TAX EXECUTIVES INSTITUTE, INC.

August 3, 2015

Courier's Desk
Internal Revenue Service
Attn: CC:PA:LPD:PR (REG–132634–14)
1111 Constitution Ave., N.W.
Washington, D.C. 20224

Re: Comments on Proposed Regulations under Section 7704(d)(1)(E)

Dear Sir or Madam:

On behalf of Tax Executives Institute, I enclose an original and eight copies of TEI's comments in response to the request for comments in REG-132634-14, which comprises proposed regulations under section 7704(d)(1)(E) of the Internal Revenue Code relating to qualifying income from activities of publicly traded partnerships with respect to minerals or natural resources.

If you have any questions or need additional information, please contact Patrick Evans, TEI's Chief Tax Counsel, at (202) 464-8351 or pevans@tei.org.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

Mark C Silbiger

Mark C. Silbiger
International President

Enclosures

TAX EXECUTIVES INSTITUTE, INC.

comments on

REG-132634-14

relating to

The Classification of Income from Certain Activities with Respect to Minerals or Natural Resources as Qualifying Income

submitted to

The Internal Revenue Service

August 3, 2015

On May 5, 2015, the Internal Revenue Service (IRS) and Treasury Department (Treasury) issued proposed regulations under section 7704(d)(1)(E) of the Internal Revenue Code relating to the classification of income from certain activities with respect to minerals or natural resources as qualifying income (the "Proposed Regulations").[1] The Proposed Regulations would apply to income earned by a partnership in a taxable year beginning on or after the date the regulations are finalized. Additionally, the Proposed Regulations provide a 10-year transition period for certain partnerships adversely affected by the Proposed Regulations during which a partnership may treat income from an activity as qualifying income.

Tax Executives Institute, Inc. (TEI or the Institute) appreciates the efforts the IRS and Treasury have undertaken to clarify the rules concerning qualifying income from activities relating to natural resources and to simplify the administration of this complex area of the law. If finalized, the Proposed Regulations would dictate the entity classification of publicly traded

[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the Code), and all "Treas. Reg. §" references are to regulations issued thereunder. All references to "PLRs" are to private letter rulings issued by the IRS.

partnerships (PTPs) conducting the affected activities, which in turn, would have a material impact not only on the taxation of the PTPs and their unit holders, but also the market values of these entities. It is therefore critical that the Proposed Regulations reflect sound policy judgments firmly grounded in the law and industry-specific facts relevant to the entity classification determination. TEI members have significant industry knowledge and experience with these issues, and the Institute is pleased to submit the following comments on the Proposed Regulations.

Tax Executives Institute

TEI is the preeminent association of in-house tax professionals worldwide. Our approximately 7,000 members represent more than 2,800 of the leading corporations in North and South America, Europe, and Asia. TEI represents a cross-section of the business community and is dedicated to developing and effectively implementing sound tax policy, promoting the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of tax administration and compliance to the benefit of taxpayers and governments alike. TEI is firmly committed to maintaining a tax system that works — one that is administrable and with which taxpayers can comply in a cost-efficient and predictable manner.

TEI, as a professional association of in-house tax executives, offers a unique perspective. Members of TEI are responsible for managing the tax affairs of their companies and must contend daily with provisions of the tax law impacting business enterprises, including the provisions concerning PTPs and the determination of qualifying income from minerals and natural resources. Further, our members work for companies involved in a wide variety of industries. Their collective perspectives are broad-based and not tied to any particular special interest group. The diversity, background, and professional training of TEI's members place the organization in a uniquely qualified position from which to comment on the Proposed Regulations.

General Views on the Proposed Regulations

TEI is concerned that the Proposed Regulations fail to capture the complex processes and activities carried on by PTPs. As a result, the Proposed Regulations provide rules that are inconsistent with section 7704(d)(1)(E) and its legislative history, as well as the settled expectations of impacted taxpayers, their investors, and the market — expectations that evolved from prior guidance in which the IRS applied the law (which remains unchanged) to detailed fact patterns thoroughly vetted during the private letter ruling (PLR) process. Some of these PLRs were issued less than two years ago. By effectively revoking established administrative rulings without a clear rationale, the Proposed Regulations damage the credibility of the IRS in the eyes of taxpayers and will have a negative impact on investors in PTPs and the capital markets as a whole.[2]

Our comments are divided into three parts. Part I describes the businesses conducted through PTPs and provides an overview of the evolution of the relevant law. Part II explains our concerns regarding the Proposed Regulations. Part III provides our recommendations.

I. Business Overview

To fully understand the impact of the Proposed Regulations on PTPs, their investors, and the overall market, it is necessary first to understand the business environment in which these entities operate. PTPs have existed since the early 1980s. After observing their early evolution, Congress felt it was important to limit the type of publicly-traded businesses not subject to an entity-level tax. Congress also sought to encourage investment in energy. In 1987, Congress

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[2] We recognize that the IRS is free to revoke or modify a PLR if it is found to be in error or there has been a change in law or IRS policy. *See* Rev. Proc. 2015, section 11.04. In the case of the Proposed Regulations, however, there have been no changes in law or principled changes in policy that would support revoking the PTP PLRs.

enacted section 7704 to preserve for certain enumerated activities the benefits of pass-through taxation with the public features of exchange-traded C corporation stock — most notably, access to public capital as a source of funds for capital expenditures and other corporate purposes. The legislation had the dual purpose of limiting pass-through status available to publicly-traded entities and not disrupting certain types of natural resource activities typically conducted in partnership form.

Section 7704 remained unchanged until 2008 when the President signed into law the Energy Improvement and Extension Act of 2008 (the Act). The Act expanded the definition of qualifying income found in section 7704(d) to include the transportation or storage of certain renewable and alternative fuels and activities involving industrial source carbon dioxide. The 2008 amendment was a significant expansion of the types of activities that generate qualifying income and led to increased investment by PTPs in various infrastructure projects, including carbon dioxide and ethanol pipelines.

Today, at least 149 PTPs are traded on U.S. exchanges. The majority of that number, 93, involve oil and gas, including oilfield services PTPs. The remaining PTPs are engaged in a variety of other qualifying activities, involving marine transportation, coal mines, propane, and other natural resources.

A PTP must generate at least 90 percent of its gross income each year from qualifying activities, otherwise the PTP will be treated as an association taxable as a corporation for federal income tax purposes. In general, qualifying income includes "passive" income, such as dividends, interest, rents, royalties and gains from the disposition of assets that generate such income. Under a special rule contained in section 7704(d)(1)(E), however, qualifying income also includes certain income generated from natural resource activities, such as the "exploration, development, mining or production, processing, refining, transportation…or the marketing of any [depletable] mineral or natural resource." Prior to the issuance of the Proposed Regulations, there was little formal guidance regarding the meaning of this quoted phrase.

As a result, taxpayers have frequently requested the IRS to issue PLRs to confirm that their income is qualifying income under the statute. The certainty provided by an IRS ruling is critically important to PTPs, which market their equity interests to public investors by affirmatively representing that they generate qualifying income and are not taxable as corporations for U.S. federal income tax purposes. The PLRs are also important to investors, who base their investment decisions on these representations made in the public offerings.

II. TEI's Specific Concerns

A. The Proposed Regulations fail to capture the complex processes and activities carried on by PTPs

TEI is concerned that the Proposed Regulations fail to capture the complex processes and activities carried on by PTPs and consequently provide rules that are inconsistent with section 7704(d)(1)(E) and its legislative history as previously interpreted and applied by the IRS in PLRs. The preamble to the Proposed Regulations provides that the rules were issued in response to the increased number of private ruling requests involving application of section 7704(d)(1)(E), as opposed to a change in policy or other concerns regarding these entities. The Proposed Regulations, however, are far more restrictive than decisions made in previously issued PLRs. There have been no intervening changes in law, and the IRS and Treasury have offered no policy rationales for changing prior determinations, which PTP sponsors and investors have relied upon to make significant, long-term investment decisions. Deviation from the IRS's application of the law embodied in 27 years of ruling practice without explanation is not sound tax administration, particularly in light of the complexity of the industry activities in issue. If adopted, the Proposed Regulations would lead to more uncertainty and litigation, as well as unwarranted administrative burden on both the IRS and taxpayers.

As discussed below, the Proposed Regulations deviate from prior rulings in three notable areas. First, the proposed regulations provide that the conversion of methane into methanol and synthesis gas is not a qualifying activity. Second, the Proposed Regulations provide that the processing of timber into pulp is not a qualifying activity. Third, the Proposed Regulations indicate that the production of olefins, other than by physical separation or as part of certain narrowly-defined refinery activities, does not generate qualifying income.

1. ***Conversion of methane into methanol and synthesis gas***

While confirming that certain "gas to liquids" activities generate qualifying income, the Proposed Regulations provide that, to qualify, the activity must occur "in one integrated conversion into liquid fuels that are otherwise produced from petroleum." Therefore, the production and sale of methanol would not be a qualifying activity because methanol is not a liquid fuel otherwise produced from the processing of crude oil. This result is directly contrary to a PLR issued in 2013 in which the IRS ruled that the production and sale of methanol *was* a qualifying activity.[3] The Proposed Regulations fail to identify any basis in industry practice or law to support this significant policy shift.

