 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. 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.

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 of the Treasury. Under section 1.702-1(a), 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 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, 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 our conclusion that the solid end product to be produced by P's facilities with the process and to be sold to an unrelated person will be entitled to the section 29 credit, the credit will be allowed to P, and the section 29 credit may be passed through to and allocated among the members of P under the principles of section 702(a)(7) in accordance with the members' interests in P as of the time the tax credit arises.

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.

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 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, it was available for production and sales before either October 1, 1983, or 3 years from the date that the facility first was placed 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 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, although a section 708(b)(1)(B) termination of P 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 P 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 facilities that is sold to an unrelated person.

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) P will be entitled to the section 29 credit for the production of the qualified fuel from a facility that is sold to an unrelated person;

(3) the Btu content of the qualified fuel produced and sold by P will be determined without regard to any material from a source not described in section 29(c)(1)(C) as required by section 29(d)(5);

(4) the contracts for construction of the facilities constitute binding written contracts within the meaning of section 29(g)(1)(A);

(5) if a 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, 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;

(6) the credit allowed under section 29 may be passed through to and allocated among all the members of P in accordance with the principles of section 702(a)(7); and

(7) a future termination of P 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 a facility that is sold to an unrelated person.

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 whether the facility was placed in service for purposes of section 29 or how the members' 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. 98-1, 1998-1 I.R.B. 7, 47. However, when the criteria in 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 with this office, a copy of this letter is being sent to your authorized representative. We also are sending a copy of this letter to the District Director, District.

Sincerely yours,

Harold E. Burghart

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Enclosure:
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