Internal Revenue Service

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Department of the Treasury
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LEGEND:

Taxpayer:	=
Ruling 1	=
Ruling 2	=
Date 1:	=
Date 2:	=
Date 3:	=
X	=
Y	=
Facility 1	=
Facility 2	=
State	=
y%	=
Site	=
Year 1	=
Date 4	=
A	=
B	=

Dear :

This letter is in response to your letter dated February 20, 2004, requesting rulings under § 29 of the Internal Revenue Code.

The facts as represented are as follows:

Taxpayer received Ruling 1 on Date 1 and Ruling 2 on Date 2 (Prior Rulings), which ruled on the issues addressed by this letter. Taxpayer seeks a confirmation of the rulings in light of Taxpayer's contribution of its interest in X to Y and the change of the chemical reagents used in the facilities.

Facility 1 is owned by X. X was wholly owned by Taxpayer until Date 3, when Taxpayer contributed its entire interest in X to Y. Because X is an entity disregarded for federal income tax purposes, Y is treated as the owner of Facility 1 for federal income tax purposes. Facility 2 is owned by Y. Y is a State limited partnership. Taxpayer, indirectly through entities wholly owned by Taxpayer, owns y% of Y. Facility 1 and Facility 2 are identical and designed to produce a solid synthetic fuel from coal.

Currently, the Facilities are located at Site. In Date 4, Taxpayer and A reached an agreement under which A will purchase synfuel from X and Y. A also entered into an agreement with X and Y to perform certain services for the Facilities. The day-to-day operations at the Facilities are conducted by B.

Taxpayer has supplied a detailed description of the process employed at the Facilities. Taxpayer also has proposed that, from time to time, one of several alternative chemical reagents may be used in the process for the production of synfuel. As described, the Facilities and the process implemented in the Facilities, including the chemical reagents, meet the requirements of Rev. Proc. 2001-34, 2001-22 I.R.B. 1293.

A recognized expert in coal combustion chemistry has performed numerous tests on the coal used at the Facilities and the synfuel produced at the Facilities and has submitted reports in which the expert concludes that significant chemical changes take place with the application of the process to the coal, including the alternative chemical reagents. Taxpayer, with use of the process, expects to maintain a level of chemical change in the production of synthetic fuel that is determined through similar analysis by experts to be a significant chemical change.

The rulings issued in prior rulings, which you wish to be reconfirmed in this private letter ruling are as follows:

1. Each facility will continue to produce a "qualified fuel" within the meaning of § 29(c)(1)(C).

2. The production of the qualified fuel from the Facilities will be attributable solely to Y, entitling Y to the § 29 credit for the production of the qualified fuel from the Facilities that is sold to an unrelated person.

3. The § 29 credit that is attributable to Y may be allocated to the partners of Y according to their ownership interest in Y at the time that the credit arises. For purposes of this allocation, a partner's interest in Y is determined by a valid allocation of that partner's share in the gross receipts from the sale of the qualified fuel.

4. If the Facilities were “placed in service” within the meaning of § 29(g)(1) prior to July 1, 1998, relocation of one or both of the Facilities after June 30, 1998, or replacement of a part of a Facility after that date will not result in a new placed in service date for that Facility for purposes of § 29, provided that the fair market value of the original property is more than 20 percent of that Facility’s total fair market value at the time of the relocation or replacement.

The changes in facts since the issuance of the prior rulings are the Taxpayer’s contribution of its interest in X to Y and the change of the chemical reagents used in the facilities as described above.

The above rulings are not affected by the Taxpayer’s contribution of its interest in X to Y and the change of the chemical reagents used in the facilities as described in the ruling request.

RULING REQUEST #1 and 2

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 are 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 alternate substance used to produce it. Coal is an alternate substance under § 1.48-9(c)(2)(i).

Consistent with its private letter ruling practice that began in the mid 1990’s, the Service, in Rev. Proc. 2001-30, provided that taxpayers must satisfy certain conditions in order to obtain a letter ruling that a solid fuel (other than coke) produced from coal is a qualified fuel under § 29(c)(1)(C). Rev. Proc. 2001-30, as modified by Rev. Proc. 2001-34, 2001-1 C.B. 1293. The revenue procedure requires taxpayers to present evidence that all, or substantially all, of the coal used as feedstock undergoes a

significant chemical change. To meet this requirement and obtain favorable private letter rulings, taxpayers provided expert reports asserting that their processes resulted in a significant chemical change.

