Third-party contact:

Internal Revenue Service

Index No.: 29.00-00
Number: **200034020**
Release Date: 8/25/2000

Department of the Treasury

Washington, D.C. 20044

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CC:DOM:P&SI:5 — PLR-109786-99
Date:
May 25, 2000

Legend:

Company A =

Company B =

Company C =

Company D =

Company E =

Plant =

Agency A =

Agency B =

Agency C =

Agency D =

Agency E =

Partnership =

Bank =

Subsidiary A =

Subsidiary B =

Project A =

Project B =

Amendment =

Unit =

State =

Facility =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

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Year 10 =

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Date 11 =

Date 12 =

Date 13 =

Dear :

This letter responds to a letter dated May 24, 1999, and subsequent correspondence, submitted on behalf of Company A by its authorized representative, requesting rulings under § 29 of the Internal Revenue Code. Company A is requesting this letter ruling on behalf of Company B.

FACTS:

The facts as represented by Company A and its authorized representative are as follows:

In the early Year 1, Company C and Company D agreed to jointly construct the Plant. Company C approached Agency A to obtain a loan guarantee. On Date 1, Agency A announced that it would provide a loan guarantee to Partnership in the amount of $a for the Plant, contingent on a final, non-appealable order from Agency B providing for a pass-through of the high-cost synthetic natural gas (SNG) to Partnership's partners' consumers. Agency B issued the order on Date 2 and Agency A executed the loan guarantee on Date 3 pursuant to the Federal Nonnuclear Energy Research and Development Act of 1974, as amended by Section 207 of Title II of Public Law 95-238, as amended. Partnership agreed to pay Agency A a guarantee fee at the rate of b percent per annum on the principal amount of the guaranteed indebtedness from time to time outstanding.

The Plant was constructed at a cost of approximately $c. Partnership funded this amount with approximately $d in equity contributions from its partners and approximately $e in loan proceeds from Bank, a corporate instrumentality of the United States. Agency C required Partnership to borrow from Bank as a condition for obtaining the Agency A loan guarantee. The Bank loan was secured by a mortgage on the Plant. The interest rate on the Bank loan was set at f of b percent above U.S. Treasury rates for the term of the loan. Construction of the Plant was completed and initial SNG production occurred in Date 4.

The placed-in-service date for the Plant for tax purposes was no later than Date 5 when the SNG was placed in the SNG pipeline. A substantial portion of the Plant was new § 38 property and alternative energy property within the meaning of § 48(l)(3) of the Internal Revenue Code of 1954. Such being the case, Partnership would have been eligible for an energy percentage under § 46(b)(2)(A). Partnership's partners were entitled to claim investment credits (including the energy percentage) with

respect to the Plant. Partnership's partners should not have received any tax benefits from § 29 credits because of the energy credit offset under § 29(b)(4). It appears that otherwise the Partnership's partners would have been entitled to at least $g worth of § 29 credits, based on the Plant's historical production and sales figures.

As construction of the Plant neared completion, it became increasingly apparent to Partnership's partners that the Plant would have insufficient cash to service the Bank loan. Partnership subsequently terminated its participation in the Plant on Date 6 (pursuant to a contractual provision) and defaulted on the Agency A guaranteed Bank loan. Upon default, Agency A assumed control over the operation of the Plant pursuant to the terms of the mortgage and gained ownership of the Plant through foreclosure on Date 7.

In Year 2, Agency A announced its intention to privatize the Plant. Agency A received several offers to purchase the Plant's assets including an offer from Company D. Its offer included a contractual agreement not to claim the § 29 credits available to the owner of the Plant. Agency A selected Company D's bid.

In Date 8, Company D formed Subsidiary A and Subsidiary B as wholly owned, for-profit, taxable subchapter C corporation subsidiaries. On Date 9, Subsidiary B purchased certain mining equipment and mining rights from Agency A for approximately $h. Also on Date 9, Subsidiary A executed the Asset Purchase Agreement (APA) and purchased from Agency A the Plant and the SNG pipeline. Subsidiary A paid approximately $i for the SNG pipeline, contractually agreed not to claim the § 29 credits and entered into an ongoing revenue sharing payment arrangement with Agency A. If Subsidiary A ignored its contractual agreement not to claim the § 29 credits, it was obligated to pay Agency A any economic benefit it received from claiming on its federal income tax return any § 29 credits earned with respect to the Plant.

Pursuant to the APA, Subsidiary A was obligated to pay Agency A revenue sharing payments for the calendar years Year 3 and Year 4 through Year 5 up to $j.

