



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

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Room 5203

Internal Revenue Service

P.O. Box 7604

Ben Franklin Station

Washington, DC 20044

Re: Comments on REG-132634-14, Qualifying Income from Activities of Publicly Traded Partnerships with Respect to Minerals or Natural Resources

Enviva Partners, LP ("Enviva" or "the Partnership") is a publicly traded partnership that processes timber feedstocks into wood pellets at five production plants in the Southeastern United States. We appreciate the opportunity to submit comments regarding the proposed Treasury regulations (REG-132634-14) (the "Proposed Regulations") defining "qualifying income" under section 7704(d)(1)(E).¹ We appreciate the Service's efforts and the breadth of its undertaking to clarify the meaning of "qualifying income" under section 7704(d)(1)(E).

While the Proposed Regulations list "wood pellets" as a product that results from timber processing, we believe that the Proposed Regulations' definition of "processing or refining" of timber does not comport with the language section 7704. Specifically, we believe that (1) "processing" and "refining" should have separate definitions; (2) those definitions should align with the definitions of "processes" and "refining" in section 613 and the regulations thereunder; (3) qualifying income should

¹ Unless otherwise noted, all references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended.

be limited by input, not output; and (4) the final regulations should permit the addition of immaterial amounts of additives that protect or enhance the natural resource input, or are necessary to meet environmental standards. Moreover, we believe that the treatment of lumber and poles and the pulping of wood chips [and other timber feedstocks] constitute the “processing” of timber under section 7704.

While one could argue that the processing of wood fibers and shavings into plywood, MDF, MDO, and other engineered wood products generates qualifying income, we are not requesting that the final regulations include those processes as qualifying activities. We are excluding the production of plywood, MDF, MDO, and other engineered wood products because a non-natural resource, principally a synthetic adhesive, is a material input in the processes that produce engineered wood products.

I. Enviva’s Business

Enviva’s five wood pelleting plants have a combined production capacity of approximately 1.7 million metric tons per year. At each of these facilities, Enviva acquires multiple types of timber feedstock, including round wood timber, chipped wood, lumber scraps, sawdust, and pulpwood for processing into wood pellets. In some cases, Enviva harvests standing timber for its own account for use as a feedstock in the pelleting process.

After the timber feedstocks are delivered to one of Enviva’s pelleting facilities, they are sorted, chipped and ground into a fine wood powder. The wood powder is then dried in a rotary drum style dryer (or in a belt dryer) until its moisture content is reduced to approximately 10 percent. Next, the dried wood powder is ground further to achieve a homogenous free-flowing material with consistent composition and moisture content and then is stored in a work-in-progress inventory bin. In some facilities, small amounts of water or steam are re-injected into the wood powder prior to the final pelleting phase described below.

The feedstock is next fed into a pellet mill chamber known as a die. The die is perforated with holes through which the wood powder is forced by a roller at pressures in excess of 30,000 psi. The intense pressure raises the temperature of the material and uses the natural lignin in the feedstock to bind the pellet together as the feedstock is forced through the holes in the die. Blades mounted on the exterior of the die cut off the pellets. The size of the perforations and the thickness of the wall of the die cavity generally determine the ultimate size of the pellets. The finished pellets usually have a cylindrical form approximately 6-8 millimeters in diameter and are generally no longer than 38

millimeters. After processing, Enviva also transports, stores, markets and distributes the wood pellets. Wood pellets are generally transported and stored in a manner similar to coal (*i.e.* bulk transportation by train, barge and truck).

Because timber is a renewable resource and the wood pelleting process requires no additives other than a small amount of water, many governments have established policies to promote the use of wood pellets as an alternative energy source. As a result, there is strong and stable international demand for wood pellets, particularly in Europe. Moreover, industry demand for alternative energy has created a growing market for wood pellets in the United States. The Partnership markets wood pellets primarily to domestic and international electric utilities, independent power producers and resellers.

II. Treatment of Timber Processing Under the Proposed Regulations

The Proposed Regulations state that “[a]n activity constitutes processing of timber if it is performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances.” Conversely, an activity does not constitute processing of timber if it “add[s] chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp.” The Proposed Regulations also include a non-exhaustive list of products that result and do not result from timber processing:

| Qualifying Timber Products | Non-Qualifying Timber Products |
|--|--|
| Wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark, and rough poles. | Pulp, paper, paper products, treated lumber, oriented strand board/plywood, and treated poles. |

III. Analysis

The approach for addressing timber and timber products in the Proposed Regulations and the list of non-qualifying timber products included therein reflects an indefensible narrowing of the words used by Congress in section 7704(d). Moreover, the approach in the Proposed Regulations presents a sharp departure from the Service’s longstanding interpretations regarding the “processing” of timber, as expressed in eight private letter rulings, spanning more than twenty years:

| PLR | Timber Product | Timber Feedstock | Processes |
|-----------------------------|--|--|---|
| 9008035 (Nov. 24, 1989) | Pulp | Cut Timber | Extracting cellulose fibers, dissolving timber in steam solution of water and chemicals, bleaching, cleaning, drying, and baling. |
| 9105015 (Nov. 1, 1990) | Lumber | Logs | Removing undesired components, such as bark and knots, and cutting logs into lumber lengths and individual boards. |
| 9338028 (June 25, 1993) | Plywood and Fiberboard | Logs, Chips, Saw Dust, and Planer Shavings | Debarking, cutting, steaming, lathing, drying, gluing, hot pressing, trimming, sanding, patching, mixing with resins, and treating with ammonia. |
| 9450029 (Sept. 19, 1994) | Plywood and Lumber | Logs | Debarking, deknottling, cutting into lumber lengths and individual boards, drying in kilns to reduce their moisture content, surfacing by a rotary planer, and chipping waste for sale to pulp or particle board mills. |
| 9822034 (Feb. 26, 1998) | Lumber, Plywood, MDF, and Other Engineered Wood Products (Including Finger Jointed Lumber, Scarfed Plywood, Edge Glued Boards, and Medium Density Overlay) | Logs, Wood Fibers, Shavings, Veneer Panels, Low Grade Studs, and Finished Lumber | Debarking, cutting, surfacing, grading steaming, peeling, drying, applying adhesive, bonding veneer sheets, patching panels, sanding, pressing the refined wood fibers and resin at high temperatures, processing with ammonia, bonding with glue, heat, and pressure, removing defects from studs, scoring studs, chipping scraps, cutting board ends to create fingers, applying heated glue, serrated cutting, bonding sheets of heavy kraft paper that have been impregnated with phenolic resin to panels of plywood using heat and pressure, shaping, painting, packaging and shipping. |

| | | | |
|------------------------------|--|--|---|
| 9822035 (Feb. 26, 1998) | Lumber and Poles | Lumber and Poles | Sale of wood products third party application of preservatives or fire retardants by applying the treatment to the wood under pressure and application of four to eight coats of a sealant. |
| 199932024 (Aug. 16, 1999) | Glued Products | Cut Timber and Lumber | Gluing small pieces of wood together, gluing together wood veneers, bonding the sheets in a hot press, grading, sanding, bonding wood chips, sawdust, and planer shavings, combining, softening, mixing with resins, drying, pressing, treating with ammonia; blending wood wafers together with resins, forming the materials into panels, binding and forming fine wood chips, shaping in the form of panels or boards. |
| 201201002 (July 7, 2011) | Logs, Wood Chips, Lumber Scraps, Sawdust, and Wood Pellets | Cut Timber, Chipped Wood, Lumber Scraps, Sawdust, and Pulpwood | Sorting, chipping, grounding into a fine wood powder, drying, pelleting with a die, cutting, transporting, storing, marketing, and distributing. |

Because there is no basis in the statute or its legislative history for giving the terms “processing” and “refining” different meanings for different natural resource inputs, final regulations should adopt commonsense standards for the terms “processing” and “refining” that should apply to all natural resources. Such standards would be consistent with many, though not all, of the IRS’s prior PLRs addressing timber processing.

First, in accordance with the plain language of section 7704, “processing” and “refining” should have separate definitions.² Second, both definitions should align with the longstanding definitions of

² See § 7704(d)(1) (“[T]he term qualifying income means...income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber)[.]”). The distinct activities that generate qualifying income under section 7704 are separated by

“refining” and “processes” in section 613 and the regulations thereunder.³ Lastly, the definition “processing” should include activities with *inputs* that are natural resources. In the context of timber, there is no difference in the composition of logs, lumber, poles, or wood chips: each is comprised of cellulose fibers, lignin, and hemicelluloses. The current regulations seem to focus on limiting the *outputs* of “processing” and “refining”; that approach finds no support in section 7704 or its legislative history. The requirement that the input of a process be a natural resource aligns with the plain meaning of section 7704, and, we note, is significantly more restrictive than the list of qualifying processes in the existing PLRs.

