Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Area Counsel (Natural Resources: Houston)

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subject: Section 29(g): Definition of a "facility"
POSTF-152813-02

This memorandum is in response to your request dated November 6, 2002, with respect to the meaning of the term "facility," as used in connection with the production of qualified fuels described in Internal Revenue Code § 29(c)(1)(C).

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Issues

1. What property constitutes the facility under § 29 for the purpose of determining when a facility that produces solid synthetic fuel from coal is placed into service?

2. If a facility has been placed in service timely, how will the relocation of all or a portion of that facility affect its qualification for the credit under § 29?

3. If a portion of a facility that has been placed in service timely is moved, how is that portion to be valued in order to determine whether the relocated facility is newly placed in service?

Conclusions

1. For purposes of § 29, the facility includes only those components that directly convert coal into a solid synthetic fuel. The facility includes equipment beginning with the hoppers and reagent tanks that directly feed the mixing chambers and continues through briquetters or pelletizers and their associated output hoppers (and supporting structure(s) for this equipment). The facility includes the electrical, instrumentation, and

control systems (and related auxiliaries, including the structures that house the electrical, instrumentation and control systems) and the foundation platform(s) for this equipment.

2. A facility that has been relocated will be considered to have been placed in service as of the date that it was originally placed in service at the prior location only if the fair market value of the facility's relocated original property is more than 20 percent of the facility's total value immediately following the relocation.

3. For purposes of determining the portion of value attributable to the moved components of a facility, the value of the relocated components (as equipment not associated with any particular activity) should be compared with the cost of the new components. Use of a value based upon the market value of a synthetic coal facility that was placed in service prior to July 1, 1998, is inappropriate in valuing the moved components for purposes of continued qualification for the § 29 credit.

Facts

The Service has issued rulings that certain facilities that produce solid synthetic fuel from coal qualify for the credit under § 29. A typical facility is described below. The feedstock coal (feedstock) is sized through a screen, prior to entering the plant, and larger pieces pass through a crusher, that reduces the feedstock to a more uniform size. Then, the feedstock may be stored in an on-site bunker for which equipment may be needed to get the feedstock to a conveyor. Next, conveyors transport the feedstock to the plant entrance, which is usually between 20 and 40 feet above grade. The plant is a modular steel unit that is normally attached to a concrete pad that serves as its foundation. The plant includes a motor control center, in which the plant operator can monitor the processes, can modify the rate at which the conveyors transport either feedstock or the solid synthetic fuel product and can modify the rate at which the chemical reagent is added to the feedstock. Some of the plants include a "fluffer" to break up the coal agglomerate (i.e., separate the feedstock particles from each other). The plant includes sprayers or nozzles, which add the chemical reagent to the feedstock; a mixer or plug mill, in which the reagent is mixed with the feedstock; and either briquetters, which consist of two rollers set a certain distance apart from each other between which the feedstock-reagent mixture passes and is compressed in briquettes, or pelletizers, which extrude the feedstock-reagent mixture as pellets when rollers push the mixture out of a drum through holes. The plant may contain internal conveyors that transport the feedstock or product within it. Components of the plant include finished product collection and stacking conveyors, which carry the product from the plant to the product storage area. Also included are permanent tanks that hold the chemical reagent, pipes that connect the reagent tanks to the plant, and pumps that move the reagent from the tanks to the plant.

Analysis:

Issue 1.

In general, § 29 provides a credit for the production of solid synthetic fuel from coal. Section 29(g)(1) (added by P.L. No. 104-188 (1996)) provides a tax credit for the sale of qualified fuels that are sold through the end of 2007 and produced from a facility that was originally placed in service after December 31, 1992, and before and July 1, 1998, pursuant to a binding written contract that was in effect before January 1, 1997. No regulations have been promulgated under § 29. Thus, we look to other published guidance of the Service and other analogous Code sections to interpret the meaning and scope of that section.