Subsidiary A estimates that from Year 7 until Year 10, it actually waived approximately $u, based on a computation of the estimated § 29 credit generated by the qualified production from the Plant.

On Date 9, when Subsidiary A purchased the Plant from Agency A, the Plant had not achieved the reduction of sulfur dioxide emissions agreed to by Partnership, Agency D and Agency E in the Plant's original construction permit. Several problems with the process remained, and Agency E issued a formal Notice of Violation on Date 13 to Agency A as the owner of the Plant. In order to avoid the issuance of a formal complaint and the assessment of civil penalties, Agency A was required to prepare a detailed plan of action outlining the steps necessary to bring the Plant into compliance. Agency A sold the Plant to Subsidiary A before the modifications to the Plant were

started. Because of this known defect at the time Subsidiary A purchased the Plant, an environmental account was established by Agency A to remedy the situation.

In Year 8, as the new owner of the Plant, Subsidiary A entered into a Consent Agreement with Agency E and agreed to install a scrubber system. Subsidiary A chose to pioneer a new scrubber technology and spent $r (including $s of the environmental account established by Agency A) on the scrubber system which began operation in the summer of Year 9.

The scrubber system has been successful in part, but its operation has not been as reliable as expected. In addition, the scrubber has created its own environmental issues; the process creates both particulate and a plume that is visible from time to time. Subsidiary A has executed a Second Consent Agreement with Agency E that requires Subsidiary A to construct environmental improvements to solve the particulate and plume problems (Project A). Subsidiary A estimates that Project A will cost approximately $t.

Project B is a carbon dioxide compression facility and an intrastate carbon dioxide pipeline that is being constructed in connection with the Carbon Dioxide Purchase Agreement between Subsidiary A and the Unit. When Project B is completed, a portion of the carbon dioxide waste gas from the Plant will be sold to Company B for later resale as a tertiary injectant for enhanced oil recovery.

On Date 10, Subsidiary A and Agency A executed the Amendment. It allows Subsidiary A to sell a substantial portion of the Plant and releases Subsidiary A from its contractual agreement not to claim § 29 credits, allowing a buyer to utilize up to $k of § 29 credits through Date 11. The Amendment allows Subsidiary A to sell the Plant if (a) the Service rules in a private letter ruling that the buyer in the transaction may utilize the § 29 credits, (b) the buyer is precluded from selling its portion of the Plant to any other party other than Subsidiary A until Date 12, and (c) the transaction documents provide that the buyer must first offer to sell its portion of the Plant to Subsidiary A at its then fair market value before offering to sell such interest to any third party.

In exchange for the release of the contractual agreement not to claim § 29 credits, Subsidiary A agreed to pay Agency A any net proceeds received by Subsidiary A attributable to the sale of the Plant over and above l percent of Project A's capitalized cost and m percent of Project B's capitalized cost. Further, Subsidiary A has agreed to pay Agency A up to $n annually (capped at $o) from the demand payments Subsidiary A receives from Company E pursuant to the Carbon Dioxide Purchase Agreement, conditioned upon Company E making such demand payments. In addition, beginning in Year 6, in lieu of the revenue sharing payment arrangement established in the APA, Agency A will share in the Plant's positive cash flow subject to a cap such that, when added to (i) the demand payments paid to Agency A, (ii) the federal income taxes paid by Subsidiary A on any proceeds received and (iii) any

excess proceeds returned to Agency A, Agency A's share of the Plant's positive cash flow will not exceed the total § 29 credits taken by the new owner of the Plant.

The Facility, which is located in State, is the first commercial-size facility in the United States constructed for the purpose of converting lignite coal into pipeline quality SNG and is presently capable of producing up to p million cubic feet of SNG per day (q million cubic feet per year). In addition to producing SNG, the Facility also produces for sale certain byproducts such as rectisol-treated syngas (RTS), phenol, crude cresylic acid, naphtha, krypton and xenon gases, liquid nitrogen, carbon dioxide waste gas, ammonium sulfate, and methanol (Other Byproducts).

The Facility is defined as the Plant less certain assets not related to the manufacture of "qualified fuel", including coal handling and screening facilities, an anhydrous ammonia plant, Project B, the SNG pipeline and certain administrative assets.

Rulings Requested

1. The SNG, RTS, and Other Byproducts produced by the Facility are "qualified fuels" for purposes of § 29(c)(1)(C).

2. The Facility is a qualified facility for purposes of § 29(f)(1)(B).

3. There is no credit offset pursuant to § 29(b)(3) prior to the implementation of the Amendment.

4. There is no credit offset pursuant to § 29(b)(3) associated with any released § 29 credits with respect to the Amendment to the extent that released § 29 credits are not used to fund capital expenditures at the Facility.

