REPORT OF
THE REGULATORY COMMITTEE

TAX GUIDANCE AND ISSUES IN THE PAST YEAR

September 2016

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INTRODUCTION AND SUMMARY

At the time of the 2015 Annual Meeting, the regulatory issue at the top of everyone's list was the proposed regulations providing guidance under I.R.C. section 7704(d)(1)(E) on qualifying income for MLPs from the exploration, mining or production, processing, refining, transportation, and marketing of minerals or natural resources. MLPA members expressed strong concern about several aspects of the proposed regulations, both at the meeting and later the same month at an IRS hearing.

The IRS promised that final regulations would be high on their agenda, and the MLP community has spent much of the past year anticipating that development. As of the writing of this report, however, the final regulations have yet to be issued.

Also occurring later in 2015 was a development raising new concerns on the regulatory front: enactment by Congress of a new audit regime for large partnerships beginning in 2018 which will make the partnership liable for any tax deficiency unless an election is made to "push out" the liability to audit year partners. Of particular concern to MLPs is whether regulations implementing the election of the audited partnership to push out a tax liability to partners that were partners during the audited year will allow a partner that is also a partnership to similarly push out the tax liability.

Other issues in which MLPA has taken an interest this year include the self-employment tax treatment of partnership and disregarded entity employees and how payments paid by an MLP for the use of capital ("GPUCs") should be characterized for purposes of section 7704(d). In addition, since the last annual meeting, the IRS has issued five new PLRs on qualifying income under section 7704, involving the "intrinsic activities" rules of the proposed qualifying income regulations, the production, storage, transportation and marketing of nitrogen-based fertilizers, and the treatment of hedging income.

New Developments

Large Partnership Audit Rules

Partnership Audit Legislation

As discussed in detail in the Federal Affairs Committee report, in October 2015, Congress enacted new rules for IRS audits of large partnerships as part of the Balanced Budget Act of 2015 (BBA). Beginning in 2018, the BBA provisions eliminate the TEFRA and Electing Large Partnership (ELP) audit rules for all partnerships with more than 100 partners and establish a new audit regime in which:

- A partnership under audit must designate a partnership representative with sole authority to act on behalf of the partnership (section 6223). The IRS will examine all tax items for the year under review (reviewed year) and determine whether adjustments should be made.
- If adjustments for the reviewed year are made, under the default rules, all adjustments are netted and an imputed amount of underpayment (imputed underpayment) is determined at the partnership level (section 6225(b)).
- A partnership will be able to modify the imputed underpayment to the extent reviewed year partners have filed amended returns and to take into account the tax rates of reviewed year partners (individuals, tax-exempt organizations, etc.), the type of income in question and passive activity losses on MLPs (section 6225(c)).
- The imputed underpayment, as modified, will be paid by the partnership in the year the audit is completed (adjustment year) (section 6225(a)).
- This will result in the adjustment year partners paying the tax for a reviewed year deficiency rather than the reviewed year partners who benefitted from the underpayment.
- Alternatively, the partnership may elect to "push out" the adjustment to the reviewed-year partners by sending them statements informing them of their share of any adjustments. The reviewed-year partners are then required to include their share of the adjustments without modification in their adjustment-year returns. This election to push out the adjustment to the reviewed year partners must be made within 45 days of the notice of final partnership adjustment. Under this election, the additional tax and interest are determined and paid at the partner level, and the underpayment rate is increased from 3% to 5% (section 6226).
- A partnership may also file a request for an administrative adjustment (AAR) of one or more items of income, gain, loss, deduction, or credit for any year and take the adjustment into account in the year the AAR is made. The partnership would have the option of paying

the adjustment or sending adjusted returns to the partners in the year of the adjustment. An AAR may not be filed if an audit of the partnership has begun (section 6227).

Also as described in the Federal Affairs Committee report, the provision that allows an MLP to modify the imputed underpayment under the default rule by the amount of passive losses of its partners was added by Ways and Means Committee Chairman Brady in last year's tax extenders bill, the "Protecting Americans From Tax Hikes Act of 2015" (PATH), pursuant to a request from MLPA.

In March 2016, the Congressional Joint Committee on Taxation (JCT) issued a "General Explanation" (Bluebook) of the tax legislation enacted by Congress the previous year. The Bluebook description of the partnership audit provisions implies that the push-out election is not available to an upper-level partnership that has adjustments pushed out from a lower tier partnership under section 6226: "The recipient partnership pays the tax attributable to adjustments with respect to the reviewed year and the intervening years, calculated as if it were an individual." In other words, in JCT's view, the push-out is only available to an audited partnership and any partnerships that are partners in the audited partnership are not allowed to make a section 6226 election. Further, it appears that any such upper tier partnership would have to pay the pushed out amount of tax without the benefit of the modifications allowed under section 6225.

The Bluebook interpretation is without statutory support and is contrary to the intent of the provision to give MLPs and other large partnerships the ability to avoid the payment of tax at the entity level. The JCT interpretation would eliminate the push-out election for many MLPs and other large partnerships, as the use of tiered partnership structures is common. While a Bluebook is technically not legislative history in interpreting the tax law, it is often used that way. IRS officials have indicated a preference for following this interpretation, as it makes tax collection easier.

MLPA has been working with the IRS, Treasury, and Congress to counter this interpretation and make sure the section 6226 election is available at all levels in a tiered partnership structure, and that the modifications provided in section 6225 are available if the upper tier partnership elects to pay the pushed-out tax liability.

MLPA Regulatory Effort

Response to Request for Comments

On March 4, the IRS, faced with the enormous task of understanding and providing guidance on the new regime, issued Notice 2016-23 requesting comments on the implementation of the new audit regime. The Notice, which is included in the meeting materials, lists eleven issue areas, some with multiple issues, in which comments are requested. These enumerated issues included:

- How the imputed underpayment is determined;
- How an adjustment under section 6225 that does not result in an underpayment is taken into account by the partnership;
- The section 6226 election, including procedures for making the election, how the adjustments should be taken into account by reviewed year partners, and the consequences when a partner fails to do so;
- The procedure and result of an AAR made by a partnership under section 6227;
- The effect of adjustments on partners' basis and on the partnership's basis in its assets; and
- How modifications to the imputed underpayment should be made with respect to publicly-traded partnerships for certain specified passive losses.

In response to the request, the Regulatory Committee met and agreed to focus MLPA's comments on issues of particular relevance to MLPs. MLPA's comment letter was drafted by PricewaterhouseCoopers with input and comment from other Committee members, and submitted on April 15, 2016. In its comments, MLPA recommended:

1. For purposes of section 6225, MLPs should be allowed to substantiate their partners' passive losses under section 469(k), rather than requiring the partners to do so.

2. MLPs making the section 6226 "push-out" election should be allowed to provide the required information to partners whose tax liability will not be affected by the election because of passive losses on the current-year K-1, rather than through a separate section 6226 statement.

3. Regulations should treat items on a section 6226 statement received by a lower-tier partnership from an upper-tier partnership in the same manner as if they were on an adjusted K-1, and the upper-tier partnership should be required to pass through the items to its partners in a manner similar to that described in section 6226.

4. The AAR mechanism under section 6227 should be applied to allow upper-tier partnerships receiving a section 6226 statement to determine and pay the tax due under rules similar to section 6225.

5. Regulations should confirm that a partnership that makes the election under section 6226 to push out an adjustment and properly provides the required statements to its partners is no longer liable for any tax with respect to the adjustment.

6. A partnership making a section 6226 election should be permitted to send the required statements to partners at any time prior to the due date (without extension) of the partnership's federal return for the adjustment year. Regulations also should provide that a partnership making a section 6226 election may report the required information to its partners on a form substantially similar to Schedule K-1.

7. Regulations should clarify that the obligation of a partnership that makes a section 6226 election to furnish statements to each partner in the reviewed year will be deemed satisfied if the partnership in good faith sends a statement to each partner to which it was required to send a Schedule K-1 for the reviewed year.

8. If a partnership making the section 6226 election challenges a final adjustment in court, it should not be required to furnish the statements to partners until 90 days after the date of final judgment or a settlement via closing agreement.

9. A taxpayer challenging a final partnership adjustment in court should be allowed, within 45 days after final judgment or a settlement via closing agreement, to revoke the section 6226 election and pay the tax as determined under section 6225.

Each of these recommendations is fully explained in the letter, which is included in the meeting materials.

<u>Meetings with Regulators</u>

On July 6, 2016, representatives from MLPA's Regulatory and Federal Affairs Committees met with Treasury officials to discuss the implementation of the new partnership audit rules. Of particular concern to MLPA was whether the regulations implementing the election that an audited partnership has under section 6226 to push out a tax liability determined after an audit to partners that were partners during the audit year will allow a partner that is also a partnership to similarly push out the tax liability. As noted earlier, the Bluebook implies, without statutory support, that the push-out election is limited to the audited partnership. MLPA requested the Treasury meeting to determine whether future regulations would also narrowly construe the push-out election thus necessitating a need for Congressional clarification of legislative intent to allow the push-out election through partnership tiers.

Treasury stated that no firm decisions had been made on whether the push-out election would be permitted through tiers of partnerships, but noted that the collection of tax deficiencies from the partners of large partnerships through multiple partnerships would result in "very expensive tax dollars." Treasury asked if it would be possible for an MLP to provide the names of the taxpayers that would ultimately pay the tax after a push-out election was made and MLPA explained that an MLP would not have such information. Treasury asked that MLPA consider whether there are any procedures that could be implemented to facilitate collection from ultimate taxpaying partners if a push-out election through partnership tiers was allowed in implementing regulations. In addition, Treasury asked MLPA to consider whether there were any other modifications to an imputed underpayment, like the passive loss adjustment provided in the legislation, which should be made if an MLP is required to, or elects to, pay the tax liability.

On August 17, 2016, at the invitation of LB&I Director Cheryl Claybough, Director of the IRS' Large Business and International (LB&I) Division, and Glenn Dance of the IRS Chief Counsel's office, MLPA Regulatory Committee representatives from the four major accounting firms met with Cheryl, Glenn, and several other IRS officials. The purpose of the meeting was to discuss issues that may be raised in MLP audits and how the IRS should handle such issues under the new partnership audit rules.

Three items were discussed: 1) the often large disparity between the total of the amounts reported on Schedule K-1s sent to partners of an MLP and the amount reported on the partnership return of the MLP; 2) partnership asset valuations; and 3) the tiered partnership issue.

The IRS said that a disparity between the K-1s and the partnership return will alone be a factor that will trigger an audit of an MLP because agents are told to expect the total amounts reported on the K-1s sent by a partnership to add up to the number on the partnership's return. The IRS requested that MLPA accounting firm representatives consider how the total K-1 amount and the MLP return amount could routinely be reconciled on an annual basis so audits would not be triggered by this fact alone.

The need for greater documentation of the basis for the values assigned to an MLP's assets was also discussed. The IRS representatives stated that they understood that some MLPs in the past have not substantiated the valuations assigned to their assets and warned that especially now, with the new audit rules making large partnership audits more likely, it will be essential for MLPs to have their documentation. *As a result of this meeting, the Regulatory Committee is strongly advising all MLPs to document how the values assigned to their assets are determined.*

The IRS asked whether an MLP could provide information with respect to the ultimate taxpayers when a push-out is made through multiple tiers of partnerships. MLPA representatives discussed the types of information that tax processors could provide to assist the IRS in following adjustments through the tiers. Nonetheless, based on the July 6 meeting as well as this one, MLPA currently does not anticipate that Treasury regulations implementing the partnership audit rules will allow a push-out election through multiple tiers of partnerships absent Congressional clarification of intent.

Application of Self-Employment Tax to Partnership Employees

On May 3, 2016, the IRS issued temporary and proposed regulations regarding the self-employment tax (SET) treatment of partners in a partnership that owns a disregarded entity. The general rule set forth in Revenue Ruling 69–184 is that an individual cannot be a partner and an employee at the same time. Therefore, if an employee of a partnership becomes a partner in the partnership, he or she ceases to be an employee for tax purposes and is treated as an independent contractor who must pay SET.

According to the IRS, some taxpayers have believed that this rule does not apply if the partners are employees of a disregarded entity owned by the partnership because the disregarded entity, not the partnership, is required to pay employment tax for its employees. The IRS issued the new regulations to make clear that this is not the case: the rule that a disregarded entity is treated as a corporation for employment tax purposes does not apply to the SET treatment of any individuals who are partners in a partnership that owns a disregarded entity. The regulations apply as of the later of August 1, 2016 or the first day of an affected employee plan year beginning after May 4, 2016.

In issuing the regulations, the IRS requested comments on the appropriate application of the principles of Rev. Rul. 69–184 to tiered partnerships and to other special situations in which it may be appropriate to permit partners to also be employees of the partnership. The IRS also requested comments on the impact on employee benefit plans and on employment taxes if Rev. Rul. 69–184 were to be modified to permit partners to also be employees in certain circumstances.

Under current law, employees of MLPs (and, under the new regulations, employees of a disregarded entity owned by an MLP) cannot own any units in their employer without losing their status as employees and being treated as self-employed individuals. In such case, the former employees would be required to pay SET and would lose the tax-favored employee benefits which employees customarily receive.

This means that MLPs cannot offer their employees the equity-based incentive compensation that is common in the corporate world without subjecting them to these burdens. It also means that if an employee of an MLP buys a unit in the MLP in the open market, he or she, often unknowingly, becomes self-employed in the eyes of the tax law. This subjects the employee to the adverse effects described above, and to back taxes and penalties for SET if he or she continues to be compensated as an employee. The MLP, which will not know about units purchased on the open market, would also be penalized for withholding taxes improperly and allowing participation by non-employees in its benefit plans.

At least one MLPA member has sent a comment letter to the IRS suggesting that publicly traded partnership employees holding units that are publicly traded be allowed to retain their employee status. The Regulatory Committee believes that such an exception is appropriate and would be beneficial to MLPs in general, and plans to draft and send a letter from MLPA supporting the concept.

Guaranteed Payments for Use of Capital as Qualifying Income

On November 3, 2015, representatives from MLPA's Regulatory Committee met with IRS and Treasury officials to discuss how guaranteed payments paid by an MLP for the use of capital ("GPUCs") should be characterized for purposes of section 7704(d). Because proposed regulations under section 707 would increase the number of payments that would be characterized as GPUCs and GPUCs were not addressed in the proposed QI regulations, MLPA asked for guidance in this area

In response to the government's request that MLPA provide specific recommendations for the treatment of GPUCs, MLPA submitted a letter (the "Letter"), requesting that guidance be issued either 1) clarifying that a GPUC is treated as a distributive share of partnership income for purposes of section 7704(d) resulting in the same character as the income of the payor partnership or 2) characterizing a GPUC by reference to the type of income it replaces, e.g., interest or rent, for purposes of section 7704(d).

The Letter explains that treating a GPUC as a distributive share of partnership income for purposes of the qualifying income test of section 7704(d) is consistent with regulations under sections 707 and 702 and with the treatment applied to guaranteed payments received by real estate investment trusts. If a GPUC is treated as a distributive share of partnership income for purposes of section 7704(d), the GPUC would constitute QI to the extent that the payor partnership generated QI.

In addition, the Letter noted that characterizing a GPUC by reference to the type of income it replaces is also consistent with IRS guidance that concludes that guaranteed payments for the use of capital constitute interest income. The Letter also explains that the legislative history accompanying the enactment of the guaranteed payment provision is inconsistent with treating a GPUC for the use of capital as interest.

MLPA anticipates that the treatment of GPUCs by a recipient partner will be addressed in future IRS guidance.

PRIOR-YEAR ISSUES STILL OUTSTANDING

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. From the time section 7704 was enacted until May 2015, very little regulatory guidance had been provided related to qualifying income. Existing final regulations deal primarily with the definition of "publicly traded," or 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 28 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 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 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.

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

During the pause, MLPA staff and member attorneys responded to questions from policymakers on services provided to oil and gas producers.

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.

IRS Hearing

On October 27, 2015 the IRS held a hearing on the proposed regulations. Linda Carlisle testified at the hearing for MLPA, and representatives of several other MLPA members attended and spoke as well. These included attorneys from Vinson & Elkins, Latham & Watkins, Andrews Kurth, and Baker Botts and speakers from Enterprise Products Partners, Westlake Chemical Partners, and SunCoke Energy Partners LP.

Comments at the hearing, including those of MLPA, focused in particular on the inadvisability and unworkability of the regulations' reliance on an exclusive list of approved activities rather than definitions with examples; the inconsistency of the refining and processing rules with Congressional intent and industry practice; the need to include "products thereof" (as in "oil, gas, and products thereof") as natural resources that could be refined and processed; and the need for greater certainty and fairness for those relying on existing PLRs. As is rarely the case in this sort of hearing, the government officials (Ossie Borosh from Treasury; Holly Porter and Glenn Dance from the IRS) engaged in considerable dialogue with the speakers.

The officials appeared to have been persuaded by speakers' comments that it is not appropriate to treat the same product differently depending on whether it is produced in an oil refinery or a gas processing facility (as is the case, for example, with ethylene), and that the emphasis on fuel as a product of refining should perhaps be changed. They seemed reluctant, however, to accept the idea that Congress intended the focus to be on whether the input to a refining or processing activity is a natural resource, preferring to focus on a list of "good" products. They also held to the belief that "products thereof" are a natural resource only in the context of pipeline transportation and not as inputs for refining and processing.

The government officials also seemed to be firmly set on the idea of an exclusive list of qualifying activities, believing it was necessary to draw a clear line. Finally, they felt that permanently grandfathering MLPs with existing PLRs overruled by the regulations would create fairness issues as compelling as those created by not doing so.

Conclusion

As this report is written, we are still awaiting the final regulations, which have been supposedly imminent for some time. In January 2016, the American Bar Association Tax Section submitted comments making many of the same recommendations as MLPA. It appears from remarks made by IRS and Treasury officials at conferences and reported in the press that the regulators are making some changes to the refining and processing rules, and have at least given some additional thought to the exclusive list issue. The degree to which their position has changed for the better on any of our concerns, however, remains to be seen.

It is worth noting that Treasury and the IRS recently issued their 2016–2017 Priority Guidance Plan. Their priority list in the partnership area included not only final regulations under section 7704(d)(1)(E) but also "Guidance under §7704(d)(1)(E) regarding qualifying income derived from fertilizer for publicly traded partnerships," an area that was left reserved in the proposed section 7704(d)(1)(E) regulations.

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 MLPA members.

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.

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 more minor interest to MLPs include:

<u>Proposed Rules for Allocation of Recourse Liabilities of a Partnership and Special Rules for Related Persons</u>

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.

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.

PRIVATE LETTER RULINGS

Since the last Annual Meeting, the IRS has released thirteen new PLRs on qualifying income under section 7704, involving the "intrinsic activities" rules of the proposed qualifying income regulations; fuel sales; ground leases of real property; the production, storage, transportation and marketing of nitrogen-based fertilizers; regasification of LNG; and the treatment of hedging income.

PLR 201541008, issued June 29, 2015; released October 9, 2015. Fuel Sales.

This ruling held that a prospective PTP's income from the transportation, storage, and marketing of fuel (additional details about this have been redacted) would be qualifying income. The prospective PTP primarily sold fuel to customers who were not end-users, including wholesalers and other fuel distributors and marketers. It also sold fuel to corporate and commercial users to negotiated contracts resulting from a competitive bidding process in quantities and prices that are not consistent with a retail sales transaction.

PLR 201545020, issued August 5, 2015; released November 6, 2015. Fluid Services.

A PTP intended to exercise its right of first offer to purchase its corporate sponsor's water-related assets and associated fluid services business. The business pumps water from local rivers, streams, and other sources and transports it through pipelines, storage facilities, and pumping stations to oil and gas production sites for use in fracking operations. It also transports, stores, processes, treats, and disposes of waste fluids associated with fracking.

The taxpayer represented that (as required by the "intrinsic activities" language in § 1.7704-4(d) of the proposed regulations under section 7704): 1) the services provided require substantial assets and equipment that are dedicated exclusively to oil and gas exploration and production; 2) the services require personnel with specialized knowledge, training, and experience; and 3) the production of oil and gas by fracking would not be commercially viable without the fluids handling services.

The IRS ruled that the delivery of water and the collection, treatment, and transport of flowback, produced water, and other fluids would constitute qualifying income under section 7704(d)(1)(E). It added, however, that the ruling is not applicable to any income derived by the PTP from the delivery of water, including recycled produced water, to affiliates or third parties where the PTP did not also collect and clean, recycle, or otherwise dispose of the delivered water after use.

PLR 201548013, issued August 5, 2015; released November 7, 2015. Oilfield Services.

The taxpayer intended to form a publicly traded partnership which would provide a full suite of fluid handling, treatment, processing and disposal services throughout the exploration, development, and production process of oil and natural gas. These included provision and handling of water and other fluids; transportation of water between sites; hot oiler and superheater services; condensate vapor control and battery vapor services; processing, treating, and disposing of waste solids and waste fluids; washing out trucks, containment bins, tanks and other equipment used in the oil and natural gas extraction and production process; cleaning and decontamination services for drilling pipelines; slurry injection activities in order to refill well sites; and marketing of hydrocarbons recovered during the waste fluid treatment and disposal process (other than to end users at the retail level).

The taxpayer made the representations necessary to meet the “intrinsic activity” test of the proposed regulations, including the use of specialized assets and equipment, the necessity of personnel with specialized knowledge and experience to perform the services, and the necessity of the fluid handling services for commercial viability of oil and natural gas production.

The IRS ruled that income from the taxpayer’s services as described below would be qualifying income under section 7704(d)(1)(E):

- The delivery of fluids, provision of inter-well water transfer services, and the processing, treatment and disposal of waste solids and waste.
- The provision of hot oiler and superheater services, slurry injection activities, drilling pipe decontamination, washout services and condensate and battery vapor control services during the exploration and production of oil and natural gas.
- The recovery and marketing of hydrocarbons other than to end users at the retail level.

The IRS specified that the ruling was not applicable to any income derived from the delivery of water to affiliates or third parties where the PTP did not also collect and clean, recycle, or otherwise dispose of the delivered water after use.

PLR 201549004, issued May 26, 2015; released November 27, 2015. Fracking services.

A corporation engaged in exploration, development, an acquisition of natural gas, NGL, and oil properties formed an MLP and transferred some of its assets to it. The corporation also gave the MLP an option to purchase its E&P services business. The MLP wished to exercise the option. While several specifics are redacted, it is clear that the services business provided a full suite of services to the corporation in all phases of exploration and production, and that the services related to fracking. The services included installing equipment and other infrastructure and providing personnel to monitor and adjust the equipment's operation. The taxpayer provides the three representations necessary under the "intrinsic activities" test in the proposed regulations: 1) the services provided require substantial assets and equipment that are dedicated exclusively to use in the exploration and production of oil and gas; 2) the production of oil and gas by fracking would not be commercially viable without these services; and 3) all services from design to operation, as well as oversight of day to day operations, are provided by persons with a specialized knowledge base, training, and experience. The IRS ruled that the MLP's income from the provision of these services would be qualifying income under section 7704(d)(1)(E).

PLR 201549013, issued August 19, 2015; released November 27, 2015. Ground leases of real property.

The taxpayer was an MLP which derived its income from leasing raw land and building rooftops. Under a typical arrangement, the owners of these sites enter into a ground lease with third-party tenants. The tenants will construct, own, and maintain cell towers, rooftop wireless and broadband internet installations, billboards, wind turbines, and solar arrays on the sites. During the term of the ground lease, the owner will sell all its rights and interests in the ground lease to the MLP, or to another party from whom the MLP later acquires them. The MLP represented that at least 85% of the income from each ground lease was from either land or a structure that was permanently affixed to the ground, not intended to be moved, and subject to damage if moved. The rents were generally fixed, but for billboards were calculated as a percentage of the tenant's gross revenue or receipts from the billboard reduced by certain expenses. The MLP also represented that the rents would be paid for the right to use the sites and that tenants would not be related to the MLP, would operate the new construction, and would be responsible for maintaining the property on the site. The MLP would provide only those services that are customarily furnished in connection with the rental of the specific type of property in its geographic area. The IRS ruled that income earned from the ground leases qualified as "rents from real property" under section 856(d), as modified by section 7704(d)(3), and therefore, constituted qualifying income within the meaning of section 7704(d)(1)(C).

PLR 201602004, issued September 25, 2015; released January 8, 2016. Fluid services; fluid, solid, and oilfield waste handling, treatment, disposal, and recycling.

A prospective MLP (currently a non-traded partnership) planned to provide a full suite of fluid, solid, and oilfield waste handling, treatment, and disposal services to oil and natural gas producers engaged in the exploration, development, and production of oil and gas. The services would include provision of fresh water, some of which would come from natural runoff and recycled water, and brine produced by injecting water into a salt cavern and retrieving the fully saturated brine that is returned through the cavern wellbore (and possibly recycled brine). It would also furnish drilling mud and casing cement. The water and other fluids would be transported by trucks, tanks, and pipelines owned and operated by the partnership. Pipelines would be used to transfer fluids between tanks at a well site and between sites at a property.

The partnership would also process, treat, dispose of, and recycle waste solids and waste fluids. It would earn income from marketing hydrocarbons recovered during the waste fluid treatment and disposal process. It intended to sell these reclaimed hydrocarbons in relevant markets other than to end users at the retail level. The partnership expected to earn income from washing out trucks, containment bins, tanks and other equipment used in the oil and natural gas extraction and production process. In addition, in conjunction with its recycling, disposal, and washout activities the partnership would earn income from recycling drilling mud.

For all these activities the partnership's employees would be present to monitor and oversee, and in some cases to operate and maintain, the various processes. The taxpayer represented that 1) the services provided by the partnership would require substantial assets and equipment that are dedicated exclusively to use in the exploration and production of oil and gas and have limited utility outside of those areas; 2) the services provided would require personnel with specialized knowledge, training, and experience; and 3) the production of oil and gas using fracking would not be commercially viable without fluid handling services.

The IRS ruled that the partnership's income from the delivery of fluids, provision of inter-well water transfer services, and the processing, treatment and disposal of waste solids and waste fluids, including washout services, would be qualifying income under § 7704(d)(1)(E). The partnership's income from the recovery, recycling, and marketing of brine, chemicals, and drilling mud to oil and gas producers and of hydrocarbons other than to end users at the retail level would also constitute qualifying income under § 7704(d)(1)(E). The IRS specified that the ruling was not applicable to any income derived from the delivery of water, brine, drilling mud, or other materials to affiliates or third parties where the partnership did not also collect and clean, recycle, or otherwise dispose of the delivered materials after use.

Interestingly, part of the rationale for the ruling was the fact that the process by which brine was produced is considered an extraction process and thus an allowable mining process.

PLR 201608011, released February 19, 2016. Fluid handling and disposal.

The taxpayer was forming a prospective PTP which would provide fluids hauling, management, and disposal services for both fresh water and brine. In addition to the fluids management services, the PTP would design, construct, and operate a number of brine stations, where it would produce brine by pumping fresh water into salt caverns and either sell it onsite or transport it to an oil and gas producer's site. It would also design, construct, and operate saltwater disposal wells and transfer flowback fluids and produced water from drilling operations to the wells by truck and pipeline for disposal. It would earn income from contracts with producers to transport fixed amounts of waste to its wells, from providing disposal services to other producers when it had excess well capacity, and from selling the filtered hydrocarbons collected as part of the disposal process.

The taxpayer made several representations that conformed with the intrinsic activities requirements of the proposed regulations under section 7704, including that it would provide personnel with specialized training, tools, and equipment who would oversee operations on a daily basis, that the training and equipment have no utility outside of oil and gas exploration, that production of oil and gas by hydraulic fracturing would not be viable without the services provided, and that processing and disposal of flowback fluids and produced water were required prior to injection in a disposal well to comply with governmental regulations and industry standards.

The IRS ruled that the PTP's gross income from its fluid management and disposal services would be qualifying income under section 7704(d)(1)(E). Income from selling the filtered hydrocarbons collected as part of the disposal process would also be qualifying income as long as the sales are not to end users at the retail level. The IRS specified that the ruling would not apply to any income from the delivery of freshwater or chemicals where the PTP did not also collect and clean, recycle, or otherwise dispose of the delivered water or other chemicals after use.

PLR 201611017, issued December 2, 2015; released March 11, 2016. Freshwater distribution, fluid handling and disposal, pressure pumping services.

An independent oil and gas company proposed to drop several midstream activities which it conducts through subsidiaries into an MLP. In addition to oil gathering and gas gathering and processing, these activities included the construction and operation of freshwater distribution pipeline systems and saltwater disposal systems. The MLP would provide fluid delivery, handling, treatment, processing, recycling and disposal services to oil and gas producers. It would also provide freshwater distribution to exploration and production operators through pipelines between freshwater delivery points and oil and gas producing wells and future drill sites. Pipelines might also deliver water into storage ponds operated by the MLP. The MLP would transport by pipeline or tank truck, store, process, treat, and dispose of waste fluids. Finally, the MLP would provide pressure pumping services to oil and gas producers and may provide production support services for wells at which a third party is providing the pressure pumping services.

