Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
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Telephone Number:

In Re:

Refer Reply To:
CC:PSI:B07 – PLR-169203-03
Date:
April 14, 2004

LEGEND:

Taxpayer =

Date 1 =
A =

B =

C =

D =

E =

Site 1 =
Date 2 =
Date 3 =

Date 4 =
Date 5 =
Date 6 =
x =
Year 1 =
Year 2 =
Date 7 =
Date 8 =
Date 9 =
a =
b =
c =

d =
Site 2 =

F =
G =
H =
y =

Dear :

This letter is in response to your letter dated December 5, 2003 and subsequent correspondence on behalf of Taxpayer, 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 partnership that is classified as a partnership for tax purposes. Taxpayer is an accrual method taxpayer, whose taxable year ends on Date 1. A, the general partner of Taxpayer, is classified as a corporation for tax purposes. The limited partners of Taxpayer are B, C, D, and E.

The facility at issue in this ruling request was designed to produce a solid synthetic fuel product from coal. A originally constructed the facility at Site 1. A constructed the facility pursuant to four contracts for the procurement of equipment, and for engineering and construction. The contracts were entered into before December 31, 1996, and are dated Date 2, Date 3, Date 4, and Date 5. Taxpayer has produced an opinion of counsel that states that the primary construction contract, dated Date 4, constituted a binding written contract under the applicable state law prior to January 1, 1997, which did not limit damages for breach to less than five percent of the total contract amount. The contract further includes such features as a description of the facility to be constructed and a lump sum price. The facility began operations in Date 6, and produced x tons of synthetic fuel in Year 1. The facility continued to produce synthetic fuel until Year 2, when its primary customer at Site 1 ceased operations.

The facility, as constructed at Site 1, consisted of the following components directly necessary for the production of qualified fuel: (1) chemical reagent hoppers; (2) feed conveyers; (3) a delumper which shredded and mixed dewatered pulp waste; (4) a gathering conveyer; (5) a feed bucket conveyer; (6) a mixer; (7) an agitated conditioner; (8) two metering screws; (9) two pellet mills; (10) a pellet cooler; (11) a pellet conveyer; and (12) a motor control center, motor starters, computer control cards and other process control and interface equipment. In addition, the facility is supported by equipment that is not directly necessary for the production of synthetic fuel. Taxpayer has undertaken certain improvements of the facility at Site 1, though not to the equipment directly necessary for the production of synthetic fuel.

Taxpayer was founded by A, B, C, and D on Date 7 to acquire the facility from A. On Date 8, Taxpayer entered into a purchase and sales agreement with A for the purchase of the facility. On Date 9, Taxpayer and A entered into an amended purchase and sales agreement governing the sale of the facility to Taxpayer. The amended purchase and sales agreement obligates Taxpayer to make certain fixed and contingent payments to A. Taxpayer has provided evidence that the net present value of the fixed payments exceed fifty percent of the total purchase price.

Also on Date 9, after a restructuring of Taxpayer's partnership interests, a second series of partnership interests were sold to E by A and B. The purchase and sales agreement concerning the second series of partnership interests requires E to make certain fixed and contingent cash payments, the amounts of which are subject to adjustment under certain circumstances. Taxpayer has provided evidence that the net present value of the fixed payments exceed fifty percent of the total purchase price of the partnership interest. In addition, E made loans to Taxpayer for the relocation of the facility and the refinancing of Taxpayer's debt obligations. After the sale of the second series of partnership interests to E, the general partnership and first series interests were owned a%, b%, c% and d% by A, B, C, and D, respectively.

Under the partnership agreement, E and C are obligated to make monthly capital contributions to Taxpayer to pay its operating costs and other obligations. A proforma attached to the ruling request indicates that project expenses are projected to exceed revenues. The failure by E or C to make its share of capital contributions will result in that partner being denied any distributions or allocations from the partnership, and could result in their interest being redeemed by the partnership or bought by another partner.