5. The denominator of the § 29(b)(3) fraction includes Subsidiary A's capital expenditures with respect to the Facility.

6. The Project B is not a qualified facility nor part of the Facility for purposes of § 29(b)(3).

7. There is no credit offset pursuant to § 29(b)(4).

Ruling #1

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 § 48(l) and its regulations is relevant to the interpretation of the term under § 29(c)(1)(C). Former § 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 § 29 and former § 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 § 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 alternative substance used to produce it. Coal is an alternative substance under § 1.48-9(c)(2)(i).

Based on the representations made, we conclude that the fuels produced in the Facility using the enumerated process result from a significant chemical change in the coal, transforming the lignite coal into the following synthetic fuels from coal: SNG, RTS, phenol, crude cresylic acid, naphtha, and methanol.

Ruling #2

Sections 29(f)(1)(B) and (f)(2) provide that § 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.

While § 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 that the property is placed in a condition or state of readiness and availability for a specifically designed function. See §§ 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i). "Placed in service" has been consistently construed as having the same meaning 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 the Plant was placed in service.

The placed-in-service deadline in § 29(f)(1)(B) is when the facility is first placed in service within the applicable dates. The placed-in-service deadlines contained in § 29(f)(1)(B) focus on the facility, and not the taxpayer owning the facility.

Accordingly, the determination of whether a facility has satisfied the placed-in-service deadline under § 29(f)(1)(B) 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. Thus, the sale of the Plant from Agency A to Subsidiary A on Date 9 pursuant to the APA did not affect when the Plant was placed in service for purposes of § 29. The sale

of the Plant will not preclude any purchaser subsequent to Subsidiary A from taking the § 29 credit for the production of the qualified fuel from the Plant that is sold to an unrelated person.

Rulings #3, #4, #5, and #6

Section 29(b)(3) provides that the credit allowable under § 29(a) shall be reduced by an amount that is the product of a fraction times the credit determined under § 29(a). The numerator of the fraction is the sum of:

I. all grants provided by the United States, a State, or a political subdivision of a State for use in connection with the project;

II. the proceeds of any issue of State or local government obligations used to provide financing for the project the interest on which is exempt from tax under § 103; and

III. the aggregate amount of subsidized energy financing (within the meaning of § 48(a)(4)(C)) provided in connection with the project.

The denominator of the fraction is the aggregate amount of additions to the capital account for the project for the taxable year and all prior years.

To the extent that the credit is available for the production and sale of any of the qualified fuel, the credit is reduced in proportion to Federal, State, and local grants, subsidized loans, and tax-exempt financing provided in connection with the construction and acquisition of the facility or its equipment. For this purpose, all tax-exempt financing and all Federal, State, and local grants (whether or not taxable or energy related), but only subsidized loans that are energy related, are taken into account. Loan guarantees are not taken into account. The proportion of a facility deemed to be financed by subsidized financing equals the sum of the grants, subsidized energy loans, and tax-exempt financing divided by the sum of the gross additions to capital account attributable to the project. See Conf. Rep. No. 817, 96th Cong., 2d Sess. 139-141 (1980), 1980-3 C.B. 299-301.

Company A represents that Agency A received fair market value for the Plant. Further, Company A represents that Subsidiary A bargained for and gave value in return for the Plant when, as part of the consideration for the Plant, Subsidiary A agreed to waive any and all rights it may have to claim any § 29 credits. Thus, as a result of the sale of the Plant from Agency A to Subsidiary A, there is no credit offset pursuant to § 29(b)(3) from Date 9, when Agency A sold the Plant to Subsidiary A, through the date of implementation of the Amendment.

Regarding Project B, Company A represents that the Facility does not require Project B to produce fuel that is qualified for the § 29 credit. Company A represents

that the Facility currently has all of the facilities necessary to produce and sell qualified fuel. Company A represents that Project B is not integral to the production of qualified fuel but is merely a facility designed to capture and deliver a portion of the carbon dioxide produced at the Facility that is currently vented. We conclude that Project B is not part of the Facility and that money associated with released § 29 credits pursuant to the Amendment that are used to fund capital expenditures at Project B are not used in connection with the acquisition or construction of the Facility. Thus, we conclude that: (1) Project B is not a qualified facility nor part of the Facility for purposes of § 29(b)(3) and (2) to the extent proceeds from the sale of the Facility, or that otherwise result from release of the § 29 credits under the Amendment, are allocated to the costs of Project B, no reduction in the amount of the credit available results because there is no grant used in connection with the Facility (§ 29(b)(3)(A)(i)(I)).

