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Commenters Weigh in on Proposed Regulations for Determining MLP Qualifying Income

IRS' proposed MLP regulations generate flurry of specific industry-related comments and spur public hearing.

> *"I'm mad as Hell, and, frankly, I'm not going to take it anymore."*
> *— Paraphrase of concerned citizen and individual MLP investor*

On May 6, 2015, the Internal Revenue Service (IRS) and the Department of the Treasury (Treasury) published proposed regulations setting forth which mineral and natural resource related activities would produce master limited partnership (MLP) qualifying income. Treasury and the IRS requested comments from the public on all aspects of these proposed regulations, and the public did not disappoint. The IRS received more than 140 comments and several commenters requested a public hearing on the proposed regulations, which has now been scheduled for October 27, 2015 in Washington, D.C.

Individual investors submitted many of the comments and clearly communicated the market's frustration with the proposed regulations. This frustration is understandable as the proposed regulations represent a complete reversal from the IRS' recent ruling practice with respect to certain activities, such as methanol and olefins production. One MLP, which is primarily engaged in olefin production and had received a private letter ruling (PLR) less than two years earlier, identifies the proposed regulations as the cause of an approximate 30% decline in its publicly traded unit price. The decline, coupled with a corresponding drop in this MLP's sponsor's share price, resulted in an evaporation of more than US$1.2 billion of market capitalization associated with the one MLP alone.

Several industry participants and industry-focused organizations also submitted comments on the proposed regulations. This *Client Alert* provides a brief overview of the most important issues these commenters raised and summarizes their proposed solutions.

Background

The proposed regulations set out which activities and services relating to minerals or natural resources generate MLP qualifying income (Qualifying Activities). Qualifying Activities include: (i) the exploration, development, mining or production, processing, refining, transportation or marketing of minerals or natural resources (Section 7704(d)(1)(E) Activities)[1] and (ii) certain limited support activities that are "intrinsic" to Section 7704(d)(1)(E) Activities (Intrinsic Activities).

The proposed regulations will not apply to income an MLP earns until the regulations are finalized. If finalized in their currently proposed form, there will be a 10-year transition period during which income previously treated as qualifying income, generally, will continue to be so treated. The specific application

of this transition period would depend on the MLP's particular circumstances, including whether it had a PLR from the IRS.

Global Comments and Those relating to the Transition Period

Commenters took the opportunity provided by the IRS and Treasury to raise several broad issues with the proposed regulations.

- ***Exclusive Lists***. Several commenters noted that the proposed regulations' use of exclusive lists to define Section 7704(d)(1)(E) Activities ignores certain potentially qualifying activities. In addition, the mineral and natural resources industries that the qualifying income exception[2] was meant to encompass are dynamic and use constantly evolving technologies. The use of exclusive lists is inconsistent with this purpose. Most of these commenters recommended that the proposed regulations should instead rely on conceptual and example-based definitions so as to include income from activities that, although not explicitly listed in the proposed regulations as Qualifying Activities, are meant to fall within the scope of the qualifying income exception.

- ***Definition of Minerals or Natural Resources***. Many commenters sought to draw the attention of the IRS to several potential issues within the proposed regulations' definition of "minerals or natural resources," primarily by asserting that the definition is too narrow in the proposed regulations.

  - "Or Products Thereof." Commenters suggested that, contrary to the language in Section 7704(d) and the legislative history relating thereto, the proposed regulations result in confusion as to whether a mineral or natural resource loses its status as such as a result of being processed or refined. Generally, these commenters asserted that, with the exception of fertilizer (which is subject to a special rule), Section 7704(d) requires that minerals or natural resources be "of a character" that is at the time of its production or extraction subject to depletion under Section 611, and the product must remain "a product thereof" (although, not necessarily subject to depletion), as it is mined or produced, processed, refined, transported and marketed. These commenters requested that final regulations clarify that a mineral or natural resource does not lose its status as such as a result of being processed or refined within the limits of "processing" and "refining," as defined in final regulations.

  - Specification of Certain Products. Commenters also requested that the proposed regulations clarify that certain products are minerals or natural resources, consistent with the statutory language of Section 7704(d) and the related legislative history. For example, the proposed regulations are unclear about whether or not several products are natural resources, including (i) liquefied natural gas (LNG), which is simply super-chilled natural gas, (ii) natural gas liquids (NGL), which include natural resources like propane, butane and ethane, and (iii) methanol, which is a refined form of methane gas (again, a natural resource under the proposed regulations). These commenters requested that the proposed regulations include a fulsome, but necessarily non-exhaustive, list of products that are minerals or natural resources for purposes of Section 7704(d)(1)(E).

- ***Ownership of Underlying Assets***. Several commenters asserted that the proposed regulations do not treat income derived from operating and managing assets or businesses that generate qualifying income in a uniform way, as the proposed regulations often look to the underlying ownership of assets. These commenters pointed out that there is no authority in the IRC, or otherwise, to distinguish whether a particular activity generates qualifying income based on the ownership of the underlying assets. Therefore, they argued, final regulations should clarify that the ownership of such

assets is not relevant to determine whether income generated using those assets is qualifying income.

- ***General Overreach of the Proposed Regulations***. Certain commenters argued that many of the concepts contained in the proposed regulations inadvertently (or inappropriately) narrow the intended scope of Section 7704(d)(1)(E). These commenters noted that the IRS' expressed motivation in issuing the proposed regulations centers on the overwhelming volume of recent PLR requests relating to the activities deemed Intrinsic Activities in the proposed regulations, as opposed to any change in law or other authoritative interpretations thereof. As a result, these commenters recommended that the regulations, prior to being finalized, be amended to only address Intrinsic Activities.

- ***A 10-Year Transition Period and Undermining the PLR Process***. Many commenters pointed out perceived inadequacies in the 10-year transition period under the proposed regulations, including that such a transition period generally undermines the PLR process. For example, these commenters argued, among other things, that (i) industry participants and investors have relied in good faith on issued PLRs, (ii) the proposed regulations result in confusion as to whether certain PLRs are still valid and (iii) a revocation of PLRs without a change in law undermines the utility of the PLR process. Generally, these commenters recommended that all outstanding PLRs be permanently grandfathered. Other commenters requested that the IRS either (i) issue individual notices to recipients of PLRs with respect to whether such PLRs are still valid or (ii) provide explicit examples in finalized regulations to demonstrate whether each PLR remains valid and outstanding.

- ***Passive Interests***. Several commenters requested clarification that passive, non-operating economic interests relating to mineral or natural resources (passive interests), such as oil and gas royalties, continue to generate qualifying income under the proposed regulations, as the use of exclusive lists to define Section 7704(d)(1)(E) Activities makes this unclear. While whether such passive interests in Qualifying Activities would produce qualifying income under the proposed regulations remains unclear, commenters argued that passive interests are clearly within the intended scope of Section 7704(d)(1)(E) and that final regulations should clarify as much.

Comments Relating to Section 7704(d)(1)(E) Activities

Commenters noted several issues that they believe require attention relating to the proposed regulations' definition of Section 7704(d)(1)(E) Activities, particularly relating to the definitions of "processing and refining."

- ***Exploration, Development, Mining or Production***. With respect to exploration, development, mining or production activities, many commenters addressed the limitations of an "exclusive list" framework, as discussed above. Several commenters also pointed out that (i) mining may be improperly limited to the extraction of minerals or natural resources from the ground and (ii) "mining and production" may also improperly exclude certain oil and natural gas post-production activities that occur prior to the depletion cut-off point, such as certain "mining processes" that are otherwise explicitly treated as mining activities under Section 613(c). Commenters noted that the definitions of mining and production should be expanded to include mining or production from waste or residue from prior mining, as well as to include activities occurring prior to the depletion cut-off point, such as mining activities under Section 613(c).

- ***Processing Activities and Refining Activities***. Many commenters raised potential issues within the proposed regulations' definitions of processing and refining activities, particularly with respect to the

proposed regulations' perceived failure to differentiate between processing activities and refining activities.

- Processing and Refining as Separate Activities. Many commenters stated that the proposed regulations, by effectively combining processing and refining into a single activity, unduly limit those activities that should otherwise constitute separate processing activities and refining activities under Section 7704(d)(1)(E). These commenters argued that canons of statutory interpretation require that processing and refining be treated as separate activities, even if subject to some overlap, as Congress used two distinct words in the statute. As a result, these commenters argued that final regulations should separately address processing activities and refining activities.

- Inconsistencies. Commenters noted that the proposed regulations result in several inconsistencies with respect to processing and refining activities.

    - *Inconsistent treatment of different inputs*. Commenters noted that the proposed regulations treat processing and refining activities differently with respect to different inputs without any basis for doing so under Section 7704(d). For example, the production of a particular finished product from crude oil might be a Qualifying Activity, whereas the production of the same finished product from natural gas or NGLs is not, despite the absence of a statutory basis for such disparate treatment. Additionally, commenters noted that the restrictive definition of processing and refining as applied to timber does not allow timber to undergo even the most fundamental processing, such as the separation of the timber into its constituent parts, as is done in the pulping of wood. Finally, some of these commenters pointed out that exactly which processing and refining activities are Qualifying Activities remains unclear. In the case of coal, for example, it is unclear under the proposed regulations whether the coking of coal is a Qualifying Activity; excluding coking would be inconsistent with prior IRS guidance and practice. Generally, these commenters proposed that final regulations should apply a single standard for processing activities and refining activities primarily focused on whether the input is a mineral or natural resource.

    - *Inconsistent limitations with respect to precedent*. Further, some commenters pointed out that, while processing and refining activities that produce fuels generally give rise to qualifying income, there is no precedent requiring that processing and refining activities must produce fuels in order to generate qualifying income. Instead, Section 7704(d)(1)(E) and its legislative history indicates that processing and refining activities fail to constitute Qualifying Activities only when resulting in products that are extremely far removed from any products that would be produced in a petroleum refinery or gas processing plant, such as plastics or nylon. In contrast, some of these commenters pointed out that olefins, whether produced as a result of processing and refining activities relating to crude oil or natural gas, are naturally occurring in both crude oil and natural gas. Again, commenters generally proposed that final regulations should apply a single standard for processing activities and refining activities primarily focused on whether the input is a mineral or natural resource and distinguish only those processes resulting in products that are so substantially altered that they more closely resemble products, such as plastic, specifically identified in the legislative history of Section 7704(d).

- Substantial Physical or Chemical Change Standard. Many commenters pointed out that processing and refining activities under the proposed regulations appear to be substantially more limited than in prior IRS guidance. In particular, the proposed regulations require that such

activities do not involve a substantial physical or chemical change to the minerals or natural resources. These commenters pointed out that processing and refining of natural resources commonly involve some degree of physical or chemical change, which is often necessary to eliminate impurities from the natural resource and, further, that there is no statutory basis for disqualifying an activity because it involves a substantial physical or chemical change. Additionally, many of these commenters pointed out that this limitation is contrary to the common meaning of each of "processing" and "refining." As a result, these commenters generally requested that final regulations define processing and refining activities consistently with prior rulings issued under Section 7704(d)(1)(E).

- Lack of Basis for the Modified Accelerated Cost Recovery System (MACRS) Classification Standard. Several commenters pointed out that the MACRS classification requirement in the proposed regulations, with respect to assets used in processing and refining activities, (i) is a novel requirement, (ii) may ignore economic realities for industry participants and (iii) otherwise lacks statutory authority. Although some commenters noted that the MACRS classification may provide a basis for a safe harbor, commenters generally requested that final regulations omit this requirement.

- Additives. Certain commenters noted that the proposed regulations fail to explicitly permit the addition of certain additives during processing and refining activities that may be required to meet environmental standards or to enhance the intrinsic qualities of the mineral or natural resource. These commenters requested that final regulations make such an allowance.

- "Mining Processes" Versus Processing. Commenters noted that the proposed regulations appear to have incorrectly defined processing activities with respect to minerals as "mining processes," which are considered mining activities under Section 613. Commenters noted that this results in certain gaps between those activities that constitute "mining," "processing" and "refining" of minerals for qualifying income purposes, which is inconsistent with the legislative history. Commenters also noted that this gap highlights certain issues, discussed above, with the proposed regulations not defining mining in relation to the depletion cut-off point and otherwise failing to distinguish between processing and refining activities. Specifically, commenters requested that the final regulations' definition of processing activities include certain "non-mining" processes otherwise identified in the IRC, rather than include those non-mining processes within the definition of mining activities. Those would include electrolytic deposition, roasting, calcining and other processes listed in Treasury regulations Section 1.613-4(g)(1).

- ***Transportation Activities***. Comments specifically relating to transportation activities, include the following:

  - Operating Activities. Several commenters reiterated general comments relating to providing contract management services for transportation activities using property owned by others, consistent with previously issued PLRs. Commenters requested that final regulations clarify that Qualifying Activities do not depend on underlying asset ownership.

  - Definition of Terminalling. Commenters noted that the proposed regulations' definition of terminalling fails to include certain activities that are conducted as a result of the terminals serving as transportation hubs for minerals or natural resources. Specifically, these commenters requested that final regulations explicitly provide that blending, testing, treating and additization activities be included as terminalling activities, as these services are often provided in conjunction with transportation activities (in addition to marketing activities) in order to make minerals or

natural resources marketable, functional and, in certain circumstances, compliant with regulatory requirements.

- Renewable Identification Numbers (RINs). Commenters noted that income from the sale of RINs should be treated as income from either transportation or marketing activities under Section 7704(d)(1)(E). Commenters explained that the ability to resell RINs derives from the provision of terminalling services by providing certain required blending services to satisfy environmental regulations. These services allow MLPs to charge less for blending activities. Therefore, commenters argued that income from the sale of RINs should constitute income from transportation activities in final regulations.

- Compression Services. Commenters noted that ambiguity remains about whether compression services — which are necessarily provided as part of transportation services to increase capacity, boost pressure and overcome the friction and hydrostatic losses inherent in normal pipeline transportation operations — are included as transportation services under the proposed regulations. Commenters therefore requested that final regulations clarify that compression services are considered transportation activities comprising Section 7704(d)(1)(E) Activities.

- Liquefaction and Regasification of Natural Gas. Commenters noted uncertainty about whether liquefaction and regasification of natural gas is included under transportation activities for purposes of the proposed regulations. As liquefaction of natural gas is necessary to support the cost-effective transportation of natural gas, and regasification returns the natural gas to its productive state, commenters requested that final regulations clarify that both liquefaction and regasification of natural gas are considered transportation activities comprising Section 7704(d)(1)(E) Activities. In the weeks following the publication of the proposed regulations, the IRS issued PLR 201538012 (May 19, 2015) and PLR 201537007 (May 26, 2015), both of which conclude that income derived from the liquefaction and regasification of natural gas constitutes qualifying income.

- Tanker ships and other vessels. Commenters noted that the proposed regulations include a barge as a mode of transportation for minerals or natural resources, but fail to include tanker ships and other vessels that operate on the water. In response, commenters requested that tanker ships and other vessels be added as modes of transportation for minerals or natural resources, and relatedly, re-emphasized the need for non-exclusive definitions throughout Section 7704(d)(1)(E) Activities.

- Retail Transportation and the Marketing of Propane. Commenters noted that the proposed regulations fail to explicitly state that income derived from the retail transportation and marketing of propane is qualifying income, as provided for in the legislative history of Section 7704(d)(1)(E). Accordingly, commenters requested that final regulations explicitly provide that the retail transportation and marketing of propane constitute transportation and marketing activities comprising Section 7704(d)(1)(E) Activities.

- Retail Transportation by Pipeline. Commenters noted that the proposed regulations fail to explicitly state that income derived from the retail transportation and marketing of minerals or natural resources by pipeline to retail locations constitutes qualifying income, as provided for in the legislative history of Section 7704(d)(1)(E). Accordingly, commenters requested that final regulations explicitly include that the retail transportation and marketing of minerals or natural resources by pipeline constitute transportation and marketing activities comprising Section 7704(d)(1)(E) Activities.

- Construction Activities. Commenters pointed out that construction activities that would be treated as transportation activities and, thus, generate qualifying income under the proposed regulations are limited to connecting a producer or refiner to a pre-existing interstate or intrastate pipeline that an MLP owns pursuant to an interconnect agreement. Commenters stated that this definition fails to recognize commercial realities in the midstream industry. These commenters asserted that MLPs are often in the best position to provide construction services for reimbursement of costs and low marginal fees with respect to: (i) interconnects, whether required by the Federal Energy Regulatory Commission or not; (ii) relocating assets; and (iii) storage and terminalling assets, each as necessary to support transportation and terminalling activities. In other words, commenters requested that the concept of construction activities as transportation activities be expanded for the purposes of final regulations to incorporate common commercial practices that are necessary for the provision of transportation activities.

- ***Marketing Activities***. Comments specifically relating to marketing activities include the following:

  - Definition of Marketing. Commenters noted that the proposed regulations inadvertently and unnecessarily create confusion as to whether the actual sale of minerals and natural resources constitutes marketing activities comprising Section 7704(d)(1)(E) Activities. These commenters requested that final regulations clarify that marketing activities include not only activities performed to "facilitate a sale," but also the specific act of selling a mineral or natural resource.

  - Definition of Retail Customers. Several commenters requested clarification regarding the meaning of "retail customers" in the proposed regulations. These commenters requested that final regulations clarify that retail customers are ultimate consumers, acquiring minerals or natural resources to meet personal needs, rather than for commercial or industrial uses, as is consistent with Supreme Court precedent and the examples contained within the proposed regulations.

  - Overlap with Certain Comments Relating to Transportation Activities. Many comments relating to marketing activities overlapped with certain comments relating to transportation activities, including with respect to commenters requesting that final regulations clarify that: (i) consistent with the legislative history of Section 7704(d), (A) the retail transportation and marketing of propane generates qualifying income and (B) the retail transportation and marketing of minerals or natural resources by pipeline generates qualifying income; and (ii) income generated by the sale of RINs constitutes qualifying income, as such income is derived from blending activities that are properly characterized as transportation or marketing activities under final regulations.

  - Packaging Activities. Commenters pointed out that packaging activities are not clearly identified as marketing activities in the proposed regulations. As minerals or natural resources must often be packaged into a known, saleable and transportable quantity in order to be marketable, these commenters requested that final regulations clarify that packaging activities constitute marketing activities comprising Section 7704(d)(1)(E) Activities.

  - Commodity Hedging. Commenters noted that the proposed regulations do not address whether income from commodity hedging constitutes qualifying income. Because commodity hedging activities are performed in the ordinary course of business for MLPs to manage risk with respect to minerals or natural resources such MLPs own, commenters requested that final regulations clarify that, consistent with historical IRS guidance, commodity hedging activities constitute marketing activities comprising Section 7704(d)(1)(E) Activities.

