

**Internal Revenue Service**

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August 18, 2000

A =

X =

Y =

L/Ps =

State =

D1 =

Dear :

This responds to a letter dated March 28, 2000, and subsequent correspondence submitted on behalf of X by X's authorized representatives, requesting a ruling that X is an eligible small ethanol producer and thus eligible for the small ethanol producer credit allowed by § 40 of the Internal Revenue Code and that the partners of X will include their distributive share of the credit under the principles of § 702(a)(7).

The information submitted states that X is a State limited partnership formed by Y and L/Ps for the purposes of leasing and operating an ethanol production facility in State (the Plant) and marketing ethanol and certain other products produced by the Plant. Y is the general partner and L/Ps are the limited partners of X.

The ethanol produced at the Plant is derived from corn and is at least 150 proof. X sells the ethanol for use as an oxygenate for blending with gasoline. The Plant has a plated productive capacity of 15 million gallons of alcohol per year. X, L/Ps, and Y, individually and together, have productive capacity for alcohol of less than 30,000,000 gallons.

Y owns the Plant but leases it to X pursuant to a lease agreement, dated D1. The limited partnership agreement for X (the Agreement) provides that Y shall manage, control, administer, and operate the business affairs of X. The Agreement provides also that Y shall be paid a management fee equal to all costs and expenses incurred by Y in the operation of the Plant. Y, as X's general partner, operates the Plant using corn X acquired from Y under a supply contract between X and Y dated D1. Pursuant to the supply contract, X will pay Y the fair market value of each bushel of corn delivered to X. If Y purchases any ethanol from X, Y will pay fair market value for the ethanol. A, the Chief Executive Officer of X's general partner, Y, represents that the relationship between Y and X was established on an arms length basis.

The Agreement provides that the L/Ps have the right to assign their interests in X subject to certain restrictions.

Section 40(a)(3) provides that for purposes of § 38, the alcohol fuels credit includes the small ethanol producer credit (SEP Credit) for an eligible small ethanol producer (Eligible Producer).

Section 40(b)(4)(A) provides that the SEP Credit of any Eligible Producer for any taxable year is 10 cents for each gallon of qualified ethanol fuel production of such producer.

Section 40(b)(4)(B) provides, generally, that the term qualified ethanol fuel production (Qualified Production) includes any alcohol that is ethanol that is produced by an Eligible Producer and that during the taxable year is sold for use or used by the Eligible Producer in the production of a qualified mixture in a trade or business (other than casual off-farm production). Section 40(b)(1)(B) defines "qualified mixture" to include a mixture of alcohol and gasoline that is sold by the taxpayer producing that mixture to any person for use as a fuel, or is used as a fuel by the taxpayer producing that mixture.

Section 40(b)(4)(C) provides that the Qualified Production of any producer for any taxable year shall not exceed 15,000,000 gallons.

Section 40(d)(1)(A) provides that the term "alcohol" includes methanol and ethanol but does not include (i) alcohol produced from petroleum, natural gas, or coal (including peat), or (ii) alcohol with a proof of less than 150.

Section 40(g)(1) provides that an Eligible Producer is a person, that at all times during the taxable year, has a productive capacity for alcohol (as defined in § 40(d)(1)(A) without regard to clauses (i) and (ii)) not in excess of 30,000,000 gallons. Pursuant to § 40(g)(3), in the case of a partnership, the limitations contained in § 40(b)(4)(C) and in § 40(g)(1) shall be applied at the entity level and at the partner or similar level.

Section 702(a)(7) provides that each partner determines that 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) of the Income Tax Regulations 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 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.

Based solely on the information submitted and the representations made, including the representations that X, Y,

and L/Ps (as of the date of the ruling request) have a productive capacity for alcohol not in excess of 30,000,000 gallons, X is an eligible small ethanol producer eligible for the small ethanol producer credit allowed by § 40. X's credit for the tax year is limited by § 40(b)(4)(C) to its Qualified Production (15,000,000 gallons).

X, as an eligible small ethanol producer, receives the entire § 40(a)(3) credit available, which is passed through to and allocated only among the partners of X under the principles of § 702(a)(7) in accordance with each partner's ownership interest in X as of the time the credit arises.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. In addition, no opinion is expressed concerning the applicability of §§ 40 and 702 upon a change in facts, including a change in any of the partners of X.

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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representatives.

Sincerely yours,  
H. GRACE KIM  
Assistant to the Chief  
Branch 2  
Office of the Associate  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes