Internal Revenue Service

Number: **201210003**
Release Date: 3/9/2012

Index Number: 613A.03-01, 613A.04-02

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:06
PLR-122594-11
Date:
November 29, 2011

LEGEND:

Taxpayer =

Subsidiary 1 =
Subsidiary 2 =
Subsidiary 3 =
Subsidiary 4 =
Subsidiary 5 =
Subsidiary 6 =
Subsidiary 7 =
Subsidiary 8 =
Subsidiary 9 =
Refinery =
Company A =
Date 1 =
Date 2 =

Dear :

This letter responds to your letter dated May 26, 2011, requesting a ruling that Taxpayer's oil and gas producing subsidiaries will qualify as independent producers for purposes of § 613A(c) of the Internal Revenue Code, and will not be treated as integrated oil companies for purposes of § 291(b) if other subsidiaries of Taxpayer engage in retail activities.

Facts

Taxpayer represents the facts to be as follows:

Taxpayer uses a calendar taxable year accounting period, and the accrual method of accounting for filing its federal income tax return.

Taxpayer is the corporate parent of an affiliated group of entities primarily involved in exploring for and producing oil and natural gas. Taxpayer is focused on discovering and developing unconventional natural gas and oil fields onshore in the United States. Taxpayer does not directly perform any oil and gas production activities or own any oil or gas upon production. Rather, Taxpayer's wholly owned subsidiaries perform these activities. Taxpayer's oil and gas producing subsidiaries are eligible to claim percentage depletion as independent producers of oil and gas under § 613A(c).

Taxpayer, through various wholly owned subsidiaries also owns and operates natural gas gathering systems that transport natural gas produced by Taxpayer's oil and gas producing subsidiaries in addition to natural gas produced by third parties. Taxpayer's wholly owned subsidiary, Subsidiary 1, purchases and markets the vast majority of Taxpayer's natural gas, in addition to production owned by certain partners in those wells. Subsidiary 1 purchases the gas either at the wellhead or at the tailgate of the gathering system. The limited amount of Taxpayer's natural gas that Subsidiary 1 does not purchase is sold directly to natural gas pipelines located in close proximity to its wells.

Subsidiary 1 sells the purchased natural gas to persons unrelated to Taxpayer, except for gas sold directly to Subsidiary 2 and Subsidiary 3. Subsidiary 2, an energy trading and management firm, is in the business of purchasing natural gas from certain natural gas suppliers, including Subsidiary 1, and selling this natural gas in bulk form to certain large commercial and industrial users. Subsidiary 3 is wholly owned by Taxpayer and serves as the well operator for the wells operated by Taxpayer's oil and gas producing subsidiaries. Subsidiary 3 uses natural gas purchased from Subsidiary 1 in its field operations as a rig fuel source and for gas lift purposes. Except for sales to Subsidiary 2 and Subsidiary 3, Taxpayer neither knows nor controls the final disposition of the natural gas carried in its gathering systems.

Taxpayer's refining activity consisted of its ownership, through its wholly owned subsidiary, Subsidiary 4 of Refinery. As of Date 1, Refinery was not operational and Taxpayer represents that it has no intention of making Refinery operational in the near future. Furthermore, if Refinery were currently operating, its maximum daily refinery runs would be below 75,000 barrels per day.

Taxpayer has no current retail activities as defined in § 613A(d)(2). However, Subsidiary 5 does own the land on which several independently owned and operated retail stations are located and has entered into certain incentive contracts with various

retail stations related to the construction of compressed natural gas (CNG) fueling facilities. None of these leases or incentive contracts involves the purchase or sale of natural gas produced, transported or marketed by any of Taxpayer's subsidiaries or affiliates.

Subsidiary 5 receives a fixed, market-based rental from each station and does not share in any income earned by the stations. Neither Subsidiary 5 nor any Taxpayer affiliated company has a marketing arrangement, trademark use, or other business relationship with any of these service stations other than as described herein. The operators of the stations are solely responsible for the operations of these stations and no Taxpayer affiliated entity derives any benefit from the operations of these stations.

Taxpayer made a cash grant to Company A to induce investment in CNG infrastructure, and pledged a portion of its future fleet CNG purchases to Company A, at market prices, to secure a CNG supply for its subsidiaries' fleet vehicles that use CNG.

On Date 2, Taxpayer created new wholly owned subsidiaries, Subsidiary 6, Subsidiary 7 and Subsidiary 8, collectively NewCo. NewCo will be entirely dedicated to specific natural gas market development projects. NewCo will not own any assets involved in the exploration and production operations of Taxpayer's oil and gas producing subsidiaries. The natural gas vehicle market development projects contemplated are the direct construction, ownership and operation of natural gas fueling stations, and the direct investment in various natural gas market research, development and demonstration initiatives.

Taxpayer, through NewCo, proposes to own and operate natural gas fueling stations. As part of this transaction, NewCo would construct a natural gas fueling station on a tract of land either owned and/or leased by NewCo and another Taxpayer subsidiary at arm's length, market-based rental prices. NewCo would be the owner of the natural gas infrastructure and would be solely responsible for the operations of the natural gas fueling station.

NewCo would negotiate and execute a natural gas supply agreement with a local distribution company, natural gas utility, natural gas wholesaler or similar entity for purchase of its natural gas. At no time will NewCo acquire any of its natural gas supply from Taxpayer, from any of Taxpayer's oil and natural gas producing subsidiaries, from any oil or gas producer related to Taxpayer, or through a product exchange involving any of these parties. NewCo potentially will enter into a service agreement with Subsidiary 9, a subsidiary of Taxpayer, for the maintenance of compressors located at the natural gas fueling station near existing Taxpayer operated areas. The fees associated with these services will be based on the market rate charged for similar services in an arm's length transaction. In the short term, the natural gas fueling stations will be strategically positioned to serve as a primary fuel supply for Taxpayer's CNG fleet vehicles; however, they will be open to the public. In the long term, Taxpayer

may expand its natural gas fueling stations operations to new, non-operating Taxpayer markets. Notwithstanding the fact that NewCo will not purchase its CNG from any Taxpayer entity, it most likely will brand its natural gas fueling stations with a reference to the Taxpayer's name.

NewCo may also invest in various natural gas market research, development and demonstration initiatives through a grant process, financing transactions, or direct equity investments. Such initiatives will not be related to the exploration or production of oil and natural gas. The initiatives will likely include direct investments in non-Taxpayer affiliates in the business of constructing, owning and operating natural gas fueling stations on similar terms and subject to limitations. The initiatives will be aimed at developing technologies and economies of scale. NewCo would seek aggressive capitalization of home-fueling technology and station facility improvement. NewCo would also seek to engage in lobbying efforts and would be responsible for identifying and developing technologies related to all aspects concerning the efficient and beneficial use of natural gas as a transportation fuel.

Law and Analysis

Section 291(b)(1)(A) provides that an integrated oil company is required to reduce by 30 percent the amount of intangible drilling and development costs allowable as a deduction under § 263(c) and amortize the amount not allowable as a deduction over a period of 60 months.

Section 291(b)(4) provides that for purposes of § 291(b), the term "integrated oil company" is defined as any producer of crude oil to whom § 613A(c), relating to independent producers, does not apply by reason of § 613A(d)(2) or (d)(4), relating to certain retailers or refineries, respectively.

Section 611 generally provides for a depletion deduction in the case of mines, oil and gas wells, other natural deposits, and timber. Section 1.611-1(a) of the Income Tax Regulations provides that in the case of exhaustible natural resources, other than timber, the allowance for depletion is computed upon either the adjusted depletion basis of the property (see § 612, relating to cost depletion) or upon a percentage of gross income from the property (see § 613 relating to percentage depletion), whichever results in the greater allowance for depletion for any taxable year.

Section 613A(a) provides that except as otherwise provided in § 613A, the allowance for depletion under § 611 with respect to any oil and gas well is computed without regard to § 613.

Under § 613A(c), "independent producers and royalty owners" are allowed a deduction for percentage depletion with respect to limited quantities (depletable quantities) of domestic crude oil or natural gas production. However, § 613A(c) does

not apply to any taxpayer that is a “retailer” or “refiner” as defined in § 613A(d)(2) and (d)(4), respectively.

Section 613A(d)(2) provides that a retailer is any taxpayer who (subject to a $5 million de minimis sale rule) directly, or through a related person, sells oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or any product derived from oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense)—

(A) through any retail outlet operated by the taxpayer or a related person, or

(B) to any person—

(i) obligated under an agreement or contract with the taxpayer or a related person to use a trademark, trade name, or service mark or name owned by such taxpayer or a related person, in marketing or distributing oil or natural gas or any product derived from oil or natural gas, or

(ii) given authority, pursuant to an agreement or contract with the taxpayer or a related person, to occupy any retail outlet owned, leased, or in any way controlled by the taxpayer or a related person.

Section 613A(d)(3) provides that for purpose of § 613A(d), a person is a related person with respect to the taxpayer for purposes of § 613A(d) if a significant ownership interest in either the taxpayer or such person is held by the other, or if a third person has significant ownership interests in both the taxpayer and such person. Section 613A(d)(3) provides that the term “significant ownership interest” means, with respect to any corporation, 5 percent or more in value of the outstanding stock of such corporation.

Section 613A(c)(8)(A) provides that for purposes of § 613A(c), persons who are members of the same controlled group of corporations are treated as one taxpayer. This provision, however, does not apply to the provisions within § 613A(d).

Section 613A(d)(4) provides that a refiner is a taxpayer whose average daily refinery runs for the taxable year exceed 75,000 barrels.

Section 1.613A-7(r)(2)(ii) provides that a taxpayer may be deemed to be a “retailer” by virtue of selling oil or natural gas or products derived therefrom through a related person in certain cases in which the taxpayer may benefit by reason of the taxpayer’s direct or indirect ownership interest in the related person.

Section 1.613A-7(r)(3) provides that the term “any product derived from oil or natural gas” means products that are recovered from petroleum refineries or extracted from natural gas in field facilities or natural gas processing plants. The term retail outlet

means “any place where sales of oil or natural gas (excluding bulk sales of such items to commercial or industrial users), or a product of oil or natural gas (excluding bulk sales of aviation fuels to the Department of Defense), accounting for more than 5 percent of the gross receipts from all sales made at such place during the taxpayer’s taxable year, are systematically made for any purpose other than for resale.”

In Rev. Rul. 85-12, 1985-1 C.B. 181, a wholly-owned subsidiary of a holding corporation produced oil and gas that it sold at or near the wellhead to unrelated parties. Another wholly-owned subsidiary of the same holding corporation was a retailer of petroleum or petroleum products it purchased from unrelated parties, selling more than $5,000,000 annually to end users. The holding corporation filed a consolidated return with its subsidiaries. The revenue ruling concludes that the producer subsidiary had no direct or indirect ownership interest in the retailer subsidiary, and, thus, did not benefit from the retail sales. Although the two subsidiaries were related persons for purposes of § 613A(d), none of the producer subsidiary's production was, in form or substance, sold through the retailing subsidiary. Thus, the producer subsidiary was not precluded from taking the percentage depletion deduction as provided in § 613A(c) or from being treated as an independent producer for purposes of the former windfall profit tax.

Rev. Rul. 92-72, 1992-2 C.B. 118, describes a situation in which a taxpayer is not considered to be selling oil or natural gas through a related retailer and therefore is not considered a retailer itself for purposes of § 613A(d)(2). In the revenue ruling:

(1) the taxpayer does not own a significant ownership interest in the retailer;

(2) the taxpayer sells its production to persons unrelated to the taxpayer and unrelated to the retailer;

(3) the retailer does not purchase oil or natural gas from the taxpayer’s customers or persons related to the taxpayer’s customers;

(4) there are no arrangements whereby the retailer acquires for resale oil or natural gas that the taxpayer produced or made available for purchase by the retailer; and

(5) neither the taxpayer nor the retailer knows or controls the final disposition of the oil or natural gas sold by the taxpayer or the original source of the petroleum products acquired for resale by the retailer.

In *Witco Chemical Corp. v. United States*, 742 F.2d. 615 (Fed. Cir. 1984), the court held that Witco, an oil producer, was not a retailer, despite the fact that it sold its petroleum products in packaging bearing its trademarks. The court based its conclusion on an analysis of Witco’s distribution agreement which did not require a distributor to use Witco’s trademark in marketing and distributing its product and which expressly restricted Witco from exercising control over the retail pricing of its products.

In *Quaker State Oil Refining Corp. v. U.S.*, 994 F.2d 824, (Fed. Cir. 1993), the court held that the taxpayer was a retailer because it used its mark to control the retail pricing of its products. Congress had levied a windfall profits excise tax on the production and sale of crude oil and refined products, excluding independent producers of crude oil from stripped well properties from that tax. The court concluded that Quaker State's distribution agreement imposed affirmative and direct obligations on its distributors to use Quaker State's trademark or trade name in marketing or distributing its motor oil.

Based on the information submitted and the representations made, we conclude that Taxpayer's oil and gas producing subsidiaries will qualify as independent producers for purposes of § 613A(c) and will not be treated as integrated oil companies for purposes of § 291(b) if other subsidiaries of Taxpayer engage in retail activities.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion whether the transactions in this case otherwise meet the requirements of § 613A.

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.

Sincerely,

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