Internal Revenue Service

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October 22, 2009

LEGEND:

Taxpayer =

State =
Location =
Purchaser =
Property A =
Property B =
Property C =
Property D =
Property E =
A =
B =
C =
D =
E =
Date 1 =
Date 2 =
Date 3 =
Method =
X =
Y =
Z =
x =
y =
z =
P =
PP =

PPP =
R =
Director =

Dear :

This letter responds to your request, dated April 23, 2009, on behalf of Taxpayer for several rulings on the proper treatment of certain property transactions described below.

The representations set out in your letter follow.

Taxpayer, a corporation formed under the laws of State, elected to be an "S Corporation" under § 1362 of the Internal Revenue Code, effective Date 1. Taxpayer's seventh year since electing to be an S Corporation ended on Date 2. Taxpayer has a calendar year accounting period and accounts for its receipts and disbursements using Method.

Taxpayer owns certain real property in Location. These properties include surface estates, surface improvements, and subsurface, primarily coal, estates. Each of the properties described below has been held by Taxpayer since at least Date 1, and each had been held by Taxpayer for more than one year as of the date of this request. Property A consists of approximately A. Property B consists of approximately B. For all of Property B, Taxpayer owns the surface estate and the coal estate. For Property A, Taxpayer owns the surface estate and most, but not all, of the coal estate. For Property C, consisting of approximately C, Taxpayer owns the surface estate, surface improvements, and the coal estate. For Property D, consisting of approximately D, Taxpayer owns the surface estate but no subsurface or coal estates. For Property E, consisting of approximately E, Taxpayer owns the surface estate as well as the coal estate.

Effective Date 3, Taxpayer enters into an agreement with Purchaser, a party unrelated to Taxpayer, under which Taxpayer transfers certain rights to these properties as set forth below. With respect to Property A, Taxpayer transfers by special warranty deed an interest in the coal property, and retains a production royalty equal to x% of the adjusted freight on board (FOB) Mine Price (as defined in the transactional documents) for surface mined coal and y% for the underground mined coal. In addition, Taxpayer grants to Purchaser a surface use easement requiring an annual payment of $X per acre until the commencement of mining on the property. Payments made for the surface use easement are recoupable against the coal mined from Property A. Purchaser will pay Taxpayer $P for the coal estate.

For Property B, Taxpayer transfers by special warranty deed an interest in the Mineral estate and retains a royalty equal to the greater of $Y per ton or x% of the

adjusted FOB Mine Price for surface mined coal and a royalty equal to the greater of $Y per ton or y% of the adjusted FOB Mine Price for underground mined coal. Taxpayer grants Purchaser full mining rights, including strip mining and surface use. Purchaser assumes full reclamation obligations for Property A and Property B. In addition, Taxpayer grants to Purchaser a surface use easement requiring an annual payment of $X per acre until the commencement of mining on Property B. Payments made for the surface use easement are recoupable against the coal mined from Property B. Purchaser will pay Taxpayer $PP for the coal estate.

For Property C, Taxpayer sells to Purchaser all of Taxpayer's interest in Property C in return for $PPP. Taxpayer leases back from Purchaser the surface of Property C for $R per year for business purposes. Purchaser may terminate this lease with respect to any portion of the surface of Property C needed for mining the coal under Property C, with an appropriate adjustment to the annual lease payment.

For Property D, Taxpayer will lease the property to Purchaser for the greater of 10 years or as long as Purchaser conducts mining operations on the property or on lands in the same coal field. The lease will be on commercially reasonable terms consistent with local leasing standards. In addition, Purchaser will pay to Taxpayer an annual payment of $X per acre until the commencement of mining on the property. This payment is fully recoupable against future coal production royalties. After mining commences, Purchaser will pay Taxpayer a surface mining production royalty equal to the greater of $Y per ton or x% of the adjusted FOB Mine Price.

For Property E, Taxpayer will lease the property to Purchaser for the greater of 10 years or as long as Purchaser conducts mining operations on the property or on lands in the same coal field. The lease will be on commercially reasonable terms consistent with local leasing standards. In addition, Purchaser will pay to Taxpayer an annual payment of $X per acre until the commencement of mining on the property. This payment is fully recoupable against future coal production royalties. After mining commences, Purchaser will pay Taxpayer a production royalty equal to the greater of $Z per ton or z% of the adjusted FOB Mine Price for coal obtained by surface mining or y% of the adjusted FOB Mine Price for coal mined using underground mining methods.

