IRS Hot Topics

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IRS Office of Chief Counsel rules on the creditability of cellulosic fuel production and its processing into other 'green' fuel

On March 11, 2011, the IRS Office of Chief Counsel issued PLR 201125008, 2011 WL 2508989, concerning the I.R.C. § 40(a)(4) and (b)(6) cellulosic biofuel producer credit. The letter ruling was released to the tax services on June 24, 2011, and is significant for two reasons. First, there is very little guidance on the cellulosic biofuel producer credit. Although the ruling cannot be cited as precedent pursuant to section 6110(k)(3), it provides valuable insight into the IRS's analysis and viewpoint on the issues. Second, for the first time, the IRS Office of Chief Counsel addressed qualification for the credit when the cellulosic biofuel is further processed into other "green" fuels.

Background

Section 38 allows a credit against income tax in an amount equal to the amount of the current year business credit, plus other adjustments not relevant to this discussion. Section 38(b)(3) provides that the amount of the current year business credit includes the alcohol fuels credit determined under section 40(a). Section 40(a) provides that the alcohol fuels credit for the tax year is an amount equal to the sum of four credits, one of which is the cellulosic biofuel producer credit.

The statute defines the term "cellulosic biofuel" to include liquid fuel produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and which meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency ("EPA") under section 211 of the Clean Air Act. The statute also adds the requirement that a taxpayer must be registered as a producer of cellulosic biofuel in order to qualify for the credit. Form 637 instructions prescribe that a cellulosic biofuel producer apply for activity letter "CB."

The cellulosic biofuel producer credit is an amount equal to $1.01 for each gallon of "qualified cellulosic biofuel production." The statute defines the term "qualified cellulosic biofuel production" to include, generally, any cellulosic biofuel produced by a taxpayer for certain sales and uses. Specifically, for claims related to sales during the tax year for which the taxpayer is claiming the credit, the cellulosic biofuel must be sold by the taxpayer to another person for use by such other person in the production of a qualified cellulosic biofuel mixture in such other person's trade or business (other than casual off-farm production); for use by such other person as a fuel in a trade or business; or who sells such cellulosic biofuel at retail to a third person and places the cellulosic biofuel in the fuel tank of that third person. The taxpayer may also claim the credit for its own uses for any of the three purposes described in the previous sentence.

As distilled from the statute and IRS guidance, a taxpayer will qualify for the cellulosic biofuel producer credit if the taxpayer (i) produces a liquid fuel; (ii) such liquid fuel is produced from any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis; (iii) such liquid fuel meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act; (iv) uses or sells such liquid fuel for the purposes described above; and (v) registers as a producer of cellulosic biofuel. With respect to requirement (iii), IRS Counsel concluded in PLR 201042018, 2010 WL 4149070, and repeats in PLR 201125008, that fuel meets the EPA's registration requirements if the EPA does not require the fuel to be registered. Currently, EPA requires registration only of motor vehicle fuels and fuel additives.

The PLR

FACTS: Under the facts of the ruling, Taxpayer owned and operated a facility that used a moderate temperature and pressure catalytic process to convert cellulosic feedstock into a liquid fuel (Cellulosic Fuel) and certain by-products such as water, light gases, and energy to meet the operating needs of the facility. Cellulosic Fuel would either be sold or further processed into gasoline (Processed Gasoline), diesel fuel (Processed Diesel Fuel), and heating oil and fuel oil (Processed Fuel Oils). The cellulosic feedstock was typically wood waste, energy crops, and agricultural residues such as corn stover, switch grass, and sorghum.

Upon receipt of a favorable ruling, Taxpayer intended to register with the IRS as a producer of cellulosic biofuel. Taxpayer would sell Cellulosic Fuel, Processed Fuel Oils, and, once EPA registration was obtained, Processed Gasoline and Processed Diesel Fuel to fleet operators operating in the United States, and to U.S. terminal operators and refiners for resale to consumers who will use the product as a fuel within the United States.

A. Cellulosic fuel and processed fuel oils

Processed Fuel Oils were lower grade fuels that resulted from the upgrading of Taxpayer's Cellulosic Fuel, but were not distinct products. Fuel Oils could be used for the same purposes as petroleum-based No. 6 fuel oil such as for use in marine diesel and other low-speed diesel engines, which are internal combustion engines. Taxpayer anticipated that Fuel Oils would be sold to refiners, terminal operators, and purchasers for ship fleets. Taxpayer represented that the purchasers will mix Fuel Oils with petroleum-based No. 6 fuel oil. Fleet purchasers will use the resulting fuel oil mixture to power vessels or other machinery. Refiners and terminal operators will sell the resulting fuel oil mixture to persons for use as fuel, predominantly in marine diesel engines.

B. Processed gasoline and processed diesel fuel

A portion of Taxpayer's Cellulosic Fuel was upgraded via processing in a hydrotreater (or another similar refining process). The upgrading of the Cellulosic Fuel produced Processed Gasoline and Processed Diesel Fuel. Taxpayer proposed to sell Processed Gasoline and Processed Diesel Fuel to refiners, terminal operators, and fleet users, such as ground delivery or trucking companies. The purchasers were expected to mix Processed Gasoline with petroleum-based gasoline, and to mix Processed Diesel Fuel with petroleum-based diesel fuel, in both cases to produce fuel suitable for use in an internal combustion engine.

Taxpayer represented that the Cellulosic Fuel, Processed Fuel Oils, Processed Gasoline and Processed Diesel Fuel are not alcohols. In addition, taxpayer represented that, determined by weight, the Cellulosic Fuel, Processed Fuel Oils, Processed Gasoline, and Processed Diesel Fuel are not more than 4 percent of any combination of water and sediment and are not more than 1 percent ash content.

RULING: Taxpayer requested a ruling that it may claim the $1.01 credit under section 40(b)(6) with respect to its sales of Cellulosic Fuel, Processed Fuel Oils, Processed Gasoline, and Processed Diesel Fuel because the production and sale of Cellulosic Fuel, Processed Fuel Oils, Processed Gasoline, and Processed Diesel Fuel constituted qualified cellulosic biofuel production. The PLR concluded that the production and sale of Cellulosic Fuel, Processed Fuel Oils, Processed Gasoline, and Processed Diesel Fuel constituted qualified cellulosic biofuel production. Provided Taxpayer satisfied all of the other requirements set forth in section 40(b)(6), Taxpayer would be eligible to claim the credit for each gallon of qualified cellulosic biofuel production. The volume of Processed Fuel Oils, Processed Gasoline, and Processed Diesel Fuel that is qualified cellulosic biofuel production, and, therefore, eligible for the credit, may be determined based on the use of generally accepted scientific practices.

Observations

Because of the paucity of guidance on the cellulosic biofuels producer credit, the PLR provides welcome insights into IRS Counsel's thinking with respect to activities for which a taxpayer may claim the credit. Currently, there is only one item of published guidance on the credit, Notice 2008-110. While taxpayers may rely upon the Notice, it provides only limited guidance on the definition and registration requirements. Furthermore, IRS

Counsel has issued some case-specific or other non-precedential writings on the credit, but a number of these concern the applicability of the credit to black liquor, a by-product of the paper and pulp making process. As section 40 has been amended to prevent the credit from applying to black liquor after 2009, such writings are of limited value.

The PLR also reveals that qualified biofuel production includes the production of a fuel that is the result of further processing of a cellulosic biofuel. Although this conclusion is not readily apparent from the statute itself, it is a reasonable conclusion given that the resulting processed fuel derives directly from cellulosic biofuel and is also produced from hemicellulosic or lignocellulosic matter. The PLR would also seem to indicate that the point at which the credit is available is at the stage at which the producer of the cellulosic biofuel engages in creditable activity, that is, any of the sales or uses described above. Thus, to the extent that further processing of the Cellulosic Fuel results in diminished gallonage, then, the credit may only be claimed with respect to the diminished amount, when the taxpayer engages in creditable activity.

Finally, the PLR is important in that it permits the taxpayer in issue to employ any reasonable scientific method in determining the amount of creditable fuel in a mixture (although the PLR itself does not describe the taxpayer's specific method nor does it otherwise provide insight as to what the Service might in the future find to be reasonable). While this conclusion may have been intuited, the PLR has put to rest some of the questions concerning creditability methodology.

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