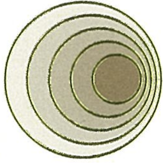

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CC:PA:LPD:PR (REG-132634-14)
Room 5203
Internal Revenue Service
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Comment on Proposed Regulation 1.7704-4 published in the Federal Register on May 6, 2015 (REG-132634-14)

Buckeye Partners, L.P. ("Buckeye", "we", "us" or "our") respectfully submits the following comments on the proposed regulations (the "proposed regulations") issued by the Internal Revenue Service (the "IRS") and the U.S. Department of Treasury (the "Treasury") on May 6, 2015 relating to qualifying income derived from the exploration, production, processing, refining, transportation and marketing of minerals or natural resources (the "natural resources exception").

Buckeye is a master limited partnership ("MLP") organized in 1986 as the first publicly traded partnership operating in the midstream pipeline business. We are one of the largest independent liquid petroleum products pipeline operators in the United States with approximately 6,000 miles of pipeline, and our terminal network comprises more than 120 liquid petroleum products terminals with aggregate storage capacity of over 110 million barrels across our portfolio of pipelines, inland terminals and marine terminals. As a traditional midstream provider whose operations consist primarily of the transportation, storage and marketing of liquid petroleum products, the overwhelming majority our operations generate qualifying income within the meaning of the section 7704 of the Internal Revenue Code (the "Code").[1]

In general, we believe that the proposed regulations attempt to accomplish more than what is required to respond to what is described in the preamble to the proposed regulations as "increased interest in the application of section 7704(d)(1)(E)." Listing each activity that generates qualifying income under the section 7704(d)(1)(E) is simply too broad of a task. As such, Buckeye recommends that the IRS revise the proposed regulations using broader defined terms consistent with the common and historical understandings of the definitions of each activity listed in section 7704(d)(1)(E) as producing qualifying income.[2] In addition, Buckeye submits the following specific comments, within the framework of the proposed regulations, with

[1] Unless otherwise noted, references to "section" are to the Code or the Treasury regulations promulgated thereunder (the "Treasury regulations").
[2] Reference, for example, the proposed definitions for "processing" and "refining" in the comment to the proposed regulations submitted by Vinson & Elkins L.L.P. on June 19, 2015.

respect to activities that we believe should be clarified as generating qualifying income and for which we have, over the last ten years, received affirmative private letter rulings from the IRS.

Qualifying Income from the Operation or Management of Pipelines, Terminals, and Storage Facilities

Proposed regulation section 1.7704-4(c)(1) should be modified to clarify that gross income from the operation or management of energy infrastructure assets, including the operation or management of pipelines, terminals and storage facilities, generates qualifying income.

Background

The use of partnerships, joint ventures, co-ownership and other shared ownership arrangements, and third party operators for energy or natural resource infrastructure assets is a long-standing and practical reality in the American energy industry.[3] Typical energy infrastructure assets require significant capital and operating expertise and service an industry that is inherently cyclical. As such, companies or investors often partner with industry-specific experts, combine resources, or contract with expert managers so that these assets are effectively and efficiency operated. Buckeye Development & Logistics, LLC, a wholly owned subsidiary of Buckeye that is disregarded for federal income tax purposes, is such an industry-specific expert that provides operation and maintenance services for third-party energy infrastructure assets.[4]

Earning gross income, including reimbursements of incurred costs and general administrative expenses, from managing or operating partially owned or third-party owned energy infrastructure assets has been and continues to be a common MLP activity, and the IRS has addressed the management and operation of energy infrastructure assets by entities owning partial or no ownership in the operated assets in many instances. For example, in private letter ruling 2004-22-023 (February 10, 2004), an MLP sought a ruling that gross income from operating two pipelines transporting natural gas liquids ("NGLs") and refined petroleum products owned by a third party constituted qualifying income as the transportation of a natural resource. The MLP performed the activities required to move the NGLs and refined petroleum products and received a management fee and certain cost reimbursements from the owner. The IRS concluded that gross income from the management fee and cost reimbursements was qualifying income. In addition to private letter ruling 2004-22-023, the IRS has come to a similar conclusion in issuing private letter rulings to eight additional MLPs, including Buckeye:

Priv. Ltr. Rul. 2006-38-018 (June 13, 2006)	operating fees and certain cost reimbursements from the maintenance and operations of pipelines partially or wholly owned by third parties
Priv. Ltr. Rul. 2007-12-002 (December 7, 2006)	gross income from operating refined product pipelines and terminals owned by a third party
Priv. Ltr. Rul. 2007-40-010 (June 27, 2007)	gross income (including cost reimbursements)

[3] At the time of section 7704 enactment, the House Report with respect to the section acknowledges this fact, stating "certain types of natural resources . . . activities have commonly or typically been conducted in partnership form." H.R. Rep. No. 100-391(II),100th Cong. (1987).

[4] As discussed further below, income from such activities are treated as qualifying income in accordance with Priv. Ltr. Rul. 2007-40-010, which Buckeye received from the IRS on June 27, 2007.

	from serving as contract operator of pipelines and terminals
Priv. Ltr. Rul. 2011-32-012 (April 29, 2011)	fees and cost reimbursements from operating partially owned natural gas processing plants, a refrigeration plant, NGL fractionators, and storage facilities for NGLs and products thereof
Priv. Ltr. Rul. 2012-33-010 (April 20, 2012)	gross income from operating a partially owned natural gas processing plant and related facilities, including an NGL storage facility
Priv. Ltr. Rul. 2013-13-014 (December 11, 2012)	service fees for operating a third party's natural gas compressor fleet
Priv. Ltr. Rul. 2013-13-015 (December 18, 2012)	gross income from a partnership's distributive share of operating services fee income and related cost reimbursements with respect to an undisclosed asset
Priv. Ltr. Rul. 2014-18-021 (October 25, 2013)	a percentage of sales fee for managing a joint venture engaged in coal mining

The activity of an owner is not the only instance in which a partnership that is engaged in the transportation, terminalling, storage or processing of a natural resource and associated activities like general administrative or back office functions (for which it receives remuneration) generates qualifying income. For example, regardless of whether an owner, lessee, or operator is the person transporting natural resources on a pipeline, there can be no question that the taxpayer is engaged in transportation because the taxpayer is engaged in the range of activities and performs the range of functions (including back office functions) that constitute transportation. If it is clear that an owner or lessee that engages in certain activities generates qualifying income then it is equally clear that an operator that engages in those very same activities must also generate qualifying income.

Proposed Modification

Buckeye proposes that the regulations, as finalized, provide that qualifying activities include the operation or management of energy infrastructure assets, including the operation or management of pipelines, terminals, and storage facilities. As such, Buckeye recommends that Proposed regulation section 1.7704-4(c)(1) include as its penultimate sentence: "Gross income, including cost reimbursements, from such activities derived by a taxpayer as owner (full or partial), operator, or manager constitutes qualifying income."

Qualifying Income from Natural Resource Blending Activities

The proposed regulations should be modified to clarify that the blending of natural resources together and the blending of additives into natural resources generates qualifying income. The proposed regulations should also clarify that gross income from the sale of renewable identification numbers ("RINs") is qualifying income.

Background – Blending Activities

In connection with terminalling activities, most terminal owners or operators inject additives into fuel as the fuel is being loaded over the "rack" and into delivery vehicles.[5] These additives, which are typically not natural resources for the purposes of section 7704, are often required by applicable regulations or otherwise enhance motor fuel blend stock. Injecting these additives at the terminal allows products owned by different customers to be commingled for storage but customized for each customer as it is loaded over the rack.

Typical additives include detergents, dyes, cetane improvers, cold flow improvers, fuel oil stabilizers, isotopic markers, lubricity/conductivity improvers, anti-icing agents and proprietary gasoline additives.[6] Ethanol is also typically blended into gasoline to satisfy EPA guidelines, and biodiesel is often blended into diesel fuel. Ethanol and biofuel can make up a significant percentage of the blended motor fuel stock (for example, 10% ethanol and 20% biodiesel are common blends), while other additives tend to make up a very small portion of the blended stock (typically less than 1%).

Although blending is addressed in the proposed regulations under "marketing" in section 1.7704-4(c)(7), the MLP industry has generally considered blending activities as a terminalling function (*i.e.*, transporting or processing natural resources for a fee). For instance, many terminal operators do not own the product being transported at the terminal, and thus are blending additives simply to meet the customer's requested specifications at the rack. Although blending could also be considered a marketing function if, for example, the blending is conducted to facilitate sale, it is more intuitively viewed as a necessary transportation activity or refining or processing if the blending processes is conducted in order to achieve the desired product (for example, a refinery blending winter blend or summer blend gasoline). Currently, the proposed regulations only address blending additives into fuels. There should be no distinction between blending an additive into fuels versus any other mineral or natural resource. Similarly, the regulations should specify that income from the essential processes of blending natural resources together, such as butane blending in a refinery or at the rack, constitutes qualifying income.

Background – Sales of Renewable Identification Numbers

The Energy Policy Act of 2005 mandates increased consumption of certain renewable fuels (such as ethanol and biodiesel). To achieve this policy goal and monitor the nation's progress, Congress created the Renewable Fuel Standard (the "RFS") program to be implemented by the United States Environmental Protection Agency (the "EPA").[7] Under the RFS program, Congress delegated the authority to the EPA to develop and implement

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[5] A "rack" is simply the complex of equipment necessary to load a delivery vehicle with fuel. The rack consists of loading arms, pumps, meters, shutoff valves, relief valves and other piping and valves necessary to fill the delivery vehicles. Treasury regulation section 48.4081-1(b), for example, defines, for purposes of that section, a rack as "a mechanism capable of delivering taxable fuel into a means of transport other than a pipeline or vessel."

[6] Each additive injected into a fuel has one or more functions. For example, detergents are required by section 211(l) of the Clean Air Act to prevent the accumulation of deposits in motor vehicle engines and fuel-supply systems. Dyes used in diesel fuel and kerosene are required by the Code to distinguish taxable product from product that is not taxed. Cetane improvers, cold flow improvers, fuel oil stabilizers, lubricity/conductivity improvers and anti-icing agents are each additives that may be added to a fuel to enhance the property of that fuel, often for a specific application or market (*i.e.*, cold weather conditions or to meet premium fuel standards).

[7] U.S. EPA, Regulation of Fuels and Fuel Additives: Renewable Fuel Standard Program; Final Rule, 40 CFR Part 80, May 1, 2007.

regulations which will ensure that transportation fuel sold in the United States contains a minimum volume of renewable fuel.

The EPA created a system of volume accounting and tracking of renewable fuels. This system is based on the assignment of unique renewable identification numbers ("RINs") to each batch of renewable fuel created and transferred in the United States. The use of RINs allows the EPA to measure and track renewable fuels as they are produced rather than as they are blended into conventional fuels. Each RIN must be transferred with the renewable fuel until the point the renewable fuel is blended into a conventional fuel or sold into the retail fuel market, at which point the RIN is "separated" from the fuel and becomes freely transferrable separate and apart from the renewable fuel.

Under the RFS, each producer or importer of conventional fuel (an "Obligated Party") is required to meet a renewable volume obligation (an "RVO") based on such Obligated Party's volumes of conventional fuel for each calendar year. If an Obligated Party does not generate sufficient RINs from its own activities to satisfy its RVO, it may acquire additional RINs from third parties.

In many instances the blending of renewable fuels into conventional fuels takes place at refined product terminals as the fuel is loaded over the rack. As a result, if the terminal operator sells fuel but is not an Obligated Party (or is able to exceed its RVO), the terminal operator may generate significant RINs that are not needed to satisfy its RVO. In other instances, RINs may be generated as part of a wholesale distribution business; similar to many terminal operators, a fuel wholesaler may generate significant RINs with limited or no RVO to satisfy. These RINs can then be traded or sold to an Obligated Party. In this manner, the sale of RINs functions as a credit trading program that allows renewable fuels to be used where they are most economical while providing a flexible means for Obligated Parties to comply with their RVOs.

