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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Contact Person:

Telephone Number:

In Reference to:

CC:DOM:P&SI:6 PLR-107987-98

Date:

OCT 21 1998

P =

X =

Y =

Z =

Dear

This letter responds to a letter dated March 25, 1998, and subsequent correspondence and representations, submitted on behalf of P by its authorized representative, requesting rulings under sections 29 and 702 of the Internal Revenue Code.

FACTS

The facts as represented by P and P's authorized representative are as follows:

P is a Delaware limited partnership. Z is the general partner of P. P was formed for the purpose of raising capital to purchase a facility for producing solid synthetic fuel from coal fines.

Z entered into a contract on December 26, 1996, for the construction of a facility that is to produce a solid synthetic fuel from coal fines using a variant of X's patented process. (The process is described below.) The construction contract has been assigned to P. The construction contract is binding and enforceable under state law and does not provide for liquidated damages or any other limitation on the maximum amount of damages available should either party fail to perform. The construction contract includes a description of the facility to be constructed, a completion date, and a maximum price.

P has acquired the facility from Z. P owns the facility, and Y, as agent for P, will operate and maintain the facility.

P has entered into a licensing agreement with X to use X's patented process to produce solid synthetic fuel from coal fines. X's patented process uses a unique substrate derived from hydrocarbon monomers and injection pressure to chemically change

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coal fines into a solid synthetic fuel. The process consists of three sequential steps:

1. In step one, coal fines may be mixed with a diluted acid (typically hydrochloric or nitric acid) to produce fixed carbon receptor sites that allow for attachment of carbon matrices.

2. The second step of the process uses a two-step chemical reaction to capture the carbon matrices into a cross-linked epi-oxygen structure that is capable of withstanding the temperatures and handling associated with solid fuel uses. The monomers freely attach to receptor sites as the catalysts used to derive the monomers evaporate. During this reaction, the monomers are co-polymerized and attached to the carbon component receptor sites. Coal fines are changed by covalently attaching a polymer at the modified carbon matrices of the coal fines and restructuring the resulting synthetic fuel into a cross-linked epi-oxygen type structure.

3. The third step of the process uses shear force and pressure to react the derived product from the second step into a final shaped form that is convenient for use in solid fuel applications. Shear force in this step induces 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 350 degrees Fahrenheit) to accelerate the chemical reaction, to release the catalysts, and to increase the hardness of the product so as to enhance its storage and handling characteristics.

The raw materials may come from multiple coal fines sources including waste fines, coal fines used as blending material for run of mine coal, and run of mine coal fines.

The original binder used in X's process consisted principally of acrylonitrile and polyvinyl alcohol. X has since substituted other monomers from the same monomer group for most of the original acrylonitrile, has substituted styrene monomers for polyvinyl alcohol, and has varied acid types and concentrations. The substitute monomers achieve the same reaction with the coal fines, but may have superior linking capability, making the desired polymerization easier and more efficient to achieve. Other monomers in addition to or in substitution for the foregoing monomers may be used in the synthetic fuel manufacturing process. The finished product may be in the shape of coal extrusions, pellets, or briquettes.

The solid synthetic fuel structure is a homogeneous, covalently bonded, integral shape whose chemical structure differs significantly from that of the parent coal fines. The

chemical reaction that occurs during this three-step process causes the solid synthetic fuel to have strength and durability similar to lump coal. In contrast, solids formed by mere compacting, gluing, or other physical binding of coal fines have proven less stable, and may introduce undesirable chemical compounds that negatively impact scrubbers and stack gases.

Y, as agent for P, will arrange for sale of the fuel to persons unrelated to P within the meaning of section 29(d)(7).

The facility is designed to facilitate relocation in the event that coal fines become unavailable at the present location. When moved to a new site and fully functional, less than 20 percent of the fair market value of the facility will consist of property added to the facility since being moved from its prior location.

RULING REQUESTS #1 AND #2

Section 29(a) allows a credit for qualified fuels that are sold by the taxpayer to an unrelated person during the taxable year and that are attributed to the taxpayer's production. 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 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, 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 operate and maintain the facility through its agent Y, 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 if it 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 and enforceable under state law and that the contract does not provide for liquidated damages or any other limitation on the maximum amount of damages available should either party fail to perform. 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 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, the relocation of P's facility 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 #5

P also requested a ruling that, assuming the other requirements of section 29 are met, the sale of the fuel by P will entitle the partners 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 fuel to be produced by P's facility 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 partners of P under the principles of

section 702(a)(7) in accordance with the partners' interests in P as of the time the tax credit arises.

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 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, 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; and

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

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 prior to July 1, 1998, 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. 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.

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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,

Harold E. Burghart

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Enclosure:
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