Internal Revenue Service

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April 16, 2004

LEGEND:

Taxpayer	=
A	=
B	=
x	=
C	=
y	=
D	=
E	=
Year 1	=
Site 1	=
F	=
Date 1	=
Date 2	=
Date 3	=
Site 2	=
Date 4	=
Date 5	=
G	=
H	=
Site 3	=
Date 6	=

Date 7 =
Date 8 =
=

Date 9 =
Date 10 =
Date 11 =
Date 12 =
J =
K =

z =

Dear :

This letter is in response to a letter received from your authorized representative on January 23, 2004, requesting rulings under § 29 and § 708 of the Internal Revenue Code.

The facts as represented by Taxpayer and Taxpayer's authorized representative are as follows:

Taxpayer is a limited liability company that is classified as a partnership for tax purposes. Taxpayer is an accrual method taxpayer with a calendar taxable year. A and B are the members of Taxpayer. A, which owns x percent of Taxpayer, is a limited liability company that, for tax purposes, is disregarded as an entity separate from its single owner C. B owns the remaining y percent of Taxpayer. The sole asset of Taxpayer is its ownership interest in D, a limited liability company which, for federal tax purposes, is disregarded as an entity separate from Taxpayer. D's sole asset is the facility at issue in this request.

The facility at issue in this request was constructed in Year 1 for E to serve as a demonstration plant. The facility began production in Year 1 at Site 1. E made some improvements to the facility in Year 1. At the end of Year 1 production from the facility was stopped due to E's financial difficulties. At the end of Year 1, F approached E about purchasing the facility. In Date 1, E filed for bankruptcy, and one of its creditors foreclosed on the facility. In Date 2, B, the general partner of F purchased the facility from E's creditor directly, and then began production.

On Date 3, the B contributed the facility to F, which then moved the facility to Site 2. On Date 4, B and F received PLR-119659-97, which concluded that the fuel produced by the facility was a solid synthetic fuel produced from coal constituting a "qualified fuel" within the meaning of § 29(c)(1)(C). PLR-119659-97 also concluded that the facility was placed in service after December 31, 1992, and that because F would own, operate and maintain the facility, F was entitled to the § 29 credit for the qualified fuel produced

by the facility that would be sold to unrelated persons. At Site 2, F expected to sell the entire output of the facility to a specific customer. However, due to an inability to produce a fuel suitable to this customer, F decided to sell the facility.

On Date 5, G purchased the facility from F and contributed it to its subsidiary H. Pursuant to the purchase and sales agreement, the facility was moved to Site 3. After being tested to ensure that it had been properly reassembled at Site 3, the facility began production in Date 6. On Date 7, H received PLR-149317-01, which ruled on the issues addressed by this letter. Because of H's severe financial difficulty, production from the facility was ceased in Date 8. I negotiated with G and H to purchase the facility, but the parties were unable to agree to terms for a sale. In Date 9, because H was unable to meet its payment obligations to F, H surrendered possession of the facility to F. F contributed the facility to Taxpayer, in exchange for an x percent interest in Taxpayer and the issuance of a y percent interest in Taxpayer for its general partner, B.

I began negotiations with F to purchase the facility. On Date 10, A was formed to acquire F's interest in Taxpayer. In anticipation of the transaction, Taxpayer contributed the facility to D in exchange for a total equity interest in D. On Date 11, the sale of F's interest in Taxpayer to A was completed, and the facility recommenced production on Date 12. The sale of F's interest in Taxpayer to A requires A to make certain fixed and contingent cash payments. Taxpayer represents that the net present value of the fixed payments exceed fifty percent of the total purchase price of the interest in Taxpayer.

The facility is currently located at Site 3, pursuant to a lease agreement with J, a party unrelated to D. Certain improvements and modifications to the facility have been made by the prior owners. However, the facility continues to utilize all of its original major components. Taxpayer has represented that the fair market value of the original property comprising the facility is more than 20 percent of the facility's total fair market value (the cost of the new property plus the value of the original property). The facility is operated and maintained on D's behalf by K, pursuant to an Operating Agreement. Under the Operating Agreement, K is paid $z per ton of synthetic fuel produced, and reimbursed for all budgeted or permitted costs incurred. J supplies the coal feedstock to D. Under a Synfuel Purchase Agreement, D sells the synthetic fuel produced by the facility to J. J must purchase a minimum quantity of synthetic fuel. D may also meet its obligation to J by delivering coal or synthetic fuel from another source.

Taxpayer has supplied a detailed description of the process employed at the facility. As described, the facility and the process implemented in the facility, including the chemical reagent, meet the requirements of Rev. Proc. 2001-34, 2001-22 I.R.B. 1293. A recognized expert in combustion, coal, and chemical analysis has performed numerous tests on the coal used at the facility and the synthetic fuel produced at the facility 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.

You request the following rulings:

1. The synthetic fuel produced at the facility is a “qualified fuel” within the meaning of § 29(c)(1)(C).

2. Neither the relocation of the facility to Site 3, modifications made to the facility after June 30, 1998, nor replacement of any part of the Facility after that date, will result in a new placed in service date for the facility for purposes of § 29, provided the fair market value of the original property is more than 20% of the facility’s total fair market value at the time of any such relocation, modification, or replacement of any part of the facility.

3. Taxpayer is entitled to all of the § 29 credits on fuel produced at the facility and sold to unrelated persons.

4. The § 29 credits to which Taxpayer is entitled will pass through and be allocated among the members of Taxpayer under the principles of § 702(a)(7) and in accordance with each members’ interest in the profits and losses of Taxpayer, as provided in the Taxpayer LLC Agreement.

5. Assuming that all other requirements of § 29 are satisfied, the fact that: (a) Taxpayer terminates and is reconstituted under § 708(b)(1)(B) will not prevent Taxpayer from continuing to claim the § 29 credit (assuming that D is a disregarded entity); (b) Taxpayer terminates as a partnership because all of its equity is owned by one member will not prevent the single member of Taxpayer from claiming the § 29 credit (assuming that D is a disregarded entity); or (c) D has two or more members will not prevent: D from claiming the credit.

RULING REQUESTS #1 AND #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. 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. § 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, taxpayer 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 facility 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 D, disregarded as an entity separate from Taxpayer, will own the facility and operate and maintain the facility through its agent, we conclude that Taxpayer will be entitled to the § 29 credit for the production of the qualified fuel from the facility that is sold to an unrelated person.

RULING REQUEST #2

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 Taxpayer's facility was "placed in service" prior to July 1, 1998, within the meaning of § 29(g)(1), relocation of the facility to a different location, or replacement of part of the facility after June 30, 1998, will not result in a new placed in service date for the facility for purposes of § 29 provided the fair market value of the original property 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 used property).

RULING REQUEST #4

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 Taxpayer may be allocated to the members of Taxpayer in accordance with the members' interests in Taxpayer when the credit arises. For the allocation of the § 29 credit, a member's interest in Taxpayer is determined based on a valid allocation of the receipts from the sale of the § 29 qualified fuel.

RULING REQUEST #5

Section 708(b)(1)(B) provides that a partnership shall be considered as terminated if within a twelve-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Section 1.708-1(b)(1)(iv) provides that if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. Section 1.708-1(b)(1)(iv) applies to terminations of partnerships under § 708(b)(1)(B) occurring on or after May 9, 1997.

As discussed above, the placed-in-service deadline in § 29(f)(1)(B) and 29(g)(1)(A) must be read as applying to when the facility is first placed in service within the applicable dates. The placed-in-service deadlines contained in § 29(f)(1)(B) and 29(g)(1)(A) focus on the facility, and not the taxpayer owning the facility.

Accordingly, the determination of whether a facility has satisfied the placed-in-service deadline under § 29(f)(1)(B) and 29(g)(1)(A) is made by reference to when the facility is first placed in service, not when the facility is placed in service by a transferee taxpayer. Therefore, we conclude that a termination of Taxpayer under section 708(b)(1)(B) will

not preclude the reconstituted partnership from claiming the § 29 credit on the production and sale of synthetic fuel to unrelated persons. A similar rule would apply if Taxpayer terminated and became a disregarded entity, or if D ceased to be disregarded for tax purposes due to the addition of a second member.

CONCLUSIONS

Accordingly, we conclude as follows:

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

2. Because the facility was "placed in service" prior to July 1, 1998 within the meaning of § 29(g)(1), 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).

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

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

5. Neither a termination of Taxpayer under § 708(b)(1)(B), a termination of Taxpayer which results in Taxpayer being a disregarded entity, or D ceasing to be a disregarded entity will preclude the succeeding entity from claiming the § 29 credit on the production and sale of synthetic fuel to unrelated persons.

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,

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