

FINAL REGULATIONS
UNDER
SECTION 7704(D)(1)(E)

MLPA TAX EXECUTIVE ROUNDTABLE

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PUBLICATION OF THE FINAL REGULATIONS

- On January 19, 2017, the final regulations under section 7704 were released by the IRS and the Treasury Department and filed with the Federal Register.
- On January 20, 2017, President Donald J. Trump imposed a government-wide regulatory freeze in a White House memorandum issued by the President's Chief of Staff.
- The memorandum included an instruction to the heads of executive departments and agencies to immediately withdraw regulations that have been sent to the Federal Register, but not yet published, until a department or agency head appointed or designated by the President reviews and approves the regulations.
- On January 24, 2017, in a surprise to many, the final regulations under section 7704 were published in the Federal Register. Because the regulations were published in the Federal Register, the regulations are now final.

FINAL REGULATIONS

- The final regulations are largely viewed as an improvement over the proposed regulations. They address favorably many, but not all, of the comments to the proposed regulations, but do so largely within the framework of the proposed regulations.
- The most significant changes are as follows:
 - No more “exclusive list” of qualifying activities
 - Greater clarity on the qualifying nature of some activities:
 - LNG liquefaction and regasification
 - Transportation and sale of propane to retail customers
 - Pipeline compression services
 - Many blending and additization activities
 - Reimbursement of costs
 - Hedging activities subject to further guidance

FINAL REGULATIONS

- The most significant changes are as follows (con't):
 - Simplified analysis of oil and gas products:
 - “Good list” approach to processing and refining of oil and gas
 - Olefins generate qualifying income
 - Methanol does not generate qualifying income
 - Narrow interpretation of hard mineral processing depending on the type of ore
 - Excludes coking of coal, steelmaking, and aluminum smelting
 - Oilfield services still qualify
 - Basin-by-basin approach for oil field service providers; and clarification that an MLP’s subcontractors are treated as partnership personnel

FINAL REGULATIONS

EXPLORATION AND DEVELOPMENT

- **Exploration:** An activity constitutes exploration if it is performed to ascertain the existence, location, extent, or quality of any deposit of a mineral or natural resource before the beginning of the development stage of the natural deposit.
- **Development:** An activity constitutes development if it is performed to make accessible minerals or natural resources.

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MINING OR PRODUCTION

- An activity constitutes mining or production if it is performed to:
 - Extract minerals or natural resources from the ground including by operating equipment to extract minerals or natural resources from mines and wells; or
 - Extract minerals or natural resources from the waste or residue from prior qualifying mining or production activities.
- The recycling of scrap or salvaged metals or minerals from previously manufactured products or manufacturing processes is not considered to be the extraction of ores or minerals from waste or residue.

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PROCESSING AND REFINING

- Under the proposed regulations, the activities of processing and refining were combined in one definition.
- Many commenters argued that the proposed regulations' use of a joint definition for processing and refining wrongly read the term "processing" out of the statute.
- The final regulations adopt the suggestion of separately defining processing and refining to better clarify what activities generate qualifying income.
- However, the final regulations retain separate standards for these activities when applied to different natural resources.

FINAL REGULATIONS

PROCESSING

- **General Rule:** An activity constitutes processing if it is performed to convert raw mined or harvested products or raw well effluent to substances that can be readily transported or stored.
- **Specific Rules:**

<u>Natural Gas</u>	<u>Crude Oil</u>	<u>Ores and Minerals</u>	<u>Timber</u>
<p>An activity performed to:</p> <ul style="list-style-type: none"> • Purify natural gas, including by removal of oil or condensate, water, or non-hydrocarbon gases. • Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and heavier streams). 	<p>An activity performed to separate produced fluids by:</p> <ul style="list-style-type: none"> • Passing crude oil through mechanical separators to remove gas. • Placing crude oil in settling tanks to recover basic sediment and water. • Dehydrating crude oil. • Operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water. 	<p>An activity that meets the definition of mining processes under the Treasury Regulations to section 613.</p>	<p>An activity performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances.</p>

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REFINING

- **General Rule:** A general rule is not provided for refining.
- **Specific Rules:** Note that specific rules are not provided for timber.

