INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-140516-07

Director
Chief, Excise Tax Program

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =

Taxpayer's Sister Company =

Synthetic Fuel Processor =

Taxpayer's Parent Company =

ISSUE:

Whether tax is imposed under section 4121 of the Internal Revenue Code (the Code) on the sale of coal produced by Taxpayer to Synthetic Fuel Processor.

CONCLUSION:

Yes. Tax is imposed under section 4121 of the Code upon the sale of coal produced by Taxpayer to Synthetic Fuel Processor.

FACTS:

Taxpayer is a mining company that produces coal in the United States. After mining the coal, Taxpayer cleans and stockpiles it, and then sells it to Synthetic Fuel Processor. Title passes to Synthetic Fuel Processor upon the sale. Taxpayer and Synthetic Fuel Processor are not related.

Synthetic Fuel Processor produces synthetic fuel at a number of facilities. At least one facility produces synthetic fuel that Taxpayer identifies as sold exclusively to foreign customers, and this is the product at issue herein. Once the coal is converted into synthetic fuel, the synthetic fuel is sold by Synthetic Fuel Processor to a related party. The related party then sells the synthetic fuel to Taxpayer's Sister Company at a reduced price. Taxpayer's Sister Company delivers the synthetic fuel to an export facility. Title from the synthetic fuel passes from Taxpayer's Sister Company to the foreign customer when it is loaded onto the ocean going vessel.

Taxpayer mines coal only after buyers are located. Thus, Taxpayer (or a related entity) enters into a binding sales contract with a foreign customer before Taxpayer sells the coal to Synthetic Fuel Processor. Taxpayer's Parent Company manages logistics with the rail company and shipping companies. Ship scheduling is accomplished at the time of contract (in coordination with rail scheduling, ship availability, steel-maker production schedules and available loading dates at the piers). Export sales are identified up to a year in advance. The time from mine to ship is usually less than 60 days.

According to Taxpayer, Synthetic Fuel Processor obtained a favorable private letter ruling from the Internal Revenue Service (the Service), allowing it to claim the section 29 credit on the synthetic fuel it produces.

Taxpayer asserts that the foreign purchasers did not care whether they received coal or synthetic fuel, because the synthetic fueling process leaves the product unchanged in terms of the customer's specific requirements, such as BTU, carbon content, ash, volatile matter, and sulfur.

LAW AND ANALYSIS:

Section 4121 of the Code imposes a tax on coal from mines located in the United States sold by the producer.

The Manufacturers and Retailers Excise Taxes Regulation § 48.4121-1(a)(1) provides that "producer" means the person in whom is vested ownership of the coal under state law immediately after the coal is severed from the ground, without regard to the existence of any contractual arrangement for the sale or other disposition of the coal.

Section 29 (which was redesignated as section 45K) provides a credit against income for the production and sale of "qualified fuels" produced from a nonconventional source,

including synthetic fuel. The credit applies to qualified fuels that are sold before January 1, 2008.

Rev. Rul. 86-100, 1986-2 C.B. 3, provides that, to be "synthetic" for purposes of the section 29 credit, a fuel must differ significantly in chemical composition, as opposed to physical composition, from the coal used to produce it. This standard was upheld in Rev. Proc. 2001-30, 2001-1 C.B. 1163, as modified by Rev. Proc. 2001-34, 2001-1 C.B. 1293, and Announcement 2003-70, 2003-2 C.B. 1090.

The Export Clause of the United States Constitution, art. I, §9, cl.5, provides "no Tax or Duty shall be laid on Articles exported from any State."

Notice 2000-28, 2000-1 C.B. 1116, provides guidance relating to coal exports and the rules for making a nontaxable sale of coal for export or for obtaining a credit or refund when the tax has been paid on the nontaxable sale of coal for export. Specifically, Notice 2000-28 provides that the section 4121 tax does not apply if the coal was in the stream of export when sold by the producer and the coal is actually exported. Coal is in the stream of export when sold by the producer if the sale is a step in the exportation of the coal to its ultimate destination in a foreign country. For example, coal is placed into the stream of export when (1) the coal is loaded on an export vessel and title is transferred from the producer to a foreign purchaser, or (2) the producer sells the coal to an export broker in the United States under terms of a contract showing that the coal is to be shipped to a foreign country.

As mentioned above, tax is imposed under section 4121 upon the sale of coal by the producer. However, under Notice 2000-28, a sale of coal is nontaxable if (1) the coal was in the stream of export when sold by the producer, and (2) the coal is actually exported. A sale of coal is nontaxable only if both prongs of this test are satisfied.

With regard to the second prong of the test set forth in Notice 2000-28, we have determined the product that was actually exported was not coal. Following the sale of coal by Taxpayer to Synthetic Fuel Processor, the coal was converted into synthetic fuel. Coal undergoes a significant chemical change during the conversion process, thereby losing its identity as coal. Therefore, Taxpayer did not export coal; it exported synthetic fuel. Because Taxpayer fails the second prong of the test, the sale cannot be classified as a nontaxable sale under Notice 2000-28.

Tax would still be imposed on Taxpayer's sale of coal if the product actually exported was coal because the coal was not in the stream of export at the time of its sale by Taxpayer to Synthetic Fuel Processor. The sale of coal to Synthetic Fuel Processor was not a necessary step in the exportation of the product to its ultimate destination in a foreign country. This is evidenced by Taxpayer's assertion that foreign purchasers consider the synthetic fuel produced by Synthetic Fuel Processor to be the same as the coal produced from Taxpayer's mine. Further, the coal was not loaded on an export

vessel following the sale and title did not transfer directly from Taxpayer to a foreign purchaser. Instead, title to the coal passed to several parties, including Synthetic Fuel Processor and Taxpayer's Sister Company, before it passed to a foreign purchaser. In addition, Synthetic Fuel Processor is not an export broker within the meaning of Notice 2000-28. Synthetic Fuel Processor only produces synthetic fuel. It is not directly involved in the export process. Thus, Taxpayer also fails under the first prong of the test set forth in Notice 2000-28.

Based on the foregoing, we conclude that Taxpayer's sale of coal to Synthetic Fuel Processor is subject to the tax imposed by section 4121.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.