An MLP that blends ethanol, biodiesel and/or other renewable fuels into a natural resource as a required part of its terminalling activities (per the RFS rules described above) generates gross income from terminalling activities both from fees collected from its customer and, potentially, from the sale of RINs.[8] As such, income from the sale of RINs clearly constitutes income derived from the MLP's transportation activities. Similarly, an MLP that produces RINs in association with its wholesale fuel distribution business generates gross income from bulk fuel sales from both the sale of fuel and the sale of RINs. The partnership, in these instances, also does nothing in addition to its normal terminalling activities to generate RINs (except for sell RINs at commercially reasonable times and in commercially reasonable quantities[9]). Because the purpose of these RIN sales is not speculative, in the proposed modification below we proposed only that income derived from the sale of RINs produced or acquired in association with a qualifying blending activity or in association with the wholesale distribution of fuels be treated as qualifying income.

Proposed Modification

Buckeye recommends that blending additives into a natural resource be added to the definition of each section 7704(d)(1)(E) activity. Specifically, Buckeye recommends that the reference to blending in proposed regulation section 1.7704-4(c)(7) be modified to state, "an

[8] Such an MLP could generate RINs if it owned the renewable fuel being blended into the customer's fuel.
[9] As a practical matter, MLPs from time to time have to purchase RINs in the market to meet a sale obligation or for other reasons.

activity constitutes marketing if it is performed to facilitate sale of minerals or natural resources . . . including blending additives into minerals or natural resources (and sales of renewable identification numbers or similar credits produced or acquired in association with a qualifying blending activity)." Similarly, we proposed that a new section 1.7704-4(c)(6)(iii) be added after "Terminalling" stating "Blending additives into a natural resource in association with transportation or terminalling activities and selling renewable identification numbers (or similar credits) produced or acquired in association therewith."

Qualifying Income from Hedging Activities

MLPs commonly engage in hedging activities. While hedging activities vary from partnership to partnership based on the needs of the partnership, hedging as a qualifying activity can be roughly divided into two categories: the hedging of commodity risk (which may affect an MLP's income and/or costs) and the hedging of interest rate risk. Although the IRS and the MLP community currently treat both commodity hedging and interest rate hedging as generating qualifying income and nothing in the proposed regulations specifically addresses these activities, the proposed regulations create unnecessary uncertainty because the proposed regulations attempt to provide an exclusive list of qualifying activities under the natural resources exception. The proposed regulations should specify that gross income from commodity hedging to reduce risk with respect to a qualifying activity and interest rate hedging to reduce risk with respect to partnership indebtedness is qualifying income.

Background – Commodity Hedging

Gross income from derivative financial instruments is not, as a technical matter, income from the actual sale of a mineral or natural resource. However, Treasury regulation section 1.7704-3 provides that qualifying income includes income from (1) notional principal contracts ("NPCs") if the property, income or cash flow that measures the amounts to which the partnership is entitled under the NPC would give rise to qualifying income if held or received directly by the partnership and (2) other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Treasury regulation section 1.446-3(h) specifically includes a payment made to terminate an NPC as income from an NPC. NPCs are defined in section 1.446-3(c)(1)(i) to include commodity swaps, but exclude futures contracts, forward contracts and options. Thus, some income from commodity hedging (*i.e.*, commodity swaps) specifically falls within the current Treasury regulations under section 7704 of the Code while some does not.

Consistent with the principles of Treasury regulation section 1.7704-3, section 1221(a)(7) of the Code and the regulations thereunder treat gain or loss from a "hedging transaction" as ordinary income if the transaction is clearly identified as a hedging transaction at the time the taxpayer enters into the transaction. A hedging transaction includes a transaction entered into by the taxpayer in the normal course of its trade or business primarily to manage the risk of price changes with respect to ordinary property held (or to be held) by the taxpayer. This tax treatment reflects that hedging transactions are entered into in the ordinary course of a taxpayer's trade or business to manage income risks associated with ordinary assets. Thus, for example, an MLP that enters into a transaction to hedge an inventory of refined products that generate qualifying income is merely "locking in" the amount of the income from that qualifying activity.

The IRS has twice concluded that gross income from commodity hedging transactions described in Treasury regulation section 1.1221-2 with respect to natural resources is qualifying income. In private letter ruling 96-19-011 (May 10, 1996), the IRS concluded that hedging transactions, as defined in section 1.1221-2, produce qualifying income if the activity is hedging with respect to the partnership's inventory of oil and gas — a true hedge and not speculation. The IRS based its conclusion on its determination that the taxpayer's hedging activity was "integral to a qualifying activity." Similarly, the IRS concluded in private letter ruling 93-39-014 (June 28, 1993) that income from the sale of natural gas futures contracts is qualifying income where the contracts were obtained by the partnership to secure the price of the natural gas it needed for its fertilizer production.

Although the rulings discussed above predate section 1.7704-3 and therefore do not expressly rely on the Commissioner's authority under section 1.7704-3(a) to treat income from ordinary and routine investments similar to NPC income as qualifying income, both rulings rely on the same principles underlying section 1.7704-3 to conclude that hedging transactions generated qualifying income where the partnerships' commodity hedges were "ordinary and routine investments" that were integral to a qualifying activity.

In accordance with the principles of Treasury regulation sections 1.7704-3 and 1.1221-2, income realized from commodity hedging transactions to hedge price risk with respect to qualifying activities (that are appropriately identified and treated as hedging transactions under section 1.1221-2) should be treated as qualifying income provided that the related income associated with the held products is qualifying income.

Background – Interest Rate Hedging

In order to obtain funds for asset acquisitions, to conduct operations, repay indebtedness or make distributions, MLPs engaged principally in the exploration, development, mining or production, processing, refining, transportation or marketing of a natural resource often borrow funds or issue debt securities. For example, the partnership may issue debt securities in a private placement or public offering, or obtain a loan from a financial institution.

Index rates often fluctuate, or float, in response to changes in the financial markets. Fixed-rate debt bears interest at a fixed rate over the life of the instrument. Floating-rate debt, by contrast, bears interest at a spread over an index rate. Certain interest rate hedging mechanisms allow an MLP to better manage its interest obligations.

At a given time, an MLP may determine that market conditions favor paying a fixed interest rate when it has floating rate debt. At other times, an MLP may determine that a floating rate is more attractive when it is has fixed rate debt. In either case, the MLP may enter into a transaction known as a standard interest rate swap. A standard interest rate swap allows an MLP to swap a fixed rate cash flow in exchange for a floating rate cash flow (a "fixed for floating swap") or a floating rate cash flow for a fixed rate cash flow (a "floating for fixed swap"). Alternatively, an MLP may desire to lock in a current rate with respect to a future issuance, in which case, one of its available options is to enter into a transaction known as a forward-start interest rate swap.

In addition to interest rate swaps, an MLP may also reduce its exposure to the risk of an increase in the cost of debt capital by entering into a transaction known as a treasury lock. A treasury lock is a common and routine transaction whereby the MLP locks in the portion of the interest rate on its debt securities attributable to the rate on a U.S. Treasury bond.

While an interest rate hedging transaction does not itself constitute the exploration, development, mining or production, processing, refining, transportation or marketing of natural resources, the prudent management of financial risks and the management of an MLP's cost of capital, including entering into interest rate hedging transactions, is a necessary part of the natural resource business. Recognizing the necessity and practicality of interest rate hedging through swaps and locks (whether or not such locks and swaps are integrated with the related debt instrument under Treasury regulation section 1.1275-6), the IRS has issued five private letter rulings to MLPs that income from such activity constitutes qualifying income.[10]

Proposed Modification

Commodity hedging and interest rate hedging are common, prudent practices of MLPs. As such, we recommend that the proposed regulations specify that gross income from commodity hedging to reduce risk with respect to a qualifying activity and interest rate hedging to reduce risk with respect to partnership indebtedness is qualifying income. Alternatively, we recommend that Treasury regulation section 1.7704-3(a)(1) be modified to make the same clarification.

Conclusion

Thank you for the opportunity to comment on the proposed regulations. We look forward to working with you to clarify the proposed regulations to reflect the subjects discussed above.

Respectfully Submitted,

Buckeye Partners, L.P.

By:
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Chief Financial Officer

[10] Priv. Ltr. Rul. 2013-13-008 (January 4, 2013); Priv. Ltr. Rul. 2012-08-021 (November 1, 2011); Priv. Ltr. Rul. 2009-19-019 (January 23, 2009); Priv. Ltr. Rul. 2008-41-017 (June 16, 2008); Priv. Ltr. Rul. 2006-35-008 (May 23, 2006).