

Private Letter Ruling 9529019, 04/24/1995, IRC Sec(s). 29

UIL No. 0029.00-00; 0029.04-00; 0029.03-00; 0052.00-00

Date: April 24, 1995

CC:DOM:P&SI:6—TR-31-00316-95

In re : ***

LEGEND:

Taxpayer = ***

Company = ***

Subsidiary A = ***

Subsidiary B = ***

Landfill = ***

Members = ***

Corp A = ***

Corp B = ***

State X = ***

City Y = ***

District = ***

Dear ***

This responds to a letter dated February 2, 1995, and additional correspondence, submitted by your authorized legal representative on behalf of the Taxpayer as a member and the manager of the Company. In that letter, a number of rulings are requested under section 29 of the Internal Revenue Code relating to a proposed landfill gas production facility to be operated by the Company. The parties involved and the represented facts are set forth below.

The Taxpayer represents that it acts as a developer, processor, and retailer of methane gas produced from landfills, with an emphasis on the development of liquified natural gas as an alternative to motor fuel. The Taxpayer intends to form a number of limited partnerships or limited liability companies in order to develop landfill gas projects at up to 12 sites. The Company was formed to develop one of such sites. Both the Taxpayer and the Company are under the audit jurisdiction of the District Director of the District. Subsidiary A and Subsidiary B are included in the Taxpayer's consolidated federal income tax return. The Taxpayer is the Company's tax matters partner.

The Taxpayer owns *** percent of the stock of Subsidiary A and Subsidiary B. Subsidiary A acts as the contracting party for the construction of landfill collection systems and installs the gas treatment and liquefaction systems to process the collected methane. Subsidiary B has the design responsibility for all cryogenic processing units for

the Taxpayer's groups of companies, as well as the design and application of the membrane systems for landfill gas treatment.

The Company was formed for the purpose of developing and operating a landfill gas production facility at Landfill. The initial members of the Company are the Taxpayer, who is the manager of the Company, and Members. An additional member will be admitted to the Company. This new member, known as the Investment Member, is expected to be a limited partnership. The Investment Member will contribute cash and other property to the Company in return for a *** percent interest in the Company's capital and profits. This will occur no later than *** and in all events will occur before the facility described below is placed in service. The Taxpayer as the manager will have a *** percent interest in the Company's capital and profits. The Members, who are currently serving as members of the Company solely to ensure its classification as a partnership for tax purposes, will withdraw from the Company upon admission of the Investment Member.

The Taxpayer will act as a general partner of the Investment Member and one or more unrelated investors will be limited partners. The Taxpayer has represented that the limited partnership items will be specially allocated but that neither the Taxpayer nor any group of trades or businesses under common control of which it is a member will own greater than a percent interest in the capital or profits of the Investment Member and that neither it nor any group of trades or businesses under common control of which it is a member will own greater than a *** percent interest in the capital or profits of the Company. The Taxpayer has also represented that no shareholders who are individuals, trusts, or estates own in the aggregate as much as *** percent of the Taxpayer's outstanding stock and that no organization owns greater than *** percent of the Taxpayer's outstanding stock. The Taxpayer further represents that the limited partnership will be classified as partnership for federal income tax purposes.

The Company entered into a 'Lease to Develop Landfill Gas' (the 'Lease') with City Y. City Y owns and controls the Landfill and represents under the Lease that it is the titleholder to the Landfill, the processing site, and the landfill gas. Under the Lease, City Y grants and leases to the Company all rights to the landfill gas for the purposes of exploring for, testing, collecting, treating, processing, selling, operating, and producing gas, and a site for construction of the production facility. The Lease term is *** months, and for so long thereafter as landfill gas is produced in commercial quantities, unless terminated under City Y's right to terminate for convenience after the *** month period ends.

The Company is obligated under the Lease to construct the landfill gas collection system and, provided the volume and quantity of landfill gas is acceptable, the processing unit. Construction is required to be completed prior to *** The Company entered into a contract with Subsidiary A for the design and construction of a gas collection and processing system (the 'Facility') for the Landfill (the 'Construction Agreement'). The Construction Agreement is a firm, fixed-price contract. The Construction Agreement does not contain any liquidated damages provision limiting damages for breach of contract.

The Construction Agreement involves a collection system consisting of a total of *** wells to be drilled. Subsidiary A will subcontract the drilling to an unrelated drilling contractor. The design and construction of the processing system will be subcontracted by Subsidiary A to Subsidiary B. The processing system will include a compression and membrane system which will remove carbon dioxide and impurities. Gas leaving this system will be delivered into a liquefaction plant which will compress and liquify the gas. The liquified gas may be delivered either into a cryogenic storage tank or into a high pressure pipe to a meter station of a commercial gas pipeline.

The Taxpayer expects to enter into a Landfill Gas Sale and Purchase Agreement for liquified natural gas with Corp A, a subsidiary of Corp B, a widely-held, publicly-traded company (the "Sales Agreement"). The Taxpayer and the Company represent that Corp A and Corp B are unrelated to the Company and its members. The Taxpayer will assign the Sales Agreement to the Company as a contribution to capital. The Sales Agreement is a take-of pay contract under which the Company will sell *** MMbtus 1 of gas produced from the Landfill per year to Corp A. The Company estimates that the production sold to Corp A will be approximately *** percent of the Facility's output. The Taxpayer will have a right of first refusal to purchase the remaining output of the Facility at a price equal to the price paid by Corp A under the Sales Agreement. The Landfill is expected to produce approximately *** MMbtus of commercially saleable gas per year.

Section 29(a) of the Code (originally designated as section 44D by the Crude Oil Windfall Profit Tax Act of 1980 ("COWPTA")) provides as a credit against tax for the taxable year an amount equal to (1) \$3 (adjusted for inflation), multiplied by (2) the barrel-of-oil equivalent of qualified fuels (A) sold by the taxpayer to an unrelated person during the taxable year, (B) the production of which is attributable to the taxpayer. Under section 29(d)(5), a barrel- of oil equivalent generally is the amount of fuel required to generate the energy equivalent of one barrel of oil, or 5.8 million Btus (British thermal units) of energy.

Under section 29(b)(1) of the Code, the full amount of the credit is available when the calendar-year "reference price" is at or below \$23.50 (adjusted for inflation). The amount of the credit allowable decreases as the reference price increases above \$23.50, and is entirely phased out when the reference price exceeds the \$23.50 amount by \$6 (both adjusted for inflation). Under section 29(d)(2)(C), the reference price for a calendar year is the annual average wellhead price per barrel for all unregulated domestic crude oil.

Section 29(c)(1)(B)(ii) of the Code provides that the term "qualified fuels" includes gas produced from biomass. Under section 29(c)(3), the term "biomass" means any organic material other than (A) oil and natural gas (or any product thereof), and (B) coal (including lignite) or any product thereof.

The COWPTA Conference Report generally defines biomass as any organic substance other than oil, natural gas, or coal, or a product of oil, natural gas, or coal. Biomass includes waste, sewage, sludge, grain, wood, oceanic and terrestrial crops and crop

residues, and waste products that have a market value. Also, the definition of biomass does not exclude waste materials, such as municipal and industrial waste, that include processed products of oil, natural gas or coal such as used plastic containers and asphalt shingles. H.R. Conf. Rep. No. 817, 96th Cong., 2d Sess. 132 (1980), 1980-3 C.B. 245, 292.

Section 29(d)(7) of the Code provides that persons shall be treated as related to each other if such persons would be treated as a single employer under the regulations prescribed under section 52(b). In the case of a corporation that is a member of an affiliated group of corporations filing a consolidated return, the corporation shall be treated as selling qualified fuels to an unrelated person if the fuels are sold to the person by another member of the group.

Section 29(g)(1) of the Code modifies section 29(f) to extend the section 29 credit for certain qualified fuels that are produced in facilities placed in service before January 1, 1997, pursuant to a binding written contract in effect before January 1, 1996. For qualified fuels produced in these facilities, the credit is available for fuels sold before January 1, 2008.

Section 7701(a)(14) of the Code provides that "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, a trust, estate, partnership, association, company, or corporation.

BIOMASS AND "TAXPAYER"

The waste deposit in the Landfill clearly is biomass under section 29(c)(3) of the Code and the COWPTA Conference Report. Thus, the landfill gas produced from that waste meets the definition of a qualified fuel under section 29(c)(1)(B)(ii). In addition, the Company is the taxpayer for purposes of section 29(a)(2)(B) because a limited liability company such as the Company may be treated for tax purposes as either a partnership or a corporation, either of which are taxpayers under section 7701(a)(14).

