HOLLY ENERGY PARTNERS

July 29, 2015

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

Re: Comments on Code Section 7704 Proposed Regulations (REG-132634-14)

To Whom It May Concern:

Holly Energy Partners, L.P. ("***HEP***") is a publicly traded limited partnership (NYSE:HEP) that is engaged in the business of operating a system of petroleum product and crude oil pipelines, storage tanks, distribution terminals and loading rack facilities in several states. We appreciate the opportunity to submit comments to the Department of the Treasury (the "***Treasury***") and the Internal Revenue Service (the "***IRS***") regarding the definition of "qualifying income" in the proposed regulations under section 7704(d)(1)(E) of the Code (the "***Proposed Regulations***").[1]

As an operator of refined product terminals and a service provider to the refinery industry, we are concerned that (i) the section 7704(d)(1)(E) activities of "marketing" and "transportation" in the Proposed Regulations are too narrow with respect to blending and terminalling activities, respectively, and (ii) the "intrinsic activity" standard in the Proposed Regulations is too subjective and does not provide a sufficient level of comfort for taxpayers performing services that are incidental to and necessary for section 7704(d)(1)(E) activities. We are writing to request that the Proposed Regulations be modified so that final regulations (i) clarify that "transportation" includes services typically performed at terminals, such as blending of natural resources and additives, and qualifying blending activities include blending with respect to any natural resource (not only fuels) and (ii) include an alternative test under which services could qualify as intrinsic to section 7704(d)(1)(E) activities. In addition, we provide an example applying this alternative test.

Qualifying Income from Natural Resource Blending Activities

Terminals are centralized facilities where natural gas or crude oil is transferred to or from storage or transportation networks (pipeline, rails, trucks, etc.) for distribution. Services provided at the terminals typically include (i) receiving products from pipelines, trucks, or railcars, (ii)

[1] Unless otherwise noted, all references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended (the "***Code***"), and all references to "Treasury Regulation" or "Treas. Reg." are to the regulations promulgated thereunder.

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storing products, (iii) inventory management, and (iv) loading products to pipelines, trucks, or railcars for distribution. In connection with such terminalling activities, most terminal owners or operators often inject additives into fuel as the fuel is being loaded over the "rack" and into delivery vehicles.[2] These additives are often required by applicable regulations or otherwise injected to enhance motor fuel blend stock based on customer specifications.[3] Additionally, at the lube oil loading rack, additives are often blended into refined petroleum distillates and lube oil base stocks to create specialty lubricating oils and greases.[4] The non-petroleum derived components of the resulting lube blends and greases generally makes up less than 10 percent of the total lube blend.

A publicly traded partnership may earn different types of income attributable to the blending activities. A wholesale fuel distributor that owns the underlying product blended at terminals and delivers such underlying product to its customers derives income from the wholesale marketing of fuel or gasoline. HEP, on the other hand, does not own the underlying product and is solely a service provider with respect to its customers' product. HEP derives income from providing terminalling and transportation services (including blending services) to its customers. As such, HEP is engaged in terminal operations and transportation services other than to facilitate the sale of its own qualifying products, and thus blending activities should not solely be considered as part of "marketing." Prior to the issuance of the Proposed Regulations, the IRS has previously held in numerous instances that the various blending activities provided by service providers at terminals constitute qualifying income.[5]

We believe that the use of the word "fuels" in the Proposed Regulations inadvertently excludes previously approved blending activities.[6] Practically, there is no difference between

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[2] A "rack" is simply the complex of equipment necessary to load a delivery vehicle with fuel or lube oil. 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."

[3] 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. Ethanol and biodiesel are also used by HEP to blend into gasoline and diesel fuel, respectively, to satisfy EPA guidelines.

[4] Lubricants, including greases, are listed as a "Major Refinery Product" in the OSHA Technical Manual's section on petroleum refining. OSHA Technical Manual, Section IV Chapter 2, available at https://www.osha.gov/dts/osta/otm/otm_iv/otm_iv_2.html.

[5] Priv. Ltr. Rul. 2014-03-004 (September 16, 2013); Priv. Ltr. Rul. 2012-32-008 (April 19, 2012); Priv. Ltr. Rul. 2012-06-004 (October 31, 2011); Priv. Ltr. Rul. 2009-21-010 (February 10, 2009); Priv. Ltr. Rul.2007-12-002 (December 7, 2006); PLR 2006-38-018 (June 13, 2006); and Priv. Ltr. Rul. 2004-22-023 (February 10, 2004).