As with the other PLRs in this area, the taxpayer made several representations that meet the requirements of the proposed qualifying income regulations, namely that: 1) the services provided by the MLP would require substantial assets and equipment that were dedicated exclusively to use in the exploration and production of oil and gas and had limited utility outside of those areas; 2) the services provided would require personnel with specialized knowledge, training, and experience; 3) the production of oil and gas using fracking would not be commercially viable without fluid handling services; 4) for each well where the MLP provided freshwater sourcing and distribution as a qualifying activity, it would also provide produced water transportation and recycling or disposal activities; and 5) for each well where the MLP provided production support services where a third party was providing pressure pumping services, it would also provide produced water transportation and recycling or disposal activities.

The IRS ruled that the MLP's income from freshwater sourcing and distribution services; produced water transportation, recycling, and disposal services; marketing of skim oil and other recoverable minerals other than to end users at the retail level; pressure pumping services; and production support services as described by the taxpayer would constitute qualifying income under section 7704(d)(1)(E). The ruling does not apply to any income from the delivery of water or other injectants, including recycled produced water, to affiliates or third parties where the MLP does not also collect and clean, recycle, or otherwise dispose of the resulting produced water after use.

PLR 201614004, issued December 10, 2015; released April 1, 2016. Transportation, parking, and hedging income.

The taxpayer was an MLP which provided pipeline gathering and transportation of crude oil, natural gas, and products thereof. Its transportation income included income from construction, maintenance and operation of lateral pipelines and new points of connection to its pipeline system. The MLP also derived income from the transportation of "produced water" from crude oil and natural gas wells of its gathering system clients. It intended to expand its water transportation services to include produced water transportation services to non-gathering clients, transportation of produced water that is not naturally occurring but is water flooded into a well to stimulate production, and transportation of produced water by truck rather than pipeline. It also intended to deliver fresh water, chemicals and other solutions to well sites for use in fracturing. The MLP would also collect, clean, recycle and otherwise dispose of the delivered water in accordance with federal, state or local regulations concerning waste products. Its employees would receive specialized training for the provision of these services and will provide services on an ongoing and frequent basis.

The MLP also derived income from parking agreements, in which its customers were charged a usage fee based on the quantities of natural gas stored ("parked") at its facilities. Parking consists of (i) the receipt of gas for the customer's accounts, (ii) the retention of the gas, and (iii) the subsequent removal of the gas for the customer's account at the agreed upon time. These included cycling agreements, i.e., parking agreements with an upper limit on the amount of gas that can be parked in a given period. Finally, in connection with the debt obtained to finance its activities, the MLP entered into hedging agreements including interest rate swaps, interest rate caps, and Treasury locks. It was specified that a ruling is sought only for those financial transactions that were not integrated with the related debt instruments.

The IRS ruled that the income from the following activities is qualifying income under section 7704(d)(1)(E): 1) transportation of crude oil and natural gas pursuant to agreements described in the ruling; 2) natural gas parking activities including income from parking and cycling agreements to the extent parking income is separated from loaning income; 3) interconnect activities enabling the customer's product to enter the MLP's pipeline system; and 4) transportation of produced water; and delivery of fresh water and injectants where the MLP will also collect, clean, recycle and dispose of the water. It also found the income from the PTP's hedging agreements to be qualifying income.

PLR 201619002, issued February 8, 2016; released May 6, 2016. Nitrogen-based fertilizers.

A corporation planned to form a publicly traded partnership (PTP). The partnership would be engaged in the production, storage, transportation, and marketing of nitrogen-based fertilizers: ammonia; ammonium nitrate; ammonium nitrate-ammonia (ANA); urea (both granulated and in solution); and urea ammonium nitrate (UAN). The taxpayer represented that these products were all direct application fertilizers, and that they would be sold in bulk to customers operating in agricultural and non-agricultural industries. The IRS ruled that the income from the foregoing activities would be qualifying income under section 7704(d)(1)(E). This would be true, however, only to the extent that 1) the products in question were of a grade that is consistent with industry standards for agricultural uses as a fertilizer, 2) the product in the form sold was commonly sold and used as a fertilizer (for example, low density ammonium nitrate or ammonium nitrate solution would not qualify), and 3) the partnership did not make direct retail sales to end users.

PLR 201633020, issued April 8, 2016; released August 12, 2016. Fluid Management and Disposal Services.

This is another PLR dealing with fluid handling services to oil and natural gas producers. In this case a partnership in formation will, after its IPO, supply drilling and fracturing fluids, including fresh water, brine, drilling mud, lubricants, and other injectants for use in drilling and hydraulic fracturing. The drilling mud will be recycled or produced from by-products of the partnership's disposal services and the remaining products sourced from third parties. The fluids will be transported to the well site by third party trucks or pipeline. The partnership's personnel will be at the well site on a regular basis to work with production teams to coordinate deliveries and will remotely monitor fluid levels to ensure a continuous supply of fluids. The partnership will also store, treat, and dispose of flowback produced water and other drilling production waste, generally using salt water disposal wells. Flowback and produced water will typically be transported to the wells by third party truck or pipelines; however, the partnership anticipates building its own pipelines.