With respect to whether the production of the qualified fuel is attributable to the Company within the meaning of section 29(a)(2)(B) of the Code, the COWPTA Senate Report states that in the case of energy production from biomass, solid agricultural by-products, coal liquefaction and gasification, and qualifying processed wood, the credit would be based on the taxpayer's interest in the facility. S. Rep. No. 394, 96th Cong., 1st Sess. 89 (1979), 1980-3 C.B. 131, 207. In this regard, the Taxpayer has represented that the Company will own the Facility for the Landfill, with the Company having all of the benefits and burdens of ownership. The Company will have all the rights to the landfill gas produced at the Facility. Moreover, the Taxpayer, Investment Member, and Members will not have any ownership interest in the Facility, as opposed to their ownership interests in the Company. Thus, because the Company will own the entire Facility, all production of landfill gas will be attributable to the Company for purposes of section 29(a)(2)(B).

SALES TO UNRELATED PERSONS

Under section 29(a)(2)(A) of the Code, the section 29 credit is allowed for qualified fuels sold by a taxpayer to an unrelated person. Section 29(d)(7) provides that persons shall be treated as related to each other if such persons would be treated as a single employer under the regulations prescribed under section 52(b).

Section 52(b) of the Code provides that, under regulations Prescribed by the Secretary, all employees of trades or businesses (whether or not incorporated) that are under common control are treated as a single employer for purposes of section 51 and 52 of the Code.

Section 1.52-1(b) of the Income Tax Regulations defines the term “trades or businesses that are under common control” as any group of trades or businesses that is either a “parent-subsidary group under common control” or a “brother-sister group under common control” or a “combined group under common control.”

Section 1.52-1(c)(1) of the regulations defines the term “parent-subsidary group under common control” as one or more chains or organizations conducting trades or businesses that are connected through ownership of a controlling interest with a common parent organization if two conditions are satisfied. First, a controlling interest in each of the organizations, except the common parent organization, must be owned (directly and with the application of section 1.414(c)-4(b)(1), relating to options) by one or more of the other organizations. Second, the common parent organization must own (directly and with the application of section 1.414(c)-4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing the controlling interest, any direct ownership interest by other organizations.

Section 1.52-1(c)(2) of the regulations defines the term “controlling interest” in the context of a parent-subsidary group under common control to mean, in the case of a partnership, ownership of more than 50 percent of the profit interest or capital interest of the partnership.

Section 1.52-1(d) of the regulations defines the term “brother-sister group under common control” as two or more organizations conducting trades or businesses if two conditions are satisfied. First, five or fewer persons who are individuals, estates, or trusts must own (directly and with the application of section 1.414(c)-4(b)(1)) a controlling interest in each organization. In this context “controlling interest” is defined with the same meaning as for a parent-subsidary group under common control except that the percentage is increased from “greater than 50 percent” to “at least 80 percent.” Second, the same five or fewer persons must be in effective control of each organization, taking into account the ownership of each person only to the extent that it is identical with respect to each organization. In this context, “effective control” has the same meaning as “controlling interest” has in the context of a parent-subsidary group under common control.

Section 1.52-1(e) of the regulations defines the term “combined group under common control” as a group of three or more organizations if two conditions are satisfied. First,

each organization must be a member of either a parent-subsidary group under common control or of a brother-sister group under common control. Second, at least one organization must be the common parent of a parent-subsidary group under common control and also a member of the brother-sister group under common control.

In this case, the Taxpayer has represented that neither it nor a group of trades or businesses under common control of which it is a member will own more than *** percent of the Company or the Investment Member. Consequently, the Taxpayer and the Company will not be members of the same parent-subsidary group under common control. The Taxpayer has represented that no shareholders who are individuals, trusts, or estates own in the aggregate as much as *** percent of the outstanding stock in the Taxpayer. Consequently, the Taxpayer cannot belong to any brother-sister group under common control. The Taxpayer has represented that no organization owns greater than *** percent of the outstanding stock in the Taxpayer. Consequently, there can be no organization that is a common parent in a parent-subsidary group with the Taxpayer other than the Taxpayer. Because the Taxpayer cannot belong to any brother-sister-group under common control, there can be no common parent of a parent-subsidary group under common control of which the Taxpayer is a member that is also a member of a brother-sister group under common control, and thus, the Taxpayer cannot be a member of a combined group under common control. In short, the Taxpayer and the Company cannot be members of either the same parent-subsidary group under common control, the same brother-sister group under common control, or the same combined group under common control. Consequently, they are not members of the same group of trades or businesses under common control.

FACILITY

Section 29 does not define the term “facility” as that term is used in section 29(g)(1) and 29(f) of the Code. In our view, the definition of facility is dependent upon the nature of the qualified fuel. For example, gas produced from geopressured brine, devonian shale, coal seams, or a tight formation is a qualified fuel under section 29(c)(1)(B)(i) that is produced by drilling through the earth to the gas deposit. The Company's landfill gas is recovered through wells drilled into the landfill and the gas is produced by using a compressor that draws a vacuum on the producing wells. The Service does not view the wells drilled into the landfill as wells in the sense of obtaining gas from gas deposits for qualified fuels under section 29(c)(1)(B)(i). Rather, the facility required to produce, filter, compress, and measure the gas is considered to be the “facility” for purposes of section 29(g)(1) and 29(f).

The Taxpayer represents that additional wells may be added to the collection system after an initial group of wells are placed in service. These additional wells will become part of an integrated collection system. Wells may be abandoned and replaced with new wells in order to maintain production of landfill gas. As the biomass in the landfill decomposes and the landfill gas is extracted, the biomass may shift or settle. This shifting or movement may require the drilling of new wells. These new wells will be considered part of the facility as long as they are connected to the existing collection and processing systems.

BINDING WRITTEN CONTRACT UNDER SECTION 29(g)(1)

Section 29(g)(1) of the Code extends the section 29 credit after 1992 for a facility that produces certain qualified fuels if the facility is placed in service before January 1, 1997 pursuant to a binding written contract in effect before January 1, 1996. A written contract to acquire or construct a facility for producing qualified fuels will satisfy the written binding contract requirement. 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. Design changes to a binding contract to construct a facility that are made for reasons of technical or economic efficiencies of operation and that cause an insignificant increase in the original contract price should not constitute substantial modifications of the contract so as to affect the status of the facility under the written binding contract requirement of section 29(g)(1).

Section 1.701-2(e) of the regulations permits the Commissioner to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or regulations.

To determine whether or not sales of the qualified fuel will qualify for the section 29 credit, it first must be determined whether the Company is treated as an aggregate of its members or as a separate entity. When subchapter K was enacted, Congress did not intend to infer:

that a partnership is to be considered as a separate entity for the purpose of applying other provisions of the internal revenue laws if the concept of the partnership as a collection of individuals is more appropriate for such provisions.

H. R. Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954). This principle is embodied in section 1.701-2(e) of the regulations.

The Company entered into a contract with Subsidiary A for the design and construction of the Facility for the Landfill pursuant to the Construction Agreement. The Taxpayer represents that the Construction Agreement is a firm, fixed-price contract. The Construction Agreement does not contain any liquidated damages provision limiting damages for breach of contract. At the time the Investment Member becomes a member of the Company, the Construction Agreement satisfies the written binding contract because the Company is a separate taxpayer from the Taxpayer, Subsidiary A, and Subsidiary B. So long as the Investment Member is a *** percent member of the Company before January 1, 1996, and before the Facility is placed in service, the Construction Agreement is a written binding contract for purposes of section 29(g)(1).

PLACED IN SERVICE

In order to qualify for the section 29 credit, the Facility must be placed in service before January 1, 1997. Section 29 does not describe when property is treated as placed in service. However, the term is defined for purposes of the investment tax credit and

depreciation deductions. For example, section 1.46-3(d)(1)(ii) of the regulations provides that property is considered placed in service in the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function. Section 1.46-3(d)(2) provides examples of when property is considered in a condition or state of readiness and availability for a specifically assigned function within the meaning of section 1.46-3(d)(1)(ii). Such examples include where “[e]quipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects.” The term “placed in service” has consistently been construed as having the same meaning for purposes of the investment tax credit and depreciation deductions. See, e.g., Rev. Rul. 76-256, 1976-2 C.B. 46; *Wilkison v. Commissioner*, 55 T.C.M. 1635 (1988).

In Rev. Rul. 76-256, 1976-2 C.B. 46, a coal-fired electric generating unit was placed in service (i.e., in a condition or state of readiness and availability for a specifically assigned function) when: (1) the necessary permits and licenses to operate the generating unit had been approved; (2) the generating unit was synchronized into the taxpayer's power grid for its function in the business of generating electric energy for the production of income; (3) the critical tests for the various components of the generating unit had been completed; (4) the generating unit was placed in the control of the taxpayer by the contractor; and (5) the daily operation of the generating unit had begun, notwithstanding the fact that the generating unit would undergo further testing to eliminate any defects.

Rev. Rul. 76-428, 1976-2 C.B. 47, describes the major components that are necessary to the operation of a nuclear generating unit as including a nuclear steam supply, a reactor auxiliary system, a control and safety instrumentation system, a radioactive waste disposal system, a fuel handling and storage system, a turbine system, and a containment system. Under the facts and circumstances described in Rev. Rul. 76-428, the unit was placed in service when: (1) the necessary permits and licenses had been approved; (2) all critical tests for various components had been completed; (3) the nuclear electric generating unit had been placed in the control of the taxpayer by the contractor; and (4) the generating unit had been synchronized into the taxpayer's power grid for its function in the business of generating nuclear electrical energy for the production of income, even though the generating unit would undergo further testing to eliminate any defects.

Based on the above factors, the Taxpayer represents that: (1) all licenses and permits necessary to operate the Facility will be obtained before it is placed in service; (2) the Facility will have completed all “critical testing” before it is placed in service; (3) the Facility will be under the Company's control once construction is complete; and (4) the Facility's ability to produce landfill gas for commercial sale will be complete. Thus, if all these events occur before January 1, 1997, and daily operations of the Facility begins before January 1, 1997 (even if further testing of the Facility to eliminate any defects occurs after that date), the Facility will be placed in service for purposes of section 29(g)(1) and 29(f) of the Code, pursuant to binding written contract that was in effect before January 1, 1996.

Accordingly, provided that (A) the Company's section 29 credit is allocated to its members in accordance with the members' interests in the company as of the time the section 29 credit arises; and, (B) when the limited partnership becomes a member of the Company, the section 29 credit also is allocated to its partners in accordance with the partners' interests in the limited partnership as of the time the section 29 credit arises, we rule, based on the Taxpayer's representations, as follows:

(1) The landfill gas produced by the Company is a qualified fuel under section 29(c)(1)(B)(ii) of the Code and its sale to an unrelated party qualifies the Company to the credit for producing fuel from a nonconventional source under section 29(a).

(2) The Company and the Taxpayer are not treated as a single employer under the regulations prescribed under section 52(b) of the Code, and, therefore, the Company is unrelated to the Taxpayer within the meaning of section 29(a)(2)(A) and 29(d)(7).

(3) The sale of landfill gas by the Company to the Taxpayer is a sale qualifying under section 29(a) and qualifies the Company to claim the credit for producing fuel from a nonconventional source.

(4) The facility required to collect, produce, filter, compress, and measure the gas for commercial sale is considered to be a facility for purposes of section 29(g)(1) and 29(f) of the Code.

(5) The facility includes all of those assets that are operational and devoted to the production of landfill gas before January 1, 1997.

(6) If the Investment Member becomes a member of the Company before the Facility is placed in service and prior to January 1, 1996, the Construction Agreement between the Company and Subsidiary A will be considered a binding written contract for purposes of section 29(g)(1) of the Code as of the date the Investment Member becomes a member of the Company, provided that neither the Taxpayer nor any group of trades or businesses under common control of which it is a member will own (A) greater than a *** percent interest in the capital or profits of the Investment Member; or (B) greater than a *** percent interest in the capital or profits of the Company. If the Investment Member does not become a member of the Company until after December 31, 1995, or after the Facility is placed in service, the Construction Agreement will not be considered a binding written contract for purposes of section 29(g)(1). Accordingly, if these conditions are satisfied, a binding contract will be in effect prior to January 1, 1996, and the Facility will be considered to have qualified for the credit extension under section 29(g) if it is placed in service prior to January 1, 1997.

No opinion is expressed on whether the Company and the limited partnership are properly classified as partnerships for federal tax purposes. No opinion is expressed on how the members' interests in the Company and the partners' interests in the limited partnership are determined. See section 702(a)(7) of the Code and section 1.704-1(b)(4)(ii) of the regulations. Finally, no opinion is expressed concerning the consequences of the above described facts under any other provision of the Code or regulations.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that this ruling 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 any such regulations are inconsistent with any conclusions in this ruling. See section 11.04 of Rev. Proc. 95-1, 1995-1 I.R.B. 9, 41. However, when the criteria of section 11.05 of Rev. Proc. 95-1 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, a copy of this letter is being sent to the Taxpayer's authorized legal representative.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of the Assistant

Chief Counsel

(Passthroughs and Special

Industries)

Enclosure:

6110 copy

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The term 'MMbtu' means one million Btus (British thermal units).