In Rev. Rul. 86-100, 1986-2 C.B. 3, a revenue ruling specifically addressing the use of coal in producing a qualified fuel under § 29, the Service adopted the definition of the term "synthetic fuel" that was the same as the definition used in former § 48(l) and its regulations (§ 48(l) was repealed for years after 1990) in interpreting that term in § 29(c)(1)(C). There the Service noted that former § 48(l)(3)(A)(iii) and § 29(c)(1)(C) contain almost identical language in describing the qualifying fuel. The revenue ruling also pointed out that the two provisions have the same overall congressional intent to encourage energy conservation and promote development of domestic energy production. However, former § 48(l) does not require a "facility," as does § 29, but focuses on equipment. Section 1.48-9(c)(5) of the regulations identifies equipment qualified for the energy investment credit, defining "synthetic fuel production equipment." A separate provision, § 1.48-9(c)(9), defines "handling and preparation equipment." This separate provision is based on a separate clause of the Code, § 48(l)(3)(C)(vii). Section 1.48-9(c)(5) covers equipment that converts an alternative substance into a synthetic solid, liquid, or gaseous fuel. Handling and preparation equipment includes equipment for unloading, transfer, storage, reclaiming from storage, and preparation (e.g., washing, crushing, drying, and weighing) of an alternative substance, such as coal, at the point where it was used in the synthetic fuel equipment also qualified for the credit. Section 48(l)(3)(A)(iii) is similar to § 29(c)(1)(C) in that both describe what qualifies under the provision for the production of a qualifying fuel. The equipment described in § 48(l)(3)(A)(vii) has no analogous provision in § 29 and this equipment is not included in a facility for purposes of § 29.

Revenue Ruling 94-31, 1994-1 C.B. 16, provides the Service's published position on what is a qualified facility for purposes of § 45(c)(3) (an analogous provision to § 29–both provisions are production credits as distinguished from the § 48(l) energy credit, which was an investment credit). This revenue ruling addresses a wind farm used to generate electricity from wind energy. While noting the array of equipment used to operate the wind farm and deliver the final product, the revenue ruling concludes, in part, that the term "facility" under § 45(c)(3) means the wind turbine (which includes blades, gear box, generator and a control and a communication mechanism), together with the tower on which the wind turbine is mounted and the pad on which the tower is situated. The revenue ruling further concludes that each wind turbine together with its tower and supporting pad is a separate facility. This definition

is quite narrow, excluding from the term facility support and delivery assets such as transformers, on-site power collection systems, monitoring and meteorological equipment, and site improvements such as roadways and fencing. While the entire wind farm may be an integrated generating plant, for purposes of the energy credit, a turbine, a tower, and a pad constituted a facility.

The rationale of Rev. Rul. 94-31 excludes from a § 29 facility, preparation equipment, feedstock and product conveyors, and storage tanks. This result is consistent with the separate definitions contained in § § 1.48-9(c)(5) and (c)(9) of synthetic fuel production equipment and the handling and preparation equipment for purposes of the energy investment credit. Some components that qualified for purposes of the energy credit, a part of the general investment tax credit, are excluded from description of a facility that qualifies for the § 29 and § 45 production credits. The storage tanks and feedstock and end-product site improvements, equipment, and conveyors, while designed for and necessary to the operation of a particular plant, represent ancillary and auxiliary equipment and not synthetic fuel production equipment.

Congress provided in § 29(b)(4) for a reduction in the § 29 credit to the extent of energy investment credit allowed in respect of the property used to produce alternative fuels eligible for the credit. This offset represents Congressional intent to deny a credit windfall to projects that qualify for both credits. It does not represent an interrelation of the two credits for purposes of defining facility.

Issue 2.

To qualify for the § 29 credit for the production of synthetic fuels, the facility that produces the fuel must have been placed in service by a particular time. If this placed in service date is met for a facility, the subsequent relocation of the facility will not affect the availability of the credit so long as all essential components of the facility are retained and the production capacity of the relocated facility is not significantly increased at the new location. Rev. Proc. 2001-30, 2001-1 C.B. 1163.

After determining what equipment constitutes a facility (see Issue 1 above), it is necessary to distinguish the relocation of a facility that continues to be treated as timely placed in service for the § 29 credit, from the creation of a new facility with a new placed-in-service date. This issue has not been addressed in any published guidance upon which taxpayers in general may rely. However, numerous Private Letter Rulings (PLRs) have been issued to taxpayers on this topic. These rulings provide that the replacement of parts as part of the relocation of a facility will not result in a new placed-in-service date for the facility or otherwise prevent the facility from continuing to be treated as timely placed in service, if the fair market value of the original property is more than 20 percent of the facility's total fair market value immediately following the relocation and replacement. The basis for this conclusion is Rev. Rul. 94-31. That ruling held that, for purposes of § 45, a facility qualifies as newly 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).

