Chapter 11
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Section 29 Tax Credits for Synthetic Fuel from Coal

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Synopsis

§ 11.01. Introduction.

Section 29 of the Internal Revenue Code provides a credit against federal income tax for producing and selling "synthetic fuel from coal" and certain other qualified fuels.[1] Synthetic fuel from coal, referred to throughout this chapter as "synfuel," is any fuel which has a chemical

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (26 U.S.C.), as amended (the "Code").

composition significantly different from the coal used to produce it. Because the credit is often worth more than the cost of the feedstock used to produce synfuel, producers can afford to sell synfuel at a discount from market prices for coal even though coal and synfuel may be marketed to the same consumers, and used for the same purposes (primarily as fuel for coal-based electricity generating facilities).

A series of events in the late 1990s helped determine the potential impact of synfuel and the section 29 credit on the traditional domestic coal market. First, the deadline for building a processing facility for synfuel passed, so that new facilities built to process synfuel can not produce a product which qualifies for the credit. Second, the IRS issued a series of favorable private rulings to the owners of existing synfuel facilities on various issues related to claiming the credit. These rulings made large coal and energy concerns more willing to invest in synfuel facilities. Third, the IRS ruled that outside investors can participate in the production of synfuel using a pay-as-you-go structure allowing synfuel facility owners to monetize the tax credit.[2] Finally, utilities began signing significant purchase contracts indicating their willingness to burn synfuel at their coal-based electricity generating facilities.

These developments of the late 1990s, combined with the market advantage sellers of synfuel have over sellers of conventional coal, have recently swept synfuel into a spotlight of cash and controversy. In terms of cash, the credit could yield nearly $10 billion in tax relief to credit investors.[3] As for controversy, a Governor and at least five members of Congress have weighed in publicly on the integrity of the credit. This chapter will explain the history of the section 29 credit and the technical requirements of claiming and calculating the credit specifically with regard

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2 For a contemporary analysis of the developments allowing synfuel facility owners to benefit from the tax credit without otherwise having significant taxable income, *see* Grindinger, Dennis J., "Various Structures for Shifting Section 29 Credits from Producer to Investor," 17 *E. Min. L. Inst.* ch. 13 (1997).

3 Estimate based on seven years remaining under the sunset provision, with a 12,000 Btu average synfuel, and 55.3 million tons of optimal annual synfuel production. Annual synfuel production estimates from Resource Data International, Inc., Financial Times Energy, *Synthetic Fuel Tax Credits: U.S. Coal Industry Impacts* (2000), at 13.

to synfuel.[4] This chapter then will review some of the current synfuel industry practices and perceived problems with the credit. Finally, the chapter concludes with a proposal aimed at ensuring the viability of the section 29 credit for synfuel by narrowing its application to practices more closely related to the original legislative intent.

§ 11.02. Application of the Section 29 Credit to Synthetic Fuel from Coal.

This section of the chapter begins by reviewing the history of the section 29 credit. The legislative history of the credit is significant in light of public speculation that the practical application of the credit with regard to synfuel has deviated from the original purpose of the credit program. This section then outlines the statutory and administrative requirements for claiming the credit for synfuel as well as the actual calculation of the credit value. Finally, this section summarizes the practice of monetizing tax credits.

[1] — History of Section 29.

The legislation that produced section 29 was a product of the weight of the oil crises. One of the first Congressional efforts to encourage new domestic energy technology as a reaction to the oil crisis came in the Energy Tax Act of 1978.[5] The Energy Tax Act of 1978 added new section 48(l) to the Code in effect at the time. Section 48(l) defined "energy property" for purposes of a new credit program to include "alternative energy property." Under the original definition of alternative energy property, taxpayers were entitled to a credit for expenditures related to "equipment which uses coal (including lignite) as a feedstock for the manufacture of chemicals or other products (other than coke or coke gas)."[6]

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4 The section 29 credit is also available for oil produced from shale and tar sands; gas produced from geopressured brine, Devonian shale, coal seams, or a tight formation; and gas produced from biomass. *See* I.R.C. § 29(c)(1). However, this chapter focuses exclusively on the section 29 credit as it applies to synfuel.

5 Energy Tax Act of 1978, Pub. L. No. 95-618, 95th Cong., 2d Sess. § 301 (1978).

6 I.R.C. § 48(1)(3)(A)(v) as originally in effect under the Energy Tax Act of 1978.