[6] Since 2003, the IRS has issued over 15 private letter rulings to taxpayers with respect to blending activities, including 10 relating specifically to lubricants. Priv. Ltr. Rul. 2014-03-008 (September 13, 2013) (blending refined petroleum distillates and lube oil base stocks with a "soap" or "thickener" to create the desired lubricant-greases and packaging and sale of lubricant-greases); Priv. Ltr. Rul. 2013-01-010 (September 28, 2012) (blending, processing, packaging, marketing, and distribution of [redacted] lubricants that are a blend of hydrocarbon-based feedstocks and small amounts of additives); Priv. Ltr. Rul. 2012-26-018 (December 7, 2011) (blending and sale of private label automotive lubricants, as well as the sale of branded lubricants and related products, to automotive dealerships, "quick lube" stores and commercial and industrial end users); Priv. Ltr. Rul. 2011-29-028 (April 7, 2011) (purchasing refined petroleum distillates and lube oil base stocks from crude oil refineries, blending and processing the base stocks (in some cases adding non-petroleum additives of less than a% of the total lube blend) and packaging

blending additives, ethanol, or biodiesel into fuels or blending additives into petroleum distillates and lube oils. HEP recommends that the IRS and the Treasury amend the definition of marketing in section 1.7704-4(c)(7) to state, "An activity constitutes marketing if it is performed to facilitate sale of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section, including blending additives into minerals or natural resources."

Additionally, the Proposed Regulations treat blending activities as qualifying income but only under "marketing" in section 1.7704-4(c)(7). The MLP industry, however, has generally considered blending activities as a terminalling function as well (i.e., transporting or processing natural resources for a fee). For instance, similar to HEP, 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. Therefore, HEP agrees that blending additives should be included in the definition of "marketing" with respect blending activities being conducted by the owner to facilitate a sale but because blending also occurs at the terminals as a fundamental part of terminalling and transportation services, we believe that such activity should also qualify as a part of the "terminalling" activity and constitute "transportation" for purposes of section 1.7704-4(c)(6). HEP recommends that section 1.7704-4(c)(6) should be amended to add a new section 1.7704-4(c)(6)(iii) after "Terminalling" stating "Blending additives into a mineral or natural resource in association with transportation or terminalling activities" and current subparagraphs (iii), (iv) and (v) should be redesignated as subparagraphs (iv), (v) and (vi), respectively.

Qualifying Income from Intrinsic Activities

The Proposed Regulations provide that certain limited support activities that are intrinsic to the specifically enumerated activities in section 7704(d)(1)(E) produce qualifying income if they meet three requirements: (1) the activity is specialized to support a section 7704(d)(1)(E) activity, (2) the activity is essential to the completion of the section 7704(d)(1)(E) activity, and (3) significant services are provided to support the section 7704(d)(1)(E) activity. With respect to the first requirement, both the personnel and the property used in the activity must be specialized and personnel are specialized only if they have received training unique to the applicable mineral or natural resource industry, and the training is of limited utility other than to support a section 7704(d)(1)(E) activity. An activity is essential to a section 7704(d)(1)(E) activity if it is necessary to physically complete the activity or comply with federal or state law regulating the section 7704(d)(1)(E) activity. With respect to the third requirement, the Proposed Regulations provide that, to be considered "significant," services must be conducted on an ongoing or frequent basis by the partnership's personnel at the site or sites of the section 7704(d)(1)(E) activity.

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and marketing the resulting specialty lubricants to wholesale distributors); Priv. Ltr. Rul. 2008-48-018 (August 26, 2008) (refining and processing crude oil into a wide variety of customized lubricating oils, solvents and waxes and packaging and marketing the refined and processed products); Priv. Ltr. Rul. 2007-18-010 (January 19, 2007) (purchasing highly refined petroleum base oils from refineries, blending the petroleum base oil with latest additive technology to make it more suitable for its intended use as lubricating oil, packaging the lubricating oil and selling lubricating oil to retailers who then sell the product through their own retailers or in bulk to wholesale distributors); Priv. Ltr. Rul. 2007-18-009 (January 19, 2007) (same); Priv. Ltr. Rul. 2007-18-007 (January 19, 2007) (same); Priv. Ltr. Rul. 2007-18-006 (January 19, 2007) (same); Priv. Ltr. Rul. 2007-18-005 (January 19, 2007) (same).

The proposed "intrinsic activity" standard is subjective, and we believe it will prove challenging to apply in many situations where a high level of certainty is required. Under the first requirement of the proposed standard, it is unclear how much training is necessary for a skill to be considered specialized. Furthermore, in determining whether property is specialized, the "limited use outside section 7704(d)(1)(E)" factor is particularly vague. Finally, the Proposed Regulations appear to exclude important support services, such as repair and maintenance of equipment and facilities used to provide services, from consideration, even though maintaining and repairing such equipment and facilities is essential to providing services on a near-continuous basis as required under typical services agreements. Under the third requirement, a facts and circumstances test is applied to determine if services are "significant" because they are performed on a frequent or ongoing basis. This requirement is similarly subject to various interpretations.

We believe that clarity and objectivity with respect to the provision of services in this area can be achieved by creating an alternative test within the "intrinsic activity" standard. Under the alternative test, activities of a service provider would qualify as intrinsic to a section 7704(d)(1)(E) activity if they would have qualified as a section 7704(d)(1)(E) activity, or an indispensable part thereof, if performed directly by the service recipient. In other words, if the activity/service is incidental to and necessary for[7] the section 7704(d)(1)(E) activity, the outsourcing of the service should not cause the income from that segment of the activity, performed by a third party, to be non-qualifying.

To incorporate this exception, section 1.7704-4(d)(1) of the Proposed Regulations could be amended as follows:

General requirements. An activity is an intrinsic activity only if (i) the activity is incidental to and necessary for a section 7704(d)(1)(E) activity and would qualify as a section 7704(d)(1)(E) activity, or part thereof, if performed by the direct participant therein instead of by a third party service provider or (ii) 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. Whether an activity is an intrinsic activity is determined on an activity-by-activity basis.

Section 1.7704-4(e) of the Proposed Regulations could be amended to add the following new example:

Example 7. Hydrogen production services at refinery.

(i) Y, a publicly-traded partnership, owns a steam methane reformer located onsite at a crude oil refinery owned and operated by Refiner. Y has a tolling agreement with Refiner under which Y receives a fee to

[7] We believe the "incidental to and necessary for" standard is appropriate in the case of intrinsic activities as supported by its usage in Treas. Reg. § 1.612-4(a) with respect to intangible drilling and development costs ("***IDCs***"). In the context of IDCs, such standard is used to determine whether expenditures paid or incurred by an operator in certain section 7704(d)(1)(E) activities, such as development and production, can be expensed, instead of capitalized.

process methane provided by Refiner within the steam methane reformer and then to deliver the produced output of hydrogen to Refiner, all of which is used in various parts of Refiner's crude oil refinery. Title to the input and the output of the steam methane reformer remains with Refiner throughout the process. Y owns, operates, services, repairs and maintains the steam methane reformer.

(ii) If Refiner owned and operated the steam methane reformer and used the hydrogen output in its refining process, such activity would qualify as the section 7704(d)(1)(E) activity of processing or refining petroleum in (c)(5). Y's income from the processing of methane via its steam methane reformer is qualifying income for purposes of section 7704(d)(1)(E) because Y is providing a service that is incidental to and necessary for Refiner's refining operations, which if Refiner had performed directly, would qualify as refining for purposes of section 7704(d)(1)(E).

Additionally, we received a favorable private letter ruling from the IRS to the effect that income from the operation of an onsite air separation unit used to supply nitrogen and oxygen solely to a crude oil refinery, and the provision of services related thereto, is qualifying income under section 7704(d)(1)(E).[8] If the Proposed Regulations become final in their current form, it will be unclear whether such operation and services qualify as intrinsic activities to a section 7704(d)(1)(E) activity and whether we can rely on our private letter ruling after the 10 year transition period. The operation of, and the provision services related to, an onsite air separation unit would qualify as an intrinsic activity under the proposed alternative test detailed above.

We believe that the foregoing changes will result in a clear and workable definition of intrinsic activities that is consistent with the language of section 7704(d)(1)(E).

Sincerely,

Leslie Simmons

Leslie Simmons
Director of Taxation
Holly Energy Partners, L.P.

[8] Priv. Ltr. Rul. 2014-08-008 (October 29, 2013).