Taxpayer has requested the following rulings:

1. Are the transactions and all amounts received by Taxpayer with respect to Properties A, B, and E "dispositions of coal with a retained economic interest" as described in § 631(c)?
2. Is gain or loss from the dispositions of coal that qualifies for treatment under § 631(c) treated as gain or loss from the disposition of property used in Taxpayer's trade or business and therefore is subject to the provisions of § 1231?

3. Is gain recognized by Taxpayer pursuant to § 631(c), whether paid at the closing of the transactions described above or upon Purchaser's extraction and sale of the coal, subject to built-in gains tax under § 1374?
4. Are amounts received by Taxpayer that qualify for treatment under § 631(c) considered "passive investment income" under § 1362?
5. Is any portion of the amounts received by Taxpayer with respect to Properties A, B, and E treated as rental receipts for use of the surface land by Purchaser?
6. Is the disposition of Property C a sale or exchange pursuant to § 1001?
7. Will built-in gains tax be incurred by Taxpayer with respect to any built-in gains recognized during the 2009 or 2010 calendar years pursuant to § 1374(d)(7)(B), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. 111-5, 123 Stat. 115?
8. Is any gain recognized by Taxpayer upon the disposition of Property C subject to the built-in gains tax under § 1374 pursuant to the application of § 1374(d)(7)(B), as amended?

Based solely on the facts submitted by Taxpayer, we rule as follows:

Conclusions:

1. The transactions and all amounts received by Taxpayer with respect to Properties A, B, and E "are dispositions of coal with a retained economic interest" as described in § 631(c).
2. Gain or loss from the dispositions of coal that qualifies for treatment under § 631(c) is treated as gain or loss from the disposition of property used in Taxpayer's trade or business and therefore subject to the provisions of § 1231.
3. Amounts received by Taxpayer during the recognition period treated as gain from the sale of coal pursuant to § 631(c), will not be subject to built-in gains tax under § 1374.
4. Amounts received by Taxpayer that qualify for treatment under § 631(c) will not be treated as passive investment income under § 1362(d)(3)(C).
5. No portion of the amounts received by Taxpayer with respect to Properties A, B, and E is treated as rental receipts for use of the surface land by Purchaser.
6. Due to the factual nature of whether a transaction constitutes a sale or exchange pursuant to § 1001, we are unable to rule on this issue.
7. Pursuant to § 1374(d)(7)(B), as amended, Taxpayer's net recognized built-in gain with respect to the 2009 and 2010 taxable years will not be subject to the built-in gains tax under § 1374.
8. Pursuant to § 1374(d)(7)(B), any gain recognized by Taxpayer upon the disposition of Property C will not be subject to the built-in gains tax under § 1374, provided such disposition occurs during the 2009 or 2010 taxable year.

Law and Analysis:

Issues 1, 2, and 5

Section 631(c) provides that, in the case of the disposal of coal mined in the United States, held for more than one year before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in the coal, the difference between the amount realized from the disposal of the coal and the adjusted depletion basis, plus the deductions disallowed under § 272, shall be considered (except by any owner as a co-adventurer, partner, or principal in the mining of such coal) as though it were gain or loss on the sale of the coal.

Under § 1.631-3(a)(2) of the Income Tax regulations, in the case of any gain or loss from a disposal of coal under § 631(c), the provisions of § 1231 apply and the coal will be considered property used in the trade or business of the taxpayer in the year in which it is sold. Section 1231 provides rules for determining gains or losses for property used in the trade or business of the taxpayer.

Section 1.611-1(b)(1) defines “economic interest” as possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place and secures, by any form of legal relationship, income derived from the extraction of the mineral.

Section 1.614-1(a)(2) provides that the term interest means an economic interest in a mineral deposit and includes royalties.

Section 1.612-3(b) provides that, if the owner of an operating interest in a mineral deposit is required to pay royalties annually whether or not the minerals are extracted, and may apply any amounts paid on account of units not extracted within the year against the royalty on the mineral thereafter extracted, the payee shall compute cost depletion on the number of units so paid for in advance of extraction.

Section 1.631-3(c)(1) provides that amounts received or accrued in advance of mining shall be treated as received from the sale of coal if the contract of disposal provides that such amounts are to be applied as payment for coal subsequently mined. For example, advance royalty payments received by an owner of coal qualify under § 631(c) where the contract of disposal grants the lessee the right to apply such royalties in payment of coal mined at a later time.

Revenue Ruling 79-144, 1979-1 C.B. 219, provides that royalty payments received under a lease of surface rights, even when measured by reference to coal mined from that area under a coal lease with a third party, are not proceeds from the disposal of coal within the meaning of § 631(c). In this ruling, the grantor of the surface

rights did not own the coal by which the royalty payments were measured and so the payments to that grantor were not for coal disposed. See also, Omer v. United States, 329 F.2d 393 (6th Cir. 1964).

Taxpayer has sold an interest in the coal estates of Properties A and B to Purchaser, and retained a royalty. In addition, Taxpayer leased the right to mine the coal from Property E. In the case of the sale of an interest in the coal estates of Properties A and B, Taxpayer receives a lump sum payment at the outset as well as a payment of $X per acre until the commencement of mining. Upon the commencement of mining, Taxpayer will receive royalty payments determined by the type of mining done by Purchaser to extract the coal. The "per acre payments" relate to the coal estates of Properties A, B, and E, and are recoupable from royalty payments from the mining of coal disposed of by Taxpayer. In the case of the lease of Property E, Taxpayer will receive a lease payment in addition to the payment of $X per acre until the commencement of mining. Upon the commencement of mining, Taxpayer will receive royalty payments determined by the type of mining done by Purchaser to extract the coal.

Taxpayer has disposed of interests in the coal estates of Properties A, B, E and has retained royalty interests. Taxpayer had held these Properties for more than one year at the time of the disposal. Taxpayer's royalty interests constitute economic interests in the coal within the meaning of § 1.611-1(b)(1) and § 1.614-1(a)(2). Taxpayer is unrelated to Purchaser. Therefore, the transactions entered into by Taxpayer with respect to Properties A, B, and E are "dispositions of coal with a retained economic interest" as described in § 631(c). Under § 1.631-3(a)(2), gains or losses from dispositions of coal with a retained economic interest within the meaning of § 631(c), are treated as gain or loss from the disposition of property used in Taxpayer's trade or business and therefore is subject to the provisions of § 1231.

Further, no portion of the amounts received by Taxpayer under these transactions with respect to Properties A, B, and E is treated as rental receipts for use of the surface land by Purchaser. With respect to the per acre payment for Properties B and E, Taxpayer has disposed of an interest in the coal estates under those properties and the per acre payments therefore relate solely to those coal estates and not to surface access. Under Rev. Rul. 69-166, 1969-1 C.B. 37, payments of advance coal royalties or bonuses that otherwise qualify under § 1.631-3(c)(1) and (3) are subject to the provisions of § 631(c). With respect to the per acre payment for Property A, Taxpayer has disposed of most, but not all, of the coal beneath that property. However, the per acre payment is recoupable only from the coal mined that has been disposed of by Taxpayer. No royalty amount is paid to Taxpayer from the coal estate not disposed of by Taxpayer. Thus, no portion of the amounts received by Taxpayer with respect to Properties A, B, and E is treated as rental receipts for use of the surface land by Purchaser.

Issue 3

Section 1374 imposes a corporate-level tax on an S corporation's net recognized built-in gain during the recognition period following (a) a C Corporation's conversion to S corporation status (§ 1374(a)), or (b) an S corporation's acquisition of C corporation assets in a transaction in which the S corporation's basis in the acquired assets is determined by reference to the basis of such assets in the hands of the C corporation (§ 1374(d)(8)).

Section 1374(d)(2) provides that an S corporation's net recognized built-in gain for any taxable year is generally its taxable income for the year computed as if it were a C corporation, but taking into account only items treated as recognized built-in gain or recognized built-in loss.