It has been suggested that, despite the conclusion in the PLRs, Rev.Rul 94-31 does not justify holding that a facility continues to have the same placed-in-service date after relocation, if more than 20 percent of the facility's value at the new location is attributable to the facility at the prior location. Rather, the revenue ruling should be understood to create a safe harbor for purposes of § 45 that, so long as not more than 20 percent of a facility was not originally placed in service a prior qualifying facility, the facility's § 45 credit entitlement will not be challenged simply because each component of the facility was not "originally" placed in service with that facility. Then, applying this conclusion to the synthetic fuel facility at issue, the facility in the new location will retain the same placed-in-service date as the original facility so long as no more than 20 percent of the value of the relocated facility comes from property other than that which had been originally placed in service. This is because Rev. Rul. 94-31 concerns how much of the value of a new facility can come from parts that were previously placed in service without the Service questioning whether the entire facility was "originally placed in service" in its current configuration, for purposes of the § 45 credit.

However, Rev. Rul. 94-31 was not issued as a safe harbor revenue ruling. If the facts given had been that not more than 20 percent of the facility was from a prior qualifying facility, we could argue that some higher percentage is required for a facility to continue its placed in service date. The argument would be that the ruling was merely concluding, under its facts of not more than 20 percent of the prior facility being included in the new facility, a new placed in service date occurred but that we would not find a continuation of the old placed in service until more than, say, 50 percent of the value of the new facility was from the prior facility. However, because the not more than 20 percent test is only in the analysis and the holding portion of the revenue ruling, this test is a conclusion on how to determine if a facility keeps its prior placed in service date or has a new placed in service date. Rev. Rul. 94-31 concluded a facility was a new facility if it did not contain more than 20 percent of its value from a prior facility. The necessary implication of conclusion is that a facility would not be a new facility, but retain its prior placed in service date and fail to produce electricity that would qualify for the § 45 credit, if the facility did have more than 20 percent of its value from a prior facility. A facility either has the prior placed in service date or a new placed in service date. The PLRs draw the conclusion from Rev. Rul. 94-31 that any facility in which more than 20 percent of the value is derived from the prior facility continues to have the placed in service date of the prior facility.

Issue 3

The relocation of a qualified facility producing synthetic fuel from coal will not disqualify the relocated facility from producing qualified fuel so long as a certain minimum amount of the relocated facility comes from the prior qualifying facility. This amount is based on a comparison of the fair market value of the property from the prior qualifying facility with the sum of the cost of the new property and the fair market value of the property from the prior qualifying facility. The method used to determine value of the moved

portion of the facility in relation to the total value of the facility can have a significant effect on such determinations. A market-based valuation of an entire plant that includes an assignment to specific, relocated equipment of the component of value attributable to the existing facility's ability to generate qualified fuel and, consequently, § 29 credits would significantly distort any comparison to the total value of the relocated plant since any newly added equipment would be at cost without any allocation of value generated by the credit.

As discussed above, Rev. Rul. 94-31 holds that, for purposes of § 45:

> A facility would qualify 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).

The ruling compares the value of the used property with the cost of the new property. Since the values discussed in the revenue ruling represent the used property unenhanced by an ability to generate tax credits, the relationship of the value of used property to the cost of new property would not create an "apples and oranges" comparison and thus no distortion. But if the fair market value of the equipment in the prior qualifying facility reflected the facility's qualification to produce both a marketable product and tax credits attributable to such production, there would be a significant distortion.

Here, the value of the materials used to construct a synthetic fuel production facility permit a comparison between the part of the facility that comes from the facility that was previously, and timely, placed in service and the part of the facility that was not. This comparison is used to determine whether the relocated facility is a qualified continuation as the facility in the prior location. If so, the relocated facility can produce qualified fuel for purposes of § 29.

The fair market value of a synthetic fuel facility that has been timely placed in service will include the value of potential tax credits. Thus, the fair market value of the facility's equipment that is relocated, if derived from the market value of the prior plant, less the value of used equipment not transferred will inflate the value of the transferred equipment compared to the cost of new equipment installed at the new location. However, any valuation method used to determine whether a relocated facility qualifies for treatment under § 29 as the prior facility should use an approach that compares fair market value of the moved components (as used equipment not associated with any particular activity) with the cost of the new components. Such valuation method will minimize anomalous distortions and will reflect the proper application of Rev. Rul. 94-31.

If you have any further questions, please contact at .