As described in more detail below, PLRs approving the treatment of lumber and the pulping of cut timber, issued shortly after the enactment of section 7704, correctly applied the plain meaning of “processing” to timber, and correctly concluded that income from the sale of pulp and treated lumber and poles constitutes “qualifying income.” These activities are no different than common processing and refining activities with respect to crude oil, natural gas, and products thereof (such as separation, purification, and blending activities). Moreover, the inputs of the treatment and pulping processes are lumber, poles, and wood chips, all of which retain the intrinsic properties of unadulterated timber: cellulose fibers, lignin, and hemicelluloses.

A. Pulping Is Merely a Form of Separation and Purification.

In PLR 9008035, the Service concluded that “the pulping of cut timber constitutes the processing of a natural resource within the meaning of section 7704(d)(1)(E) of the Code, and that Partnership will derive qualifying income from the manufacture and sale of pulp.” There, the partnership owned a mill that extracted pulp from cut timber using the kraft process. First, either the mill or an outside producer debarked logs and cut them into wood chips. Next, in a pressure vessel known as a digester, the mill dissolved lignin from the chips in a steam-heated solution of water and chemicals. The mill then washed the separated cellulose fibers in water and passed the wet pulp solids (“brown stock”) through knotters, which caught any undigested chips. Finally, the mill bleached, cleaned, dried, baled, and sold the brown stock in bulk to paper producers. On these facts, the Service

commas. Conversely, two words for the same activity, such as “mining” and “production,” are separated by the word “or.” Elementary principles of statutory construction confirm that “processing” and “refining” are separate activities that require separate definitions.

³ See Treas. Reg. § 1.613-4(g)(1), listing non-mining processes. The Proposed Regulations apparently look instead to the *mining* processes in Treas. Reg. § 1.613-4(f)(2)-(6), which have been part of “mining” for over 70 years, and thus should not be part of “processing.”

concluded that the pulping of cut timber constitutes the processing of timber, and thus income from the manufacture and sale of pulp constitutes qualifying income.

The Proposed Regulations erroneously depart from this interpretation.⁴ The Proposed Regulations define “processing” as an activity “done to purify, separate, or eliminate impurities.” Under this general definition, it is difficult to see why the pulping of cut timber does not constitute “processing” and why the drafters of the Proposed Regulations thought it necessary to adopt an unnatural restriction to apply specifically to timber. Raw timber consists of three components, apart from water: cellulose fibers, lignin, and hemicelluloses. Wood pulp is comprised almost entirely of pure cellulose fibers. The pulping process merely *separates* the cellulose fibers from the rest of the timber, that is, the lignin and hemicelluloses. In short, the exclusion of pulping on the basis that using a digester “add[s] chemicals...to timber to manipulate its physical or chemical properties” contravenes the general definition of “processing” in the Proposed Regulations, because pulping purifies, separates, and eliminates impurities in the timber. In so doing, the definition of “processing” for timber also arbitrarily prejudices publicly traded partnerships that process timber, rather than other natural resources, such as crude oil.

The Proposed Regulations should adopt definitions of the terms “processing” and “refining” that are consistent with their plain meaning and can be applied to all natural resources. The definition of “processing” should include activities with natural resource inputs. There is no support in section 7704 or its legislative history for limiting “processing” to activities that do not effect a chemical or physical change, or for limiting “processing” to activities that generate certain outputs. Rather, section 7704 and its legislative history support limiting the inputs of “processing” to natural resources.

The final regulations should allow publicly traded partnerships to separate the components of all natural resources, including timber. The pulping process merely separates the components of timber: cellulose fibers, lignin, and hemicelluloses. The Preamble acknowledges that petroleum refineries not only separate the components of crude oil, but also add chemicals and foreign substances to manipulate crude oil’s physical or chemical properties.⁵ Inexplicably, the Proposed

⁴ Note that the very first private letter ruling ever issued by IRS regarding Section 7704(d)(1)(E) addressed the pulping of timber, and concluded that pulping was within the meaning of “processing” of timber for the purposes of Section 7704(d)(1)(E).

⁵ “An activity that chemically converts the physically separated components is processing or refining of crude oil only if one or more of the products of the conversion are recombined with other physically separated components

Regulations permit the separation of crude oil, but not timber. As in the separation of crude oil, the input in the kraft pulping is a natural resource. The composition of wood chips is identical to the composition of timber. Any foreign substances in the pulping process are catalysts, rather than inputs. That is, the foreign substances in the kraft process temporarily facilitate separation of the timber; they do not permanently adhere to or combine with the input, like resin adheres to wood fibers in the production of MDO. In other words, the foreign substances in pulping are processors, rather than inputs that are being processed.

The final regulations should treat activities, such as pulping, that separate natural resource inputs into their constituent components, as generating qualifying income. Therefore, “pulp” should be listed as a product that results from timber processing or refining.

B. Treatment of Lumber and Poles Constitutes the Processing of Timber.

In PLR 9105015, the Service concluded that “processing” includes the sawmilling of timber to (1) remove undesired components, such as bark and knots, from logs, (2) cut the logs into lumber lengths, and (3) further cut the logs into individual boards that are sold on a wholesale basis.

In PLR 9822035, the Service concluded that “processing” also includes treating softwood and hardwood lumber and timber poles. Treatment of lumber involves applying a preservative or fire retardant to the wood under pressure, then sealing the wood by applying coats of a sealant. Poles are simply timber logs which have been debarked and, in some cases, cut to standard lengths. The treatment process for poles is the same as for lumber.

The Proposed Regulations list “treated lumber” and “treated poles” as products that are not the result of timber processing, while “rough lumber” and “rough poles” are listed as qualifying products.⁶ The general definition of “processing” in the Proposed Regulations states, “an activity will

of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline.”

⁶ We note that the Proposed Regulations are unclear about what constitutes “rough lumber” and “rough poles.” Lumber, by definition, is timber that has been cut into boards and, sometimes, planed and sanded. While the

not qualify as processing...if the activity causes a *substantial* physical or chemical change in a mineral or natural resource, or transforms the extracted mineral or natural resource into new or different mineral products or into manufactured products.” Thus, the standard for timber is more stringent than the general standard, as the definition of “processing” for timber includes activities with *no* foreign substances, and excludes activities that add *any* foreign substances “to manipulate timber’s physical or chemical properties....” The last clause of the timber processing standard—“to manipulate its physical or chemical properties”—is at best vague, and at worst is an arbitrary narrowing of “processing” exclusively for the timber industry. Any standard in the final regulations should be uniform for all natural resources.

The definition of “processing” for timber and other natural resources should not prohibit processes that effect a chemical change, substantial or otherwise. Rather, as discussed above, “processing” should include activities with inputs that are natural resources. “Processing” should also permit the addition of an immaterial amount of additives to enhance or protect the intrinsic properties of the natural resource, such as the treatment of lumber to protect the underlying wood, or the addition of detergent additives to gasoline.

Additionally, many products require the application of a nominal amount of additives to meet environmental and other regulatory standards. For example, the U.S. Environmental Protection Agency (“EPA”) requires the addition of certain detergent additives to gasoline and diesel to control fuel injector and intake valve deposits.⁷ Just as the addition of these additives qualifies as “processing” of “oil, gas, or products thereof,”⁸ the addition of additives to timber to meet regulatory standards should qualify as “processing” of timber. To create a consistent standard that accords with the plain language of section 7704 and its legislative history, the final regulations’ definition of “processing” should permit the addition of small amounts of additives to meet regulatory requirements.

While we believe that the definition of “processing or refining” of timber in the Proposed Regulations must be revised to appropriately administer section 7704, we note that treated lumber and poles should be listed as products of timber processing even under the existing standard in the Proposed Regulations. Treatment processes *protect*, rather than manipulate, the timber’s physical and

regulations apparently indorse such lumber as a qualifying product, the term “rough” in this context has the potential to create uncertainty.

⁷ See 40 C.F.R. § 80.161(a)(iii).

⁸ “Oil, gas, or products thereof” includes gasoline. See H.R. Rep. No. 100-495 (Dec. 21, 1987).

chemical properties, generally from fire and other environmental hazards. The internal discord between the general timber processing standard and the list of excluded products demonstrates the Proposed Regulations' focus on excluding outputs, rather than inputs, of processing. Because "processing" is inherently a broad term that encompasses many activities, it is infeasible to address every existing and future process and output for every natural resource, much less create an exclusive list of qualifying activities. The list of natural resource inputs, on the other hand, is much shorter and will not change.

We also note that the standard in the Proposed Regulations raises the issue of intent, that is, whether the processor adds the chemical or foreign substance *to manipulate* timber's physical or chemical properties. Under this standard, it appears that the addition of vegetable oil to dried wood feedstock, for example, to lubricate a wood pellet mill chamber, would qualify as "processing" because the oil is not added to manipulate the wood. While we believe this is the correct result, it seems unduly burdensome to incorporate intent into the definition of "processing." To align with the plain language of section 7704, the definition of "processing" should apply consistently to all natural resources, and should focus on whether the input of the process is a natural resource, rather than whether the output has undergone a chemical or physical change.

C. The Addition of Additives to Wood Pellets Is No Different than the Addition of Additives to Refined Petroleum Products.

The Proposed Regulations list wood pellets as a product that results from timber processing. However, the Proposed Regulations prohibit the addition of chemicals or other foreign substances to timber "to manipulate timber's physical or chemical properties." As discussed above, the final regulations should permit the addition of small amounts of additives that enhance or protect the intrinsic properties of the natural resource, or are necessary to meet environmental standards. Needless to say, any limitation on additives should not hinge on the intent of the timber processor.

Although wood pellets are commonly made without the addition of any non-timber additives (other than water),⁹ it is possible, if not likely, that customers or regulators may require the addition of

⁹ It should be noted that water is added to the timber feedstocks that make up pellets, but the net result of the pelleting process is, in almost all cases, a reduction in the water present in the timber that makes up the pellets.

an additive to reduce the emissions profile of wood pellets. For example, if environmental regulators determine that an additive would reduce the impact of burning wood pellets, the regulators may require the application of such an additive to all wood pellets sold to utilities within the regulated jurisdiction. Such regulations would likely be similar to the regulations that currently require the application of additives to gasoline.¹⁰ The addition of a relatively small amount of additives (*e.g.*, less than [5]% of the net weight of the pellet) to protect or enhance the intrinsic properties of the wood should not affect whether processing of timber into wood pellets generates qualifying income.

D. The Final Regulations Should Not Include the MACRS Asset Class Limitation.

Even in situations where a taxpayer engages in a processing or refining activity that meets the first two requirements of the “processing or refining definition, the final requirement of the definition would deny qualifying income status to income derived from that activity if the taxpayer fails to use “an appropriate” MACRS class life for purposes of depreciation of the assets used in that activity. This rule would apparently apply even if the taxpayer’s failure were reasonable, inadvertent, isolated, or the result of the IRS’s refusal to grant consent to change to an appropriate depreciation method.¹¹ Requiring a PTP to have appropriately classified all assets used in the activity under MACRS has no statutory support and would create great uncertainty for PTPs and their investors because qualifying income from processing or refining would be dependent upon an IRS audit determination that an asset was properly classified under MACRS.

The insertion of a MACRS class life requirement into any definition of processing or refining is inconsistent with the language of section 7704(d)(1)(E). Regardless of the precise interpretation of the statutory terms “processing” and “refining,” a processing or refining activity cannot become something else merely because a taxpayer uses a specific depreciation method or uses a different asset to accomplish the same result. Under the Proposed Regulations, two taxpayers who do exactly the same things for exactly the same reasons in exactly the same manner could be treated as performing different activities based on the depreciation method they might elect. The inconsistency of this result is compounded by the widely accepted belief that the MACRS categorization system is significantly outdated.¹²

¹⁰ See 40 C.F.R. § 80.161(a)(iii).

¹¹ See Treas. Reg. § 1.446-1(e)(2)(iii), Ex. 14 (requiring IRS consent to change the MACRS class life for an asset).

¹² In a report to Congress in 2000, the Department of the Treasury reported:

The current depreciation system is dated. The asset class lives that serve as the primary basis for the assignment of recovery periods have remained largely unchanged since 1981, and most class lives date back at least to 1962. Entirely new industries have developed in the interim, and manufacturing processes in traditional industries have changed. These developments are not reflected in the current cost recovery system, which does not provide for updating depreciation rules to reflect new assets, new activities, and new production technologies.

The only logical approach is to determine whether a taxpayer's activity is processing or refining for purposes of Section 7704(d)(1)(E), and then, if deemed necessary and legally permissible, impose on the taxpayer's assets a MACRS class life that is consistent with that conclusion. The Service already enforces its interpretation of the MACRS rules in this manner. It is not necessary to interject regulation of MACRS issues into the qualifying income regulations.¹³

IV. Recommendations

For the foregoing reasons, we believe that the final regulations should contain separate definitions of "processing" and "refining." These definitions should not include chemical or physical change limitations, and should not limit qualifying income by reference to the MACRS asset classes. Rather, these definitions should require all material inputs of processing and refining to be natural resources, and should permit the addition of immaterial additives to protect or enhance the natural resource input, or to meet environmental regulatory standards. For this purpose, a foreign substance that catalyzes the processing of a natural, such as a chemical or detergent that aids in the separation of timber, should not be considered a material input.

Sincerely,



Carlisle Sewell

Director, Tax Planning and Compliance
Enviva LP

See U.S. Department of the Treasury, Report to the Congress on Depreciation Recovery Periods and Methods, Washington, D.C.: Office of Tax Policy (July 28, 2000).

¹³ See, e.g., TAM 200629031; FSA 199949016 (discussing when taxpayers should be required to use MACRS asset class 13.3).