Section 1374(d)(3) provides that recognized built-in gain includes any gain recognized on the disposition of an asset during the recognition period, except to the extent the S corporation shows that (a) it did not hold the asset as of the beginning of the first taxable year for which it was an S corporation (the "Conversion Date"), or (b) the gain recognized was greater than the excess of the asset's fair market value over its adjusted basis on the Conversion Date.

Section 1374(d)(7)(A), as amended by the American Recovery and Reinvestment Act of 2009, P.L. 111-5, provides in general that the term "recognition period" means the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation.

Section 1.1374-4(a) provides that § 1374(d)(3) applies to any gain or loss recognized during the recognition period in a transaction treated as a sale or exchange for federal income tax purposes.

Situation 4 of Rev. Rul. 2001-50, 2001-2 C.B. 343, addresses the § 1374 treatment of an S corporation that holds coal or domestic iron ore property with built-in gain on the date its election to convert from a C corporation to an S corporation is effective and which recognizes such built-in gain during the recognition period on the disposal of coal or domestic iron ore property under a contract to which § 631(c) applies. Rev. Rul. 2001-50 provides that notwithstanding the treatment accorded income under § 631, the income received from the sale of produced coal involves the receipt of normal operating business income in the nature of rent or royalties and is not subject to tax under § 1374. Accordingly, an S corporation's gain recognized pursuant to § 631(c) during the recognition period is not recognized built-in gain within the meaning of § 1374(d)(3).

Based solely on the information submitted and on the authority set forth above, we rule that amounts received by Taxpayer during the recognition period that are treated as gain from the sale of coal under § 631(c) will not be subject to the built-in gains tax under § 1374.

Issue 4

Section 1362(a) permits a small business corporation, as defined in § 1361(b), to elect to be treated as an S corporation. Such an election terminates under the provisions of § 1362(d)(3) if the corporation's passive investment income exceeds 25 percent of its gross receipts for three consecutive years and if, at the close of each of those years, the corporation has accumulated earnings and profits.

Section 1362(d)(3)(C)(i) provides that the term "passive investment income" includes gross receipts derived from royalties. Under § 1.1362-2(c)(5)(ii)(A)(1), the term "royalties" generally means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property. Under § 1.1362-2(c)(5)(ii)(A)(3), however, royalties does not include amounts received upon disposal of timber, coal, or domestic iron ore with respect to which the special rules of § 631(b) and § 631(c) apply.

Based solely on the facts submitted, we conclude that amounts received by the taxpayer that qualify for § 631(c) treatment will not be treated as passive investment income under § 1362(d)(3)(C).

Issue 6

Under section 4.02(1) of Rev. Proc. 2009-3, 2009-1 C.B. 107, 115, the Service does not rule on overly factual issues, such as whether a party to a transaction has acquired the benefits and burdens of ownership of property and is thus the owner of such property. A ruling that the disposition of Property C is a sale or exchange would require such a determination and we therefore cannot rule on this issue.

Issues 7 and 8

Section 1374(d)(7)(A), as amended by the American Recovery and Reinvestment Act of 2009, provides in general that the term "recognition period" means the 10-year period beginning with the 1st day of the 1st taxable year for which the corporation was an S corporation.

Section 1374(d)(7)(B), as amended by the American Recovery and Reinvestment Act of 2009, provides in pertinent part that in the case of any taxable year beginning in 2009 or 2010, no tax shall be imposed on the net recognized built-in gain of an S corporation if the 7th taxable year in the recognition period preceded such taxable year.

Based solely on the information submitted and on the authority set forth above, we rule that, pursuant to § 1374(d)(7)(B), Taxpayer's net recognized built-in gain with

respect to the 2009 and 2010 taxable years will not be subject to the built-in gains tax under section 1374.

Further, we rule that, pursuant to § 1374(d)(7)(B), any gain recognized by Taxpayer upon the disposition of the North Tract will not be subject to the built-in gains tax under § 1374, provided such disposition occurs in the 2009 or 2010 taxable years.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed as to the tax treatment of any income that may be realized by Taxpayer during the recognition period under § 1374, other than that described in the above rulings.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of 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 your authorized representative. A copy is also being sent to the Director.

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

Sincerely,

Brenda M. Stewart
Senior Counsel, Branch 6
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

cc: