2015 Annual Meeting

REPORT OF THE REGULATORY COMMITTEE

TAX GUIDANCE AND ISSUES IN THE PAST YEAR

October 2015

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INTRODUCTION AND SUMMARY

The period between the 2014 and 2015 Annual Meetings has been perhaps the most significant since the 1980s in terms of tax regulatory developments affecting MLPs. In May, after over a year of waiting for the "private letter ruling ('PLR') pause" to end, the IRS and Treasury Department issued proposed regulations providing guidance on permissible activities relating to natural resources under section 7704(d)(1)(E) (the "Proposed Regulations"). The Proposed Regulations touched off a widespread reaction in the MLP world and led to a major project to develop comments from MLPA.

Other regulatory developments of less significance but potential interest included:

- Final regulations under section 706 on the allocation of tax items when partners' interests change during a tax year;
- Final regulations on start-up and organizational expenditures after technical termination of a partnership under section 708(b)(1)(B);
- Proposed regulations on "hot assets" under section 751(b);
- An MLPA effort to extend the tax treaty treatment proposed by the OECD for Collective Investment Vehicles ("CIVs") to MLPs; and
- Five new PLRs on qualifying income under section 7704, including two that were issued after the Proposed Regulations were promulgated.

NEW DEVELOPMENTS

Proposed Regulations on Qualifying Income under Section 7704(d)(1)(E)

Background

MLPs, like all publicly traded partnerships, must continuously meet the "qualifying income" test of section 7704(d)(1) in order to retain partnership tax treatment. Since section 7704 was enacted, very little regulatory guidance has been provided related to qualifying income. Existing

regulations deal primarily with the definition of "publicly traded," and regulations relating to qualifying income mostly restate the statute.

Because an MLP's existence as a partnership depends on having 90 percent or more of its gross income be qualifying income, it is critical that its managers and unitholders are certain which activities engaged in by the MLP will earn qualifying income. Existing and incipient MLPs generally will ask their tax attorneys for an opinion that the income from an activity is qualifying income. If the attorneys issue a "will" opinion—i.e., that they are certain that the income will qualify under section 7704(d)(1)—then the MLP will engage in the activity. If the attorneys are not certain, the MLP will request a PLR from the IRS. A PLR is a letter that is issued by the IRS to a taxpayer in response to the taxpayer's request for clarification of the law as it applies to a specific situation, and the PLR applies only to that taxpayer and the situation described. While a PLR interpreting section 7704(d)(1) is applicable only to the taxpayer requesting it (whose identity is not released) and cannot be used as precedent, PLRs have provided a valuable indication of the IRS' thinking for the last 27 years in the absence of more general guidance. Although IRS has the right to revoke a PLR because it has changed its mind about the interpretation of the law, this very rarely happens.

Until March 2014, the IRS had issued 100 PLRs interpreting the qualifying income definition (eight of which were released in March 2014 or later because of the lag between issuing the PLR to the taxpayer and its release to the public), with 20 issued and 18 released in 2012; and 36 issued and 29 released in 2013. In March 2014 the IRS instituted a moratorium or pause on issuing new PLRs under section 7704 without any formal announcement.

As IRS and Treasury officials explained the PLR pause at the 2014 Annual Meeting, a large number of rulings had been issued in 2012 and 2013, authored by various IRS attorneys. Many of the PLRs applied section 7704 to activities that had not been considered before, in particular various services provided with regard to fracking operations. There was concern about ruling on new areas without guidelines to follow. The purpose of the pause, they said, was to allow a working group to develop such guidelines, which should take two or three months.

As time passed, the project evolved from providing guidelines for PLRs to issuing formal guidance that would provide greater clarity to section 7704 and reduce the need for PLRs. While the prospect of such guidance was (and is) welcome, the process of developing it took over a year. During that time, only two PLRs dealing with situations clearly covered by the statute were released.[1] Thus, MLP IPOs and other transactions not covered by "will" opinions were held in abeyance. During the pause, MLPA staff and member attorneys responded to questions from policymakers on services provided to oil and gas producers.

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[1] Fourteen PLRs decided before the pause began were also released during that period.

Proposed Regulations

On May 6, the IRS and Treasury issued Proposed Regulations under section 7704(d)(1)(E) providing guidance on qualifying income for MLPs from the exploration, mining or production, processing, refining, transportation, and marketing of minerals or natural resources. The Proposed Regulations were unexpectedly broad, not only addressing issues related to third party services provided to oil and gas producers (the "intrinsic activity" portion of the Proposed Regulations), which as noted had been discussed with policymakers during the pause, but also providing a definition of each activity permitted under section 7704(d)(1)(E) along with an exclusive list of what was permitted under that definition.

The Proposed Regulations are particularly detailed in limiting the activities that constitute permitted refining and processing and are much narrower than the legislative history and industry practice would dictate. They are contrary to the holdings in many prior PLRs and in at least one case, reversed a holding upon which an MLP's entire business was based. The Proposed Regulations provide a ten-year transition period for activities that would not be qualifying activities under the Proposed Regulations but were approved by PLRs. This transition rule, however, did not prevent the most affected MLPs from experiencing a drop in share price.

MLPA Comments

Soon after the Proposed Regulations were issued, a number of tax lawyers, accountants, and MLP tax staff formed a working group under the auspices of the Regulatory Committee to prepare comments for submission to the IRS. The group had numerous discussions to identify issues, and the Regulatory Committee solicited comments from MLPA members. After issues were identified, group members drafted comments, which were incorporated into the MLPA's comments (under its name at the time, NAPTP) and submitted to the IRS on August 4, 2015 by MLPA's Tax Counsel, Linda Carlisle.

MLPA's comments are over 90 pages long. They begin by noting that the Proposed Regulations provide much-needed clarity with respect to the activities conducted by MLPs and describe many ancillary services necessary for the performance of a qualifying activity. There are several aspects to the regulations, however, that cause MLPA strong concern. These are:

(1) **Exclusive lists 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. MLPA 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 MLPA 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 MLPA 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. MLPA 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. MLPA 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 other 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. MLPA 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). MLPA 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. MLPA 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. MLPA 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 suggested modifications 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. Treating the provision of management services with respect to any section 7704(d)(1)(E) activity 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. Modifying the Proposed Regulations to allow 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.

MLPA was joined by a number of MLPs, other companies, associations, and individuals in submitting comments, many of them raising the same concerns. Several members of the Louisiana Congressional delegation sent a letter to Treasury Secretary Lew, and the entire Republican side of the House Ways and Means Committee (other than the chairman) sent a letter to the IRS and Treasury, expressing concern as well. The IRS has scheduled a hearing on the proposed regulations on October 27, 2015 at 10:00 a.m. Linda Carlisle will be testifying at the hearing for MLPA.

Proposed Regulations under Section 751 (b)

On October 31, 2014, the IRS and Treasury issued proposed regulations providing guidance with regard to partners' interests in a partnership's unrealized receivables or inventory items (often referred to as "hot assets") under section 751(b). Under section 751, which was enacted to prevent the conversion of ordinary income into capital gain, when a partner sells or exchanges a partnership interest, that portion of the gain representing the partner's interest in hot assets is taxed as ordinary income rather than capital gain. The proposed regulations address how a partner should measure its interest in a partnership's hot assets and the tax consequences to a partner of a distribution reducing that interest.

The current section 751(b) regulations use a gross value approach to determine a partner's interest in hot assets rather than the partner's share of unrealized gain or loss in partnership property. In contrast, the proposed regulations adopt a taxpayer-friendly hypothetical sale approach as the method to be used to determine whether a distribution reduces a partner's interest in the partnership's hot assets. This approach relies upon section

704(c) to preserve a partner's share of unrealized gain and loss in the partnership's hot assets after the hypothetical sale.

Although section 751(b) applies only when a partner's share of unrealized gain in the partnership's hot assets is reduced or the unrealized loss is increased, the proposed regulations contain an "anti-abuse rule" that allows the IRS to recast transactions that rely on the rules of section 704(c) to defer ordinary income while monetizing most of the value of the partnership interest. MLP distributions to public unitholders are generally not the type of distribution that could give rise to a shift in the partnership's hot assets. Accordingly, these regulations should not have much impact on the unitholders of NAPTP members.

MLPA Comments to the OECD Urging that the Tax Treatment of Collective Investment Vehicles be Extended to MLPs

Many MLPs engage directly or indirectly in business activities outside the United States, such as when pipeline systems cross borders. If an MLP structures its foreign activities in a non-U.S. entity, local country income taxes and withholding taxes are imposed on dividend distributions or payments of interest from such entities.

The OECD has explored how tax treaties should be applied to collective investment vehicles (“CIVs”) which are funds that are widely-held, hold a diversified portfolio of securities, and are subject to investor-protection regulation in the country in which they are established. The one difference between MLPs and CIVs is that investors in MLPs pool their capital to invest in business assets in certain sectors rather than in equity or debt securities as in CIVs.

There are two types of issues related to the application of tax treaties to CIVs and MLPs: (i) the substantive entitlement to treaty benefits by such vehicles either in their own right or on behalf of its investors; and (ii) the administrative standards for claiming treaty benefits.

In letters dated January 8, 2015 and June 15, 2015 to the OECD with copies to the U.S. Treasury, MLPA urged that any relief proposed in OECD commentaries or model treaty language for CIVs include MLPs. Treasury informed MLPA, however, that the OECD refused to consider expanding the definition of CIVs due to treaty shopping concerns. Treasury is now aware of the problems MLPs face in obtaining treaty benefits, but we have been told that it does not have the resources at this time to devise a workable solution that our treaty partners will accept.

DEVELOPMENTS ON ISSUES FROM PREVIOUS YEARS

Final Regulations on Start-up and Organizational Expenditures after Technical Termination

Proposed Regulations

On December 6, 2013, the IRS and Treasury issued proposed regulations concerning the deductibility of start-up expenditures and organizational expenses for partnerships following a technical termination partnership under section 708(b)(1)(B). The regulations were issued to settle the question whether a technical termination allows immediate deduction of the portion of such expenses that remains unamortized.

Under the rules of section 708(b)(1)(B), a partnership is considered technically to be terminated if there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within a 12-month period. Because their units are publicly traded, this may happen to MLPs. Reg. § 1.708-1(b)(4) provides that in the case of such a termination, the following is deemed to occur: (i) the terminating partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and (ii) immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in liquidation of the terminated partnership, in proportion to their respective interests in the terminated partnership. This allows either the dissolution and winding up of the terminated partnership or, in the case of MLPs, the continuation of the business by the new partnership.

Section 195(b)(1)(A) limits the amount of startup expenditures that may be deducted in the year of a start-up to $5,000. Remaining expenses may be amortized over a 180 month period. Section 195(b)(2) provides that in any case in which a trade or business is completely disposed of by the taxpayer before the end of the amortization period, any deferred expenses attributable to the trade or business not yet allowed as a deduction by reason of section 195 may be deducted to the extent allowable under the loss rules of section 165. Section 709(b)(1)(A) provides similar rules for partnership organizational expenses.

The proposed regulations stated that a new partnership formed due to a technical termination under section 708(b)(1)(B) must continue amortizing the section 195 and section 709 expenses incurred by the terminating partnership using the same amortization period that the terminating partnership had adopted. According to the preamble, the proposed rules were issued to clarify whether a technical termination would allow a partnership to immediately deduct such expenses as provided in sections 195 and 709 for the complete disposition of a trade or business (section 195) or liquidation of a partnership (section 709). The IRS noted that the rule adopted in the proposed regulations would align the amortization of start-up and

organizational expense with the treatment of intangible property under section 197, as intended by Congress.

Final Regulations

On July 23, 2014, a week after the 2014 Annual Meeting, final regulations were published in the Federal Register. The final regulations adopted the proposed regulations unchanged except for one minor, nonsubstantive change for clarity. In Reg. § 1.708–1(b)(6)(i), the words "using the same amortization period adopted by the terminating partnership" were changed to "over the remaining portion of the amortization period adopted by the terminating partnership" to make clear that the amortization period does not restart.

The regulations apply to technical terminations under 708(b)(1)(B) that occur on or after December 9, 2013, the date the proposed regulations were published.

Final Regulations on Allocating Tax Items When Partners' Interests Change

Proposed Regulations

On April 13, 2009 the IRS issued proposed regulations under section 706, which deals with partnership and partner tax years, addressing how partnerships should allocate tax items to partners who enter, leave, or otherwise change their interest in the partnership during a tax year. The proposed rules potentially impacted the monthly conventions generally used by PTPs to account for the numerous partners who buy and sell units during the year.

The proposed regulations generally provided that partnerships should divide the tax year into segments based on the dates when partners' interests change ("variations"). The partnership should determine the distributive shares of partnership items in each segment using the "interim closing of the books method"[2] and allocate items among partners in accordance with their respective partnership interests during the segment. With agreement of the partners, however, the partnership could use a proration method[3] rather than an interim closing of the books method. If the partnership used the interim closing method, it could use either a daily convention (the books are deemed to close at the end of the day on which the change occurs) or a semi-monthly convention[4]. If the partnership used the proration method, the proposed

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[2] The interim closing of the books method assumes for purposes of the allocations that the partnership's books were closed just before the change in partnership interests and allocates items based on ownership interests at the time the books were "closed."

[3]Under a proration allocation method, the items allocated among the partners are based on their pro rata share on each item for the entire tax year.

[4] The semi-monthly convention assumes that any ownership change that occurs on the 1st-15th days of the month, is deemed occur on the last day of the preceding month, while any for ownership change during the second half of the month is deemed to occur on the last day of the month)

regulations require a daily convention. The same convention must be used for all variations within the tax year.

For PTPs, which have partners changing interests on a daily basis, the proposed rules posed particular issues. The preamble to the regulations stated that the IRS and Treasury were aware that some PTPs are using a monthly convention (any change occurring during a month is deemed to occur on one particular day of the month, usually the first day or the last day) or a semi-monthly convention with the proration method. In light of this, the proposed regulations provided a special rule exempting existing PTPs from the proposed rule requiring that a daily convention be used with the proration method. Instead a safe harbor was provided under which PTPs, whether using the interim closing of the books method or a proration method, could use either the semi-monthly convention or a monthly convention that treated all transfers of publicly traded units during a month as occurring on the first day of the following month under a consistent method adopted by the partnership. Block transfers of units would not qualify for the safe harbor.

The Association submitted comments to the IRS on July 13, 2009 that were limited to items that particularly affected PTPs.

Final Regulations

On August 3, 2015, final regulations were published in the Federal Register. The final regulations changed the requirements of the proposed regulations somewhat to allow partnerships to use both the interim closing and the proration methods during the same tax year. A partnership divides the tax year into segments based on interim closings of the books, and if it chooses to use proration, the proration periods are specific portions of each segment for which the partnership chooses to use the proration method. The first proration period begins at the beginning of the segment and ends when the first variation occurs for which the proration method is used. The second proration period begins immediately after the close of the first and ends with the next variation, and so on until the end of the segment. The partnership must use the same convention for all variations for which it uses the interim closing method. PTPs are also permitted to use semi-monthly and monthly rather than daily conventions for variations for which they use the proration method. However, PTPs must use the same convention for all variations during the tax year.

In the final regulations, the provisions of the PTP safe harbor, with modifications in response to comments, have been incorporated into the main provisions of the regulations, so that a separate safe harbor is no longer needed.

Below are MLPA's recommendations and how they are treated in the final regulations.

- **Include a quarterly convention as an additional safe harbo**r. Such a convention would allow PTPs making quarterly distributions to allocate tax items of a quarter to their unitholders who are the record holders on the date the quarterly distribution is declared.

  This recommendation was not accepted in the final regulations. However, the IRS concurrently issued proposed regulations that would allow PTPs, with the agreement of all partners (which can be accomplished by inclusion in the partnership agreement), to treat income subject to withholding on distributions to foreign partners under section 1446 as an extraordinary item, and allocate it to unitholders who are the record holders on the date the distribution is declared.

- **Allow PTPs using the proration method to prorate their annual aggregate tax items by the number of month**s (instead of by the number of days) during the year as a variation of the calendar day convention. The final regulations did not adopt this recommendation. .

- **Remove the block transfer exclusion** and apply the safe harbor conventions (as provided in Prop. Reg. § 1.706-4(b)(3)) to transfers of all PTP units regardless of whether the units are publicly traded—or alternatively, apply the safe harbor conventions to transfers of all publicly traded PTP units (using an expanded definition) and limit the block transfer exclusion only to transfers of non-publicly traded PTP units.

  The IRS agreed to extend the provisions of the safe harbor to block transfers of publicly traded units, but not of nontraded units, which will have to follow the rules for nontraded partnerships. Thus for nontraded units, the PTP must use the calendar day convention for all variations for which it uses a proration method.

- **Provide that existing PTPs (defined in the regulations as those formed before April 14, 2009) continue to be grandfathered from having to apply the conventions provided by the regulations even if they have one or more technical terminations** under section 708(b)(1)(B) on or after April 14, 2009. This was accepted in the final regulations.

The final regulations generally apply to partnership tax years beginning on or after August 3, 2015, with the exception of the grandfather for existing PTPs described above.

PRIOR-YEAR ISSUES STILL OUTSTANDING

Proposed Regulations on Partnership Disguised Sales of Property and Treatment of Partnership Liabilities

Proposed regulations dealing with disguised sales of property to or by a partnership under section 707 and the treatment of partnership liabilities under section 752 were issued on January 30, 2014. The section 752 rules have engendered a good deal of discussion and controversy, as they take a different, and stricter, approach to allocating liabilities among partners by replacing an "ultimate liability" standard with a six-factor test. It is the changes in the disguised sales rules, however, particularly those dealing with the exception for "preformation capital expenditures," that is of greatest interest to MLPs.

Disguised Sale Rules

Under the current rules, reimbursements for certain capital expenditures incurred by a contributing partner during the two-year period preceding the contribution may be paid without being subject to treatment as a disguised sale. The amount of reimbursements for preformation capital expenditures is limited to 20 percent of the fair market value of the property at the time of contribution. The fair market value limitation, however, does not apply if the fair market value of the contributed property does not exceed 120 percent of the contributing partner's adjusted basis in the property.

The proposed regulations make three clarifications to the exception:

1) Under the current rules, it is unclear how the 20 percent limitation is calculated when multiple properties are contributed. The proposed regulations provide that the 20 percent limitation and the exception are calculated separately for each property contributed. Thus, the values of multiple properties contributed to a partnership would not be aggregated.
2) The proposed regulations clarify that the term "capital expenditures" has the same meaning as it has under the tax code and regulations, except that it includes capital expenditures that the taxpayer can (and does) elect to deduct as well as those that are required to be capitalized. This means that amounts giving rise to bonus depreciation deductions would be considered preformation expenditures. Deductible expenses that a taxpayer elects to capitalize, however, would not be considered to be capital expenditures.
3) The proposed regulations provide that to the extent that a partner has funded a capital expenditure with a borrowing and the economic responsibility to repay the borrowing has shifted as a result of the property's contribution to a partnership, payments to the partner are not treated as reimbursements for preformation capital

> expenditures. Thus, reimbursements would be limited to the partner's share of the assumed liability. Some taxpayers had taken the position that a partner could finance capital expenditures with a qualified liability and be reimbursed for those expenditures as preformation capital expenditures without triggering sale treatment.

Other provisions of the proposed regulations: broaden the definition of which liabilities are "qualified" and thus excluded from disguised sale treatment; clarify that a reduction in a partner's share of a liability will not be deemed to be made in anticipation of a contribution of property and thus treated as a sale (the "anticipated reduction" rule) if it is subject to the entrepreneurial risks of partnership operations; provide additional guidance regarding the application of the section 707 rules to tiered partnerships; and apply the netting rules for increases and decreases in partnership liabilities under Reg. § 1.752–1(f) to determine the effect of a merger under the disguised sale rules.

Partnership Liabilities

A partner's basis in his partnership interest is increased by his share of recourse liabilities. Section 752 provides that a partner's share of recourse liability equals the portion of the liability for which the partner or a related person bears the economic risk of loss. Under the existing regulations, a partner generally bears the economic risk of loss for a partnership liability to the extent the partner, or a related person, would be obligated to make a payment if the partnership's assets were worthless and the liability became due and payable.

The existing regulations' "ultimate liability" test for allocating liability assumes the worst case scenario, even when it is reasonably anticipated that the partnership will be able to meet the liability itself with its profits or capital. The IRS and Treasury believed that some partnerships were incurring non-commercial obligations for the sole purpose of allocating liability to a partner. To address this concern, the proposed regulations under section 752 adopt a six-factor test for assigning liability. The factors are intended to show that the terms of the payment obligation are reasonable and are not designed solely to obtain tax benefits.

The proposed regulations require that: 1) the partner or related person demonstrate sufficient net worth to satisfy the liability or be subject to reasonable restrictions on asset transfers for inadequate consideration; 2) the partner or related person periodically provide commercially reasonable documentation of its financial condition; 3) the obligation not end prior to the term of the partnership liability; 4) the obligor not be required to hold money or other liquid assets in an amount that exceeds its reasonable needs; 5) the partner or related person receive arm's length consideration for assuming the obligation; and 6) the partner or related person be contractually liable for the full amount of the liability.

In addition, the proposed regulations revise the anti-abuse rule under Reg. § 1.752–2(j) to address the use of intermediaries, tiered partnerships, or similar arrangements to avoid the

bottom-dollar guarantee rules. They also change the rule in Reg. § 1.752–2(b)(1) to reduce the partner's payment obligation by the amount of any right to reimbursement from any person, rather than only from another partner or related person or the partnership. Finally, the proposed regulations eliminate the "significant item method" and the "alternative method" as acceptable ways of determining a partner's interest in partnership profits for the purpose of allocating nonrecourse liabilities. They adopt an approach based on the liquidation value of the partner's interest in the partnerships compared to the total liquidation values of all partners' interests.

The proposed changes to the disguised sale rules would generally apply to transactions with respect to which all transfers occur after the effective date of final regulations. The liability allocation proposed rules would similarly only apply to liabilities assumed by a partnership after the date the regulations are published in final form.

Other Regulations

Other partnership regulations that are still outstanding in proposed form but of less interest to MLPs include:

Proposed Regulations on Partnership Basis Allocation Adjustments for Built-In Losses

On January 16, 2014, the IRS and Treasury issued proposed regulations making changes to the basis allocation regulations to implement section 704(c)(1)(C). The rules govern contributions of built-in loss property to partnerships and are meant to ensure that only contributing partners can take into account built-in losses. The proposed regulations also amend the rules governing basis adjustments under sections 743(b) and 734 to prevent the inappropriate transfer of losses among partners.

Proposed Rules for Allocation of Recourse Liabilities of a Partnership and Special Rules for Related Persons

On December 13, 2013, the IRS and Treasury issued proposed regulations under section 752 intended to clarify the rules for allocating recourse liabilities (liabilities for which at least one partner bears the economic risk of loss) when the economic risk of loss overlaps among partners. The proposed regulations also address the allocation of liability in tiered partnerships and make several clarifications to the related party rules.

PRIVATE LETTER RULINGS

Due to the "PLR pause" that preceded the Proposed Regulations, only a few private letter rulings have been issued since the 2014 Annual Meeting. The IRS has released six PLRs—three decided before the Proposed Regulations were promulgated and three afterwards.

After Proposed Regulations Were Promulgated

PLR 201538012, issued May 19, 2015, released September 18, 2015. Storage, Transportation, and Marketing.

The information in this PLR is heavily redacted, but the ruling is that income from a prospective PTP's storage services to third party customers, pipeline transportation services, and marketing, including revenue from various sales and services agreements, will be qualifying income.

PLR 201537014, issued May 29, 2015, released September 11, 2015. Water Services.

A prospective PTP planned to earn income primarily by assessing fees for gathering, transporting, processing, treating and disposing of saltwater produced in the exploration and production of oil and natural gas. Its assets would include ownership interests in saltwater disposal wells and associated assets including pipelines, rights of way, and equipment to operate the disposal wells. As a complement to the primary business, the PTP would remove skim oil from drilling waste during the disposal process and market it to relevant, non-end user markets. The prospective PTP represented that the personnel providing the services received unique training, the saltwater disposal system did not have commercially viable uses, the processing and treatment were required by government regulations and industry standards, the personnel provided onsite services on a daily basis, and offsite monitoring services were performed on an ongoing basis for the exclusive use of the disposal system. Based on these facts and representations, the IRS ruled that the PTP's income from providing the processing, treatment, and disposal services, as well as its income from marketing skim oil, would be qualifying income under section 7704(d)(1)(E).

PLR 201537007, issued May 26, 2015, released September 11, 2015. Liquefaction of natural gas and regasification of LNG.

A prospective PTP owned an interest in entity Y, whose subsidiary entity A owns an LNG receiving and regasification terminal. Another subsidiary of Y's, entity B, plans to construct and own liquefaction facilities at the terminal that will allow it to process and convert natural gas into LNG. A has a series of regasification agreements with company C under which it is committed to receive a specified amount of C's LNG via tankers, store it in LNG tanks at the terminal, process the LNG into natural gas, and deliver the natural gas to C. A bears the risk of loss from the time the LNG is received at the terminal until the natural gas is delivered. Once B has constructed its liquefaction facilities, it plans to enter into a similar liquefaction agreement with C. It is expected that the liquefaction terminal would ultimately have several customers. The IRS ruled that income derived by the prospective PTP, directly or indirectly, from contracts for the processing, regasification, liquefaction, and storage of natural gas will be qualifying income under section 7704(d)(1)(E).

Before Proposed Regulations Were Promulgated

PLR 201523018, issued January 29, 2015, released June 5, 2015. Income from Interest rate swaps, interest rate caps, and treasury locks.

The taxpayer requesting the ruling is a PTP which periodically issues both fixed-rate and floating-rate debt securities in order to finance asset acquisitions and conduct its business operations. The PTP uses standard interest rate swaps, forward start interest rate swaps, interest rate caps, and treasury locks to manage its exposure to the market reference rate on its debt, which affects the interest it must pay on the debt securities. The IRS ruled that the PTP's income from each of the four types of financial transactions was qualifying income.

Under existing regulations (Reg. § 1.7704-3(a)(1)), qualifying income includes income from notional principal contracts and other substantially similar income from ordinary and routine investments to the extent determined by the IRS. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership. In this case, the standard interest rate swap and interest rate cap are specifically included in the definition of notional principal contract and would generate qualifying income if held directly by the PTP.

The forward-start interest rate swaps and the treasury locks are specifically listed in the definition of a notional principal contract, but, the IRS decided they are both ordinary and routine transactions and, in this case, were entered into for the same purpose as a notional principal contract, that is to lock in an interest rate or manage the risk of interest rate movements on Company's borrowing. Because they are substantially similar to notional principal contracts they may also constitute qualifying income,

PLR 201451002, issued September 8, 2014, released December 19, 2014. Oil and gas gathering, processing, transportation and terminalling.

This PLR was issued to a limited partnership which planned to become publicly traded. The partnership owned oil and gas gathering systems and subsystems, a gas fractionation and processing plant, a truck terminal and a rail terminal, and rail tank cars specially designed to haul crude oil. It planned to use the assets to earn income under four agreements. These are described in detail in the PLR; but in quick summary:

Agreement A: Gather and transport crude oil, including operation and maintenance of the gathering systems.

Agreement B: Gather and transport untreated natural gas, including operation and maintenance of the gathering systems.

Agreement C: Provide gas processing services, deliver methane into interstate pipelines, and deliver NGLs to interstate pipelines and a rail terminal. Included are operation and maintenance of the processing plant, scheduling of gas deliveries, and storage of NGLs.

Agreement D: Terminal and transport crude oil and NGLs for a per-barrel fee. Services included receiving crude oil from pipeline gathering systems, unloading trucks, storing crude oil in storage tanks, loading crude oil and NGLs onto railcars, storing propane in an underground storage cavern, and delivering crude oil through pipelines.

The IRS ruled that the partnership's income from the agreements as described in the PLR would be qualifying income under section 7704(d)(1)(E).

PLR 201448019, issued May 22, 2014; released November 28, 2014. Processing Iron Ore.
A publicly traded partnership requested a ruling regarding income from activities related to iron ore and products derived from the ore. The nature of the activities has been redacted, but the ruling refers to the beneficiation and pelletizing processes used to process lower grade iron ores, which were the subject of PLR 201351009. Processing iron oxide in this manner into direct reduced iron creates a suitable feedstock for steel manufacturing, with byproducts including carbon dioxide, water, and others which have been redacted The ruling mentions the possible purchase of feedstocks from third parties and sale of a product in bulk quantities (but not to end users at the retail level); again, details are redacted. The IRS ruled that the PTP's income from its refining and processing activities and from the sale of direct reduced iron products as described would be qualifying income under section 7704(d)(1)(E).