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Memorandum

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subject: Exemption for Lignite from the Black Lung Excise Tax when Extracted with Other Ranks of Coal

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ISSUE

How will appropriate records of the testing, in accordance with the testing procedures set forth in the American Society for Testing and Materials (Annual Book of ASTM Standards Part 26, D 388) ("ASTM D 388"), of a coal seam containing both coal and lignite (the lowest rank of coal) provide a basis for calculating the amount of lignite excluded from tax under § 4121 of the Internal Revenue Code ("Code") on sales of coal from that seam?

CONCLUSION

If a taxpayer contemporaneously extracts coal and lignite during mining, the taxpayer must follow the testing procedures found in ASTM D 388 to determine the amount or percentage of lignite in the coal seam. A document that states the proportions or percentages of the various ranks of lignite and other types of coal in a seam will satisfy the adequate records requirement set forth in Treas. Reg. § 48.4121-1(c)(1), provided the testing of the coal seam meets all of the requirements set forth in ASTM D 388. Therefore, a taxpayer that has conducted proper testing pursuant to ASTM D 388 and has appropriate documentation of the test results can deduct the percentage of lignite

reflected in the documentation from its tax base for purposes of § 4121 of the Code when it sells or uses the coal from that seam.

FACTS

The LMSB Mining Industry Program has identified a situation that has arisen in several examinations for which it seeks legal advice. For purposes of this memorandum, we assume that Taxpayer operates a mine from which taxable coal and nontaxable lignite are extracted. Taxpayer's mining operations extract all coal (including lignite), without separation or segregation of coal by rank. The extracted coal is commingled and sold by Taxpayer.

Taxpayer has engaged professionals, including a geologist and a coal consulting firm, to sample, test, and delineate the occurrence of lignite in the coal seam prior to removal. The tests disclose that a portion of the coal seam falls within the characteristics of lignite, as set forth in ASTM D 388.

Taxpayer has records of coal sales, billing records, and coal supply contracts. However, these records do not report the material that Taxpayer mines or sells in terms of the coal classifications contained in ASTM D 388; rather, Taxpayer's records classify the mineral in terms of the aggregate heating values of the material sold. Taxpayer's records show that all computed heating values for the material sold are in excess of 8,300 Btu/lb, which is the upper Btu limit for lignite.

All coal was sold at standard contractual prices for what is referred to in the industry as subbituminous C coal. The contracts do not appear to have been adjusted for the presence of any lignite. Taxpayer does not separately track or identify the mining or sale of any of the claimed lignite, nor does it selectively mine lignite or any other rank of coal.

LAW

Section 4121(a)(1) of the Code imposes an excise tax on coal from mines located in the United States that is sold by the producer at an amount equal to the rate per ton determined under § 4121(b). The coal excise tax funds the Black Lung Disability Trust Fund. The Black Lung Disability Trust Fund provides benefits to miners afflicted with coal worker's pneumoconiosis (black lung disease) and to the survivors and dependents of miners affected with coal worker's pneumoconiosis.

The tax on underground mined coal is the lower of $1.10 per ton or 4.4 percent of the sales price. The tax on surface mined coal is the lower of $.55 per ton or 4.4 percent of the sales price. Section 4121(b) of the Code.

Section 4121(c) of the Code provides that the tax imposed by § 4121(a) shall not apply in the case of lignite. The legislative history of § 4121 states that the exemption from

the federal excise tax on coal "applies to 'lignite' as defined in accordance with the standard specifications for the classification of coals by rank of the American Society for Testing and Materials (p. 214, 1976 Annual Book of ASTM Standards, Part 26, D 388)." S. Rep. No. 95-336; 95th Congress, 1st Session (July 12, 1977). The Committee report also explains that lignite was exempted from the tax primarily because "it was concluded that there is little or no evidence to connect lignite mining with the incidence of pneumoconiosis."

Treas. Reg. § 48.4121-1(c)(1) provides that:

> The excise tax of coal does not apply to lignite or imported coal. Lignite is defined in accordance with the standard specification for classification of coals by rank of the American Society for Testing and Materials (Annual Book of ASTM Standards Part 26, D 388). The procedures specified in D 388 must be followed. If a producer extracts both taxable coal and lignite, then the producer must maintain adequate records to establish the portion of the mineral mined that is exempt from the tax. In determining whether all or a portion of the mineral extracted is lignite, the Service will consider all the facts and circumstances. For example, if a producer sells lignite and coal, the Service will examine all the facts and circumstances, including the contract price, contract specifications, and the amount of lignite extracted as it compares to the amount of lignite sold.

Section 6001 of the Code requires that every person liable for any tax imposed by the Code keep records, render such statements, make such returns and comply with the rules and regulations as the Secretary may from time to time prescribe.

ANALYSIS

At issue in this case is the proper method for determining the tax base for purposes of § 4121 of the Code. This inquiry turns on the construction of Treas. Reg. § 48.4121-1(c)(1). The construction of Treas. Reg. § 48.4121-1(c)(1) begins with the plain language of the regulation. *Abbott Labs. v. U.S.*, 84 Fed. Cl. 96, 103 (2008).

The second and third sentences of Treas. Reg. § 48.4121-1(c)(1) provide that "lignite is defined in accordance with the standard specification for classification of coals by rank of the American Society for Testing and Materials (Annual Book of ASTM Standards Part 26, D 388)" and that the "procedures specified in D 388 must be followed." ASTM D 388 provides, among other things, guidelines for the standard classification of coal by rank and the methods for sampling coal for classification purposes. Under ASTM D 388, the classification of coal as lignite is in no way dependent upon either mining or sale. Instead, ASTM D 388 requires that classification is based on laboratory analysis of samples taken while the mineral is in the coal seam. Thus, the plain language of these sentences informs the taxpayer and the Service that the presence of lignite in a coal seam must be determined prior to extraction.

The fourth sentence of the regulation provides that "if a producer extracts both taxable coal and lignite, then the producer must maintain adequate records to establish the portion of the mineral mined that is exempt from the tax." This is the key sentence in the regulation with respect to the question at hand. Its plain language requires that taxpayers maintain adequate records of the portion of the mineral extracted that is lignite. As noted above, ASTM D 388 requires that the classification of a mineral as taxable coal or nontaxable lignite be made *in situ*. Because the testing is done *in situ*, a document that reports the results of testing under ASTM D 388 with respect to the coal seam as a whole will establish the proportions of lignite and coal in the material extracted from that seam.

The fifth sentence of the regulation provides that "in determining whether all or a portion of the mineral extracted is lignite, the Service will consider all the facts and circumstances." This sentence suggests that the Service may consider whether an expert's testing of a coal seam meets the requirements of ASTM D 388.[1]

The sixth sentence of the regulation provides examples of the types of documentation that the Service will examine "if a producer sells lignite and coal." This sentence merely provides a nonexhaustive list of examples of the types of documents a taxpayer should maintain.

Based on the foregoing, we conclude that a document that states the proportions or percentages of lignite and other types of coal in a seam will satisfy the adequate records requirement set forth in Treas. Reg. § 48.4121-1(c)(1), provided the testing of the coal seam meets all of the requirements set forth in ASTM D 388. Therefore, a taxpayer that has conducted proper testing pursuant to ASTM D 388 and has adequate documentation of the test results can deduct the percentage of lignite reflected in the documentation from its tax base for purposes of § 4121 of the Code when the mineral is mined from that seam and thereafter sold or used.

CONTRA ARGUMENTS AND OTHER CONSIDERATIONS

Although we believe that the language of Treas. Reg. § 48.4121-1(c)(1) supports the conclusion reached in this memorandum, we recognize that there are several plausible contra arguments.

A. Construction of the sixth sentence of Treas. Reg. § 48.4121-1(c)(1)

A plausible reading of the sixth sentence of Treas. Reg. § 48.4121-1(c)(1) is that it requires taxpayers to maintain records of separate mining and separate billing for taxable coal and nontaxable lignite. That sentence provides as follows:

[1] We in no way suggest that the Service should challenge the applicability of ASTM D 388. Both the legislative history of § 4121 and Treas. Reg. § 48.4121-1(c)(1) require that the amount of lignite be determined in accordance with ASTM D 388.

> For example, if a producer sells lignite and coal, the Service will examine all the facts and circumstances, including the contract price, contract specifications, and the amount of lignite extracted as it compares to the amount of lignite sold.

We note, however, that the sixth sentence merely provides a nonexhaustive list of examples of facts and circumstances that taxpayers and the Service may consider in determining the amount of lignite sold. The other provisions in the regulation provide the specific rules governing the exemption and testing methods for lignite. In addition, the fourth sentence of Treas. Reg. § 48.4121-1(c)(1) expressly recognizes that lignite may be mined simultaneously with other ranks of coal, which undercuts any argument that the regulation imposes a separate mining requirement upon taxpayers. Finally, because the regulation does not expressly require separate billing or other similar documentation, it does not support requiring taxpayers to maintain these types of records in order to substantiate a tax exemption for lignite.

B. Lignite that is commingled with coal loses its character as lignite for purposes of § 4121, unless the taxpayer provides adequate substantiation

A second possible contra argument is that when taxable coal and nontaxable lignite are commingled, the lignite loses its character as lignite and the entire amount of mineral sold is subject to the coal excise tax.

In *Murphy Oil v. U.S.*, 81 F. Supp. 2d 942 (W.D. Ark, 1999), the court considered the taxability of “refinery grade propylene” under § 4662 of the Code. Refinery grade propylene is a mixture of propylene, which is subject to the tax, and propane, which is not. The court found that because the taxpayer used sales contracts that specified the weight of both the propylene and the propane, it was possible to determine with specificity the tax to be imposed upon the propylene. Thus, the court held that the chemical excise tax should be imposed only upon the weight of the taxable propylene. Id.

In *Holmes Limestone Co. v. U.S.*, 946 F. Supp. 1310 (N.D. Ohio 1996), aff’d, Nos. 97-3075 and 97-3129, 1998 WL 773890 (6th Cir.(Ohio) 1998), the court considered the issue of what constitutes "coal" for the purposes of the coal excise tax. Specifically, the court considered whether a “run of mine” or “ROM” coal product, which contained high levels of impurities, is taxable coal.[2] The court held that because ROM is treated as a saleable unit of coal within the industry, the entire ROM product is "coal" for the purpose

[2] ROM coal is a combination of pure coal, in-seam impurities such as shales, sulphur, and moisture, and a small portion of overburden and underclay. In *Holmes*, the taxpayer estimated impurity levels as high as 25%. Producers of ROM coal either take it to a washing plant where it is crushed and cleaned to remove a substantial portion of the impurities or sell the ROM coal as is, in its raw, unwashed condition. The taxpayers in *Holmes* generally did not wash their ROM coal to separate out impurities. Instead, they sold the unwashed ROM coal as a unit of mineral.

of the coal excise tax. However, the court found two exceptions to the general rule: (i) that excess water found in ROM can be excluded from its total weight, and (ii) that the small portion of overburden and underclay or out-of-seam material contained in ROM may also be excluded. Id. Based on this holding, the court determined that since there was no reasonable basis for determining the amount of out-of-seam material in the ROM, the taxpayer was not entitled to a deduction for the out-of-seam material. Id.

The *Murphy Oil* and *Holmes Limestone* cases stand for the proposition that when a taxable item and a nontaxable item are sold as a single unit, the entire unit is taxable unless the taxpayer can demonstrate with some degree of specificity the amounts of the taxable and nontaxable items in the unit. It is possible to analogize these cases to the case of a taxpayer that contemporaneously extracts coal and lignite during mining and sells the mixture of coal and lignite as a unit. Based on the holdings in *Murphy Oil* and *Holmes Limestone*, one could argue that if a taxpayer does not have contracts or other documentation that reflect the amount or proportion of lignite sold, the taxpayer cannot satisfy the facts and circumstances test of Treas. Reg. § 48.4121-1(c)(1).[3] We believe, however, that the conclusion reached in this memorandum is consistent with *Murphy Oil* and *Holmes Limestone* because it requires that taxpayers claiming an exemption for lignite maintain adequate records based on ASTM D 388, a regulatorily required testing method.

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Please call Jennifer Bernardini at (202) 622-3110 or Stephanie Bland at (202) 622-3130 if you have any further questions.

[3] One could make a similar argument based on § 6001 of the Code, which requires that every person liable for any tax imposed by the Code keep records, render such statements, make such returns and comply with the rules and regulations as the Secretary may from time to time prescribe