

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Contact Person:

199917075

Telephone Number:

In Reference to:

Date: CC:DOM:P&SI:6 – PLR-109638-98

JAN 28 1999

Re:

Partnership =
V =
W =
X =
Y =
Z =
Company A =
Company B =
State A =
State B =

Dear

This letter responds to the ruling request of Partnership, dated April 16, 1998, as supplemented with information submitted on behalf of Partnership. Three rulings are requested: (1) Partnership will produce a qualified fuel within the meaning of section 29(c)(1)(C) of the Internal Revenue Code; (2) the contracts, as amended, with Company A for the engineering and construction of the facilities satisfy the requirement in section 29(g) for a "binding written contract" before January 1, 1997; and (3) Partnership will be entitled to the tax credit under section 29(a) on the qualified fuel sold to unrelated persons, provided the facilities producing the fuel were placed in service by the deadline in section 29(g) (June 30, 1998) for placing facilities in service to qualify for the tax credit.

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

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Partnership is a limited partnership formed for the purpose of raising capital to build two facilities for producing synthetic fuel (one facility in State A and one facility in State B). The general partner will be V with a 0.1 percent interest and the limited partners will be one or more institutional investors with 99.9 percent of the interests.

Each facility is owned by a separate project limited liability company. All project limited liability companies are owned by Partnership. The reason for separate project limited liability companies is to ensure that creditors of one project do not have a claim against the other projects. Each project limited liability company is classified as a disregarded entity for federal income tax purposes.

X signed binding written contracts with Company A before January 1, 1997, for the engineering and construction of the facilities on a turnkey basis. On April 15, 1998, the contracts were assigned to the project limited liability companies. Each construction contract provides for liquidated damages of at least 5 percent of the contract price, a description of the facility to be constructed, a completion date, and a maximum price for the facility. The contracts have been modified to subcontract the work to Company B, to simplify the design of the facilities, and to clarify the obligations of the parties. Partnership represents that the construction contracts are binding under applicable state law.

W sold the interests in the project limited liability companies to Partnership on April 18, 1998. Partnership paid to W for each project limited liability company an amount of cash at closing and agreed to pay W (1) an amount of cash when the facility is placed in service and (2) installment purchase payments each quarter equal to a fixed percentage of the section 29 credits generated by the facility. Payment of the latter amounts has been deferred.

Partnership represents that W has a license authorizing it to use a patented process owned by X for converting coal fines into solid synthetic fuel. W sublicensed the use of the process to each project limited liability company. The sublicense grants each project limited liability company the right to use the process in exchange for royalty payments as follows: (1) an amount of cash when the facility is placed in service and (2) a fixed percentage of the section 29 credits generated by the facility.

The limited partners in Partnership will contribute capital to Partnership to cover the installment purchase payments and royalty payments to W and the operating losses of the project limited liability companies.

The installment purchase payments and royalty payments to W will be subordinated for each project limited liability company to any deficit remaining after application of capital contributions and proceeds of sale of fuel to the costs of operation for that facility. Any subordinated amounts will be paid on or before August 1, 2008, regardless of cash availability.

Y is the site lessor for the facilities and is supplying the coal fines for the facilities. Additional coal fines may be purchased from other sources. Y is buying the output from the facilities. Partnership may sell the output to other parties under certain circumstances. Z is the operator of the facilities. Both Y and Z are unrelated to Partnership.

X's patented process uses a substrate derived from various hydrocarbon monomers (such as acrylonitrile, polyvinyl alcohol, styrene, or butadiene) and injection pressure to change coal fines into a solid synthetic fuel. The process consists of three steps.

In step one of the process, the coal fines are collected, sized, cleaned, and combined. This results in fixed carbon molecules consisting of carbon, hydrogen, and oxygen. Next, acid (typically hydrochloric or nitric acid) is added to the fixed carbon molecules resulting in the removal of pyritic sulfur, the formation of a weak acid solution and water, and the stripping of some oxygen atoms from the fixed carbon molecules. During step one, an emulsion surfactant may be used to remove compounds such as clay and silicates; but the surfactant is not a part of the chemical process.

In step two of the process, the carbon molecules are introduced to a mixture of monomers, resulting in a process known as co-polymerization, which results in a chain of carbon molecules. The monomers combine together the chains of carbon molecules.

In step three of the process, shear force and pressure are used to shape the fuel into a final shaped form which is convenient for use in solid fuel applications. Shear forces in this step induce heat from friction and an exothermic reaction in which the carbon molecules rise in temperature to as much as 170 degrees Fahrenheit. Heat may also be applied (typically at approximately 300 to 350 degrees Fahrenheit) to reduce the moisture and increase the hardness of the product so as to enhance its storage and handling characteristics.

Partnership represents that tests of the fuel produced using the process reveal a significant chemical change in the coal fines.

Section 29(a) of the Code allows a credit for qualified fuels sold by the taxpayer to an unrelated person during the tax year, the production of which is attributable to the taxpayer. The credit for the tax 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) of the Code 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 which has a Btu content of 5.8 million, with certain exceptions not applicable here. Section 29(d)(6) defines "barrel" to mean 42 United States gallons.

Sections 29(f)(1)(B) and (f)(2) of the Code 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) of the Code modifies section 29(f) in the case of a facility producing qualified fuels described in section 29(c)(1)(C), which qualified fuels include solid synthetic fuels produced from coal or lignite. Section 29(g)(1)(A) provides that for purposes of section 29(f)(1)(B), such a facility is to 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) is to be applied by substituting for the date therein January 1, 2008. The effect of this provision is to extend to December 31, 2007, the time during which the production of the facility meeting the above binding-contract rule and is placed in service after December 31, 1992, may be sold and qualify for the credit.

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) of the Code 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. The ruling notes that

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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 Partnership, including the preponderance of proffered data on the significant difference in the chemical composition of the fuel to be produced from that of the coal fines, the fuel to be produced using the process will be a solid synthetic fuel from coal within the meaning of Rev. Rul. 86-100 and section 1.48-9(c)(5)(ii) of the regulations. Accordingly, the process produces a qualified fuel as defined in section 29(c)(1)(C) of the Code.

A construction contract is binding only if it is enforceable under local law against a taxpayer and it does not limit damages to a specified amount, e.g., by use of a liquidated damages provision. A contract containing a 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 were executed prior to January 1, 1997. The contracts include such essential features as a description of the facilities to be constructed, a completion date, and a maximum price. It is represented that the contracts are binding under applicable state law and that the contracts provide for liquidated damages of at least five percent of the contract price.

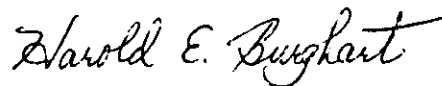
Accordingly, based on the facts as presented by Partnership and Partnership's authorized representative, we conclude as follows:

1. Partnership with use of the described process will produce a "qualified fuel" within the meaning of section 29(c)(1)(C) of the Code.
2. The contracts, as amended, with Company A for the engineering and construction of the facilities satisfy the requirements of section 29(g) of the Code for a "binding written contract" before January 1, 1997.
3. Partnership will be entitled to the credit, pursuant to section 29(a) of the Code on the qualified fuel sold to unrelated persons, provided the facilities were placed in service by the deadline in section 29(g) (June 30, 1998) for placing facilities in service to qualify for the tax credit.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusions in the ruling. See section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria in section 12.05 of Rev. Proc. 99-1 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, the original of this letter is being sent to Partnership, and a copy is being sent to the first-named authorized representative.

Sincerely yours,



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