In Announcement 2003-46, 2003-30 I.R.B. 222, the Service announced that it was reviewing the scientific validity of test procedures and results presented of significant chemical change in expert reports. In Announcement 2003-70, 2003- I.R.B. 1090, the Service announced that it had determined that the test procedures and results used by taxpayers were scientifically valid if the procedures were applied in a consistent and unbiased manner. However, the Service concluded that the processes approved under its long standing ruling practice and as set forth in Rev. Proc. 2001-30 did not produce the level of chemical change required by § 29(c)(1)(C). Nevertheless, the Service announced that it recognized that many taxpayers and their investors have relied on its long standing ruling practice to make investments. Therefore, the Service announced that it would continue to issue rulings on significant chemical change, but only under the guidelines set forth in Rev. Proc. 2001-30, as modified by Rev. Proc. 2001-34.

This ruling is provided to Taxpayer consistent with Announcement 2003-70 and the Service's long standing ruling practice. Accordingly, based on the expert test results submitted by Taxpayer, we conclude that the synthetic fuel produced at the Facilities using the described process and specified chemical reagents is a solid synthetic fuel produced from coal constituting a "qualified fuel" within the meaning of § 29(c)(1)(C). Because Y will own Facility 2 and operate and maintain Facility 2 through its agent, we conclude that Y will be entitled to the § 29 credit for the production of the qualified fuel from Facility 2 that is sold to an unrelated person. Because X, disregarded as an entity separate from Y, will own Facility 1 and operate and maintain Facility 1 through its agent, we conclude that Y will be entitled to the § 29 credit for the production of the qualified fuel from Facility 1 that is sold to an unrelated person.

RULING REQUEST #3

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.

Section 7701(a)(14) provides that "taxpayer" means any person subject to any internal revenue tax. Generally, under § 7701(a)(1), the term "person" includes an individual, a trust, estate, partnership, association, company, or corporation.

Section 702(a)(7) provides that each partner determines the partner's income tax by taking into account separately the partner's distributive share of the partnership's other items of income, gain, loss, deduction, or credit to the extent provided by regulations prescribed by the Secretary. Section 1.702-1(a) provides that the distributive share is determined as provided in § 704 and § 1.704-1.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit is, except as otherwise provided in chapter 1 of subtitle A of title 26, determined by the partnership agreement.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances) if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 1.704-1(b)(4)(ii) provides that allocations of tax credits and tax credit recapture (except for § 38 property) are not reflected by adjustments to the partners' capital accounts. Thus, these allocations cannot have economic effect under § 1.704-1(b)(2)(ii)(b)(1), and the tax credits and tax credit recapture must be allocated in accordance with the partners' interests in the partnership as of the time the tax credit or credit recapture arises. If a partnership expenditure (whether or not deductible) that gives rise to a tax credit in a partnership tax year also gives rise to valid allocations of partnership loss or deduction (or other downward capital account adjustments) for the year, then the partners' interests in the partnership with respect to such credit (or the cost giving rise to it) are in the same proportion as the partners' respective distributive shares of the loss or deduction (and adjustments). See § 1.704-1(b)(5), example (11). Identical principles apply in determining the partners' interests in the partnership with respect to tax credits that arise from receipts of the partnership (whether or not taxable).

Based on the information submitted and the representations made, we conclude that the § 29 credit attributable to Y may be allocated to the partners of Y in accordance with the members' interests in Y when the credit arises. For the allocation of the § 29 credit, a member's interest in Y is determined based on a valid allocation of the receipts from the sale of the § 29 qualified fuel.

RULING REQUEST #4

To qualify for the § 29 credit, Taxpayer's facility must be placed in service before July 1, 1998, pursuant to a binding written contract in effect before January 1, 1997.

Rev. Rul. 94-31, 1994-1 C.B. 16, concerns § 45, which provides a credit for electricity produced from certain renewable resources, including wind. The credit is based on the amount of electricity produced by the taxpayer at a qualified facility during the 10-year period beginning on the date the facility was originally placed in service, and sold by the taxpayer to an unrelated person during the taxable year. Rev. Rul. 94-31 holds that, for purposes of § 45, a facility qualifies 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 included in

the facility plus the value of the used property).