<u>Natural Gas and Crude Oil</u>	<u>The following are not products of natural gas or crude oil refining:</u>	<u>Ores and Minerals</u>
<ul style="list-style-type: none"> • The further physical or chemical conversion or separation processes of products resulting from processing activities, and the blending of certain petroleum hydrocarbons, <u>to the extent they give rise to a product included in the non-exclusive list</u>; and • The further physical or chemical conversion or separation processes and blending <u>of the products listed in the non-exclusive list, to the extent the resulting product is also in the list.</u> 	<ol style="list-style-type: none"> 1) Any product that results from further chemical change of a product listed in the non-exclusive list that does not result in the same or another product also in the list (such as, the upgrading of petroleum coke to calcined coke). 2) Heat, steam, or electricity produced by processing or refining. 3) Products obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts sold. 4) Plastics or similar petroleum derivatives. 	<ul style="list-style-type: none"> • A process performed subsequent to a mining process to eliminate impurities or foreign matter <u>and which is a necessary step in achieving a high degree of purity from metallic ores and minerals which are not customarily sold in the form of the crude mineral product.</u> • The final regulations indicate that the following constitute ores and minerals not customarily sold in the form of the crude mineral product: lead, zinc, copper, gold, silver, and any other ores or minerals the Commissioner may identify through published guidance.

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OIL AND GAS PRODUCTS LIST

- 1) Ethane.
- 2) Ethylene.
- 3) Propane.
- 4) Propylene.
- 5) Normal butane.
- 6) Butylene.
- 7) Isobutane.
- 8) Isobutene.
- 9) Isobutylene.
- 10) Pentanes plus.
- 11) Unfinished naphtha.
- 12) Unfinished kerosene and light gas oils.
- 13) Unfinished heavy gas oils.
- 14) Unfinished residuum.
- 15) Reformulated gasoline with fuel ethanol.
- 16) Reformulated other motor gasoline.
- 17) Conventional gasoline with fuel ethanol – Ed55 and lower gasoline.
- 18) Conventional gasoline with fuel ethanol – greater than Ed55 gasoline.
- 19) Conventional gasoline with fuel ethanol – other conventional finished gasoline.
- 20) Reformulated blendstock for oxygenate (RBOB).
- 21) Conventional blendstock for oxygenate (CBOB).
- 22) Gasoline treated as blendstock (GTAB).
- 23) Other motor gasoline blending components defined as gasoline blendstocks in the Treasury Regulations, *e.g.*, alkylate, raffinate, reformate, isomerate, toluene, transmix containing gasoline.
- 24) Finished aviation gasoline and blending components.
- 25) Special naphthas (solvents).
- 26) Kerosene-type jet fuel.
- 27) Kerosene.
- 28) Distillate fuel oil (heating oils, diesel fuel, and ultra-low sulfur diesel fuel).
- 29) Residual fuel oil.
- 30) Lubricants (lubricating base oils).
- 31) Asphalt and road oil (atmospheric or vacuum tower bottom).
- 32) Waxes.
- 33) Petroleum coke.
- 34) Still gas.
- 35) Naphtha less than 401F end-point.
- 36) Other products of a refinery that the Commissioner may identify through published guidance.

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TRANSPORTATION

- In general, an activity constitutes transportation if it is performed to move minerals, natural resources, or products produced through processing or refining, including transportation by pipeline, marine vessel, rail, or truck.
- However, transportation does not include the movement of such minerals, natural resources, or products directly to retail customers or to a place that sells or dispenses to retail customers, except for the movement via pipeline to a place that sells to retail customers.
- Transportation specifically includes the following activities:
 - Providing storage services
 - Providing certain terminalling services
 - Moving or carrying (whether by owner or operator) products via pipelines, gathering systems, and custody transfer stations.
 - Operating marine vessels (including time charters), railcars, or trucks
 - Providing compression services to a pipeline
 - Liquefying or regasifying natural gas

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MARKETING

- An activity constitutes marketing if it is the bulk sale of minerals, natural resources, or products produced through processing or refining.
- Marketing also includes activities that facilitate sales (such as packaging) as well as certain blending and additization activities.
- Except for retail sales of liquefied petroleum gas, marketing does not include retail sales (sales made in small quantities directly to end users), which includes the operation of gasoline service stations, home heating oil delivery services, and local natural gas delivery services.

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ADDITIONAL ACTIVITIES

- Income from certain additional activities will also be considered to be derived from a qualifying activity:
 - Cost Reimbursements
 - Hedging [Reserved]
 - Passive Interests
 - Blending
 - Additization

FINAL REGULATIONS

ADDITIONAL ACTIVITIES: COST REIMBURSEMENTS

- If the partnership is in the trade or business of performing a qualifying activity, qualifying income includes income **received to reimburse the partnership** for its costs in performing that qualifying activity, whether imbedded in the rate the partnership charges or separately itemized.
- Reimbursable costs may include, but are not limited to the costs of:
 - Designing, constructing, installing, inspecting, maintaining, metering, monitoring, or relocating an asset used in that qualifying activity; or
 - Providing office functions necessary to the operation of that qualifying activity (such as staffing, purchasing supplies, billing, accounting, and financial reporting).

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ADDITIONAL ACTIVITIES: HEDGING

- Final Regulations reserve on the issue and requests comments.
- Preamble to the Final Regulations:
 - Hedging income should give rise to qualifying income when it is derived from a Section 7704(d)(1)(E) activity.
 - Hedging income and gains, as well as deductions and losses must be taken into account.
 - Ex. Hedging transactions to manage risk of price changes or currency fluctuations with respect to ordinary property from which qualifying income is derived is treated as an adjustment to qualifying income, provided the transaction is entered into in the ordinary course and is clearly identified by the end of the day on which it is entered into.
 - Ex. Forward contract, commodity sales. Gain increases qualifying income, loss decreases qualifying income.
 - Ex. Notional principal contracts if the property, income, or cash flow that measures the amount to which the partnership is entitled under the NPC would give rise to qualifying income if held or directly received by the partnership.

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ADDITIONAL ACTIVITIES: PASSIVE INTERESTS

- Qualifying income includes income and gain from a passive interest or a non-operating interest in a mineral or natural resource, including:
 - Production royalties
 - Minimum annual royalties
 - Net profits interests
 - Delay rentals
 - Lease-bonus payments
- Payments received on a production payment will not be qualifying income if they are properly treated as loan payments under section 636.

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ADDITIONAL ACTIVITIES: BLENDING

- Blending is common among all natural resources
- Blending is treated as qualifying so long as the products being blended are component parts of the same mineral or natural resource
 - Oil and gas products are treated as the same type of natural resource
- Qualifying Examples:
 - Blending gasoline components to make finished gasoline
 - Blending different grades of coal
- Non-Qualifying Example:
 - Blending asphalt with gravel for roads

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ADDITIONAL ACTIVITIES: ADDITIZATION

- Additization is permissible as described below if the additives aid in the transportation of a product, enhance or protect the intrinsic properties of a product, or are necessary as required by federal, state or local law, but only if such additives do not create a new product:
 - Oil and gas products: Up to 5% non natural resource additives (and up to 20% ethanol or biodiesel) added at a terminal or upstream from the terminal
 - Ores and minerals other than oil and gas: Incidental amounts of material such as paper dots to identify shipments, antifreeze to aid in shipping, or compounds to allay dust as required by law or reduce losses during shipping
 - Timber: incidental amounts to comply with government regulations

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INTRINSIC ACTIVITIES

- The Treasury Department and the IRS agreed with commenters that the injections exception should be revised to account for industry practice in which a producer may not hire the same company to provide both water delivery and disposal services.
- Accordingly, the regulations relax the “well-by-well” matching requirement for the provision of water and other injectants for use in oil and gas exploration.
- Instead, the final regulations allow for the provision of water or injectant if the MLP is also in the trade or business of collecting, cleaning, recycling, or otherwise disposing of injectants within the same “geographic area.”

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INTRINSIC ACTIVITIES

- Under the final regulations, qualifying income includes income from intrinsic activities. An activity is an intrinsic activity only if it:
 - is **specialized** to support a qualifying activity,
 - Requires that the partnership provide personnel to support a qualifying activity and that those personnel have received training “that is unique to the mineral or natural resource industry.”
 - Requires that, to the extent the activity involves the use of specific property, the property is dedicated to performing qualifying activities and is not easily converted to another use.
 - is **essential** to the completion of the qualifying activity, and
 - An activity is essential if it is required to physically complete a qualifying activity (including in a cost-effective manner, such as by making the activity economically viable).
 - requires **significant services** to support the qualifying activity.
 - Requires that services provided are conducted on an ongoing or frequent basis by the partnership’s personnel at the site or sites of the qualifying activity.
 - Services are not significant with respect to a qualifying activity if the services principally involve the design, construction, manufacturing, repair, maintenance, lease, rent or temporary provision of property.

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TRANSITION RULE

- A partnership may treat income from an activity as qualifying income during the 10-year transition period if:
 - The partnership has a PLR.
 - The partnership is publicly traded and engaged in the activity after May 6, 2015, but before January 19, 2017, and the income from that activity is qualifying income under the proposed regulations.
 - Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as generating qualifying income under a reasonable interpretation.
 - Prior to May 6, 2015, the partnership had entered into a binding agreement for the construction of assets to be used in an activity that generated qualifying income under a reasonable interpretation.