Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Telephone Number:

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PLR-150160-06
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April 05, 2007

In Re:

LEGEND

Taxpayer =

Parent =

Dear :

This is in reply to your letter dated October 18, 2006, requesting a ruling regarding the federal income tax characterization of certain sulfur dioxide emission allowances granted to or acquired by Taxpayer for use in its trade or business. Specifically, Taxpayer requests a ruling that the emission allowances it uses in its business are not supplies within the meaning of Internal Revenue Code section 1221(a)(8).

FACTS

Parent is primarily engaged through Taxpayer, a subsidiary, in the generation and sale of electricity at wholesale and retail. Taxpayer owns sulfur dioxide emission allowances created under the air allowance program which is a part of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, § 401 et seq., 104 Stat. 2584 (1990), 42 U.S.C. section 7651 et seq. (the "Act"). The purpose of the Act was to reduce acid rain through allocations of sulfur dioxide emissions to fossil fuel-powered combustion

devices owned by electricity generating companies. The air allowance program is administered by the Environmental Protection Agency (EPA).

As provided under the Act, EPA allocated sulfur dioxide emission allowances to fossil fuel-powered combustion devices which were operational on November 15, 1990 and to some that became operational after November 15, 1990 but before January 1, 1996. The allocation is based in part on 1985-1987 operating levels of each combustion device covered by the Act. In general, each emission allowance permits a combustion device to emit one ton of emissions without penalty. EPA maintains a sulfur dioxide emission account for each covered fossil fuel-powered combustion device. Only those emission allowances recorded by EPA in a combustion device's emission account as of the emission account transfer deadline for a given year may be applied against the combustion device's emissions during that year.

In general, an emission allowance may be applied against emissions occurring in the year to which it has been allocated by EPA; transferred; sold or exchanged; or held for and applied against emissions occurring in a future year. It may not, however, be applied against emissions occurring in a year prior to the year to which it has been allocated by EPA. For instance, 2007 allowances cannot be used for compliance in 2006.

Under the Act, the owner or operator of a fossil fuel-powered combustion device must account to EPA for the total of emissions from combustion devices during a calendar year. The owner or operator of a combustion device has until the emission allowance transfer deadline to acquire and record with EPA emission allowances sufficient to equal emissions during that calendar year.

The Act prohibits the operation of any combustion device in a manner that causes the combustion device to exceed its emission limitation. A combustion device's emission limitation equals the number of emission allowances in the combustion device's emission allowance account that may be applied against emissions of that combustion device during that calendar year. Each measurement of emissions in excess of a device's emission limitation is a separate violation of the Act. The owner or operator must pay a $2,000 penalty to EPA for each excess ton produced.

Taxpayer buys and sells emission allowances periodically as needed with the intent to maintain a portfolio of emission allowances to satisfy the requirements of the Act.

Federal Energy Regulatory Commission (FERC) accounting rules treat emission allowances separate from, and in a different manner, than supplies. See 18 C.F.R. Pt. 101 (2006).

Taxpayer requests a ruling that:

Taxpayer's sulfur dioxide emission allowances are not items of the type that are excluded from the definition of a capital asset in section 1221(a)(8); that is, emission allowances are not supplies of a type regularly used or consumed by the taxpayer in the ordinary course of the taxpayer's trade or business.

LAW and ANALYSIS

Section 1221(a) (8) provides that the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--
(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Section 41(b)(2)(C) provides that the term "supplies" means any tangible property other than—

(i) land or improvements to land, and
(ii) property of a character subject to the allowance for depreciation.

Treas. Reg. § 1.162-3 provides that:

> Taxpayers carrying materials and supplies on hand should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation during the taxable year for which the return is made, provided that the costs of such materials and supplies have not been deducted in determining the net income or loss or taxable income for any previous year. If a taxpayer carries incidental materials or supplies on hand for which no record of consumption is kept or of which physical inventories at the beginning and end of the year are not taken, it will be permissible for the taxpayer to include in his expenses and to deduct from gross income the total cost of such supplies and materials as were purchased during the taxable year for which the return is made, provided the taxable income is clearly reflected by this method.

Treas. Reg. § 1.471-1 provides that:

> In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases, whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. Merchandise

> should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected. (But see § 1.472-1).

Taxpayer argues that it would be inappropriate to treat the emission allowances at issue as supplies within the meaning of section 1221(a)(8) because they are not tangible property as envisioned by the authorities cited above. FERC accounting rules treat the emission allowances separate from, and in a different manner than, supplies. Section 41(b)(2)(C) explicitly provides that supplies, for purposes of determining a research credit, only includes certain tangible property. Both Treas. Reg. § 1.162-3 and §1.471-1 arguably refer to only tangible property when describing supplies.

For the reasons set forth by Taxpayer, the emission allowances at issue are not supplies for purposes of section 1221(a)(8).

CONCLUSION

Taxpayer's sulfur dioxide emission allowances are not items of the type that are excluded from the definition of capital asset in section 1221(a)(8): that is, the emission allowances are not supplies of a type regularly used or consumed by Taxpayer in the ordinary course of its trade or business.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any transaction or item discussed or referenced in this letter.

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 a Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representatives.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for a ruling, it is subject to verification upon examination.

Sincerely,

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ROBERT M. CASEY
Senior Technician Reviewer
Branch 3
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: