



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR: Industry Director, Natural Resources & Construction (LM:NRC)

FROM: ASSISTANT TO THE BRANCH CHIEF, BRANCH 6
CC:P&SI:6

SUBJECT: WITHDRAWAL OF REQUEST FOR RULING LETTER AFTER
ADVERSE OPINION REACHED

In accordance with § 8.07(2)(b) of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 32, this Chief Counsel Advice advises you that taxpayers within your jurisdiction withdrew a request for a private letter ruling after an adverse opinion was reached. Pursuant to § 6110 (k)(3), this Chief Counsel Advice is not to be cited as precedent.

LEGEND:

X =

Y =

Z =

a =

Z submitted a ruling request on behalf of two of its wholly owned subsidiaries, X and Y. X and Y are natural gas producers that operate a natural gas production plant. The gas processed at this facility has a high hydrogen sulfide content. For the gas to be marketable the hydrogen sulfide must be removed from the gas. Following removal, the hydrogen sulfide byproduct, a highly toxic substance, must be disposed of. Hydrogen sulfide can no longer be released to the atmosphere. In a, assets that convert the hydrogen sulfide into sulfur by chemical process were placed in service by X and Y at the facility. By converting the hydrogen sulfide into elemental sulfur, the toxic gas is transformed into a relatively inert chemical that can be stored in large piles. The sulfur produced is sold to reduce the costs of hydrogen sulfide disposal.

It was requested that the Service rule that the sulfur production assets discussed above are, for depreciation purposes, includible in asset class 28.0, Manufacture of Chemicals and Allied Products, rather than asset class 49.23, Natural Gas Production Plant.

Section 167(a) provides a depreciation allowance for the exhaustion, wear and tear of property used in a trade or business or held for the production of income. The depreciation deduction provided by section 167(a) for tangible property placed in service after 1986 generally is determined under section 168. This section prescribes two methods of accounting for determining depreciation allowances: (1) the general depreciation system (GDS) in section 168(a); and (2) the alternative depreciation system (ADS) in section 168(g). Under either depreciation system the depreciation deduction is computed by using a prescribed depreciation method, recovery period, and convention.

For purposes of either GDS or ADS, the applicable recovery period is determined by reference to class life or by statute. Section 168(i)(1) provides that the term "class life" means the class life (if any) that would be applicable with respect to any property as of January 1, 1986, under former section 167(m) as if it were in effect and the taxpayer were an elector. Prior to its revocation, section 167(m) provided that in the case of a taxpayer who elected the asset depreciation range system of depreciation, the depreciation deduction would be computed based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group.

Section 1.167(a)-11(b)(4)(iii)(b) sets out the method for asset classification under former section 167(m). Property is included in the asset guideline class for the activity in which the property is primarily used. Property is classified according to primary use even though the use is insubstantial in relation to all of the taxpayer's activities.

Rev. Proc. 87-56, 1987-2 C.B. 674, sets forth the class lives of property that are necessary to compute the depreciation allowances under section 168. The revenue procedure establishes two broad categories of depreciable assets: (1) asset classes 00.11 through 00.4 that consist of specific assets used in all business activities; and (2) asset classes 01.1 through 80.0 that consist of assets used in specific business activities. The sulfur production assets at issue in the present case are not includible in the asset classes consisting of specific assets used in all business activities. The two business activity asset classes listed below are set forth in Rev. Proc. 87-56.

Asset class 28.0, Manufacture of Chemicals and Allied Products, includes assets used to manufacture basic organic and inorganic chemicals. Assets includible in this class have a 5-year recovery period for GDS purposes and a 9.5-year recovery period for ADS purposes.

Asset class 49.23, Natural Gas Production Plant, is not further described in the revenue procedure. Assets includible in this class have a 7-year recovery period for GDS purposes and a 14-year recovery period for ADS purposes.

In the present case, the sulfur production assets are an integral part of the natural gas production plant business activity. The hydrogen sulfide content must be removed from the gas for the gas to be marketable through natural gas pipelines. The hydrogen sulfide cannot be vented to the atmosphere after it is removed from the natural gas but must be converted into a form in which it can be stored or sold. The sulfur production assets change the hydrogen sulfide into a stable elemental form that can be easily stored. Accordingly, the sulfur production assets enable the natural gas production plant to operate.

An essential component of natural gas production is the removal of hydrogen sulfide. The process of removal is not complete until the hydrogen sulfide has been converted into a stable or marketable form. The conversion of the hydrogen sulfide into sulfur in the present case is not a separate business activity but, rather, a necessary part of the business activity of producing pipeline quality natural gas.

In recent years there has been an excess of sulfur on the market. There is no economic reason to operate the sulfur production assets except that their operation enables the natural gas production plant to operate.

If you have any questions regarding this matter, please call me at (202) 622-3110.

MARK PITZER
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Office of Associate Chief Counsel
(Passthroughs & Special Industries)