

August 4, 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 REG-132634-14, Qualifying Income from Activities of Publicly Traded Partnerships with Respect to Minerals or Natural Resources

Western Refining, Inc. together with its subsidiaries (“Western Refining”, “we”, or “our”) is an independent crude oil refiner and marketer of refined products. In addition to crude oil refining and marketing refined products, Western Refining also indirectly owns a 38.4% limited partner interest and the general partner interest in Northern Tier Energy LP (“Northern Tier”), a publicly traded partnership that owns and operates a crude oil refinery in St. Paul Park, Minnesota. In addition, Western Refining owns a 66.2% limited partner interest and the general partner interest of Western Refining Logistics LP (“Western Refining Logistics”), a publicly traded partnership that owns and operates terminals, storage tanks, pipelines and other logistics assets and related businesses. As the indirect owner of the general partner of Northern Tier and Western Refining Logistics, we appreciate the opportunity to comment on the proposed Treasury regulations’ effort to define “qualifying income” under the natural resources exception of section 7704(d)(1)(E).¹

The touchstone for these regulations must be Congress’ special intent to provide a *broad* exception for income derived from the exploration, development, mining or production, processing, refining, transportation or the marketing of natural resources, including oil, gas, and products thereof.² In seeking to establish an exclusive list of activities that constitute “section 7704(d)(1)(E) activities,” the proposed regulations, as currently drafted, instead are *restrictive* in nature and fail to account for the common activities that occur as a part of “refining” within the fences of a crude oil refinery and potential changes to market demand, developing practices and technologies.

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

² “In the case of natural resources activities, special considerations apply. Thus, passive-type income from such activities is considerably broader, and includes income and gains from exploration, development, mining or production, refining, transportation (including through pipelines transporting gas, oil, or products thereof), or marketing of, any mineral or natural resource, including geothermal energy and timber.” H.R. Rep. No. 100-495, 100th Cong., 1st Sess. (1987).

The definition of petroleum “refining or processing” is restrictive, potentially excluding even certain current practices of petroleum refiners

Crude oil refining is the process of separating the hydrocarbons present in crude oil and converting them into marketable finished, or refined, petroleum products such as gasoline, diesel, jet fuel, asphalt, kerosene, propane, LPG, propylene, sulfur, lubricants and solvents. The Environmental Protection Agency states that “[t]he petroleum refining industry converts crude oil into **more than 2500 refined products**, including liquefied petroleum gas, gasoline, kerosene, aviation fuel, diesel fuel, fuel oils, lubricating oils, and feedstocks for the petrochemical industry.”³ According to the U.S. Energy Information Administration, as of January 1, 2015, there were 140 operating oil refineries in the United States.⁴ A variety of factors control the processes that a petroleum refiner employs and the inputs (*e.g.*, the type and grade of crude oil and other partially refined products from crude oil and natural gas) that a petroleum refiner acquires for its activities.⁵ Needless to say, the activities of a petroleum refiner are complex and various. Operational complexity yields a *significant benefit* for crude oil refiners and is viewed a competitive advantage in the marketplace. Complexity, for example, may contribute to lower per-barrel costs or higher margins per barrel of throughput. As such, it is essential for the definitions provided for petroleum refining to be broad, flexible, and unrestricted by current technologies.

The current definition of petroleum “refining or processing”, however, is based upon the premise that crude oil refining only includes the physical separation of crude oil and limited chemical changes when making fuels. Jointly defining refining and processing as a single activity, Prop. Reg. Section 1.7704-4(c)(5)(iii)(A) states that “[a]n activity constitutes processing or refining of petroleum if the end products of these processes are not plastics or similar petroleum derivatives and the activity is performed to:

- (1) Physically separate crude oil into its component parts . . . ;
- (2) Chemically convert the physically separated components if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels . . . ; or
- (3) Physically separate products created through activities described in [(1) or (2)].”

The definition is further limited by specific activities enumerated as “nonqualifying activities.” Prop. Reg. Section 1.7704-(c)(5)(iii)(B) states that “the following products are not

³ Environmental Protection Agency, AP-42, Compilation of Air Pollutant Emission Factors: Section 5.1 Petroleum Refining (final section April 2015) (emphasis added), *available at* http://www.epa.gov/ttn/chief/ap42/ch05/final/c05s01_2015.pdf. The EPA also states, “Petroleum refinery activities start with receipt of crude for storage at the refinery, include all petroleum handling and refining operations, and they terminate with storage preparatory to shipping the refined products from the refinery.” *Id.*

⁴ “Petroleum & Other Liquids: Number and Capacity of Petroleum Refineries,” www.eia.gov, *available at* http://www.eia.gov/dnav/pet/pet_pnp_cap1_dcu_nus_a.htm.

⁵ The inputs for existing Western Refining and Northern Tier crude oil refineries include crude oil, intermediates, and blend stocks such as natural gasoline, butanes, isobutane, and olefins.

obtained through processing of petroleum” including “[a]ny product that results from further chemical change of the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil petroleum refining or includes the physical separation of crude oil.” We believe that there are several deficiencies in the above definition.

There is no basis in fact for differentiating between chemical changes with respect to fuels and chemical changes with respect to other products of crude oil refining.

The definition of “refining or processing” intentionally favors the production of gasoline and other fuels without reason. To be able to convert a physically separated component of crude oil “in a manner that is necessary to the cost effective production of gasoline and other fuels,” but not be able to conduct identical processes to produce other refinery products such as asphalts, solvents, olefins or lubricants has no support in the statute, its legislative history, or from any particular fact about crude oil refining. Indeed, the opposite is true, and chemical processes occur in crude oil refining with respect to fuels and other petroleum products. For example, two of the processes currently used in a crude oil refinery to remove wax from a petroleum product - and therefore improve the performance of the product by increasing “cold flow” properties - are solvent dewaxing and catalytic dewaxing. Solvent dewaxing, first used in crude oil refineries in 1935,⁶ physically removes paraffins, or wax, from another petroleum product (such as diesel fuel or lubricating oils). Catalytic dewaxing, first used in crude oil refineries nearly 40 years later,⁷ is a chemical process that converts paraffins into cracked and isomerized molecules that may remain in the product.⁸ In many instances, catalytic dewaxing is preferable as more cost-effective than solvent dewaxing. Under the current limited exception for gasoline and other fuels, it would appear that catalytic dewaxing is a “qualifying activity” with respect to diesel fuel, but not a “qualifying activity” with respect to lubricating oil because paraffins are chemically converted in the process. Similarly, it is unclear that further hydrotreating of the diesel fuel or lubricating oil would be a qualifying activity, since such process would be a chemical conversion following a chemical conversion described in Prop. Reg. Section 1.7704-4(c)(5)(iii)(A)(2). Arguably, if the resulting product after catalytic dewaxing is a “product of conversion,” then physical separation is the *only* qualifying activity available to the product under Prop. Reg. Section 1.7704-4(c)(5)(iii)(A)(3).⁹ Thus, in addition to showing that the current definition can exclude the *same activity* with respect to different components of crude oil, it also shows that the definition can exclude the *same activity* (e.g. hydrotreating) with respect to the *same component of crude oil* (e.g. diesel) by simply employing a newer technology.

⁶ See Occupational Health and Safety Administration: Petroleum Refining Processes, www.osha.gov, available at https://www.osha.gov/dts/osta/otm/otm_iv/otm_iv_2.html.

⁷ *Id.*

⁸ The resulting molecules of cracking that remain in the petroleum product include lower molecular-weight paraffins, olefins, and alkylbenzenes. See Terry E. Helton et al., “Catalytic Hydroprocessing a Good Alternative to Solvent Processing,” *Oil & Gas Journal* (July 20, 1998), available at <http://www.ogj.com/articles/print/volume-96/issue-29/in-this-issue/refining/catalytic-hydroprocessing-a-good-alternative-to-solvent-processing.html>.

⁹ Notably, Northern Tier currently only uses solvent dewaxing in its refinery. However, the example is an appropriate example of a more complex process that can lead to an operational benefit. Similarly, it is difficult to conclude that refining and processing are without distinction, as Prop. Reg. Section 1.7704-4(c)(5) readily distinguishes between refining and processing in many instances, often concluding, by negative implication, that refining is simply an inapplicable term with respect to several minerals or natural resources.

Another example of an activity that should be considered the refining or processing of a natural resource is the air-blowing of asphalt (also referred to as asphalt blowing). Air-blowing produces asphalt with improved high temperature performance and harder physical properties.¹⁰ Air-blowing is an oxidation process whereby air is passed through heated asphalt, removing electrons from the asphalt molecules. A catalyst may also be used to improve the oxidation process.¹¹ A recent publication by the Environmental Protection Agency lists asphalt blowing as a major refinery process.¹² Asphalt blowing, however, could be considered a chemical conversion of the molecules of asphalt because the oxidation process is a chemical reaction.¹³ Thus, asphalt blowing is a second example of where the restrictive joint definition of “refining or processing” under the proposed regulations may exclude major refinery processes currently employed in petroleum refineries. That blowing compressed air through hot asphalt could, even on an arguable basis, not be considered the refining, or even the processing, of a natural resource is a significant deficiency in the current definition.