2. ***Processing of timber into pulp***

The Proposed Regulations also conclude that "processing" timber does not include "activities that add chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp." Contrary to this proposed rule, the IRS previously issued PLRs concluding that both pulp-making and the production of medium-density fiberboard and engineered wood products generate qualifying income.[4] Again,

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[3] Priv. Ltr. Rul. 2001346007 (July 18, 2013).
[4] *See, e.g.*, Priv. Ltr. Rul. 90-08-035 (Nov. 24, 1989); Priv. Ltr. Rul. 98-22-034 (Feb. 26, 1998); Priv. Ltr. Rul. 93-38-028 (June 25, 1993).

the Proposed Regulations identify no change in industry practice or law to support this policy shift.

3. *Production of olefins*

The Proposed Regulations are even more restrictive for PTPs that process or refine natural gas and petroleum products. Under a hypothetical example in the Proposed Regulations, a company that chemically obtains ethane or propane from the physical separation of natural gas and processes it into the olefins ethylene and propylene through the use of a steam cracker does not generate qualifying income through the sale of the olefins. The example contradicts a 2012 PLR in which the IRS concluded that the sale of olefins derived from the processing of ethane and propane through a cracking process constitutes qualifying PTP income.[5] Again, there have been no changes in industry practice and no changes in law, yet the Proposed Regulations lead to completely different results than past IRS rulings.

Since 1987, when Congress decided to redefine the appropriate boundaries of the corporate tax in section 7704 following regular legislative order, including committee hearings and a conference committee, the IRS and taxpayers, through open and frank discussions in the private ruling process, have slowly filled in the interstices in the legislative scheme, more clearly defining the scope of qualifying activities. The IRS and Treasury should not by fiat change prior ruling decisions that have been relied upon extensively in capital market transactions without explaining the policy concern, how the statute and legislative history support the new interpretation of the law, and what perceived error in interpretation was made in the prior legal positions taken by the IRS. Taking a completely different view of how unchanged law should apply to unchanged facts creates distrust and uncertainty in the U.S. tax system at a time when taxpayers and investors are seeking more certainty and stability from taxing jurisdictions.

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[5] Priv. Ltr. Rul. 201241004 (July 2, 2012).

The capital markets have already responded to this increased uncertainty. The employer of one TEI member saw a $1 billion drop in its market capitalization in the first few days following the release of the Proposed Regulations. Further, several affected investors have already submitted comments to the IRS and Treasury detailing how their investments and retirement savings have been adversely impacted by the issuance of the Proposed Regulations. These Proposed Regulations have injected uncertainty and instability into the PTP market and have raised concerns about PTP investments generally, highlighting the importance of revising the Proposed Regulations so they are consistent with the law as previously applied by the IRS and the industry facts in issue.

The Tax Court recently provided an apt reminder that regulations must accurately depict facts that control a legal determination. *See Altera Corporation v. Commissioner*, 145 T.C. No. 3 (July 27, 2015) (invalidating the 2003 cost sharing regulations because the final rule lacked a basis in fact). The current situation in which there have been no changes in law and the Proposed Regulations are nevertheless overturning years of private ruling determinations demonstrates that the rules in their current form fail to accurately depict pertinent industry facts.[6] We encourage the IRS and Treasury to take this opportunity to gather complete and accurate facts from impacted industry experts and revise the Proposed Regulations accordingly.

B. Limiting qualifying activities to an exclusive list should be avoided

As a matter of both tax policy and administration, TEI recognizes the value to the government and taxpayers of publishing an illustrative list of activities that generate qualifying income. Such a list can save taxpayers and the IRS time and effort by eliminating the need for

[6] The preamble to the Proposed Regulations notes that the exclusive lists of operations that comprise qualifying activities under the proposed rules were based in part on discussions with IRS engineers specializing in the various oil and natural resource fields. We respectfully submit that in circumstances like this where complex chemical processes are involved there is no substitute for direct input from taxpayer specialists who work directly in the impacted industries.

unnecessary private rulings when activities clearly generate qualifying income. Similarly, an illustrative list may also help simplify administration of and compliance with qualifying income regulations. However, an exclusive list like that provided in the Proposed Regulations should be avoided, particularly an exclusive list that does not fully reflect the manner in which impacted processes are conducted.

An exclusive list implies that every possible activity has been identified, considered and categorized, which is unlikely for all technologies employed by taxpayers engaged in qualifying activities with respect to natural resources today and clearly impossible for future, unknown technologies. Further, by relying on discussions with IRS engineers — not industry experts — the IRS and Treasury have failed to conduct the information gathering and due diligence necessary to formulate a fair and appropriate list of activities. If finalized in their current form, the Proposed Regulations would lead to increased uncertainty and require frequent updating as the industry evolves due to both market and technological changes. Retaining an exclusive list would also adversely impact innovation and the introduction of new processes, because there would undoubtedly be a lag period between the time new processes are introduced (or could be introduced) and the issuance of updated guidance. It is unclear whether the private ruling process could fill these inevitable gaps because of the exclusive nature of the qualifying income list provided in the Proposed Regulations.

