Internal Revenue Service

Department of the Treasury

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This letter responds to a letter dated September 4, 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 partnership. X is the sole general partner of P. X and Y are the limited partners in P. X is wholly-owned by A. A is wholly-owned by B. B is owned by C and D.

P is the assignee of a contract dated Date 1 for the construction of a facility that is to produce a solid synthetic fuel from coal fines using the process described below. The construction contract is valid under state law and provides for liquidated damages of at least five percent of the cost of the facility. It also includes a description of the facility to be constructed, a completion date, and a maximum price. P represents that the facility was placed in service on Date 2.

X acquired its limited partnership interest pursuant to a purchase agreement dated Date 3 as amended on Date 4. For the limited partnership interest, X agreed to pay a fixed dollar amount at closing and a fixed dollar amount per ton of fuel produced by the facility through Date 5. X acquired its general partnership interest pursuant to a purchase agreement dated Date 4. For the general partnership interest, X agreed to pay a fixed dollar amount. Y acquired its limited partnership interest on Date 6 as the result of the conversion of a portion of an existing construction loan from Y. X's acquisition of the limited partnership interest and general partnership interest was consummated on Date 7. P represents that a termination under section 708(b)(1)(B) occurred.

X operates and maintains the facility. X will be paid costs plus 10 percent. X will acquire the coal fines for the facility on the spot market on behalf of P. X will also market the fuel produced by the facility on the spot market on behalf of P. The fuel will be sold to unrelated utilities, power generators, and other third party coal users.

In the first phase of the production process, fine coal screenings are crushed to a uniform size feedstock material for processing by the facility. In the next phase, crushed feedstock material is conveyed to a high speed mixer designed to homogenize the material prior to the application of the binder material. The sized homogenous feedstock material is then mixed in a high speed paddle type mixer with a customized

blend of chemically reactive aromatic hydrocarbons (i.e., co-reactants). These customized co-reactants consist of high viscosity, high molecular weight, oxygen deficient, aromatic molecules. Prior to mixing, the co-reactants are heated up to 400 degrees Fahrenheit. In the final phase of production, the mixture of feedstock material and co-reactants is subjected to pressures of between 2000-3000 pounds per square inch by passing through a hydraulically driven roll type briquetter.

P has had experts conduct numerous tests on fuel produced from coal fines using the process. By the preponderance of these tests' results, P and P's authorized representative represent that there is a significant chemical difference between the fuel produced by the process and the coal fines from which the fuel was made and that any fuel for which the credit will be claimed in the future will also result from a significant chemical change in the coal fines from which the fuel is made.

Section 5.1 of the Amended and Restated Agreement of Limited Partnership (the "Agreement") provides that all items of partnership income, gain, deduction, loss and credits, except as otherwise specified, shall be allocated to the partners in accordance with their Partners' Percentages.

Section 5.4(c) of the Agreement provides that all credits against federal income tax with respect to the partnership's operations or property shall be allocated among the partners in accordance with their Partners' Percentages for the period during which the event giving rise to the credit occurred. In particular, section 29 credits shall be allocated among the partners in accordance with their Partners' Percentages at the time of the sale of the solid synthetic fuel giving rise to the credits.

Section 2.1 of the Agreement provides that the term "Partners' Percentages" means the percentage in interest of the partners in P set forth on Exhibit A annexed to the Agreement, as such percentages may be adjusted from time to time.

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 facility 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 facility and because X on behalf of P will operate and maintain the facility, 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

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

RULING REQUEST #5

To qualify for the section 29 credit, the 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) 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. 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) of the Income Tax Regulations 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 partner's 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, assuming the solid synthetic fuel produced qualifies for the section 29 credit, the credit will be allowed to P and the credit may be passed through to and allocated to the partners of P under the principles of section 702(a)(7) in accordance with each partner's interest in P as of the time the tax credit arises. We express no opinion, however, regarding how the partners' interests in P are determined.

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 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.

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 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, although the section 708(b)(1)(B) termination of the predecessor partnership to P resulted in a deemed transfer of assets to a new partnership, P, this termination of the predecessor partnership and formation of a new partnership did not affect when the facility was placed in service for purposes of section 29. The termination of the predecessor partnership under section 708(b)(1)(B) will not preclude P from taking the section 29 credit for the production of the qualified fuel from the facility 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 the 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 contract for construction of the facility constitutes a "binding written contract" within the meaning of section 29(g)(1)(A);

(5) P's facility is "placed in service" for purposes of section 29(g)(1) on the date that the facility was first placed in a condition or state of readiness and availability to produce qualified fuel, as provided in sections 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i) (we express no opinion on when the facility was placed in service);

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

(7) the termination of the predecessor partnership to P under section 708(b)(1)(B) will not preclude P from taking the section 29 credit for the production of the qualified fuel from the 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 when P's facility was placed in service for purposes of section 29 or how the partners' 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. 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, a copy of this letter is being sent to P's authorized representative.

Sincerely yours,

CHARLES B. RAMSEY
Branch Chief, Branch 6
Office of Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosure:
Copy for section 6110 purposes