ADA CARBON SOLUTIONS
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August 4, 2015

CC:PA:LPD:PR (REG-132634-14)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Regulations (REG-132634-14) under Section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended, With Respect to the Status of Income as "Qualifying Income"

ADA Carbon Solutions, LLC ("ACS") respectfully submits this letter in response to the request for comments on the proposed regulations published in the Federal Register (*see* 80 Fed. Reg. 25970 (to be codified at 26 C.F.R. pt. 1)) on May 6, 2015 (the "Proposed Regulations") under section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended (the "Code"),[1] relating to qualifying income from the exploration, development, mining or production, processing, refining, transportation and marketing of minerals or natural resources. We recognize the efforts of the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") to implement a comprehensive definition of qualifying income as it relates to minerals and natural resources, and we believe that input from participants in the mineral and natural resources industries will result in improved final Treasury Regulations.

Further, please consider this letter to be ACS's timely, written request for a public hearing regarding the Proposed Regulations.

I. EXECUTIVE SUMMARY

Our comments principally address the scope of activities that the Proposed Regulations treat as processing of ores and minerals. We believe that the Proposed Regulations ignore the plain meaning of the word "mining" set forth in the Code and the existing Treasury Regulations and effectively write "processing" of ores and minerals as an independent activity under section 7704(d)(1)(E) out of the statute. This result could not have been intended by Congress.

[1] Unless otherwise noted, references to "Section" or "§" are references to the Code or the Treasury regulations promulgated thereunder (the "Treasury Regulations").

Section 7704(d)(1)(E) identifies seven activities with respect to minerals or natural resources that produce qualifying income. The first five of the section 7704(d)(1)(E) activities—exploration, development, mining or production, processing, and refining—reflect a comprehensive upstream-to-downstream progression of different activities that are directed at minerals or natural resources as a feedstock and that ultimately result in a marketable product. Each of these separate activities, when applied to a mineral or natural resource feedstock, generates qualifying income.

Each of the words of the statute must be given its plain meaning.[2] The word "mining" is defined in section 613(c)(2) and Treasury regulation section 1.613-4(f)(1) to include not only the excavation of the ore or mineral but also specifically defined "mining processes." These mining processes are described in Treasury regulation section 1.613-4(f)(2) as "ordinary treatment processes normally applied by mine owners or operators in order to obtain the [first] commercially marketable mineral product . . . ."

By contrast, the Proposed Regulations define the independent section 7704(d)(1)(E) activity of "processing" to include only the "mining processes" described in Treasury regulation section 1.613-4(f)(1)(ii). This approach causes the Proposed Regulations to ignore the well-established and long-standing definition of "mining" set forth in the Code and existing Treasury regulations, and effectively eliminates the word "processing" of ores and minerals from the statute. Such an interpretation and application violates the bedrock principle of statutory construction that effect must be given to the plain meaning of all of the words of a statute.[3]

As a result, under the Proposed Regulations, income derived from the listed "mining processes" constitutes qualifying income, and income derived from the "refining" of ores constitutes qualifying income; but income derived from the processes that occur between "mining" and "refining" does not constitute qualifying income. Thus, the Proposed Regulations exclude from qualifying activities numerous mineral processing activities that purify, separate or eliminate impurities from ores and minerals and that necessarily must take place before "refining," as defined in the Proposed Regulations, can occur. This construct produces the certainly unintended and clearly illogical result that a publicly traded partnership may refine a partially processed mineral but may not carry out the processing activities necessary to prepare such mineral for refining activities. Given the well-established meaning of "mining" (which includes "mining processes"), "nonmining processes" and "refining" with respect to ores and minerals, and the structure and plain meaning of the words of section 7704(d)(1)(E), it is clear that Congress intended "processing" to include those nonmining processes that occur after "mining" and before "refining."

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[2] *See, e.g.*, *Weingarden v. Comm'r of Internal Revenue*, 825 F.2d 1027, 1029 (6th Cir. 1987) ("The starting point in a statutory interpretation case is the language of the statute itself."); *Fed. Deposit Ins. Corp. v. Meyer*, 510 U.S. 471, 476 (1994) (stating the proposition that an undefined term in a statute must be given its ordinary and natural meaning).

[3] *See, e.g.*, *Barnhart v. Signmon Coal Co., Inc.*, 534 U.S. 438, 461-62 (2002) quoting *Connecticut Nat. Bank v. Germain*, 503 U.S. 249, 253-54 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and it means in a statute what it says there.").

II. ACS'S BUSINESS

ACS is a privately-held limited liability company that processes and markets activated carbon. ACS intends to form a publicly-traded partnership by contributing its activated carbon business to a newly formed limited partnership (the "Partnership") and effecting an initial public offering of units in the Partnership (the "IPO"). In 2013, ACS received a private letter ruling from the Service concluding, among other things, that ACS's income derived from mining, processing and marketing of activated carbon will constitute qualifying income under section 7704(d)(1)(E).

The feedstock for activated carbon is lignite coal mined from the earth. ACS mines or purchases and then processes lignite coal to produce products useful in the utility and manufacturing industries. After the lignite coal is either mined or purchased by ACS, the coal is transported via truck to a processing facility owned by ACS that processes lignite coal into activated carbon. The first step in this process is for the lignite coal to be crushed and stored until it is ready for processing into activated carbon. Once ready for processing, the coal enters the facility by traveling along a conveyer belt. The lignite coal is then fed into a series of furnace hearths where it is exposed to progressively higher temperatures. The heat drives off moisture, volatile organic compounds (*e.g.*, benzene, acetones and other organics), hydrogen, sulfur, oxygen and nitrogen, all of which are naturally occurring constituents in lignite coal, in order to concentrate the elemental carbon found in lignite coal. The process also causes some of the bonds that make up the compounds present in lignite coal to rearrange, allowing oxygen to attach to the surface of the coal. As stated above, lignite coal continues through each hearth where it is heated at progressively higher temperatures (up to 1600 degrees Fahrenheit). To become "activated," the lignite coal is exposed to steam, which creates and enlarges pores in the carbon surface. In the final stage, the lignite coal is "quenched" or cooled. This end product is activated carbon, which has had its moisture and volatile compounds removed and has had new pores created and existing pores enlarged by the injection of steam. The carbon is then reduced to the desired particle size through the use of mills.[4]

ACS sells most of its activated carbon for use in coal-burning facilities, such as utilities and industrial boilers. ACS also sells activated carbon for use in waste-to-energy facilities and by municipalities to treat water. As an alternative to the sale of pure activated carbon, in some instances ACS further processes a portion of its activated carbon by treating or mixing it with various additives in order to create a more effective product for particular applications. For example, it has been found that activated carbon treated with halogens, such as bromine, or with other additives may improve mercury capture performance in facilities with certain operating conditions. The amount of additive can vary depending on customer circumstances, but ACS's finished activated carbon products are always made up of less than 30% additives in terms of overall weight. ACS does not sell these products at the retail level. Instead, ACS's customers use ACS's products for electricity production or as part of other industrial processes.

[4] ACS's activated carbon products are generally milled to a median particle size of between 8-30 microns, depending on the particular product.

III. DETAILED DISCUSSION

A. *Section 7704(d)(1)(E) Treats "Processing" as an Independent Activity*

The Proposed Regulations are intended to provide guidance on what constitutes "qualifying income" from minerals or natural resources under section 7701(d)(1)(E), which defines qualifying income, in relevant part, to mean "income and gains derived from the exploration, development, mining or production, processing, refining, transportation . . . or the marketing of any mineral or natural resource."

Section 7704(d)(1)(E) identifies each of "mining or production," "processing" and "refining" as a separate activity, separated by commas. The only activities not separated by commas are "mining or production." The combination of "mining or production" correctly reflects that ores and minerals are mined, while oil and gas are produced. In contrast, section 7704(d)(1)(E) treats "processing" and "refining" as separate activities. Thus, section 7704(d)(1)(E) must be interpreted to give each term a separate meaning. The Supreme Court has made this a fundamental tenet of statutory construction. *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883); *Astoria Federal Savings & Loan Ass'n v. Solimino*, 501 U.S. 104, 112 (1991); *Bailey v. United States*, 516 U.S. 137, 146 (1995). As discussed below, in violation of this principle the Proposed Regulations both ignore the plain meaning of "mining" and effectively write "processing" out of section 7704(d)(1)(E).

Section 7704(d)(1)(E) defines "mineral or natural resource" as any product of a character with respect to which a deduction for depletion is allowable under section 611. Section 611 provides depletion deductions for mines, wells and other natural deposits. In an integrated mining operation, the producer is entitled to claim percentage depletion on the value of the mineral or natural resource after the completion of all mining processes. This point is referred to as the "depletion cut-off point." The legislative history to section 7704(d)(1)(E) makes clear that the reference to depletion was intended only to identify the minerals and natural resources and was not intended to suggest that qualifying income must itself be income that would qualify for percentage depletion.[5] However, as applied to processing of ores and minerals, the Proposed Regulations in effect—and inappropriately—cut off qualifying income at the depletion cutoff point.

B. *The Proposed Regulations Treat "Processing or Refining" as a Single, Integrated Activity*

The Proposed Regulations use the term "qualifying activities" to describe activities relating to minerals and natural resources that would produce qualifying income. Under the Proposed Regulations, qualifying activities include only "section 7704(d)(1)(E) activities" and activities that are "intrinsic" to section 7704(d)(1)(E) activities. Section 1.7704-4(c) of the

[5] S. Rep. No. 445, 100th Cong., 2d Sess. 424 (1988) ("The reference in the bill to products for which a depletion deduction is allowed is intended only to identify the minerals or natural resources and not to identify what income from them is treated as qualifying income. Consequently, whether income is taken into account in determining percentage depletion under section 613 does not necessarily determine whether such income is qualifying income.")

Proposed Regulations limits the scope of qualifying activities to an exclusive list of activities, and specifically states that "[n]o other activities qualify as section 7704(d)(1)(E) activities."

The Proposed Regulations combine the terms "processing or refining" and define such integrated term collectively as activities that are "done to purify, separate, or eliminate impurities." This combined definition includes two caveats. First, the partnership's designation of assets used in the activity under the modified accelerated cost recovery system ("MACRS") must be consistent with processing or refining of a natural resource. Second, under the Proposed Regulations "an activity will not qualify as processing or refining if the activity causes a substantial physical or chemical change in a mineral or natural resource, or transforms the extracted mineral or natural resource into new or different mineral products or into manufactured products." As described below, there is nothing in the statute or in its legislative history to support this integrated, three-pronged definition of "processing or refining" in the Proposed Regulations and such construct is, in fact, contrary to the plain meaning of the words "processing" and "mining."

C. *The Proposed Regulations Should Define Mining, Processing and Refining in a Manner Consistent with Section 613 and the Treasury Regulations Promulgated Thereunder*

Section 7704(d)(1)(E) does not contain definitions for mining, processing or refining that are specific to such section. Under general principles of statutory construction, where Congress uses similar words and phrases in different Code provisions, those terms have the same meaning in each provision.[6] As such, the Proposed Regulations reliance on the Treasury regulations promulgated under section 613 to define the terms "processing" and "refining" is appropriate because section 7704(d)(1)(E) specifically references the depletion rules. Unfortunately, the drafters of the Proposed Regulations did not apply the definitions provided by Congress in section 613 and the associated Treasury regulations in the manner originally intended by Congress.

Mining and Mining Processes. Section 613(c) provides a detailed definition of mining, which includes:

> not merely the extraction of the ores and minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto) and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills where such treatment processes are applied thereto as are not in excess of 50 miles . . . .

Section 1.613-4(f)(1) of the Treasury Regulations implements this definition by defining "mining" to include both (i) the extraction of ores or minerals from the ground, and (ii) "mining processes" described in paragraphs (2) through (6). In general, these processes, which include,

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[6] *E.g., Commissioner v. Keystone Consolidated Industries*, 508 U.S. 152, 159 (1993); *Seaman v. Commissioner*, 29 T.C.M. (CCH) 1331, 1333 (1970), of aff'd, 479 F.2d 336 (9th Cir. 1973).

for example, cleaning, breaking, dust allaying, and treating to prevent freezing (for coal) and sorting, concentrating, sintering and substantially equivalent processes (for ores such as iron ore), are "ordinary treatment processes normally applied by mine owners or operators to obtain the [first] commercially marketable product or products." For ores and minerals that are not customarily sold in crude form, section 1.613-4(f) treats additional processes as mining processes.

It is not clear why the Proposed Regulations do not adopt the definition of "mining" from section 613. Instead, the Proposed Regulations omit "mining processes" from the definition of "mining" and effectively narrow the term "mining" to include only "[o]perating equipment to extract natural resources from mines and wells" and "[o]perating equipment to convert raw mined products . . . to substances that can be readily transported or stored."

Nonmining Processes. Section 613(c)(5) provides a list of nonmining processes, *i.e.*, processes that are performed after mining processes are completed. Those processes include (among others) electrolytic deposition, roasting, calcining, thermal or electric smelting refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, and thermal action.

A number of the listed nonmining processes eliminate impurities from ores or minerals, thus falling within the general definition of processing provided by the Proposed Regulations. For example, section 1.613-4(g)(6)(ii) of the Treasury regulations defines "thermal smelting" as "processes which reduce, separate, or remove impurities from ores or minerals by the application of heat." Examples of such processes include "the furnacing of copper concentrates" and "the heating of iron ores, concentrates or pellets in a blast furnace to produce pig iron." Similarly, section 1.613-4(g)(6)(vi) provides the example of blending iodine, a naturally occurring resource, with common salt for the purpose of producing iodized table salt as being within the meaning of "blending with other materials" as used in section 613(c)(5). Another such process, "thermal action," means "processes which involve the application of artificial heat to ores and minerals, such as . . . the expansion or popping of perlite . . . ." Treas. Reg. § 1.613-4(g)(6)(viii). Roasting is a further example of a heating process performed to remove impurities in ores or minerals. *See* Treas. Reg. § 1.613-4(g)(2).

Most of the nonmining processes provided for in section 613 and the related Treasury regulations effect a physical or chemical change and, thus, likely fail the third prong of the definition of "processing or refining" in the Proposed Regulations. Moreover, the Proposed Regulations go further than the statute and related Treasury regulations, defining "processing" of ores and minerals to mean only the mining processes described in Treasury regulation section 1.613-4(f)(1)(ii). This narrowing eliminates any nonmining process from the definition of "processing or refining," including those that purify and yet do not cause a substantial physical or chemical change. This definition misapplies the definition of "mining" in both the statute and related Treasury regulations and by doing so, effectively eliminates processing of ores and minerals from section 7704(d)(1)(E).

Despite the principle included in the Proposed Regulations that an activity constitutes processing or refining of a natural resource if it eliminates impurities from natural resources, the Proposed Regulations limit the processing of ores and minerals to activities that generate

depletable income and exclude any activity that might cause a substantial physical or chemical change, even though Congress made clear that qualification of an income stream as depletable is not necessary to the qualification of the income as qualifying income.[7]

Refining. Section 1.613-4(g)(6)(iii) defines "refining" to refer to non-mining processes "used to eliminate impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as, for example, the refining of blister copper." The section further states that, "[i]n general, a refining process is designed to achieve a high degree of purity by removing relatively small amounts of impurities or foreign matter from smelted or partially processed ores or minerals." The Proposed Regulations appropriately look to section 1.613-4(g)(6)(iii) of the Treasury Regulations for the definition of "refining" but inappropriately neglect to apply those same regulations to define "mining" and "processing," as discussed above.

D. *Congress Originally Intended That "Processing" of Ores and Minerals Would Include the "Nonmining Processes" Described in Treasury Regulation Section 1.613-4(g)*

Given the well-established meaning of "mining" under section 613 and the Treasury Regulations promulgated thereunder, for purposes of section 7704(d)(1)(E) Congress clearly intended that "processing" would include the nonmining processes listed in section 613(c)(5), which are carried out after mining activities have been completed and before refining activities begin. For example, before copper can be refined, concentrated copper ores (a mixture of copper sulfide, iron sulfide and other metals) must be smelted in a furnace to yield blister copper, which is then refined in an anode furnace to yield pure copper.[8] Similarly, to concentrate the elemental carbon found in lignite coal to produce activated carbon, the coal must be oxidized in the presence of heat and steam, which causes a physical and chemical change in the coal.[9] In addition, a portion of the activated carbon produced by ACS is treated with a halogen, a naturally occurring resource, or other additives to produce a more effective form of activated carbon. The Proposed Regulations recognize the commercial need to, at times, add materials or other substances to processed minerals or natural resources to create a marketable product. Such actions do not prevent the underlying activity from being considered a section 7704(d)(1)(E) activity.[10]

The fact that the definition of refining in the Proposed Regulations refers to partially processed minerals further indicates that nonmining processes, such as smelting, that are preparatory to refining should constitute "processing." Otherwise, the construct provided by the Proposed Regulations would produce the illogical result that income derived from refining a smelted mineral, such as blister copper, generates qualifying income but that income derived

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[7] S. Rep. No. 445, 100th Cong., 2d Sess. 424 (1988).

[8] United States Environmental Protection Agency, Metallurgical Industry, AP 42, ch. 12.3, "Primary Copper Smelting" (1986).

[9] In this process some of the bonds that make up the compounds present in lignite coal rearrange, and pores in the carbon surface are created and enlarged, all of which allows oxygen to attach to the surface of the mineral.

[10] *See* Prop. Treas. Reg. 1.7704-4(7) (treating blending additives into fuels as marketing, a section 7704(d)(1)(E) activity).

from the predecessor smelting process does not generate qualifying income. The Proposed Regulations appear to compel this result even though smelting accomplishes precisely the result—removing impurities from ores or minerals—that the Proposed Regulations define as processing or refining. The Proposed Regulations ignore this inconsistency.

Pursuant to this reasoning, the term "processing" must include nonmining processes applied to depletable natural resources after production or mining activities and before refining activities. Accordingly, processes applied to ores and minerals, up to and including processes that eliminate impurities from ores and minerals or apply limited amounts of additives to the ores and minerals to create a marketable product, should be characterized as processing of ores and minerals that produces qualifying income.

E. *The "Substantial Chemical Change" Limitation Is Inconsistent with Section 7704(d)(1)(E) and Original Congressional Intent*

Under the Proposed Regulations, except as specifically provided otherwise, an activity does not qualify as processing or refining if the activity "causes a substantial physical or chemical change in a mineral or natural resource, or transforms the extracted mineral or natural resource into new or different mineral products or into manufactured products." The preamble to the Proposed Regulations suggests that the source of this rule is section 1.613-4(g)(5) of the Treasury Regulations, which defines "transformation processes" to mean:

> Processes which effect a substantial physical or chemical change in a crude mineral product, or which transform a crude mineral product into new or different mineral products, or into refined or manufactured products, are nonmining processes except to the extent that such processes are specifically allowed as mining processes in section 613(c) or under paragraph (f) of this section.

While this definition is helpful in determining whether a process constitutes a mining process for which depletion is allowable, it was not intended by Congress to distinguish—nor is it helpful in distinguishing—between activities that qualify as processing or refining of an ore or mineral, which produce qualifying income, and activities that constitute manufacturing, which do not produce qualifying income. This distinction is clear from the fact that the definition in section 1.613-4(g)(5) treats refining, which the Proposed Regulations recognize as a qualifying activity, as a transformative process. There simply is no basis in the statute, the related Treasury regulations or in the legislative history for imposing a blanket exclusion of any activity that results in a "substantial" physical or chemical change from the definition of processing or refining under section 7704(d)(1)(E).

IV. RECOMMENDATIONS

We believe that the final regulations should be amended as follows:

A. Section 1.7704-(c)(4) of the Proposed Regulations should be amended to explicitly define "mining" a in manner consistent with section 613 and the

Treasury regulations promulgated thereunder by making reference to the definition of such term in Treasury Regulation section 1.613-4(f).

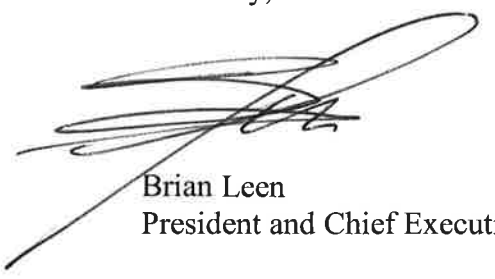
B. The general definition of processing or refining in section 1.7704-4(c)(5)(i) of the Proposed Regulations should be amended to (i) eliminate the exclusion of activities involving a substantial physical or chemical change or the transformation of the mineral into a new and different product from the definition of refining or processing, (ii) eliminate the MACRS consistency requirement and (iii) permit the application of additives to a processed or refined mineral or natural resource in order to create a marketable product.

C. Section 1.7704-4(c)(5) of the Proposed Regulations should be amended to provide separate definitions for "processing" and "refining." Because an amended definition of "mining" in section 1.7704-(c)(4) of the Proposed Regulations will include the "mining processes" described in Treasury Regulation section 1.613-4(f)(1)(ii), the definition of "processing" should eliminate the reference to such section. Instead, the final regulations should define processing and refining of ores and minerals to include the nonmining processes listed in Treasury Regulation section 1.613-4(g)(1). In addition, the final regulations should clarify that any process that is undertaken to reduce impurities in the ore or mineral, such as exposing the ore or mineral to heat, as well as any process necessary to carry out those activities, constitutes processing or refining within the meaning of section 7704(d)(1)(E).

D. Section 1.7704-4(c)(1) of the Proposed Regulations should be amended to eliminate the concept that qualifying activities are limited to those specifically identified in paragraph (c).

We believe that the foregoing changes will result in a clear, consistent and workable definition of "processing" that is consistent with the original language of section 7704(d)(1)(E) and original Congressional intent as expressed in the legislative history.

Sincerely,



Brian Leen
President and Chief Executive Officer

cc: C. Timothy Fenn (Latham & Watkins LLP)