

August 4, 2015

**Via Federal eRulemaking Portal**

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 Proposed REG-132634-14, Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources

Dear Sir or Madam:

Sempra Energy, a California Corporation (“**Sempra**”, “**we**” or “**us**”), appreciates the opportunity to submit this letter in response to the request for comments on the Proposed Treasury Regulations Section 1.7704-4<sup>1</sup> (the “**Proposed Regulations**”) issued under Section 7704 of the Internal Revenue Code of 1986, as amended (the “**Code**” or “**Section**”), made by the Department of the Treasury (the “**Treasury**”) and the Internal Revenue Service (the “**IRS**”).<sup>2</sup> The Proposed Regulations propose definitions for the activities a publicly traded partnership may engage in to generate qualifying income for purposes of Section 7704(d). In order to assist in developing accurate guidance, we would like to point out that the Proposed Regulations fail to specifically include natural gas liquefaction and regasification in the exclusive list of processing activities that generate qualifying income. Treating income derived from such activity as qualifying income is consistent with the legislative history of Section 7704 and the IRS's conclusions in Priv. Let. Rul. 201224023.

The remainder of this comment sets forth our recommendation, outlines the state of the liquefied natural gas (“**LNG**”) industry, discusses the effect that the Proposed Regulations, as currently written, may have on the characterization of natural gas liquefaction and regasification, and describes why specifically enumerating liquefaction and regasification as a qualifying activity would comport with the legislative history of Section 7704(d)(1)(E) and the IRS's published position.

I. Summary of Recommendation

LNG processing and the transportation and marketing of LNG should be explicitly included in the Proposed Regulations' list of activities that generate qualifying income for the purposes of Section 7704. Congress has indicated through legislative history that the definition

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<sup>1</sup> REG-132634-14, 80 F.R. 25970-25977 (May 6, 2015)

<sup>2</sup> This request was made in the Notice of Proposed Rulemaking dated May 6, 2015.

of a Section 7704(d)(1)(E) activity includes activities related to natural resources that have not been chemically altered, but not derivatives of those natural resources. LNG is chemically unaltered natural gas that has simply been purified and processed into a liquid to facilitate transport and marketing. Enumerating LNG processing as an activity that generates qualifying income is consistent with Congressional intent and the IRS's conclusions in Priv. Let. Rul. 201224023, and will provide certainty to MLPs that are or will be engaged in natural gas liquefaction or regasification.

## II. The State of the Industry

Natural gas liquefaction is the process of converting natural gas into its liquid form for easier transport and marketing. The liquefaction process involves the removal of contaminants such as sulfur, mercury, water, carbon dioxide and heavy hydrocarbons. The natural gas is then condensed into a liquid by cooling the gas to negative 260 degrees Fahrenheit. LNG takes up about 1/600th the volume of natural gas in the gaseous state. LNG can then be transported to markets where a pipeline would not be feasible, including overseas markets. Before the LNG can be sold to consumers and used, it must be reconverted into its gaseous state at a regasification facility. The LNG produced by a natural gas liquefaction facility can be transported, sold, or stored for later use. There are MLPs currently developing liquefaction facilities in the United States.

## III. Application of The Proposed Regulations to LNG Activities

Section 7704 provides that a publically traded partnership may only be treated as a pass-through entity for federal income tax purposes if 90 percent of its income is characterized as "qualifying income" under Section 7704(c)(2).<sup>3</sup> Section 7704(d)(1)(E) defines qualifying income as including, in part, "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." Natural gas is recognized to be a natural resource as defined by Section 7704(d)(1)(E),<sup>4</sup> but there is no definition in the statute for any of the above listed qualifying activities.<sup>5</sup>

The Proposed Regulations attempt to define qualifying income and the activities that can generate qualifying income under Section 7704(d)(1)(E). These Proposed Regulations were introduced in order to provide an exclusive list of the activities that produce qualifying income under Section 7704.<sup>6</sup> Under the Proposed Regulations, qualifying income is defined as including only income and gains from qualifying activities with respect to minerals or natural resources as defined in Section 1.7704-4(b) of the Proposed Regulations. The term "qualifying activities" is defined to include "Section 7704(d)(1)(E) activities" and "intrinsic activities." This comment letter will address how LNG will be treated under the Proposed Regulations' definition of (i) processing and refining, (ii) transportation, and (iii) marketing.

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<sup>3</sup> I.R.C. § 7704(a)-(c).

<sup>4</sup> See S Rep 100-445, at 424 (1988) (stating that "natural resource" includes any product of a character with respect to which a deduction for depletion is allowable under Section 611), I R C § 613A(b)(1) (providing that natural gas is allowed a deduction for depletion under Section 611)

<sup>5</sup> The term "qualifying activities" in this comment has the definition provided by the Proposed Regulations

<sup>6</sup> 80 FR 25970-01

*A. The Proposed Regulations' Definition of Processing & Refining*

The Proposed Regulations state that unless otherwise provided, "an activity is processing or refining if it is done to purify, separate, or eliminate impurities."<sup>7</sup> The activities that constitute the processing of natural gas are specifically defined. An activity constitutes processing of natural gas if it is performed to:

- (A) Purify natural gas, including by removal of oil or condensate, water, or non-hydrocarbon gases (including carbon dioxide, hydrogen sulfide, nitrogen, and helium);
- (B) Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and gas condensate); or
- (C) Convert methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.<sup>8</sup>

Neither liquefaction nor regasification is specifically mentioned, and neither fits neatly into any of the above three enumerated processing activities. Although there is some purification that occurs during the liquefaction process, purification is not the primary goal of liquefaction. Additionally, some hydrocarbon gasses are removed from the natural gas, which is a category of contaminant that is not mentioned in Section 1.7704-4(c)(5)(ii)(A). Liquefaction does not separate natural gas into its constituents or convert methane into liquid fuels, making Section 1.7704-4(c)(5)(ii)(B) and (C) inapplicable. The preamble to the Proposed Regulations states that the definitions provided by the Proposed Regulations are intended to be exclusive. Under the Proposed Regulations as written, there is a risk that natural gas liquefaction would not be considered a qualifying processing activity.<sup>9</sup>

Natural gas liquefaction and regasification are currently accepted as qualifying processing activities. The legislative history of Section 7704 carefully defines natural resources as including only oil, gas and products thereof that have not undergone additional processing beyond that of petroleum refineries or field facilities.<sup>10</sup> This delineation in the definition between processed and unprocessed natural resources is important, because it demonstrates Congressional intent that processing and refining should only be qualifying activities if performed on unprocessed or unaltered natural resources. The legislative history provides "plastics and similar petroleum derivatives" as examples of what are not a natural resource under Section 7704. The term "derivative" is not further defined by the statute or the legislative history. When a term is not defined, established principles of statutory interpretation provide that the term should be given its ordinary and accepted meaning. The Merriam-Webster Dictionary defines a

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<sup>7</sup> Prop. Treas Reg. § 1.7704-4(c)(5)(i)

<sup>8</sup> Prop. Treas Reg § 1.7704-4(c)(5)(ii)

<sup>9</sup> There is support for the inclusion of liquefaction among activities that qualify for the intrinsic activities exception under Prop Treas Reg 1 7704-4(d), but because liquefaction and regasification are so central to the effective marketing and transportation of natural gas, they should be expressly qualified as processing activities.

<sup>10</sup> COMREP ¶77,041 01 Certain publicly traded partnerships treated as corporations, (87 OBRA, PL 100-203, 12/22/87).

“derivative” as (i) a chemical substance related structurally to another substance and theoretically derivable from it; or (ii) a substance that can be made from another substance.<sup>11</sup>

Neither liquefaction nor regasification alters the chemical makeup of natural gas in any way or turns the natural gas into a derivative product. The LNG that is produced is still the same raw natural resource, and would immediately revert to its original gaseous state when released into an unrefrigerated, unpressured environment. Because LNG retains its character as natural gas, a qualified natural resource, before and after the liquefaction process, this processing should be a qualifying activity. In fact, The IRS has historically considered natural gas liquefaction to be an activity that generates qualifying income. For example, in Priv. Let. Rul. 201224023, a company operated a natural gas liquefaction facility and sold the LNG. The IRS held that income derived from this activity was qualifying income for the purposes of Section 7704.<sup>12</sup>

The Proposed Regulations have expressly included activities that are substantially similar to natural gas liquefaction in both nature and purpose. The definition for qualifying mining and production activities include “[o]perating equipment to convert raw mined products or raw well effluent to substances that can be readily transported or stored (for example, . . . operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water).”<sup>13</sup> A heater-treater, like a liquefaction or regasification facility, changes the temperature of the natural resource and filter out some elements to facilitate transport and storage.

#### *B. The Proposed Regulations’ Definition of Transportation and Marketing*

The Proposed Regulations define qualifying activities related to transportation as “the movement of minerals or natural resources and products produced under paragraph (c)(4) or (5) [processing or refining] of this Section, including by pipeline, barge, rail, or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers.”<sup>14</sup> Retail customers do not include a person who acquires oil or gas for refining or processing, or a utility.<sup>15</sup> The Proposed Regulations go on to list specific qualifying transportation activities, such as providing storage services, terminalling, operating gathering systems and custody transfer stations, and operating pipelines, barges, rail, or trucks.<sup>16</sup> The legislative history provides an example of what should be considered a qualifying transportation activity:

[T]he income of a partnership whose exclusive activity is transporting refined petroleum products by pipeline is intended to be treated as passive-type income, but the income of a partnership whose exclusive activities are transporting refined petroleum products by truck, or retail marketing with respect to refined petroleum

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<sup>11</sup> *Derivative*, MERRIAM-WEBSTER (July 21, 2015) <http://www.merriam-webster.com/dictionary/derivative>.

<sup>12</sup> I.R.S. PLR 201224023 (June 15, 2012).

<sup>13</sup> Prop. Treas. Reg. § 1.7704-4(c)(4)(ii).

<sup>14</sup> Prop. Treas. Reg. § 1.7704-4(c)(6).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

products (e.g., gas station operations) is not intended to be treated as passive-type income.<sup>17</sup>

Proposed Regulations define qualifying activities related to marketing as an activity “performed to facilitate sale of minerals or natural resources and products produced under paragraph (c)(4) or (5) [processing or refining] of this Section.”<sup>18</sup> Qualifying marketing activities do not include activities and assets involved primarily in retail sales.<sup>19</sup> The legislative history further clarifies that marketing at the level of processing or refining is to be treated as a qualifying activity, but marketing at the retail level is not.<sup>20</sup>

In order for the transportation and marketing of LNG to qualify as activities that generate qualifying income, LNG must first be considered to be produced under paragraph (5) of Prop. Reg. 1.7704-4(c), the definition of processing and refining. There is clear Congressional intent and IRS guidance to support the transportation and marketing of LNG as activities that generate qualifying income. LNG is most commonly transported by tanker when the destination is overseas. LNG can also be transported by truck or rail. However, regardless of the method of transportation, LNG must be reconverted to natural gas at a regasification facility before it can be distributed to end users. There is no retail market for LNG. This places the transportation of LNG squarely within the Proposed Regulations definition, as LNG cannot be transported directly to “a place that sells or dispenses to retail customers.” Additionally, the required regasification of LNG means that selling bulk LNG must be done wholesale to customers that have access to regasification facilities. This type of marketing at the level of processing or refining exactly fits the legislative intent behind the requirements in the Proposed Regulations.

The IRS reached the same conclusion in Priv. Let. Rul. 201224023. In that ruling the company at issue engaged in both storage of LNG, which is a transportation activity under the Proposed Regulations, and sales of LNG, a marketing activity under the Proposed Regulations. The IRS held that these activities generated qualifying income. Because the transportation and marketing of LNG are the types of activities that Congress intended to include in the 7704 definition of qualifying activities, the transportation and marketing of LNG should be expressly included in the Proposed Regulations’ definitions of qualifying activities.

There is clear Congressional intent to include natural gas liquefaction and regasification as a qualifying processing activity. If natural gas liquefaction and regasification are not specifically enumerated in the Proposed Regulations, it could make activities related to the transportation and marketing of LNG disqualified as well, as the definitions for these activities in the Proposed Regulations integrate the definition for qualifying processing and refining activities. Excluding these activities would contravene the legislative history demonstrating that Congress intended for the bulk transportation and wholesale marketing of natural resources to generate qualifying income. The preamble to the Proposed Regulations asserts that the Proposed Regulations are consistent with the Section 7704 statutory framework and its legislative history. In order to prevent a possible contravention of the legislative history through the disqualification of activities that Congress intended to generate qualifying income, natural gas liquefaction and

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<sup>17</sup> S. Rep 100-445, at 424 (1988)

<sup>18</sup> Prop. Treas Reg. § 1.7704-4(c)(7)

<sup>19</sup> *Id.*

<sup>20</sup> S. Rep 100-445, at 424 (1988).

regasification processing and the transportation and marketing of LNG produced by liquefaction should be explicitly included in the Proposed Regulations' exclusive list of activities that generate qualifying income for the purposes of Section 7704.

#### IV. Summary and Recommendation

Congress has indicated through legislative history that the definition for natural resources under Section 7704(d)(1)(E) includes resources that have not been chemically altered, but does not include derivatives of those natural resources. LNG is not a derivative product. It is pure, chemically unaltered natural gas that has simply been processed into a liquid to facilitate transportation and marketing. In fact, this makes liquefaction and regasification substantially similar in substance and in purpose to other qualifying activities that are expressly included in the Proposed Regulations.

Additionally, if natural gas liquefaction is not specifically enumerated, it could make activities related to the transportation and marketing of LNG disqualified as well, as the definitions for these activities in the Proposed Regulations integrate the definition for qualifying processing and refining activities. This would contravene the legislative history demonstrating that Congress intended that the bulk transportation and wholesale marketing of natural resources at the processing and refining level should generate qualifying income. Congress did not intend this process to be constrained by the requirements set forth in the Proposed Regulations for intrinsic activities. Enumerating LNG activities among those that generate qualifying income is consistent with Congressional intent and the IRS's conclusions in Priv. Let. Rul. 201224023, and will provide certainty to MLPs that are or will be engaged in natural gas liquefaction.

In order to help satisfy Treasury's intent that the Proposed Regulations be consistent with the Section 7704 statutory framework and its legislative history, Sempra recommends that natural gas liquefaction and regasification be explicitly included as a qualifying processing activity and the transportation and marketing of LNG produced by liquefaction should be explicitly included in the Proposed Regulations' exclusive list of activities that generate qualifying income for the purposes of Section 7704.

Respectfully Submitted,

By: 

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