Comments Relating to Intrinsic Activities

Commenters noted several issues requiring attention relating to the proposed regulations' definition of Intrinsic Activities, including the following:

- ***"Specialization" Requiring the MLP's Provision of Personnel***. Several commenters noted that the "specialization" component of the Intrinsic Activities requires further clarification in final regulations, including with respect to the following:

  - Requiring the MLP's Provision of Personnel. Commenters noted that "specialization" in the proposed regulations requires that the partnership provide personnel, which ignores the normal commercial practices of MLPs. These commenters pointed out that the employees that conduct business and perform services for the MLP are typically either independent contractors or employees of the MLP's sponsor (or a subsidiary thereof) that are seconded to the MLP, as opposed to employees of the MLP itself. Accordingly, these commenters requested that final regulations broaden the concept of "partnership provided personnel" to include independent contractors hired by the MLP and employees of affiliates of the MLP that operate under the supervision, direction and control of the MLP or its general partner.

  - Requiring Specialized Property. Additionally, commenters pointed out that the "specialization" requirement that tangible personal property used in conjunction with performing an Intrinsic Activity be of limited use other than for performing Section 7704(d)(1)(E) Activities is unduly (and likely unintentionally) burdensome. For example, these commenters asserted that this specialization requirement could exclude equipment like a bulldozer, which is necessary for site preparation to drill an oil well (a Section 7704(d)(1)(E) Activity), but obviously has other uses. Accordingly, these commenters requested that final regulations determine specialization as relating to property based on the use rather than on the character of such property.

- ***Back-office or Management Services***. Commenters noted that the proposed regulations create ambiguity as to whether back-office or management services performed with respect to Qualifying Activities generate qualifying income. For back-office or management services performed with respect to assets owned or jointly owned by the party performing such services, commenters took the position that such back-office or management services are necessary for Qualifying Activities and, therefore, should also be Qualifying Activities. Relatedly, as discussed above, many of these commenters requested that final regulations clarify that qualifying income may be derived with respect to Qualifying Activities, including management services, regardless of the ownership of the underlying assets used for such Qualifying Activities.

- ***Injectants***. Several commenters sought to draw attention to the proposed regulations' requirements regarding injectants.

  - Well-by-well Basis. Commenters pointed out that the proposed regulations appear to require that MLPs that provide injectants at wells also collect, clean, recycle or otherwise dispose of the injectant on a well-by-well basis, and, with respect to water for example, on a molecule-by-molecule basis. As a commercial matter, the supply and collection, cleaning and recycling of injectants are rarely provided on a well-by-well basis. As such, these commenters generally requested that injectant-related services constitute Intrinsic Activities to the extent such services are solely (or primarily) provided to persons engaged in Section 7704(d)(1)(E) Activities.

  - Improper Reference to Sand. Several commenters noted that the proposed regulations improperly reference sand when describing injectants. Because sand is a depletable resource

under Section 611, and therefore a mineral or natural resource under Section 7704(d)(1)(E), commenters argued that whether sand is considered an injectant for Intrinsic Activities purposes is generally irrelevant. Therefore, these commenters requested that references to sand as an injectant be removed from final regulations to avoid confusion.

Conclusion

While still only in proposed form, the additional guidance relating to the classification of income from certain activities with respect to minerals or natural resources as qualifying income is material to many MLPs and their partners. Accordingly, many who submitted comments requested a public hearing. That public hearing will occur on October 27, 2015. Prior to promulgating final regulations, the IRS will consider the discussed comments; however, we are unable to predict whether any of these comments or other proposals will ultimately be adopted in the final regulations. Moreover, when the proposed regulations will be finalized remains highly uncertain. In the meantime, taxpayers and investors should consult their tax advisors and consider carefully the potential impact of the proposed regulations on planned or completed transactions and arrangements.

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Endnotes

[1] All Section references herein are to the Internal Revenue Code of 1986, as amended (the IRC), unless otherwise specified.

[2] Under the qualifying income exception, a publicly traded partnership, or an MLP, is treated for US federal income tax purposes as a partnership, rather than as a corporation, if at least 90% of its gross income is qualifying income.