"When Service Matters"

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Internal Revenue Service
CC:PA:LPD:PR (REG-132634-14)
Room 5203
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

Gentlemen:

Quality Magnetite, LLC is pleased to submit comments to the Internal Revenue Service (the "***Service***") regarding the Proposed Treasury regulations (REG 132634-14) (the "***Proposed Regulations***") that define "qualifying income" under section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended (the "***Code***"). We believe that our gross income from our business of processing and marketing magnetite, a naturally occurring form of iron oxide, is qualifying income from the processing and marketing of natural resources under section 7704(d)(1)(E). The Proposed Regulations as drafted, however, appear generally to treat mineral processing activities as non-qualifying activities and unnecessarily raise doubt as to whether a crushed form of iron oxide is still a natural resource. We believe this result is inconsistent with the plain language of section 7704, and we are submitting this comment letter to request that the final regulations clarify that processing activities such as ours generate qualifying income and that crushed iron oxide remains a natural resource.

Specifically, the definition of "qualifying income" in the Proposed Regulations treats processing and refining as a single activity, contrary to the plain language of section 7704(d)(1)(E), which treats processing and refining as separate activities. Further, the Proposed Regulations appear to limit processing of minerals to activities that constitute mining under Treas. Reg. § 1.613-4(f). There appears to be no basis for the limitations in the proposed regulations – no support can be found for them in section 7704 or its legislative history.

Instead, the final regulations should define mineral processing to include non-mining processes described in Treas. Reg. § 1.613-4(g)(1).

The Proposed Regulations also require that the partnership's position that an activity is processing or refining be "consistent with" the Modified Accelerated Cost Recovery System ("***MACRS***") asset class for the assets used in that activity. Using MACRS asset class descriptions as a proxy for qualifying activity descriptions may be convenient, but the asset classes are largely meaningless in determining what is qualifying income.

Additionally, the Proposed Regulations exclude from qualifying activities "activities that cause a substantial physical or chemical change in a mineral or natural resource, or that transform the extracted mineral or natural resource into new or different mineral products, including manufactured products." As described in more detail below, we process magnetite ore via crushing and milling to meet customer specifications. Where only the size of our product is changed, we do not see any rationale for excluding the crushing and milling from "processing" nor sale of the resulting magnetite from qualifying "marketing" income.

I. Our Business

We are a small company that globally sources and processes magnetite, a type of iron oxide that possesses natural magnetic properties (chemical formula Fe3O4). Raw magnetite, after being extracted from the ground, crushed and separated from sand and other unwanted material, is transported from various points of origin to our primary processing facilities in Kenova, West Virginia and Mount Vernon, Indiana. To process the magnetite ore, we first dry the magnetite. The magnetite ore is then sifted on a vibrating screen to remove any remaining undesirable debris. If necessary, the ore is sized by additional crushing or milling of the magnetite to satisfy our customers' desired consistency. Our processed magnetite ranges from 135u to 1u (.005315 inches to .00003937 inches). The sized magnetite is then delivered to storage silos or the bagging station and later delivered to our customers.

Over 90% of our magnetite sales are to coal washing plants where the magnetite is used in coal flotation to assist with causing debris to separate out from the processed raw coal. Not only are we processing and marketing magnetite (a natural resource per the definition of section 7704(d)(1)(E)), but we are also assisting in the processing of another natural resource, coal. Given that we start with a natural resource (iron oxide) and simply crush and mill it to the appropriate size, then sort and sell the product, we believe prior interpretations of section 7704(d)(1)(E) would have included activities such as our and that any reasonable standard adopted by final regulations for processing and marketing of a natural resource should include activities such as ours.

II. Discussion

The Definition of "Processing and Refining" in the Proposed Regulations Is Inconsistent With the Language of Section 7704.

Section 7704(d)(1)(E) defines "qualifying income" as:

> 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….

In the statute, each distinct qualifying activity is separated by a comma, with the exception of "mining" and "production," which are separated by the word "or." This makes sense, because "mining" and "production" are different words for the same qualifying activity. Specifically, ores and minerals are "mined," while oil and gas are "produced." By separating each qualifying activity with commas, the plain language of section 7704 indicates that Congress intended "processing" and "refining" to be separate qualifying activities. However, the Proposed Regulations treat the separate activities of "processing" and "refining" as a single "processing or refining" category.

The Definition of "Processing or Refining" Effectively Writes the Word "Processing" Out of Section 7704.

Under the Proposed Regulations, an activity is processing or refining of ores and minerals if it is either a "mining process" described in Treas. Reg. § 1.613-4(f)(1)(ii) or "refining" as described in Treas. Reg. § 1.613-4(g)(6)(iii). Section 613(c)(2) and Treas. Reg. § 1.613-4(f)(1)(ii) include the "mining processes" referred to in the Proposed Regulations in the definition of *mining*, not processing.[1] Thus, the Proposed Regulations define "processing and refining" to mean only activities that constitute mining and refining. For hard minerals, this has the effect of writing the word "processing" out of section 7704.

When Congress enacted section 7704 in 1987, it chose to employ the same words or variations thereof that Congress used in section 613 and which the Treasury Department defined in the section 613 regulations.[2] The section 613 regulations were first promulgated in 1943, under the Internal Revenue Code of 1939.[3] Each time Congress amended section 7704, it

[1] In addition, the proposed regulations erroneously define mining of ores and minerals to mean only activities "performed to extract minerals or natural resources from the ground" and exclude the mining processes that are part of the definition of mining in 1.613-4(f)(1).

[2] *See* T.D. 6446, 1960-1 C.B. 208.

[3] *See* Revenue Act of 1943, § 124 ("(c) Definition of gross income from the property. Section 114(b)(4) is amended by adding at the end thereof the following: (B) Definition of gross income from property. As used in this paragraph the term 'gross income from the property' means the gross income from mining. *The term 'mining', as used herein*,

did so against the backdrop of these definitions in those regulations. Congress could not have intended to restrict "processing" to the mining processes in section 613. Accordingly, the final regulations should define "processing" consistently with the definitions in section 613 and the regulations thereunder. Since "mining" and "processing" are separate qualifying activities under section 7704, "processing" cannot mean mining processes described in Treas. Reg. § 1.613-4(f)(2)-(6). Therefore, "processing" must mean processes that are neither mining nor refining.

Under Section 613 Regulations, "Processing" Includes Nonmining Processes Such as Pulverization (Including Crushing and Milling).

The section 613 regulations divide "processes" into "mining processes" (which are part of the definition of "mining") and "non-mining processes," *i.e.,* processes that are not mining and therefore are not taken into account in determining the depletion cutoff point.[4] Treas. Reg. § 1.613-4(g)(1) defines nonmining processes to include such processes as "electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping." The list of processes in Treas. Reg. § 1.613-4(g)(1) does not, however, include the manufacturing processes listed in Treas. Reg. § 1.613-4(g)(4), which describes "[t]he production, packaging, distribution, and marketing of manufactured products, and the processes necessary or incidental thereto[.]" Our magnetite processing business incorporates only one of these processes: fine pulverization through crushing and milling.

The Proposed Regulations include a separate limitation on processes that cause "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. Several of the non-mining processes, such as calcining, smelting and thermal action, result in a chemical change to the ore or mineral.[5] The preamble to the

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shall be considered to include not merely the extraction of the ores or minerals from the ground but also *the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products*....") Emphasis added. The Act then described mining processes and non-mining processes.

4 See Treas. Reg. § 1.613-4(f)(2)-(6), -4(g). Section 611 provides depletion deductions for mines, wells and other natural deposits. In an integrated mining operation, the producer is entitled to claim percentage depletion on the value of the mineral or natural resource after the completion of all mining processes. This point is referred to as the "depletion cut-off point." The legislative history to section 7704(d)(1)(E) makes clear that the reference to depletion was intended only to identify the minerals and natural resources and was not intended to suggest that qualifying income must itself be income that would qualify for percentage depletion. S. Rep. No. 445, 100th Cong., 2d Sess. 424 (1988).

5 The Proposed Regulations include a separate limitation on processes that cause "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. The preamble to the Proposed Regulations suggests that the source of this rule is section 1.613-4(g)(5) of the Treasury Regulations, which defines "transformation processes" in a similar manner and treats them as nonmining processes that may not be taken into account for

Proposed Regulations suggests that the source of this rule is Treas. Reg. § 1.613-4(g)(5) of the Treasury Regulations, which defines "transformation processes" in a similar manner and treats them as nonmining processes that may not be taken into account for depletion purposes. There is no support in section 7704 or its legislative history for such a limitation, and even if there was, it would not justify treating all non-mining processes – such as fine pulverization through crushing and milling – as nonqualifying activities.

The Treasury Regulations treat "[c]rushing and grinding" as mining processes, but not "fine pulverization."[6] Instead, the Treasury Regulations characterize fine pulverization, defined as grinding or size reduction process applied to reduce the normal topsize of a mineral product to less than .0331 inches," as a "non-mining process."[7] Finely pulverized minerals are harder to ship than ground or crushed minerals, as the size and weight of the particles increases the risk of loss; thus, minerals are not pulverized to bring them to shipping grade. Thus, distinguishing between crushed and finely pulverized minerals may make sense in determining the depletion cutoff point. However, there is no basis whatsoever to determine whether a particular mineral grinding activity produces qualifying income based on the size of the particles. Other than its size, there is no difference – physical or chemical – between unprocessed magnetite and processed magnetite.[8] It is still magnetite and thus it is still a natural resource.

MACRS Limitation Creates Confusion.

For an activity to qualify as processing or refining, the Proposed Regulations also require the partnership's position that the activity is processing or refining be "consistent with" the partnership's designation of a MACRS asset class for the assets used in that activity. The MACRS asset classifications were not intended to distinguish refining and processing from other activities. They do not even cover all types of business activities. In the context of processing a hard mineral, this limitation causes only confusion.

III. Recommendations

The final regulations should include the following revisions to give effect to the plain meaning of section 7704:

- Provide separate definitions for "processing" and "refining."

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depletion purposes. There is no support in section 7704 or its legislative history for such a limitation, and even if there was, it would not justify treating all nonmining processes as nonqualifying activities.

6 Treas. Reg. § 1.613-4(f)(5)(i). Fine pulverization is considered a mining process, however, if it is necessary to another process that is a mining process; for example, if fine pulverization is a prerequisite to concentrating the mineral, then it is treated as a mining process. Treas. Reg. § 1.613-4(f)(2)(iii).

7 Treas. Reg. § 1.613-4(g)(6)(v).

8 Drying and removal of waste material are mining processes. See Treas. Reg. § 1.613-4(f)(5) (crushing and grinding, size classification and drying to remove free water treated as mining processes).

- Include the mining processes described in Treas. Reg. § 1.613-4(f)(1)(ii) in the definition of "mining."

- Define "processing" to include nonmining processes described in Treas. Reg. § 1.613-4(g)(1). At a minimum, the final regulations should identify fine pulverization of minerals as a qualifying activity.

- Strike the MACRS consistency requirement.

We are happy to answer any questions or otherwise provide information that will be helpful in your efforts.

Sincerely,

Allen Varney

Allen Varney
President