

Part IV - Items of General Interest

Section 29 – Test Procedures and Significant Chemical Change

Announcement 2003-70

Section 29 of the Internal Revenue Code provides a tax credit for the production and sale of solid synthetic fuels produced from coal. Rev. Rul. 86-100, 1986-2 C.B. 3, adopts for purposes of § 29(c)(1)(C) the definition of synthetic fuel in § 1.48-9(c)(5) of the Income Tax Regulations. Section 1.48-9(c)(5)(ii) provides that, to be "synthetic," a fuel must differ significantly in chemical composition, as opposed to physical composition, from the substance used to produce it. Rev. Rul. 86-100 describes favorably processes such as gasification, liquefaction, and production of solvent refined coal that result in substantial chemical changes to the entire coal feedstock rather than changes that affect only the surface of the coal.

Consistent with its ruling practice that began in the mid 1990's, the Internal Revenue Service, in Rev. Proc. 2001-30, 2001-1 C.B. 1163, provided that taxpayers must satisfy certain conditions in order to obtain a letter ruling that a solid fuel (other than coke) produced from coal is a qualified fuel under § 29(c)(1)(C). Rev. Proc. 2001-30, as modified by Rev. Proc. 2001-34, 2001-1 C.B. 1293. The revenue procedure requires taxpayers to present evidence that all, or substantially all, of the coal used as feedstock undergoes a significant chemical change. To meet this requirement and obtain favorable private letter rulings, taxpayers have provided expert reports asserting that their processes resulted in a significant chemical change.

In Announcement 2003-46, 2003-30 I.R.B. 222, the Service stated that it would review the scientific validity of test procedures and results presented as evidence of significant chemical change. The Service also stated that no additional rulings on the question of significant chemical change would be issued until the completion of the review.

The principal tests used to determine that chemical changes to coal have occurred involve sophisticated technology and a large number of complex steps to prepare samples for testing as well as to analyze and interpret results. In reviewing these tests, the Service has consulted with experts and has considered the views of taxpayers in the synthetic fuels industry and their experts and advisers.

The Service has finished the review started with Announcement 2003-46. As a result of this review, the Service has determined that the test procedures and results used by taxpayers are scientifically valid if the procedures are applied in a consistent and unbiased manner. The Service believes, however, that the

processes approved under its long standing ruling practice and as set forth in Rev. Proc. 2001-30 do not produce the level of chemical change required by § 29(c)(1)(C) and Rev. Rul. 86-100. Nevertheless, the Service continues to recognize that many taxpayers and their investors have relied on its long standing ruling practice to make investments. Therefore, the Service will continue to issue rulings on significant chemical change but only under the guidelines set forth in Rev. Proc. 2001-30, as modified by Rev. Proc. 2001-34.

Although the Service will resume its ruling practice, the Service has continuing concerns regarding the sampling and data/record retention practices prevalent in the synthetic fuels industry. Accordingly, in order to receive future rulings, taxpayers will be required to (i) maintain sampling and quality control procedures that conform to ASTM or other appropriate industry guidelines at their synthetic fuel production facilities, (ii) obtain regular reports from independent laboratories that have analyzed the synthetic fuel produced in such facilities to verify that the coal used to produce the fuel undergoes a significant chemical change, consistent with prior ruling practice, and (iii) maintain records and data underlying the reports that taxpayers obtain from independent laboratories including raw FTIR data, and processed FTIR data sufficient to document the selection of absorption peaks and integration points. The Service also plans to issue guidance extending these requirements to taxpayers already holding rulings on the issue of significant chemical change. In addition to these requirements, the Service is considering whether to impose certain requirements on laboratories used by taxpayers to demonstrate significant chemical change, consistent with prior ruling practice, such as requiring that the laboratories be accredited by the NIST National Voluntary Laboratory Accreditation Program.

DRAFTING INFORMATION

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