Project A is a pollution control facility that is necessary for the continued operation of the Facility. Thus, we conclude that the denominator of the fraction described in § 29(b)(3) includes the capital expenditures associated with Project A and Subsidiary A's other capital expenditures integral to the production of qualified fuels at the Facility. Further, to the extent that the Amendment waived a portion of the consideration originally paid by Subsidiary A for the Facility and such portion has been or will be used to fund Project A, we conclude that such portion is a federal grant under § 29(b)(3) with respect to the Facility.

Ruling #7

Section 29(b)(4) provides that the amount allowable as a credit under § 29(a) with respect to any project for any taxable year (determined after the application of § 29(a)(1), (2) and (3)) shall be reduced by the excess of--

(A) the aggregate amount allowed under § 38 for the taxable year or any prior taxable year by reason of the energy percentage with respect to property used in the project, over

(B) the aggregate amount recaptured with respect to the amount described in subparagraph (A)--

(i) under § 49(b) or 50(a) for the taxable year or any prior taxable year, or

(ii) under this paragraph for any prior taxable year.

The amount recaptured under §§ 49(b) or 50(a) with respect to any property shall be appropriately reduced to take into account any reduction in the credit allowed by this section by reason of the preceding sentence.

The Conference Committee report that accompanied the Crude Oil Windfall Profit Tax Act of 1980 states that the production credit is also reduced, dollar-for-dollar,

in proportion to energy investment credits allowed in respect of the property used to produce the alternative fuels eligible for the credit. All energy investment credits allowed to any party (including parties to a lease of the property and to predecessors) with respect to the fuel production property are taken into account.

In the present case, Company A and its authorized representative(s) represent that during the time Subsidiary A has owned the Plant, the §29 credit calculated on the production from the Facility under §§ 29(a) and 29(b)(1) and (2), but not including § 29(b)(3), (4), (5), and (6), exceeds the aggregate amount of the energy credit taken for the Facility under § 38 for all prior years by reason of the energy percentage. The waiver of the credit by Subsidiary A was a waiver of the credit after the application of § 29(b). Thus, during the time Subsidiary A owned the Facility, the full amount of the energy credit would have been recaptured (even if none of the energy credit was recaptured when the Facility was owned and disposed of by prior owners). Thus, we conclude that there is no credit offset pursuant to § 29(b)(4).

Conclusions

Based solely on the applicable law and the representations of Company A and its authorized representative, we conclude as follows:

(1) the Facility, with the use of the enumerated process, will produce the following qualified fuels, within the meaning of § 29(c)(1)(C): SNG, RTS, phenol, crude cresylic acid, naphtha, and methanol;

(2) the Plant is “placed in service” for purposes of § 29(f) 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 §§ 1.46-3(d)(1)(ii) and 1.167(a)-11(e)(1)(i) (we express no opinion on when the Plant was placed in service);

(3) there is no credit offset pursuant to § 29(b)(3) prior to the implementation of the Amendment;

(4) there is no credit offset pursuant to § 29(b)(3) associated with any released § 29 credits with respect to the Amendment to the extent that released § 29 credits are not used to fund capital expenditures at the Facility; however, to the extent that the Amendment waived a portion of the consideration originally paid by Subsidiary A for the Facility and such portion has been or will be used to fund Project A, there is a federal grant under § 29(b)(3) used in connection with the Facility;

(5) the denominator of the § 29(b)(3) fraction includes Subsidiary A’s capital expenditures integral to the production of qualified fuels at Facility;

(6) Project B is not a qualified facility nor part of the Facility for purposes of § 29(b)(3); and

(7) there is no credit offset pursuant to § 29(b)(4).

Except as specifically ruled upon above, we express no opinion concerning the federal income tax consequences of any proposed transaction. Specifically, we express no opinion on when the Plant was placed in service for purposes of § 29 nor whether any purchaser of the Facility subsequent to Subsidiary A is entitled to take the § 29 credit from the Facility's production of the qualified fuel.

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. 2000-1, 2000-1 I.R.B. 4, 46.

However, when the criteria in section 12.05 of Rev. Proc. 2000-1 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 Company A's authorized representative.

Sincerely yours,
Charles B. Ramsey, Chief, Branch 6
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosure:
copy for § 6110 purposes