Jointly defining petroleum “refining or processing” while separately defining “transportation” and “marketing” misses key steps in the value chain.

There are two potential viewpoints when evaluating the intent of the statute to treat income from the exploration, development, mining or production, processing, refining, transportation, or marketing of a mineral or natural resource as qualifying income. The legislature either could have intended to create a specific, exclusive list of activities that generate qualifying income, or the legislature could have intended to capture the entire value chain of a mineral or natural resource – that any income from bringing the mineral or natural resource out of the ground to selling that mineral or natural resource to, as limited by the legislative history, non-retail customers should generate qualifying income. It is unlikely, however, that the legislature intended a partially exclusive list, or to capture several broad concepts through the list but not others.

The concept that the legislature intended to capture the entire value chain for developing natural resources is not without merit. The list provided follows the natural progression for which the activities occur; the statute has been interpreted for nearly 30 years as expansive in nature, rather than exclusive; and considering exploration, development, mining or production, processing, refining, transportation or marketing each separately could lead to unintended gaps (when, for example, all of these activities are conducted by a single partnership) or significant overlap (making it difficult to categorize an activity as definitively one 7704(d)(1)(E) activity or

¹⁰ Patrick Lavin, *Asphalt Pavements: A practical guide for design, production and maintenance for engineers and architects* (Spon Press 2003).

¹¹ *Id.*

¹² Environmental Protection Agency, AP-42, *Compilation of Air Pollutant Emission Factors: Section 5.1 Petroleum Refining* (final section April 2015) (emphasis added), *available at* http://www.epa.gov/ttn/chief/ap42/ch05/final/c05s01_2015.pdf.

¹³ While significant technical detail is outside of the scope of this comment, the difficulties in labeling exactly what changes occur in asphalt oxidation is clear. See J. Claine Peterson, *A Review of the Fundamentals of Asphalt Oxidation*, Transportation Research Circular E-C140, National Research Council (October 2009), *available at* <http://onlinepubs.trb.org/onlinepubs/circulars/ec140.pdf> (“Asphalt molecules are relatively large and of complex structure, and are highly diverse in their chemical composition. Many of the molecules are polyfunctional; that is, they contain more than one functional chemical moiety per molecule. For this and other reasons it is impractical, if not impossible, to separate asphalt into its individually different molecules for further analysis.”).

another). For example, nearly any “processing” of a natural resource could be considered “marketing” a natural resource if such processing is required to sell or facilitate the sale of the natural resource.

Stopping at the half-way point between the premise that the statute provides an exclusive list of activities that generates qualifying income or the premise that the statute seeks to represent the entire value chain of activities from exploration to sale leads has no reasoned basis. This is exactly the result of a joint definition of “refining or processing” which essentially reads processing out of the statute. An example of such an illogical result relates to the blending or processing of asphalt.

Asphalt is a direct product of crude oil refining. Indeed, because of the distinctive nature of various types of crude oil, asphalt can comprise as little as 1% and as much as 90% of crude oil.¹⁴ However, “straight run” asphalt, or asphalt that is subject to little or no modification after the separation of asphalt from the component parts of crude oil, is being superseded by modified asphalt in road building – by far the most significant market for asphalt in the United States. Modified asphalt may undergo several processes after separation from crude oil, including the use of additives that allow for flexibility in meeting stringent performance grade asphalt specifications (such as polymer and polyphosphoric acid); blending various grades of produced asphalts to meet specifications; and, as previously discussed, air-blowing. Many of these activities are closely analogous to the required modifications of gasoline for use as a motor fuel. These modifications may be required by law, required to meet specifications (including federal, state, and local standards for roads), or represent advances in technology that should not be hindered by an overly simplistic view of processing. In fact, the IRS has previously ruled that income from the production and sale modified asphalt produced by a taxpayer that contained up to specified percentage of non-petroleum based additives constitutes qualifying income.¹⁵ These activities should represent the very center of what the word “processing” was intended to encompass as related to a natural resource produced in crude oil refining. However, “processing” is essentially undefined with respect to a refined petroleum product, especially if not a fuel.

The baseless preference for fuel is continued in the definition of “marketing.”

Although blending occurs in some fashion with respect to nearly every product of crude oil refining, the proposed regulations only address blending in the context of fuels. The proposed regulations state “[a]n 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 fuels.” This is simply not adequate and provides for the disparate treatment of taxpayers undertaking analogous activities under the statute.

The IRS has addressed blending in several contexts outside of the blending of fuels. The most analogous example to fuel blending is blending lubricating oils, where the IRS has issued numerous private letter rulings that income from the blending of lubricating oils constitutes

¹⁴ See Lavin, *supra* note 10, at 4.

¹⁵ Priv. Ltr. Rul. 2009-27-002 (March 23, 2009).

qualifying income.¹⁶ However, the IRS has previously approved blending activities with respect to many other activities, including to achieve the correct percentage of nitrogen in fertilizer products,¹⁷ to produce iron pellets suitable for use in a blast furnace,¹⁸ and blending straight-run asphalt with non-natural resource additives to produce modified asphalt.¹⁹ These prior rulings by the IRS are consistent with the plain language of the statute: blending activities that do not change a natural resource into a new product should be considered either the processing of a natural resource or an activity performed to facilitate the sale of a natural resource. With respect to fuels, lubricants, and asphalt, blending could also properly be considered a transportation activity where blending is accomplished at a terminal.

Logistics providers cannot operate without a consistent definition of “natural resources.”

The legislative history and IRS interpretative history of section 7704(d)(1)(E) strongly support that *any product* of a crude oil refinery is a natural resource. In fact, with respect to oil, gas, or products thereof, only products produced by additional processing beyond that of a petroleum refinery or field facility, such as plastics or similar petroleum derivatives, are not considered natural resources.²⁰ The proposed regulations, however, attempt to differentiate between certain identical products that are produced in a crude oil refinery and also produced in another facility or process, creating an inconsistent definition of a “natural resource”.

Logistics providers like Western Refining Logistics bring natural resources to market by handling, transporting, terminalling and storing the products based on the needs of its customers and market demands. Natural resources may arrive at the inlet of a pipeline, a terminal loading dock, or a tank farm from virtually any source as long as the natural resource meets contractually determined specifications. If not sent directly from a single refinery and without any intermediate storage or transportation, these natural resources may have been comingled with any quantity of product with similar specifications. Further, refineries like Western Refining or Northern Tier may purchase inputs like natural gasoline for its crude oil refinery from the open market. In these instances, even the crude oil refinery itself would be unaware of whether any particular quantity of output was wholly derived from crude oil. Publicly traded partnerships have an obligation to their shareholders to be able to prove with a high degree of certainty that ninety percent or more of their gross income is qualifying income for the purposes of section 7704. Requiring a publicly traded partnership to track the “lineage” of a particular product to be transported, stored, or even used as an input into a crude oil refinery is not practical given the nature of the industry. Even if the logistics provider knew the lineage of all the products it transports, a logistics provider would also have to know the depreciation lives adopted by the producers of the products transported because of the requirement in the Proposed Regulations for consistency with respect to depreciation class lives. Knowledge of such tax return positions would be nearly impossible for a logistics provider to attain, particularly

¹⁶ See, e.g., Priv. Ltr. Rul. 2014-03-008 (September 13, 2013) (blending refined petroleum distillates and lube oil base stocks to create greases).

¹⁷ See Priv. Ltr. Rul. 2013-31-002 (April 16, 2013) (blending liquid urea with water to produce a solution with a nitrogen concentration saleable both as fertilizer and diesel exhaust fluid); Priv. Ltr. Rul. 2013-08-004 (November 5, 2012) (similar).

¹⁸ Priv. Ltr. Rul. 2013-51-009 (September 12, 2013) (blending iron ore with binder, limestone and dolomite);

¹⁹ Priv. Ltr. Rul. 2009-27-002 (March 23, 2009) (blending straight-run asphalt with non-natural resource additives).

²⁰ H.R. Rep. No. 495, 100th Cong., 1st Sess. 943 (1987), 1987-3 C.B. 946-947.

because the position may not even have been decided by the producer at the time the logistics provider receives the products.

Conclusion

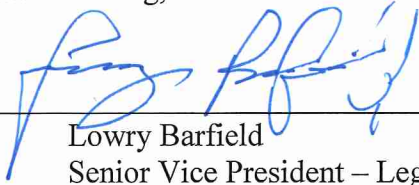
Western Refining appreciates the efforts of the IRS and Treasury department to define the words that are foundational to our businesses. We encourage the IRS and Treasury to re-evaluate their attempt to comprehensively address the current activities that are part of the refining, processing, transportation or marketing of refined petroleum products and, instead, to provide simple definitions of well-known terms that better serve Congress' expansive intent and provide a guidepost for the industry that will survive the test of time.

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Regards,

Western Refining, Inc.

By: _____



Lowry Barfield

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