

**PROPOSED REGULATIONS ON QUALIFYING INCOME
UNDER SECTION 7704(d)(1)(E)**

Summary of NAPTP Comments

On May 6, 2015, the IRS released proposed regulations under section 7704(d)(1)(E) of the tax code relating to qualifying income for publicly traded partnerships (PTPs, more commonly known as MLPs) from the exploration, mining or production, processing, refining, transportation, and marketing of minerals or natural resources. The Proposed Regulations provide much needed clarity with respect to many activities currently conducted by MLPs, guidance which has previously been available only through individual private letter rulings (PLRs).

While welcoming this clarity, NAPTP has significant concerns with some aspects of the Proposed Regulations. Our principal concerns are listed below.

- (1) **Exclusive list of activities.** The Proposed Regulations provide an "exclusive list" of the operations that comprise each enumerated activity (i.e., exploration, mining or production, processing, refining, transportation and marketing) in section 7704. The operations involved in each activity, however, are varied and change as technologies evolve. Exclusive lists of operations that comprise each activity are inconsistent with Congressional intent in 1987 to broadly construe these terms, and any list will be outdated as soon as it is written. For example, fracking, the most common method of extracting oil and gas today, was unknown in 1987. NAPTP recommends that the Proposed Regulations be revised to provide definitions of each qualifying activity, as is currently done in the Proposed Regulations, along with several *examples* of operations which do and do not satisfy the definition, rather than an exclusive list.
- (2) **Abandoning prior standards.** The Proposed Regulations abandon certain standards utilized by the IRS in issuing PLRs since 1987. This is of concern both because NAPTP believes that the IRS applied the correct standards when the PLRs were issued, and because MLPs have structured activities and investors have provided capital in good faith reliance on the PLRs that have been issued. One NAPTP member's PLR, upon which its business as an MLP depends, would be inconsistent with the Proposed Regulations if finalized, and its share price has been detrimentally affected since the Proposed Regulations were issued. NAPTP recommends that the Proposed Regulations be revised to provide that an MLP that has received a PLR under section 7704(d)(1)(e) may continue to rely on the PLR indefinitely.
- (3) **Overly restrictive definitions of processing and refining.** NAPTP has major concerns with the definition of "processing and refining" set forth in the Proposed Regulations which generally requires that the activity be done to "purify, separate or eliminate impurities." In

addition, the Proposed Regulations require that the MLP's designation of the depreciation class life for assets used processing and refining must reflect that the activity is processing and refining. This definition does not encompass the activities undertaken to refine and process oil, gas, and minerals and the products thereof in a manner consistent with the statute, the legislative history and the PLRs interpreting the terms issued over the past 27 years. Specific concerns include:

- The definitions are inconsistent with section 7704 and with existing Treasury Regulations. The Proposed Regulations unduly restrict the definition of “refining” and essentially read “processing” out of the statute.
- The Proposed Regulations apply different principles for the processing and refining of different natural resources. There is no statutory basis for disparate treatment of different natural resources.
- The Proposed Regulations state that an activity would not qualify as processing or refining if the activity “causes a substantial physical or chemical change in a mineral or natural resource” unless certain fuels are produced in petroleum refineries. Processing and refining of minerals, natural resources and products thereof often involve some degree of physical or chemical change, and there is no statutory basis for disqualifying an activity because it involves a substantial physical or chemical change.
- The depreciation classification of the assets used in the activity, and the focus on the production of fuels have no statutory basis.
- The Proposed Regulations create inconsistencies in the treatment of comparable activities where substantially identical processes are used to create the same products. For instance cracking that occurs in a refinery would generate qualifying income while cracking in a natural gas processing plant would not.
- Refining partially processed ores and minerals is treated as a qualifying activity but the processing activities that take place prior to refining are treated as non-qualifying activities.
- The restrictive definition of processing and refining as applied to timber does not allow timber to undergo even the most fundamental refining processes, such as the separation of the timber into its constituent parts, as is done in the pulping of wood.

- (4) **“Natural Resources” definition.** NAPTP is concerned that the definition in the Proposed Regulations of natural resources to which the enumerated activities may be applied is too narrow in that it does not include “products thereof.” The statute provides that natural resources include “oil and gas and products thereof”. Congress did not intend that a mineral or natural resource lose its status as a natural resource by being processed or refined for purposes of section 7704(d)(1)(E). NAPTP recommends that the Proposed Regulations specifically provide that a mineral or natural resource remains a product thereof when it is processed or refined.

- (5) Transportation.** NAPTP recommends that the examples of activities that qualify as transportation include: (i) the designing, constructing, relocating and installation of pipeline interconnects and storage and terminal facility expansions; (ii) the operation of terminals and gathering systems; (iii) common activities relating to terminalling including testing, blending, treating, additization, and the sale of RINs; (iv) natural gas compression; (v) liquefaction and regasification of natural gas; (vi) the operation of tanker ships and vessels; and (vi) the transportation and marketing of liquefied petroleum gas, in particular propane.
- (6) Marketing.** NAPTP recommends that the definition of “marketing” be clarified to: (i) better reflect the common meaning of “marketing” and the common meaning of “retail”; (ii) specify that the retail sale of propane and other liquefied petroleum gas is a qualifying marketing activity; (iii) delete the exclusion for gas delivery services because all pipeline transportation generates qualifying income; (iv) include income derived by non-operating interest owners relating to the sale of a mineral or natural resource as an example of marketing income; and (iv) include packaging, blending, the sale of RINs and commodity hedging as examples of qualifying marketing activities.
- (7) Other Comments.** Other comments include:
- a. Revising the Proposed Regulations to take account of the fact that MLPs generally do not have their own employees, but rather use the services of employees of the general partner or other affiliate.
 - b. Providing management services with respect to any section 7704(d)(1)(E) activity should be treated as income from the respective section 7704(d)(1)(E) activity without regard to ownership of the business or assets generating the income, as was done in a number of PLRs.
 - c. Refining the Proposed Regulations which allows income from service activities provided in support of a qualifying section 7704(d)(1)(E) (e.g., operations in support of fracking activities by a producer) to be treated as qualifying income if the activity is specialized to support a section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity.