

Private Letter Ruling 9627022, 7/05/1996, IRC Sec(s). 29

UIL No. 0029.00-00; 0029.01-00; 0029.05-00

Date: April 9, 1996

CC:DOM:P&SI:6-TR-31-1893-95

In re : ***

LEGEND:

Taxpayer = ***

Subsidiary A = ***

Subsidiary B = ***

Corp A = ***

Corp B = ***

Corp C = ***

State X = ***

State Y = ***

State Z = ***

District = ***

Dear ***

This responds to a letter dated August 22, 1995, and subsequent correspondence, submitted on behalf of the Taxpayer and its subsidiaries. In the letter, rulings are requested under section 29 of the Internal Revenue Code relating to construction of landfill gas collection systems to be owned and operated by the Taxpayer's subsidiaries. The parties involved and the represented facts are set forth below.

The Taxpayer is a corporation organized under the laws of State X. The Taxpayer is the common parent within the meaning of section 1504(a) of the Code of an affiliated group of corporations. The Taxpayer, Subsidiary A and Subsidiary B, and Corp A, Corp B, and Corp C are all under the examination jurisdiction of the District.

Subsidiary A is organized under the laws of State Y. Subsidiary A is a *** subsidiary of the Taxpayer and is a member of the Taxpayer's affiliated group. Subsidiary A, in turn, is the parent of numerous operating subsidiaries that are also members of the Taxpayer's affiliated group.

Subsidiary A, through certain of its *** subsidiaries (the "Landfill Subs"), provides integrated solid waste management services, including the operation of approximately *** solid waste disposal landfills throughout the United States. Of the *** solid waste disposal landfills, approximately *** of the sites produce landfill methane gas that is sold to third parties for the generation of electricity or other uses.

Corp A is a corporation organized under the laws of State X. Corp A is *** percent owned by Subsidiary B, a *** subsidiary of the Taxpayer, *** percent by the Taxpayer

directly, and *** percent by Corp C, which is *** percent owned by the Taxpayer and *** percent owned by the public. Due to the fact that no entity owns 80 percent of Corp A, Corp A is the common parent within the meaning of section 1504(a) of the Code of its own affiliated group of corporations. Because Corp C is *** percent owned by public shareholders, Corp A and Corp B are indirectly *** percent owned by the public.

Corp B is organized under the laws of State Z. Corp B is a *** subsidiary of Corp A and is a member of Corp A's affiliated group. Corp B is a consulting engineering firm that as a segment of its business designs and manages the construction of gas collection systems and gas-to-energy facilities for solid waste disposal landfills. The Landfill Subs have contracted with Corp B, in addition to other construction companies, for the construction and oversight and development of its solid waste landfill gas collection systems. In addition, Corp B provides design and construction management services to other third-party landfill owners and operators.

The Taxpayer represents that Subsidiary A is operator of commercial sanitary waste landfills in the United States. Waste is hauled to one of the Landfill Subs' solid waste landfills for disposition. The decomposing of organic-rich-stored waste in a sanitary landfill produces methane gas as a natural by-product. Landfill gas is approximately 45 percent carbon dioxide and 55 percent methane gas. The methane gas by-product poses a serious health and safety hazard and the Taxpayer represents that because of this hazard, the landfill owner is required by federal and state regulations, in most instances, to control the landfill methane gas. See e.g., 40 C.F.R. section 258.23.

According to the Taxpayer, a gas collection system is installed to monitor and collect the gas. Gas that is not properly vented can explode causing damage to life and property. Companies owning landfills can control the gas by installing passive systems such as trenches, barriers, and vents to prevent gas from migrating underground and to give the gas an outlet into the atmosphere. Another way to control the landfill gas, according to the Taxpayer, is by installing active systems in which gas is drawn via a vacuum to the surface by wells and a blower. The gas is either flared, vented, or collected for further use. The Landfill Subs typically install an active landfill gas collection system to efficiently remove and dispose of the methane gas. After the gas is collected by one of the Landfill Subs, the landfill methane gas could be flared, sold for energy generation, used in leachate management, used in the production of methanol, used in the production of liquefied natural gas, or used in other methane "utilization" processes.

According to the Taxpayer, in designing a solid waste landfill, a topographical plan ("Footprint") is made detailing the topography, height, and volume of the landfill. The Footprint also includes the placement of the integrated gas collection system wells, trenches, and piping. The Footprint represents the final topography of the landfill and corresponding systems after the landfill is ultimately filled with solid waste and covered. Before construction of the landfill, the Footprint is submitted to state and Federal regulatory agencies for approval of the design and capacity of the landfill.

The Taxpayer further represents that the landfill gas collection system consists of gas collection wells and trenches connected by lateral pipeline to form an interconnected network. The methane gas is recovered through wells and trenches drilled into the landfill. The header pipeline conveys the gas to a location, known as a "condensate knock-out vessel," where the gas is filtered of liquids and particulate matter. The methane gas is produced by the use of a blower that draws a vacuum on the producing wells and trenches and compresses the gas for delivery to the "utilization" equipment. The methane gas then proceeds to a meter where it is measured and recorded (gas flow, Btu content, etc.). The methane gas is then ultimately flared or sold for beneficial use.

The gas production of a typical landfill changes over time because of the changing microbial activity that creates the gas. Once a landfill stops accepting refuse and is capped, modification of the production facility occurs only for maintenance reasons. Wells, trenches, piping, and the other equipment is replaced when its functional performance degrades. A replacement well is installed to collect the gas from the same radius of influence when the original well fails to produce the expected gas quantity or quality. Inadequate gas production from a well can stem from physical damage (due to settlement, for example), plugging of the gas transport passageways (pipe slots or gravel interstitial space, for example), the movement of free liquids within the refuse mass, or other occurrences that block the flow of gas from the extraction point. The occurrence of these problems and the resulting need for replacement wells is largely unpredictable due to various site specific landfill construction and refuse composition factors.

According to the Taxpayer, Corp B typically designs the gas collection systems for the Landfill Subs. The required gas collection system equipment is then procured by the Landfill Subs. The gas collection system construction and installation work is performed by various unrelated third-party general contractors specializing in this type of construction work. These general contractors contracted with the Landfill Subs for the construction and installation of the systems, with Corp B acting as construction oversight agent for the Landfill Subs (the "Construction Contract"). The Taxpayer represents that a Construction Contract is valid under state law and provides for liquidated damages of at least 5 percent of the cost of the production facility. Before the equipment is installed, the appropriate Air Emission and Solid Waste Construction permits under authority delegated by the EPA are obtained. After the equipment is installed, the state agencies confirm that the Landfill Subs are in compliance with the applicable permits. As the solid waste landfill expands due to the addition of more solid waste, more wells and gas collection system piping are installed to capture the methane gas. It costs approximately *** per acre of landfill to design, permit, and install a typical gas collection system.

The Taxpayer (or its subsidiaries) is required to notify the state environmental agencies for changes to the gas collection system. The notification requirements are established by the various states and may range from a more formal permit modification to a filing of an as-built drawing. The state environmental agencies have authority delegated by the EPA to regulate the landfill gas collection systems.

In the Taxpayer's transactions, the various Landfill Subs contracted before January 1, 1996, with Corp B to design gas collection systems including wells and trenches on approximately *** solid waste landfills owned and operated by the Landfill Subs (the 'Design Contract'). The Design Contract identifies the design of each gas collection system needed for the solid waste landfill, including the number and type of methane gas collection wells.

The Landfill Subs contracted before January 1, 1996, with unrelated third-party vendors to acquire the materials (piping, etc.) needed to construct the solid waste landfill methane gas collection system (the "Acquisition Contract") as detailed in the Footprint. The costs involved in each of material Acquisition Contract are in excess of 5 percent of the total cost of the methane gas collection system detailed in the Footprint. The material Acquisition Contract is also a valid written contract under state law. The Acquisition Contract does not contain any liquidated damages provision limiting damages for breach of contract.

The Taxpayer represents that the Design Contract, Acquisition Contract, and Construction Contract for each gas collection system were entered into before January 1, 1996, and each gas collection system will be "placed in service" before January 1, 1997.

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.

Sections 29(f)(1)(B) and 29(f)(2) of the Code provide that the section 29 credit applies to qualified fuels which are produced in a facility that was placed in service after December 31, 1979, and before January 1, 1993, and which are sold before January 1, 2003. Section 29(g)(1)(A) modifies section 29(f)(1)(B) to extend the section 29 credit for qualified fuels described in sections 29(c)(1)(B)(ii) or 29(c)(1)(C) 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, section 29(g)(1)(B) modifies section 29(f)(2) to provide that the credit is available for fuels sold before January 1, 2008. Section 29(g)(1) provides, however, that section 29(g)(1) does not apply to any facility that produces coke or coke gas unless the original use of the facility commences with the taxpayer.

The first requested ruling involves the written binding contract requirement in section 29(g)(1)(A) of the Code. Section 29(g)(1) 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. Section 29 does not define the term “facility;” however. In our view, the facility includes wells drilled, dug, or laid into the landfill, the compressor that draws a vacuum on the producing wells, and the collection system that collects the gas. The Service does not view wells drilled, dug, or laid 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). Thus, the facility is the entire gas collection system (wells and/or trenches, condensate knock-out vessel, blower, and meter) because it produces, filters, compresses, and measures the landfill-produced methane gas.

A written contract to acquire or construct a “facility” for producing qualified fuels will satisfy the written binding contract requirement under section 29(g)(1) of the Code. 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).

The Taxpayer represents that each Construction Contract is valid under state law and provides for liquidated damages of at least 5 percent of the cost of the production facility. Each Construction Contract entered into by the Landfill Subs with an unrelated third-party general contractor satisfies the written binding contract requirement under section

29(g)(1) of the Code even though Corp B is named construction oversight agent for the Landfill Subs in the contract. The mere fact that the Landfill Subs contracted with Corp B for the Design Contract does not change this conclusion. The Design Contract identifies the design of the gas collection system needed for each production facility. The Acquisition Contract, in comparison, does not satisfy the written binding contract requirement by itself because it does not involve a contract to construct or acquire the production facility from an unrelated third-party. However, the Construction Contract alone satisfies the requirement.

The second requested ruling involves the placed-in-service requirement in section 29(g)(1)(A) of the Code. 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 first 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.

The Taxpayer represents that the appropriate state Air Emission and Solid Waste Construction permits will be obtained. After installation of the equipment, the state agencies will confirm that the Landfill Subs are in compliance with the applicable permits. The Landfill Subs will own and control the landfills and production facilities. If these events occur before January 1, 1997, and daily operations of the production facility begins before January 1, 1997 (even if further testing of the facility to eliminate any defects occurs after that date), the production facility will be placed in service for purposes of section 29(g)(1)(A) of the Code, but only for wells and/or trenches in place by that date.

Accordingly, based on the Taxpayer's representations, we rule as follows:

(1) The Construction Contract entered into before January 1, 1996, between the Landfill Subs and third-party general contractors for the construction and installation of the gas collection system constituting the facility satisfies the written binding contract requirement under section 29(g)(1)(A) of the Code. Based on favorable ruling number 2, the section 29 credit is allowed under section 29(g)(1)(B) through December 31, 2007, for fuel satisfying the requirements of section 29(a)(2). The naming of Corp B as construction oversight agent for the Landfill Subs does change this conclusion.

(2) The gas collection system constituting the production facility will satisfy the placed-in-service requirement in section 29(g)(1)(A) if before January 1, 1997, the landfill has an operational gas collection system (well and/or trench, condensate knock-out vessel, blower, and meter), where: (1) the necessary permits and licenses to operate the facility have been approved; (2) the facility begins to function in the business of producing landfill gas for the production of income; (3) the critical tests for the various components of the facility have been completed; (4) the facility was placed in the control of the Taxpayer (or the Landfill Subs) by the third-party general contractor; and (5) the daily operation of facility has begun, notwithstanding the fact that the facility may have to undergo further testing to eliminate any defects.

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. 96-1, 1996-1 I.R.B. 8, 39. However, when the criteria of section 11.05 of Rev. Proc. 96-1 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. A copy of this letter should be attached to the Taxpayer's consolidated federal income tax return for the first taxable year in which a Landfill Subs claims the section 29 credit for landfill gas produced from a facility constructed pursuant to the Construction Agreement.

Sincerely yours,

CHARLES B. RAMSEY

Chief, Branch 6

Office of the Assistant

Chief Counsel

(Passthroughs and Special

Industries)

Enclosure:

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