Taxpayer intends to relocate the facility to Site 2, which is owned by F and G. Taxpayer will place the facility at Site 2 pursuant to a lease agreement with F. Taxpayer will purchase coal feedstock from various third party suppliers. F will provide certain coal and synthetic fuel preparation and handling services to Taxpayer, and will also assist Taxpayer in procuring coal supplies and transportation from third parties. Taxpayer will sell its synthetic fuel to F, for use in the power plant owned by F and G. Taxpayer represents that F and G are each an unrelated party to Taxpayer. In the event that F does not purchase all of the facility's output, Taxpayer may sell excess synthetic fuel to unrelated third parties. In the event that Taxpayer does not produce enough synthetic fuel to meet F's needs, Taxpayer will sell coal to F. Taxpayer will enter into an operation and maintenance agreement with H, a wholly-owned subsidiary of A, under which H will operate and maintain the facility on Taxpayer's behalf. Taxpayer will reimburse H for all reasonable costs incurred by H in operating and maintaining the facility, and pay to H a service fee of y% of all reimbursable costs.

As part of relocating the facility to Site 2, certain ancillary equipment will not be moved, and will be replaced at Site 2. Taxpayer has provided evidence that, following the relocation, the fair market value of the original property comprising the facility will be

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).

Taxpayer has supplied a detailed description of the process employed at the facility. Taxpayer has proposed that, from time to time, one of four alternative chemical reagents may be used in the process for the production of synthetic fuel. As described, the facility and the process implemented in the facility, including the chemical reagents, 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 have requested the following rulings:

1. Taxpayer, with use of the enumerated process, will produce a “qualified fuel” within the meaning of § 29(c)(1)(C).

2. The construction contract constitutes a “binding written contract in effect before January 1, 1997” within the meaning of § 29(g)(1)(A).

3. Production from the facility will be attributable solely to Taxpayer within the meaning of § 29(a)(2)(B), and Taxpayer will 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 allocation of 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. A termination of Taxpayer under § 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.

6. Provided the 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 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 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.

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 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

Sections 29(f)(1)(B) and (f)(2) provide that § 29 applies with respect to qualified fuels which are produced in a facility placed-in-service after December 31, 1979, and before January 1, 1993, and which are sold before January 1, 2003.

Section 29(g)(1) modifies § 29(f) in the case of a facility producing qualified fuels described in § 29(c)(1)(C). Section 29(g)(1)(A) provides that for purposes of § 29(f)(1)(B), a facility shall be treated as placed-in-service before January 1, 1993, if the facility is placed-in-service before July 1, 1998, pursuant to a binding written contract in effect before January 1, 1997. Section 29(g)(1)(B) provides that if the facility is originally placed-in-service after December 31, 1992, § 29(f)(2) shall be applied by substituting "January 1, 2008" for "January 1, 2003".

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. The construction contract, executed prior to January 1, 1997, includes such features as a description of the facility to be constructed and a lump sum price. The contract does not limit damages for breach to less than five percent of the total contract amount. Taxpayer provided an opinion of counsel that the contract is binding under applicable law. Therefore, the contract is a binding written contract for purposes of § 29(g)(1).

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 partners of Taxpayer in accordance with the partners' interests in Taxpayer when the credit arises. For the allocation of 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.

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.

RULING REQUEST #6

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. While § 29 does not define "placed-in-service," the term has been defined for purposes of the deduction for depreciation and the investment tax credit. Property is "placed-in-service" in the taxable year the property is placed in a condition or state of readiness and availability for a specifically assigned function. Section 1.167(a)-11(e)(1)(i) and § 1.46-3(d)(1)(ii) of the Income Tax Regulations. "Placed in service" has consistently been construed as having the same meaning for purposes of the deduction for depreciation and the investment tax credit. See Rev. Rul. 76-256, 1976-2 C.B. 46.

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 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 mixer (including any coal hoppers and reagent tanks directly feeding the mixer) through the output from the pellet mill or other forming equipment (including output hoppers, if any). Hence, the facility's total fair market value includes the process equipment such as the mixer, the pellet mill 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).

CONCLUSIONS

Accordingly, we conclude as follows:

1. The synthetic fuel produced at the facility using the enumerated 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. The contract for the construction of the facility constitutes a “binding written contract in effect before January 1, 1997” within the meaning of § 29(g)(1)(A).

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 allocation of 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. A termination of Taxpayer under § 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.

6. Because the 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 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 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 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 Taxpayer.

Sincerely,

/s/
Joseph H. Makurath
Senior Technician Reviewer, Branch 7
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: