BAKER BOTTS L.L.P.

ONE SHELL PLAZA
910 LOUISIANA
HOUSTON, TEXAS
77002-4995

TEL +1 713.229.1234
FAX +1 713.229.1522
BakerBotts.com

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Mike Bresson
TEL: 7132291199
FAX: 7132292799
michael.bresson@bakerbotts.com

CC:PA:LPD:PR (REG-132634-14)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments to Proposed Regulations under Section 7704(d)(1)(E)

Ladies and Gentlemen:

Baker Botts L.L.P. appreciates the opportunity to submit comments to the proposed regulations ("Proposed Regulations") under section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended (the "Code"), relating to qualifying income of a publicly traded partnership ("PTP").[1] Although we represent a number of PTPs, these comments are not submitted on behalf of any client.

The Proposed Regulations are a thoughtful and comprehensive interpretation of the aspects of Section 7704(d)(1)(E) that they cover, but we urge you to consider the following points as you work toward finalizing them:

- The Regulations should not provide an exclusive list of activities that produce qualifying income; instead, they should set forth general principles and illustrate those principles with examples of activities that do (or do not) qualify.
- Regulations outside the context of "intrinsic activities" may be unnecessary.

[1] REG-132634-14: 80 F.R. 25970-25977 (May 6, 2015).

- The definitions of "processing" and "refining" in the Proposed Regulations are too restrictive; they should be expanded to be more consistent with the statute, the relevant legislative history and the past private letter ruling practice of the IRS.
- The definitions of "transportation" and "marketing" should be revised, or examples of qualifying activities should be added, to clarify that a number of activities that clearly qualify under the statute, the legislative history and/or past private letter rulings issued by the IRS will continue to qualify.
- Taxpayers who have previously received private letter rulings should be provided with more guidance whether the activities that qualify under the rulings are still qualifying activities under the regulations; this clarity could be provided by revising the regulatory tests, providing extensive examples in the regulations, promulgating a more expansive transition/grandfather rule, or some combination of those approaches.
- The scope of the transition rules should be clarified.

The discussion below expands upon these points.

Do Not Specify an Exclusive List of Activities That Qualify

The Proposed Regulations set forth an exclusive list of the natural resource-related activities that can produce qualifying income. Any natural resource-related activity that is not expressly described in the Proposed Regulations would not produce qualifying income, even if it otherwise clearly falls within the broad scope of Section 7704(d)(1)(E).[2]

This restrictive approach is inconsistent with the broad language and scope of the statute. A taxpayer who clearly qualifies under the language of the statute should not be excluded from

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[2] Proposed Regulation 1.7704-4(c)(1) provides: "Section 7704(d)(1)(E) activities include the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource *as limited to those activities described in this paragraph (c) or as provided by the Commissioner by notice or in other forms of published guidance. No other activities qualify as section 7704(d)(1)(E) activities.*" (Emphasis added.)

the benefits of Section 7704(d)(1)(E) simply because the activity is omitted (perhaps inadvertently) from the regulation's exclusive list of qualifying activities.

While some interested taxpayers have combed the Proposed Regulations to identify items which were omitted from the exclusive list and have suggested additions to the list, that does not address the fundamental problem we see with the use of an exclusive list. The types of businesses that currently monitor the interpretation of Section 7704(d)(1)(E) most carefully are those for which the financial markets currently have an appetite, based on current economic conditions and current technology. But markets and technologies change. Businesses that are clearly covered by the broad language of section 7704(d)(1)(E) but take no current interest in the Proposed Regulation comment process should not be penalized.

We suggest that, rather than providing an exclusive list of qualifying activities, the regulations should provide general definitions that are illustrated with many examples.

Consider Limiting the Scope of the Regulations to Intrinsic Activities

We suggest that the IRS consider whether regulations are needed at all outside the context of the "intrinsic activities" governed by Proposed Regulation 1.7704-4(d).

We understand that one of the principal factors that led the IRS and Treasury to issue proposed regulations under Section 7704(d)(1)(E) was the many ruling requests that the IRS has received regarding activities that would now be tested under the category of "intrinsic activities" under Proposed Regulation 1.7704-4(d), such as providing water for well fracturing. This is an area in which the IRS was well versed from past ruling requests and the high quality of the Proposed Regulations on this topic reflects that level of study.[3]

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[3] There are some aspects of the intrinsic activities rules of Proposed Regulation 1.7704-4(d) that should be clarified. For example, (i) PTPs often use the employees and independent contractors of their general partner and its affiliates to provide their services, so the meaning of the term "partnership personnel" should be clarified to include those personnel and (ii) an example illustrating the qualifying nature of the