The negative aspects of having an exclusive list of qualifying activities far outweigh any efficiencies that could be gained in the tax administration process. We therefore strongly recommend revision of the Proposed Regulations to provide an illustrative, nonconclusive list reflecting input from industry experts.

C. The proposed 10-year transition period is insufficient

The proposed 10-year "grandfathering" of existing operations is insufficient for PTPs and their investors that relied on prior IRS rulings or ruling practices. The Proposed Regulations may cause several PTPs, particularly those involved in the processing of petrochemicals, to be taxed as corporations after the transition period. These PTPs would lose their pass-through tax status despite, in some instances, having obtained a favorable PLR from the IRS. We are troubled by this result because the classification of an entity as being a pass-through or taxable at the entity-level is perhaps the most fundamental tax consideration of a business enterprise, both for sponsors forming the business and their investors. Sponsors who form PTPs generally have 30 to 40-year time horizons for assets placed in the PTP structure and spend several years and significant capital evaluating and implementing the PTP structure. Similarly, PTP investors evaluating PTPs as investment vehicles seek stable, predictable long-term cash-flows that exceed the proposed 10-year grandfathering period.

It is fundamentally unfair to tax a PTP at the entity level after thoroughly vetting its business and providing a PLR upholding its pass-through tax status, particularly when, as here, the PTP sponsors and investors relied on the private ruling when organizing their respective investments and there is no principled basis in law or fact for revoking the ruling through contrary regulations. Such a result, even with the proposed 10-year grandfathering period, would likely cause PTP investors to view PTPs as short-term investments and transfer their capital to other more long-term investment options. Sponsors of recently formed PTPs adversely affected by the Proposed Regulations may not be able to fully recover their investment in the formation and offering of such PTPs if they have to be unwound after such a relatively short transition period.

From a broader tax policy perspective, revoking a series of PLRs absent a change in law or fact undermines the integrity and certainty intended by the tax ruling system. Even with the proposed 10-year grandfathering provision, it imparts uncertainty into the extent to which taxpayers can rely on PLRs generally, which will have a ripple effect, causing uncertainty and increased tax costs to businesses undertaking capital market transactions. Accordingly, if final regulations are ultimately adopted that remain inconsistent with previously issued PLRs, TEI recommends that the 10-year transition period be changed to a permanent grandfathering provision in certain situations as recommended below.

III. Recommendations

Based on the foregoing, TEI offers the following recommendations:

1. The IRS and Treasury should consult directly with industry experts and adversely impacted taxpayers before finalizing the Proposed Regulations. Consultations with industry experts will allow the IRS and Treasury to more fully understand the nature of the PTP market and how the Proposed Regulations will impact taxpayers, PTP sponsors, investors and the overall economy.

2. Unless there is a principled basis for adopting a change in policy, the IRS and Treasury should revise the Proposed Regulations to ensure consistency between these rules and previously issued PLRs. If the IRS and Treasury determine that a change in policy is necessary, they should explain the policy concern, how the statute and legislative history support the new interpretation of the law, and what error in interpretation was made by the IRS in its prior determinations.

3. The Proposed Regulations should be revised to eliminate exclusive lists of qualifying activities and replace them with illustrative lists that reflect current industry practice and are flexible enough to capture future advances in technology. The IRS and Treasury should consult

directly with industry experts and impacted taxpayers to ensure the illustrative lists reflect industry practice.

4. Finally, if regulations are ultimately adopted that remain inconsistent with previously issued PLRs, the 10-year transition period should be changed to a permanent grandfathering provision for taxpayers that either received a PLR confirming that income they generate is qualifying income under the statute or relied upon written opinions of tax advisors that were based on prior IRS-issued guidance and referenced in a prospectus filed with the Securities and Exchange Commission. The need for a transition period would be completely eliminated if the final regulations remain consistent with previously issued PLRs, but in the event a transition period is included, it should be drafted in a way that does not undermine the integrity and certainty intended by the tax ruling system or disproportionately harm existing PTPs and investors that relied on previously issued IRS guidance.

Conclusion

Tax Executives Institute appreciates this opportunity to present its views on REG-132634-14 relating to qualifying income from activities of publicly traded partnerships with respect to minerals or natural resources. If you have any questions about the comments, please contact Katrina Welch, chair of TEI's Federal Tax Committee, at (214) 479-1022 or katrina@TI.com or Patrick Evans, TEI's Chief Tax Counsel, at (202) 464-8351 or pevans@tei.org.

Respectfully submitted,

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