Rev. Rul. 94-31 concerns a factual context similar to the present situation. Consistent with the holding in Rev. Rul. 94-31, the relocation of the facility to a different location after June 30, 1998, or replacement of part of the facility after that date, will not result in a new placed in service date for the facility for purposes § 29 provided the fair market value of the property used at the original facility is more than 20 percent of the facility's total fair market value at the time of relocation or replacement (the cost of the new equipment included in the facility plus the value of the property used at the original facility).

Rev. Rul. 94-31 describes a windfarm that consists of an "array of wind turbines, towers, pads, transformers, roadways, fencing, on-site power collection systems, and monitoring and meteorological equipment." Notwithstanding that the windfarm consisted of all of these items, the ruling concludes that the "facility" for purposes of § 45 is confined to "the property on the windfarm necessary for the production of electricity from wind energy." (emphasis added.) The present situation is similar to Rev. Rul. 94-31. Thus, for purposes of determining the facility's total fair market value at the time of relocation or replacement, the facility consists of the process equipment directly necessary for the production of the qualified fuel, starting at the immediate input of the coal and chemical reagents to the pug mills or mixers (including any coal hoppers and reagent tanks directly feeding the pug mills or mixers) through the output from the pellet mills or other forming equipment (including output hoppers, if any). Hence, the facility's total fair market value includes the process equipment such as pugmills or mixers, the pellet mills or other forming equipment, the equipment necessary to interconnect such equipment, the electrical, instrumentation, control systems and auxiliaries related to such equipment (including the structures that house such electrical, instrumentation and control systems), the foundation platform(s) for the above-referenced equipment, and an appropriate allocation of the engineering, project management, overhead, and other costs assignable to the relocation of such equipment and construction. The facility's total fair market value does not include costs associated with the purchase and installation of equipment that supports the operation of the facility but is not directly necessary for the production of the qualified fuel, such as coal beneficiation, or preparation equipment (e.g., crushers, screens, dryers, or scales), other material handling or conveying equipment (e.g., stacking tubes, transfer towers, storage bunkers, mobile equipment, or conveyors), certain site improvements (e.g., fencing, lighting, earthwork, paving), separate office and bathhouse trailers for facility personnel, and buildings (if a "building" for purposes of § 168 of the Code).

Sampling and quality control are necessary for operational control of a production facility. However, a particular type of sampling equipment generally is not necessary for the production of qualified fuel. Thus, the costs of sampling equipment are excluded from the facility's total fair market value unless the particular sampling equipment is necessary for operational control of the facility.

Consistent with the holding in Rev. Rul. 94-31, provided the Facilities were "placed in service" prior to July 1, 1998, within the meaning of § 29(g)(1), relocation of one or both of the Facilities to a different location, or replacement of part of one of the Facilities after June 30, 1998, will not result in a new placed in service date for the Facilities for purposes of § 29 provided the fair market value of the original property is more than 20 percent of each of the Facilities' total fair market value at the time of relocation or replacement (the cost of the new equipment included in the facility plus the value of the used property).

CONCLUSIONS

Accordingly, we conclude as follows:

1. The synthetic fuel produced at the Facilities using the described process and the specified reagents is a solid synthetic fuel produced from coal constituting a “qualified fuel” within the meaning of § 29(c)(1)(C).

2. Production from the Facilities will be attributable solely to Y within the meaning of § 29(a)(2)(B), and Y shall be entitled to the § 29 credit for qualified fuel from the facility that is sold to an unrelated person.

3. The § 29 credit attributable to Y may be allocated to the partners of Y in accordance with the partners’ interests in Y when the credit arises. For the § 29 credit, a partner’s interest in Y is determined based on a valid allocation of the receipts from the sale of the § 29 qualified fuel.

The conclusions drawn and rulings given in this letter are subject to the requirements that the taxpayer (i) maintain sampling and quality control procedures that conform to ASTM or other appropriate industry guidelines at the facility that is the subject of this letter, (ii) obtain regular reports from independent laboratories that have analyzed the fuel produced in such facility to verify that the coal used to produce the fuel undergoes a significant chemical change, and (iii) maintain records and data underlying the reports that taxpayer obtains from independent laboratories including raw FTIR data and processed FTIR data sufficient to document the selection of absorption peaks and integration points.

Except as specifically ruled upon above, we express no opinion concerning the federal income tax consequences of the transaction described above.

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.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Joseph H. Makurath
Senior Technician Reviewer
Office of Associate Chief Counsel
(Passthroughs & Special Industries)