But the scope of the natural resource-related activities covered by Section 7704(d)(1)(E) apart from "intrinsic activities" is very broad. The prospect of drafting regulations that provide specific rules for determining whether a particular activity qualifies is daunting. The task is made more difficult by the fact that

- relatively few PTPs have attempted to qualify their income as derived from exploration, development, mining or production of a mineral or natural resource and
- PTPs that seek to qualify their income as derived from the refining, processing, transportation or marketing of a mineral or natural resource typically rely upon a "will" opinion of their tax counsel and seek a private letter ruling only as to income streams that present an element of uncertainty.[4]

As a result, the IRS and taxpayers have had relatively little opportunity for dialog regarding the nature of the activities that should qualify under Section 7704(d)(1)(E) outside certain narrow areas of relative uncertainty. We urge the IRS and Treasury to consider whether, under these circumstances, the time is ripe for adoption of regulations on topics other than the nature of "intrinsic activities."

Expand the Definitions of Processing and Refining

The definitions of "processing" and "refining" in the Proposed Regulations are too restrictive. They should be expanded to be more consistent with the statute, the relevant legislative history and the past private letter ruling practice of the IRS.

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marketing of fuel, lubricants and related products at natural resource extraction sites (consistent with past private letter rulings) should be added.

[4] PTPs require a high level of comfort that they satisfy the qualifying income standard under Section 7704, since failure to satisfy the standard would subject the PTP to corporate income taxes at the entity level. Historically, PTPs have typically achieved this comfort from "will" opinions of their tax counsel. PTPs typically seek private letter rulings only in situations where there is an element of uncertainty (even a small one) regarding the interpretation of Section 7704(d)(1)(E).

The Proposed Regulations generally define "processing" and "refining" together as activities "done to purify, separate or eliminate impurities," excluding most activities that "cause "a substantial physical or chemical change in a mineral or natural resource" or "transform the extracted mineral or natural resource into new or different mineral products or into manufactured products." Proposed Regulation 1.7704-4(c)(5). They go on to provide specific rules for determining the qualifying character of specific products as follows:

- Natural Gas[5]
    - The activity consists of
        - Purifying natural gas to remove oil, condensate, water or non-hydrocarbon gases
        - Separating the components of the natural gas (methane, ethane, propane, butane, etc.) from each other or
        - Converting methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.
- Petroleum[6]
    - The assets used in the activity have a MACRS class life of 13.3, Petroleum Refining and
    - The activity consists of
        - Physical separation of crude oil into components
        - Chemical conversion of the physically separated components if one or more of the products of the conversion are recombined with other physically separated components to produce gasoline or other fuels or

[5] The Proposed Regulations lack a specific category for gases other than natural gas, such as helium and naturally occurring carbon dioxide.

[6] The Proposed Regulations lack a category for non-hydrocarbon products of crude oil, such as sulfur.

        - Physical separation of the products created in either of the processes described above.

- Ores and Minerals
    - The activity constitutes a "mining process" or a "refining process" under the percentage depletion regulations.
- Timber
    - The activity is performed to modify the physical form of timber, including by application of heat or pressure to timber, without adding any foreign substances.
    - Specific examples are provided of products that meet this standard (such as wood chips and rough lumber) and products that do not (such as pulp and paper).

The Proposed Regulations include two examples that treat identical ethylene molecules produced from oil and gas differently under the standards described above. Ethylene produced from natural gas-derived inputs at a steam cracker is nonqualifying, while ethylene produced from crude oil at a petroleum refinery is qualifying. Proposed Regulation 1.7704-4(e), Examples 1 and 2.

The Proposed Regulations also contain an example in which diesel fuel, gasoline and methanol are produced from methane derived from natural gas. The diesel fuel and gasoline qualify because they are liquid fuels otherwise produced from petroleum and the methanol does not qualify because it is not a liquid fuel otherwise produced from petroleum. Proposed Regulation 1.7704-4(e), Example 3.

The Proposed Regulations are inconsistent with the IRS's prior practice in issuing private letter rulings regarding products derived from oil, gas, ores and minerals, and timber. The IRS has previously ruled that products such as olefins (including ethylene produced from natural gas-derived inputs), diolefins, methanol, aluminum ingots and pulp produce qualifying income.

More important, as discussed below, the Proposed Regulations represent an unduly narrow reading of Section 7704(d)(1)(E) and its legislative history and create a standard that will be difficult to administer.

