Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.
Telephone Number:

Re:

Refer Reply To:
CC:PSI:B07 – PLR-109414-03
Date:
November 7, 2003

LEGEND:

P	=
V	=
W	=
X	=
Y	=
Z	=
Members	=
A	=
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s	=
t	=
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Location 1	=
Location 2	=
Location 3	=
Location 4	=
Site A	=
Site B	=

State 1 =
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Date 1 =
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Date 8 =

Dear :

This letter responds to a letter, dated February 10, 2003, and subsequent correspondence, submitted on behalf of Z by its authorized representative, requesting rulings under section 29 of the Internal Revenue Code.

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

Z seeks rulings in light of Z's proposed acquisition of an interest in P and P's proposed use of the reformulated chemical reagent. On Date 1, P received PLR 100182-98 and on Date 2, P received PLR 119233-99, both of which rule on issues similar to those addressed by this letter.

P is a State 1 limited liability company classified as a partnership for federal income tax purposes. P's members (Members) are: X, a State 1 corporation; Y, a State 2 corporation; and Z, a State 1 limited liability company that is disregarded for federal income tax purposes. X is a wholly-owned subsidiary of W, a publicly held State 1 corporation. Y is a wholly-owned subsidiary of X. Z is a wholly-owned subsidiary of V, a State 1 limited liability company that has elected to be taxed as a corporation for federal income tax purposes.

P owns Facility 1, Facility 2, and Facility 3 (Facility or Facilities) for the production of solid synthetic fuel from coal. Facility 1 and Facility 2 were originally in Location 1 and Facility 3 was originally in Location 2.

On Date 3, W acquired z percent of the outstanding capital stock of Y and y percent of the membership interests in P for cash paid in full at closing and quarterly contingent payments subject to certain limitations. At this time, Y owned the remaining x percent of the interests in P. After completing the acquisition, W contributed its newly acquired interests in Y and P to X.

After Date 3, P relocated and reassembled Facility 1 and Facility 2 and began operating at Site A in Location 3. Site A is adjacent to a coal mine, coal preparation

plant and coal storage and loading complex that is owned and operated by A. In addition, P relocated and reassembled Facility 3 and began operating at Site B in Location 4. Site B is adjacent to a coal mine, coal preparation plant and coal storage and loading complex that is owned and operated by B.

Each Facility has a single production line, consisting of a single extruder which is fed by a single set of two mixers. The coal feedstock is fed via conveyors through the mixers, which mix the coal feedstock and the chemical reagent and (if necessary) an acid conditioner. The synthetic fuel then flows through the extruder. P has not removed or bypassed such extruders, but the die plate on the end of the extruder has been removed. P does not currently produce briquettes, pellets or an extruded fuel product. The finished product is transferred along conveyor belts until it is outside the plant, and then stored in one or more stockpiles.

P has entered into a number of agreements with parties unrelated to P and its Members with respect to the operation of synthetic fuel production at the Facilities. These agreements have been provided and described in detail in the ruling request.

In connection with the relocations of the Facilities, Z's authorized representative has supplied a detailed list of changes that were made to the equipment comprising each Facility. Z has represented that, following the relocations, the fair market value of the used property is more than 20 percent of each relocated Facility’s total fair market value at the time of relocation (i.e., the fair market value of the used property plus the cost of any new property).

On Date 4, Y distributed a w percent membership interest in P to X. After the distribution, X and Y each owned a u percent membership interest in P.

On Date 5, Z purchased an interest in P for cash and a commitment to make ongoing capital contributions to cover its share of operating deficits. Pursuant to a Purchase Agreement dated Date 6, Z agreed to purchase an increased interest in P. Z's consideration for the interest in P consists of: (i) a cash payment; (ii) a non-recourse fixed payment base note; (iii) a non-recourse obligation to make quarterly fixed payments as scheduled under the Purchase Agreement; and (iv) a recourse obligation to make certain quarterly variable payments that is subject to adjustment under certain circumstances. The closing on this subsequent purchase was on Date 7. The net present value of the cash, the base note and the fixed quarterly payments is expected to exceed 50 percent of the net present value of the total consideration payable.

The Amended LLC Agreement of P provides for the allocation of all items of income (including gross income and receipts from the sale of synthetic fuel), expense and deduction among the Members in accordance with their sharing ratios (which is the same ratio in which capital contributions are made to cover operating deficits). Through Date 8, Z’s sharing ratio will be t percent. After Date 8, it will be s percent.

Tax credits under section 29 will be allocated among the Members in accordance with their sharing ratios. The Members generally will make monthly capital contributions in the same ratios.

Z has supplied a detailed description of the process employed at the Facilities. P began using a reformulated chemical reagent in the process for the production of synthetic fuel at the Facilities soon after Date 7.

A recognized expert in coal combustion chemistry has performed tests on the coal used at the Facilities and the synthetic fuel produced at the Facilities, and has submitted reports on fuel produced from coal using the process described in the ruling request with the use of the reformulated chemical reagent. The expert has concluded in each case that a significant chemical change takes place with the application of the process using the reformulated chemical reagent.

The rulings requested by Z, in light of its use of the reformulated chemical reagent and the proposed transactions described above, are:

1. Each of the Facilities, with use of the process described and the reformulated chemical reagent, will produce a "qualified fuel" within the meaning of section 29(c)(1)(C);

2. The production of qualified fuel from the Facilities will be attributable solely to their owner, P, entitling P to section 29 credits on such fuel sold to unrelated parties; and

3. The section 29 credit attributable to P may be passed through and allocated among the Members in accordance with the Members' respective interests in P when the credit arises, which will be determined based on a valid allocation of the receipts from the sale of the qualified fuel.

RULING REQUESTS 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 section 48(l) and its regulations are relevant to the interpretation of the term under section 29(c)(1)(C). Former section 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 section 29 and former section 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 section 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 section 1.48-9(c)(2)(i). Under this rule, if a solid synthetic fuel produced from coal, such as synthetic fuel, differs significantly in chemical composition from its parent coal feedstock, the solid synthetic fuel is a "qualified fuel" within the meaning of section 29(c)(1)(C).

At all of the Facilities, P originally used a chemical reagent that is manufactured from a styrene butadiene copolymer. The manufacturer has since developed a reformulated chemical reagent. The reformulated reagent also is manufactured from a styrene butadiene copolymer, together with polyvinyl acetate. As discussed above, P proposes to use the reformulated reagent at all of its Facilities.

Based on the information supplied by Z and Z's authorized representative, including the test results submitted by Z, we agree that the fuel produced in the Facilities using the process and reformulated chemical reagent described in Z's ruling request and subsequent correspondence will result in a significant chemical change to the coal, transforming the coal into a solid synthetic fuel from coal. Because P owns the Facilities and operates and maintains the Facilities through a contract operator, we conclude P will be entitled to the section 29 credit for the production of the qualified fuel from the Facilities that is sold to an unrelated person.

RULING REQUEST 3

Under section 7701(a)(14), the term "taxpayer" means any person subject to any internal revenue tax. Section 7701(a)(1) provides that the term "person" includes an individual, trust, estate, partnership, association, company, or corporation. Accordingly, P should be treated as the "taxpayer" for purposes of the section 29 credit.

Section 702(a)(7) and the regulations thereunder require each partner to take into account separately the partner's distributive share of each class or item of the partnership's income, gain, loss, deduction, or credit. See Treas. Reg. § 1.702-1(a). Section 1.702-1(a)(8)(ii) of Income Tax Regulation requires each partner to take into account separately the partner's distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability different from that which would otherwise result. Under Treas. Reg. section 1.702-1(a), a partner's distributive share is determined as provided in section 704 and Treas. Reg. § 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 (i) the partnership agreement does not provide for the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) or (ii) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) lacks substantial economic effect.

Under Treas. Reg. § 1.704-1(b)(4)(ii), allocations of tax credits and tax credit recapture (except for section 38 property) do not result in any adjustments to the partners' capital accounts. Thus, these allocations cannot have economic effect under section 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 tax credit recapture arises. The Regulations provide, however, that in determining the partners' interests in the partnership regarding tax credits that arise from receipts of the partnership (whether or not taxable), such as the section 29 credit, if that receipt also gives rise to a valid allocation of partnership income, the partners' interests in the partnership with respect to such item of credit will be in the same proportion as such partners' respective distributive shares of such income. Treas. Reg. § 1.704-1(b)(4)(ii).

Based on the information submitted and the representations made, we conclude that the section 29 credit attributable to P may be passed through to, and allocated to, the partners of P in accordance with each partner's interest in P when the credit arises. For the section 29 credit, a partner's interest in P is determined based on a valid allocation of the receipts from the sale of the section 29 qualified fuel.

Accordingly, based on the information submitted and representations made, we conclude as follows:

1. Each Facility, with use of the process described and the reformulated chemical reagent, will produce a "qualified fuel" within the meaning of section 29(c)(1)(C);

2. The production of qualified fuel from the Facilities will be attributable solely to their owner, P, entitling P to section 29 credits on such fuel sold to unrelated parties; and

3. The section 29 credit attributable to P may be passed through and allocated among the Members in accordance with the Members' respective interests in P when the credit arises, which will be determined based on a valid allocation of the receipts from the sale of the qualified fuel.

The conclusions drawn and rulings given in this letter are subject to the requirements that taxpayer (i) maintain sampling and quality control procedures that conform to ASTM or other appropriate industry guidelines at the facilities that are the subject of this letter, (ii) obtain regular reports from independent laboratories that have analyzed the fuel produced in such facilities 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. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling may be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in this ruling. See section 12.04 of Rev. Proc. 2003-1, 2003-1 I.R.B. 1, 50. However, when the criteria in section 12.05 of Rev. Proc. 2003-1 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

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

Sincerely yours,

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

Enclosure:
Copy for section 6110 purposes