In connection with its disposal services, the partnership will provide truck and tank washout services. It will also earn income from selling hydrocarbons and other minerals and natural resources that are collected as part of the disposal process. As in other PLRs, the taxpayer has made representations regarding specialized personnel, lack of utility for the equipment and personnel training outside oil and gas exploration, that the processing and treatment of flowback fluids and produced water is required by government regulations and industry standards, and that production of oil and gas via fracking would not be possible without these services.

The IRS ruled that the partnership's income from its fluid management and disposal services will be qualifying income under section 7704(d)(1)(E), as will its income from sales of filtered hydrocarbons and other minerals collected as part of the disposal process as long as the sales are not to end users at the retail level. The ruling does not apply to any income from the delivery of water or other injectants, including recycled produced water, to affiliates or third parties where the partnership does not also collect and clean, recycle, or otherwise dispose of the resulting produced water and drilling production waste after use.

PLR 201636025, issued May 26, 2016; released September 2, 2016. Regasification of LNG.

A PTP owns indirectly all of the outstanding equity interests in a limited partnership (LP) that is treated as a disregarded entity for tax purposes. LP owns and operates a liquefied natural gas receiving and regasification terminal. It has a processing agreement with two suppliers under which it receives LNG and processes it into gas for future transport. During this process the suppliers retain ownership of the LNG, while LP possession and control from its receipt until it is delivered to the suppliers' delivery point. The suppliers pay a fixed monthly capacity fee for these services, for which they subscribe to a percentage of the terminal's capacity. The IRS ruled that the income derived from the processing agreement is qualifying income under section 7704(d)(1)(E).

PLR 201636039, issued June 8, 2016; released September 2, 2016. Interest Rate Swaps and Other Financial Transactions.

The taxpayer is a PTP with two primary business segments: (i) pipelines and transportation; and (ii) wholesale marketing and terminalling. In order to finance asset acquisitions and conduct its business operations, the PTP periodically issues both fixed-rate and floating-rate debt securities. To manage its exposure to interest rate movements, the PTP enters into interest rate swaps, interest rate caps, forward locks, and treasury locks (together, the "Financial Transactions"). In some cases, the Financial Transactions entered into by the PTP are integrated with the related debt instruments under § 1.1275-6 of the Income Tax Regulations. The PTP requested a ruling only on Financial Transactions that are not integrated. The IRS ruled that the income Company from each of the four types of Financial Transactions is qualifying income **w**ithin the meaning of section 7704(d)(1) of the Code and section 1.7704-3(a)(1) of the Regulations. The IRS cautioned that apart from that specific ruling, it did not express or imply any opinion concerning the federal tax consequences of the Financial Transactions under any other provision of the Code.

PLR 201637007, issued June 13, 2016; released September 9, 2016. Fluids, Solids, and Oilfield Waste Services.

This PLR is quite similar to others dealing with oilfield services. The taxpayer is a PTP which is engaged in certain midstream operations. As a part of that business, the PTP provides fluid, solids, and oilfield waste handling, treatment, and disposal services to customers engaged in the exploration for, and development and production of, oil and natural gas. It supplies and transports drilling and fracturing fluids via trucks, tanks, and for some freshwater, pumps and pipelines. It also treats, recycles, and disposes of drilling and production wastes and provides truck and tank washout services, and recycling or disposal services related to the resulting fluids. It also earns income through the provision of frac tanks for temporary storage of water, flowback, produced water, pit water, drill cuttings, and other drilling and production wastes; and it provides hydrocarbon remediation services, removing hydrocarbons from the drilling waste at its facilities during the waste treatment and disposal process and sells such reclaimed hydrocarbons.

The PTP makes the common representations regarding its personnel's specialized knowledge, training, and experience; the essential nature of its services to oil and gas drilling and fracking operations; that the processing and treatment of fluids is necessary to comply with government regulations and industry standards; and the continuous, daily involvement of its personnel throughout the cycle of each producing property.

The IRS ruled that the PTP's income from its fluid management, transportation, disposal, washout, and storage services is qualifying income under section 7704(d)(1)(E), as is the income from its hydrocarbon remediation services performed as part of the disposal process so long as the PTP does not sell the recovered hydrocarbons to end users at the retail level. The ruling is not applicable to any income from the delivery and transportation of water, brine, or other injectants where the PTP does not also collect and clean, recycle, or otherwise dispose of the resulting produced water and drilling production waste after use.

Summaries of all PLRs providing guidance on qualifying income under section 7704, along with links to the full text of each, can be found in the Members section of the MLPA website at https://www.mlpassociation.org/membership/member-section/irs-private-letter-rulings-on-qualifying-income-under-i-r-c-7704.