Section 7704(d)(1)(E) treats income derived from the "processing" or "refining" of a "mineral or natural resource" as qualifying income. The common meanings of the terms "processing" and "refining" are sufficiently broad[7] that the more limiting factor in the statutory definition is the requirement that the processing or refining activities must be performed as to a "mineral or natural resource." The legislative history of Section 7704(d)(1)(E) confirms this point by framing the issue (in the context of oil and gas products) as whether the product is a "mineral or natural resource" and using the term "processing" to describe both activities that produce qualifying income and activities that are too far downstream to produce qualifying income:

> [N]atural resources include…oil, gas or products thereof. ….. For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by *additional processing* beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. (Emphasis added.)

Applying the legislative history's "mineral or natural resource" centered view of the limitations on "processing" and "refining" shifts the focus to the nature of the products that the PTP processes or refines. That is, the question becomes: does the activity still relate to

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[7] For example, as other comments to the Proposed Regulations have pointed out, the Oxford Dictionaries define the verb "process" as "to perform a series of mechanical or chemical operations on (something) in order to change or preserve it."

unlocking the value of the mineral or natural resource extracted from the earth, or has it moved beyond that point?[8]

In the case of oil and gas products, this means that the focus should be on the nature of the particular volume of product handled by the PTP as (i) oil or gas, or derived from oil or gas, and (ii) of a type produced in petroleum refineries[9] or field facilities (and not a plastic or similar petroleum derivative). For example, under this view, regardless of the location of the activity or the depreciation classification of the equipment used, production from oil or natural gas-derived inputs of :

- ethylene, propylene, butadiene or alkylate is qualifying because these products are of a type produced to varying degrees at refineries
- methanol and MTBE are qualifying because a significant use of those products is as (or to produce) blending components for fuels produced at refineries (*e.g.*, the product resulting from a mixture of gasoline and methanol or MTBE is still "gasoline") and
- LNG from the liquefaction of natural gas, and natural gas from the regasification of LNG, is qualifying because both constitute the application of a "process" to natural gas.[10]

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[8] Section 7704(d)(1) defines a "mineral or natural resource" as "any product of a character with respect to which a deduction for depletion is allowable under Section 611," with certain exceptions. But section 7704(d)(1)(E) clearly contemplates that a product retains its "mineral or natural resource" character far beyond the point at which depletion is calculated, as evidenced by the statute's express references to "fertilizer" and "gas, oil, or products thereof" as examples of a mineral or natural resource.

[9] Since the focus is on the general nature of the product as produced in a petroleum refinery, it is improper to impose a limitation that is based upon the particular location at which the volume of product being tested under Section 7704(d)(1)(E) was produced, the type of equipment used or the manner in which the equipment is classified under MACRS. At a minimum, all products identified in NAICS Code 324110 (cited in the Preamble to the Proposed Regulations) should be recognized as products of a type produced in petroleum refineries. The heavy emphasis placed on refinery production of fuel products in the Proposed Regulations is not supported by Section 7704(d)(1)(E) or the legislative history.

[10] As the liquefaction and regasification of natural gas are essential to the non-pipeline transportation of natural gas, they could alternatively be viewed as producing qualifying income from the "transportation"

Moreover, physical blending activities with respect to refinery-type products, such as

- combination at a terminal of fuel oil and a cutter stock to produce bunker fuel
- blending of additives into fuels, lubricants and other refinery-type products to enhance, preserve or complement their function and
- blending of ethanol or biodiesel into a fuel

should qualify under this standard. And qualifying oil, gas and products thereof should include products that arrive by a path less traveled, such as transmix (a mixture of two different products at their interface in a pipeline) and waste hydrocarbons blended with water or other products that are recovered from environmental clean-up activities or transmission line "drips" and will be processed like crude oil.

Applying the principles described above to oil and gas products has the collateral virtue of simplifying the test whether transportation of a particular volume of product produces qualifying income. For example, if ethylene and propylene produced at a refinery is qualifying but ethylene and propylene produced from natural gas inputs is nonqualifying (as appears to be the case under the Proposed Regulations), an ethylene or propylene pipeline operator has the burden of trying to trace the volumes of product back to their producers and enquiring how the volume of product was produced. By contrast, under the approach we suggest above, all of the ethylene and propylene would qualify because in each case it was produced from oil or natural gas-derived inputs and is a product of a type produced at refineries.

To give effect to the broad scope of Section 7704(d)(1)(E) described above, the general definitions of "processing" and "refining" of a "mineral or natural resource" should be broad

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of natural gas or from "intrinsic activities" with respect to natural gas, but the most natural, straightforward application of the statute is that these activities constitute the "processing" of natural gas.

enough so that principles similar to those described above for oil and gas products apply to the refining and processing of all other minerals and natural resources. Under this view, for example

- In the case of coal, the coking of coal, or the production of hydrocarbons of a type produced from crude oil in a petroleum refinery, should qualify
- In the case of ores and minerals, activities that extract the principal value inherent in the raw ore or mineral, such as the production of elemental metals from metallic ores, should qualify and
- In the case of timber, pulping should be added to the list of activities that qualify under the Proposed Regulations.

Moreover, in each case the addition of additives to enhance, preserve or complement the mineral or natural resource product, such as the chemical treatment of sand, should qualify.

Expand the Definitions of Transportation and Marketing

The definitions of "transportation" and "marketing" in the Proposed Regulations should be revised, or examples of qualifying activities should be added, to clarify that a number of activities that clearly qualify under the statute, the legislative history and/or past private letter rulings issued by the IRS will continue to qualify.

Proposed Regulations 1.7704-4(c)(6) and -4(c)(7) set forth a list of activities that qualify as the "transportation" or "marketing" of a mineral or natural resource.[11] Transportation and marketing activities omitted from that list that should be added (as examples) include

- hedging commodity prices with respect to volumes of mineral or natural resource products (such as oil and natural gas) marketed by the PTP[12]

[11] As discussed above, the regulations should abandon the concept of an exclusive list in favor of examples illustrating the general rule.

- natural gas compression services
- retail marketing and transportation of liquefied petroleum gas, including propane
- a broader range of pipeline interconnect construction activities than is covered by the Proposed Regulations
- relocations of pipelines at the request of third parties
- sales of renewable identification numbers (RINs) generated through terminaling activities
- transportation of oil and gas products in any vessel, including tanker ships.

Other comments to the Proposed Regulations have provided excellent explanations of the simple reasons these activities are described in Section 7704(d)(1)(E) and should be added to the regulations, so we will not repeat those explanations here. However, we note that in most cases these activities have been the subject of past favorable private letter rulings by the IRS.

Eliminate Uncertainty Regarding Effect on Existing Private Letter Rulings

The Proposed Regulations place taxpayers who have received private letter rulings from the IRS in a difficult position. Under the transition rules of Proposed Regulation 1.7704-4(f), a taxpayer is only entitled to rely on a private letter ruling during the roughly ten year "Transition Period" following the adoption of the regulations in final form. In many cases, it may be difficult, if not impossible, for a taxpayer to discern with certainty to what extent its private letter ruling is (or is not) consistent with the new qualifying income rules set forth in the Proposed Regulations. And the IRS has indicated that it will not issue private letter rulings regarding the application of the transition period rules and does not intend to provide specific notices to taxpayers revoking or modifying past prior letter rulings. This may leave the taxpayer with no avenue to the level of certainty regarding the qualifying nature of its income that is necessary to

[12] In addition, the regulations under Treas. Reg. 1.7704-3 should be clarified so that taxpayers are not required to seek private letter rulings that interest rate swaps, Treasury locks and similar products produce qualifying income.

market PTP equity to public investors. We suggest that the regulations be modified (or that the IRS revise its policy) to provide that certainty through one or more of the following mechanisms:

- revising the regulatory tests to clarify their scope
- providing extensive examples that incorporate the facts of most private letter rulings or
- permanently grandfathering existing private letter rulings.

Moreover, due to the reliance placed by recipients of private letter rulings (including those that are clearly inconsistent with the Proposed Regulations), we suggest that the IRS and Treasury give the heaviest consideration to the option of permanently grandfathering existing private letter rulings.

Clarify the Other Aspects of the Transition Rules

Under the transition rules of Proposed Regulation 1.7704-4(f), a PTP may treat income from an activity as qualifying income during the Transition Period if, prior to May 6, 2015, the PTP was publicly traded, engaged in the activity, and treated the income from the activity as giving rise to qualifying income (provided that this treatment was based upon an objectively reasonable interpretation of the statute prior to the issuance of the Proposed Regulations). It is unclear

- what the scope of an "activity" is
- how a PTP would have "treated" income from a particular activity as qualifying, in the absence of any tax return schedule that tracks which activities produce qualifying income and
- to what extent beginning construction of a project should be treated as engaging in the activity to which the project is directed.

We suggest that the regulations be revised to

- specify an expansive view of the nature of an "activity"

- eliminate the requirement that the PTP "treat" the income as qualifying and require simply that the income is qualifying under a reasonable interpretation of the statute (apart from the Proposed Regulations) and
- treat a PTP as engaged in an activity if it has begun construction of a project to conduct that activity.

Once again, we appreciate the opportunity to comments on the Proposed Regulations. Feel free to contact Michael Bresson if you would like to discuss any of our comments.

Respectfully submitted,

Baker Botts L.L.P.

By: 

Michael Bresson