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 Proposed Regulations under Section 7704(d)(1)(E)

Dear Sirs and Mesdames:

The National Association of Publicly Traded Partnerships ("NAPTP")[1] is pleased to submit comments on the proposed regulations promulgated on May 6, 2015 under section 7704(d)(1)(E)[2] relating to qualifying income from the exploration, mining or production, processing, refining, transportation, and marketing of minerals or natural resources (the "Proposed Regulations"). The Proposed Regulations provide much needed clarity with respect to many activities currently conducted by publicly traded partnerships ("PTPs") and describe many ancillary services that are necessary for the performance of a qualifying activity.

NAPTP, however, is very concerned that the Proposed Regulations: (i) do not reflect the dynamic nature of the enumerated activities because they set forth an "exclusive list" of the operations that comprise each activity; (ii) set forth very restrictive definitions of processing and refining without statutory support; and (iii) abandon certain standards utilized by the Internal Revenue Service ("IRS") in issuing private letter rulings ("PLRs") since 1987. In addition,

[1] NAPTP's name will change to Master Limited Partnership Association ("MLPA") on September 1, 2015.
[2] Unless otherwise noted, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code") and to the regulations ("Reg. § _____") promulgated thereunder.

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NAPTP has numerous comments regarding certain omissions and needed clarifications in the Proposed Regulations.

Our detailed comments and suggested changes are discussed below. NAPTP also requests that a public hearing on the Proposed Regulations be held.

I. BACKGROUND

PTPs have been in existence since 1981, and were first created to add liquidity to partnership investments. In doing so, they provided businesses that had traditionally operated in partnership form with the ability to raise capital from individual investors who could not afford the sizeable, illiquid, investment demanded by nontraded partnerships. By creating partnership investments that came in affordable and liquid units, PTPs allowed smaller investors to invest in energy and real estate development while providing those industries with a valuable new source of capital.

In the Omnibus Budget Reconciliation Act of 1987 (the "1987 Act"),[3] Congress enacted section 7704 to limit the use of PTPs to the industries that had traditionally used partnerships. The legislative history reflects the fact that Congress granted partnership treatment to a broad range of business activities related to minerals and natural resources. The House bill provided partnership treatment to PTPs engaged in the exploration, development, mining or production, refining, transportation and marketing of minerals and natural resources.[4] The Senate bill had no provision relating to PTPs, but in Conference the list of qualifying activities was expanded to include the processing of mineral and natural resources. The legislative history to the Conference Report provides:

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[3] H.R. Rep. No. 100-495, pt. 1, at 946-7 (1987).

[4] H.R. 3545, 100th Cong., pt. 2, at 1124 (1987).

> Income and gains from certain activities with respect to minerals or natural resources are treated as passive-type income. Specifically, natural resources included fertilizer geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer, includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. Income of certain partnerships whose exclusive activities are transportation and marketing activities is not treated as passive-type income. For example, the 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 products (e.g., gas station operations) is not intended to be treated as passive-type income.[5]

In floor statements made before the Conference Bill was passed, Ways and Means Committee Chairman Dan Rostenkowski[6] and Senate Finance Committee Chairman Lloyd Bensten[7] clarified that partnerships primarily engaged in the purchase, transportation, storage, distribution and retail and wholesale marketing of liquefied petroleum gas (e.g., propane), and the transportation of such products by trucks, rail cars, or pipelines would generate qualifying income.

In the "Technical and Miscellaneous Revenue Act of 1988" (the "1988 Act"),[8] Congress clarified the definition of the term "minerals or natural resources" as follows:

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[5] H.R. Rep. No. 100-495, at 946-47 (1987).

[6] 133 Cong. Rec. H11967-68 (daily ed. Dec. 21, 1987).

[7] 133 Cong. Rec. S18651-02 (daily ed. Dec. 22, 1987).

[8] H.R. 4333, 100th Cong. (2d Sess. 1988).

> For purposes of subparagraph (e), the term "mineral or natural resource" means any product of a character with respect to which a deduction for depletion is allowable under section 611; except that such term shall not include any product described in subparagraph (A) or (B) of section 613(b)(7).

In addition, Congress clarified the treatment of certain transportation activities as follows:

> In the case of transportation activities with respect to oil and gas and products thereof, the conferees intend that, in general, income from transportation of oil and gas and products thereof to a bulk distribution center such as a terminal or a refinery (whether by pipeline, truck, barge or rail) be treated as qualifying income. Income from any transportation of oil or gas or products thereof by pipeline is treated as qualifying income. Except in the case of pipeline transport, however, transportation of oil or gas products thereof to a place from which [they are] dispensed or sold to retail customers is generally not intended to be treated as qualifying income. Solely for this purpose, a retail customer does not include a person who acquired the oil or gas for refining or processing, or partially refined or processed products thereof for further refining or processing, nor does a retail customer include a utility providing power to customers. For example, income from transporting refined petroleum products by truck to retail customers is not qualifying income. Income from transportation and marketing of liquefied petroleum gas in trucks and rail cars or by pipeline, however, may be treated as qualifying income. See statement of Mr. Rostenkowski, 133 Cong. Rec. H 11968 (December 21, 1987); see also statement of Senator Bentsen, 133 Cong. Rec. S 18651 (December 22, 1987) (substantially similar language).[9]

All of the provisions enacted in 1988 were effective as if included in the 1987 Act.

In 2008, Congress expanded section 7704 to permit PTPs to engage in the transportation and storage of biofuels and to include industrial source carbon dioxide in the definition of a natural resource. Congress has not modified the treatment of minerals and natural resources since the 1987 Act was clarified in 1988.

Since 1987, taxpayers have many times resolved questions regarding whether business income earned by a PTP engaged in activities with respect to minerals or natural resources is

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[9] H.R. Rep. No. 100-1104, at 18 (1988).

"qualifying income" through the PLR process because no regulations interpreting section 7704(d)(1)(E) have been issued. The Preamble states that the Proposed Regulations were issued in response to increased requests for PLRs indicating increased interest in the application of section 7704(d)(1)(E).

II. GLOBAL COMMENTS

A. Exclusive Lists

As noted above, section 7704(d)(1)(E) provides qualifying income status to income and gain from the broad range of activities in the exploration, development, mining or production, processing, refining, transportation, and the marketing of any mineral or natural resource. The technologies involved in performing each of the listed activities continues to evolve. For example, fracturing has become a standard technique for accessing gas and petroleum in recent years, but was not used in 1987. The Proposed Regulations, however, ignore the dynamic character of each of the activities and provide an "exclusive list" of the operations that comprise each enumerated activity.

NAPTP recommends that the Proposed Regulations be revised to provide definitions of each qualifying activity, as is currently done in the Proposed Regulations, and several examples of operations which do and do not satisfy the definition. Such a change is necessary to reflect Congressional intent to provide qualifying income status to the income and gain resulting from new operations developed to effectuate any of the enumerated activities.

B. Partnership Personnel

The Proposed Regulations present differing requirements for the personnel required to perform or support section 7704(d)(1)(E) activities. Prop. Reg. § 1.7704-4(d)(2) provides that an activity is specialized if "(i) [t]he partnership provides personnel to perform or support a section

7704(d)(1)(E) activity and those personnel have received training unique to the mineral or natural resource industry that is of limited utility other than to perform or support a section 7704(d)(1)(E) activity." (Emphasis added.) Prop. Reg. § 1.7704-4(d)(4)(i) provides that an activity requires significant services to support the section 7704(d)(1)(E) activity if it 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) activities. (Emphasis added.) Prop. Reg. § 1.7704-4(d)(4)(ii) provides that "[p]artnership personnel" perform significant services only if those services are necessary for the partnership to perform an activity that is essential to the section 7704(d)(1)(E) activity, or to support the section 7704(d)(1)(E) activity. (Emphasis added.)

PTPs generally operate in limited partnership form with a general partner that has the sole responsibility for providing the employees and other personnel necessary for the PTP to conduct its operations. General partners secure the services of the required personnel in a number of ways. Most PTPs have entered into various arrangements with affiliates whereby the affiliates provide the necessary personnel to provide services on behalf of the PTP. In such a case, the employees that conduct business and perform services for the PTP are generally employed by either the PTP's sponsor or a subsidiary of the PTP's sponsor (other than the PTP itself). At all times that such personnel are conducting business or performing services for the PTP, such personnel are explicitly operating under the supervision, direction and control of the general partner pursuant to an employee services agreement or some other form of legal arrangement. In other cases, a PTP may hire third party service providers to conduct its operations. Some PTPs employ, either directly or through their subsidiaries, the employees that perform such operations.

Given the different means by which a PTP secures the necessary workforce to perform its functions, NAPTP recommends that the Proposed Regulations be revised to consistently use the term "partnership provided personnel" with respect to the personnel required to perform or support a section 7704(d)(1)(E) activity, and that such term be clarified to include not only employees of the PTP but also independent contractors hired by the PTP and employees of affiliates of the PTP that operate under the supervision, direction and control of the PTP or its general partner.

C. Processing and Refining Activities

The definition in the Proposed Regulations of "processing and refining" does not encompass the activities undertaken to refine and process oil, gas, and minerals and the products thereof in a manner consistent with the statute, the legislative history and the PLRs interpreting the terms issued over the past 27 years. NAPTP recommends that the definition of these operations in the Proposed Regulations be revised as explained below.

D. Outstanding PLRs

While NAPTP believes that the PLRs issued to date were decided correctly, it recommends that any previously issued PLRs under section 7704(d)(1)(E) be permanently grandfathered. Prior to the issuance of final regulations, taxpayers were compelled to obtain PLRs to determine whether activities would generate qualifying income and structured their businesses to comport with guidance issued in PLRs. Although the IRS clearly has the authority to revoke a PLR, this happens very rarely.[10] Even with a ten-year transition period, revoking a PLR upon which a publicly traded company has structured most or all of its operations can have a dramatic negative impact on a taxpayer which relied in good faith on the IRS' ruling. One member of NAPTP experienced a thirty percent drop in its unit price when the Proposed Regulations were issued only nine months after it began trading in reliance on a PLR stating that

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[10] See, e.g., PLR 9127024 (Apr. 4, 1981); PLR 9127028 (Apr. 4, 1981); and PLR 9127029 (Apr. 4, 1981).

its activities would generate qualifying income. NAPTP recommends that the Proposed Regulations be revised to provide that a taxpayer who has received a PLR under section 7704(d)(1)(E) is allowed to continue to rely on the PLR indefinitely.

E. Operating and Management Arrangements for Section 7704(d)(1)(E) Activities

Providing management services with respect to any section 7704(d)(1)(E) activities should be treated as income from the respective section 7704(d)(1)(E) activity without regard to ownership, as was done in a number of PLRs.[11] For example, the IRS has ruled that metering natural gas, monitoring specifications of natural gas, conducting plant maintenance, hiring plant personnel, purchasing supplies, and handling the billing, accounting, financial reporting and treasury functions for the plants constituted a qualifying activity.[12] NAPTP recommends that the Proposed Regulations be revised to provide that management fees or cost reimbursements received for operating or managing a section 7704(d)(1)(E) activity (including conducting back office functions that are conducted as part of the overall management of the section 7704(d)(1)(E) activity) on behalf of others are qualifying income – whether those receipts are properly included in income or are treated as a reduction of operating costs and expenses by the person conducting the operation.[13]

III. DEFINITION OF MINERAL OR NATURAL RESOURCE – PROP. REG. § 1.7704-4(b)

The Proposed Regulations provide the following definition of a mineral or natural resource:

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[11] See, e.g., PLR 201233010 (Apr. 20, 2012); PLR 201132012 (Apr. 29, 2011); PLR 200740010 (June 27, 2007); PLR 200712002 (Mar. 23, 2007); PLR 200422023 (Feb. 10, 2004).

[12] PLR 201132012 (Apr. 29, 2011).

[13] PLR 201132012 (Apr. 29, 2011).

> (b) Mineral or natural resource. The term mineral or natural resource (including fertilizer, geothermal energy, and timber) means any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or other similar inexhaustible sources). For purposes of this section, the term mineral or natural resource does not include industrial source carbon dioxide, fuels described in section 6426(b) through (e), any alcohol fuel defined in section 6426(b)(4)(A), or any biodiesel fuel as defined in section 40A(d)(1).

NAPTP is concerned that the definition in the Proposed Regulations does not include "products thereof" of natural resources.

A. Legislative Framework

Section 7704(d)(1)(E) provides that qualifying income includes:

> 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 (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel described in subsection (b), (c), (d), or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1). (Emphasis added.)

Thus, "gas, oil or products thereof" as well as "fertilizer, geothermal energy and timber" are examples of minerals or natural resources in the statute. The flush language of section 7704(d)(1) provides that

> the term "mineral or natural resource" means any product of a character with respect to which a deduction for depletion is allowable under section 611; except that such term shall not include any product described in subparagraph (A) or (B) of section 613(b)(7).

The legislative history to section 7704(d)(1)(E) discusses minerals and natural resources as follows:

> Specifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer, includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives.[14]

With respect to other minerals and natural resources that are products "of a character" with respect to which a deduction for depletion is allowable under section 611, the legislative history explains:

> [t]he reference in the bill to products for which a depletion deduction is allowed is intended only to identify the minerals or natural resources and not to identify what income from them is treated as qualifying income. Consequently, whether income is taken into account in determining percentage depletion under section 613 does not necessarily determine whether such income is qualifying income under section 7704(d).[15]

Taken together, the statute and legislative history provide the basis for determining whether an item is a mineral or natural resource. With the exception of fertilizer (that is the subject of a special rule), the product must be "of a character" that is at the time of its production or extraction subject to depletion under section 611[16] and the product must remain a "product thereof" as it is mined or produced, processed, refined, transported and marketed. The examples of "gas, oil and products thereof" in section 7704(d)(1)(E) and the legislative history's explanation of the intent to treat oil, gas and products thereof as natural resources make it clear

[14] H.R. Rep. No. 100-455 at 946-47 (1987).

[15] S. Rep. No. 100-445, at 424 (1988).

[16] Other than products that are specifically excluded from the definition, such as soil, sod, dirt, turf, water, or mosses and minerals from sea water, the air, or similar inexhaustible sources.

that a mineral or natural resource does not lose its status as a natural resource by being processed or refined for purposes of section 7704(d)(1)(E). This is further evidenced by the legislative history's explanation that "section 613 does not necessarily determine whether income is qualifying income."

B. Examples of Minerals and Natural Resources and Products Thereof

The following are examples of products that are "products thereof" with respect to various types of natural resources.

1. Oil and Gas

The statute and its legislative history indicate that products of oil and natural gas that are of a type commonly recovered from either petroleum refineries or field facilities remain natural resources for the purposes of section 7704(d)(1)(E). For example, "oil, gas and products thereof" would include products such as gasoline, kerosene, number 2 fuel oil, diesel fuel, methane (including liquefied natural gas), methanol,[17] ethane, ethylene, propane, propylene, butane, isobutane, butylene, butadiene, MTBE, lubricating oils, white mineral oils, solvents, petrolatums, asphalts, waxes and similar products of oil and gas processing and refining.

The legislative history provides a clear stopping point for when a product of crude oil and natural gas is no longer a natural resource, referring to products that are the result of processing beyond the types that are common in petroleum refineries or field facilities such as plastics or similar petroleum derivatives, e.g., polyethylene, polyvinyl chloride (also known as PVC), polypropylene, nylon, styrofoam, and fiberglass.

[17] When section 7704(1)(d)(E) was enacted, methanol was a common fuel used in high performance engines. For example, prior to 2007, all vehicles in the Indianapolis 500 had to be fueled with methanol. Today, methanol is still used in high performance vehicles.

2. **Timber**

Timber retains its characteristic as a natural resource after it is debarked, chipped, cut, ground, dried and compressed. As such lumber, wood chips, sawdust and wood pellets remain treated as a natural resources. Although the physical shape and size of the timber has changed, the wood substance is the same. In the production of wood pellets, the wood is compressed and excess liquids are removed, but the remainder of the components of the wood remain.

3. **Hard minerals**.

With respect to hard minerals, blister copper, metallurgical coke (from metallurgical coal) and activated carbon (from lignite coal), soda ash (from trona ore) and crushed, pulverized or pelletized iron ore are examples of products that are natural resources. Blister copper is a partially processed impure form of copper that is further refined in producing pure copper. The Proposed Regulations acknowledge, by example, that blister copper can be further refined. Metallurgical coke is produced from the coking of metallurgical coal, a heating process that drives off the volatile components of the coal, resulting in a nearly pure carbon substance. Similarly, activated carbon is simply lignite coal that has had its moisture and volatile compounds removed and has had new pores created and existing pores enlarged by subjecting the coal to steam and then quickly cooling the remaining carbon. Soda ash is the commercially marketable product from trona ore, produced by a series of crushing, calcining, dissolving, and filtering the trona. Depending on its intended use, iron ores may be crushed, pulverized or pelletized. Pulverized iron ore may be sold for use in industrial processes such as the washing of coal, while pelletized iron ore is typically further refined in the production of steel. In each instance, only the size and shape of the iron ore has changed. Whether iron ore is crushed, pulverized or pelletized, it is still iron ore.

4. Industrial Source Carbon Dioxide and Alternative Fuels Activities

The Proposed Regulations exclude from the definition of mineral or natural resource "industrial source carbon dioxide, fuels described in section 6426(b) through (e), any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1)."

In 2008, section 7704(d)(1)(E) was amended, by the Energy Improvement and Extension Act of 2008 (P.L. 110-343), to treat as generating qualifying income all section 7704(d)(1)(E) activities with respect to industrial source carbon dioxide, and the transportation and storage of "any fuel described in subsection (b), (c), (d), or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1)" (together, the "Listed Alternative Fuels"). These activities were added to expand the applicability of section 7704(d)(1)(E) to industrial source carbon dioxide and Listed Alternative Fuels. The Proposed Regulations do not address the provisions added in 2008, but industrial source carbon dioxide may be, and certain Listed Alternative Fuels such as liquefied natural gas ("LNG") and liquefied petroleum gas ("LPG") are natural resources.

5. Depletable Carbon Dioxide

Industrial source carbon dioxide is not treated as a mineral or natural resource under the statute, but is instead the subject of a special allowance for treatment by section 7704(d)(1)(E) in a manner similar to minerals and natural resources. However, naturally occurring and depletable carbon dioxide (often produced with and separated from raw natural gas streams) is, and always has been, a mineral or natural resource for the purposes of section 7704(d)(1)(E).

6. Liquefied Natural Gas.

Methane is a natural resource for purposes of section 7704(d)(1)(E), and LNG is methane that has been super-cooled and converted to liquid form to facilitate its transportation and storage. LNG is a natural resource. However, LNG is listed in section 6426(d)(2)(C). The fact that LNG is a Listed Alternative Fuel has no impact on its status as a natural resource.

7. Liquefied Petroleum Gas

LPG is another example of a product that is a Listed Alternative Fuel that is a natural resource. LPG is similar to LNG in that it is not a liquid in its natural state, but is simply a cooled mixture of propane, butane, and other components of natural gas such as propylene and butylenes. Since the enactment of section 7704(d)(1)(E) in 1987, the status of LPG as a natural resource has been clear – both from the legislative history, which makes a special exception regarding the delivery of LPG to end users at the retail level, and from industry practice, as some of the earliest publicly traded partnerships operating under section 7704(d)(1)(E) were in the business of selling LPG and propane.

C. Proposed Revision

For the reasons stated above, NAPTP recommends that Prop. Reg. § 1.7704-4(c)(1) be revised as follows:

> (c) Mineral or natural resource. (1) The term mineral or natural resource means fertilizer, geothermal energy, timber, and any product of a character with respect to which a deduction for depletion is allowable under section 611 and products thereof, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or other similar inexhaustible sources).

(2) A mineral or natural resource with respect to which a deduction for depletion is allowable under section 611 remains a product thereof when it is processed or refined as defined in Reg. § 1.7704-4(c)(5).

(3) The following are examples of minerals or natural resources:

(i) Oil, gas and products thereof, including gasoline, kerosene, number 2 fuel oil, diesel fuel, methane (including liquefied natural gas), methanol, ethane, ethylene, propane, propylene, butane, isobutane, butylene, butadiene, MTBE, lubricating oils, white mineral oils, solvents, petrolatums, asphalts, waxes and similar of a type produced from oil and gas processing and refining, regardless of the natural resource hydrocarbon source from which they originate.

(ii) Wood chips, wood pellets and sawdust produced from processing timber.

(iii) Metallurgical coke and activated carbon produced from coal.

(iv) Soda ash produced from trona; and

(v) Magnetite produced from crushing iron one.

IV. SECTION 7704 (d)(1)(E) ACTIVITIES

A. Exclusive Lists – Prop. Reg. § 1.7704-4(c)(1)

The Proposed Regulations provide that the activities which generate qualifying income are limited to the activities described in the Proposed Regulations or as listed in subsequent guidance. The operations required to explore, develop, mine or produce, process, refine, transport, or market a mineral or natural resource are varied and change as technologies evolve. The statute and legislative history do not list exclusive operations that satisfy the definitions of each enumerated activity because Congress was aware that operations change over time. Exclusive lists of operations that comprise each activity are inconsistent with Congressional intent to broadly construe these terms and will be outdated as soon as any exclusive list is written. Indeed, Prop. Reg. § 1.7704-4(c)(2)(v), which refers to "similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146)" and Prop. Reg. § 1.7704-4(c)(3)(iv), which refers to "Performing a development technique such as" some techniques listed for minerals and for oil and gas, do not list specific operations and demonstrates that an exclusive list cannot describe all of the specified activities under section 7704.

Accordingly, NAPTP recommends that Prop. Reg. § 1.7704(c)(1) be revised as follows:

> (c) Section 7704(d)(1)(E) activities—(1) Definition. Section 7704(d)(1)(E) activities include operations satisfying the definitions of the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource as described in this paragraph (c).

B. Exploration – Prop. Reg. § 1.7704 – 4(c)(2)

The Proposed Regulations provide a workable definition of exploration activities consistent with the PLRs that have been issued over the past 27 years and industry practice which has evolved based upon such PLRs. An exclusive list of operations that comprise this definition, however, does not allow for changes in technologies and cannot accurately describe all existing technologies or technologies developed in the future. Indeed, Prop. Reg. § 1.7704-4(c)(2)(v), which refers to "similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146)", does not list specific operations and demonstrates that an exclusive list cannot describe all of the activities that constitute exploration activities.

Accordingly, NAPTP recommends that Prop. Reg. § 1.7704-4(c)(2) be revised as follows:

> (2) Exploration. An activity constitutes exploration if it is performed to ascertain the existence, location, extent, or quality of any deposit of a mineral or natural resource before the beginning of the development stage of the natural resource deposit. Examples of exploration activities include:
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> (i) Drilling, completion, or abandonment of an exploratory or stratigraphic type test well;
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> (ii) Conducting drill stem and production flow tests to verify commerciality of the deposit;
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> (iii) Conducting geological or geophysical surveys;

(iv) Interpreting data obtained from geological or geophysical surveys; and

(v) For minerals, test pitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146), (see § 601.601(d)(2)(ii)(b) of this chapter) if conducted prior to development activities with respect to the minerals.

C. Development – Prop. Reg. § 1.7704-4(c)(3)

The Proposed Regulations provide a workable definition of development activities consistent with the standards in PLRs that have been issued over the past 27 years and industry practice. An exclusive list of operations that comprise this definition, however, does not allow for changes in technologies and cannot accurately describe all existing technologies or technologies developed in the future. Indeed, Prop. Reg. § 1.7704-4(c)(3)(iv), which refers to "Performing a development technique such as" some techniques listed for minerals and for oil and gas, does not list specific operations and demonstrates that an exclusive list cannot describe all of the activities that constitute development activities.

Accordingly, NAPTP recommends that Prop. Reg. § 1.7704-4(c)(3) be revised as follows:

> (3) Development. An activity constitutes development if it is performed to make accessible minerals or natural resources. Examples of development activities include:
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> (i) Drilling wells to access deposits of mineral or natural resources;
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> (ii) Constructing and installing drilling, production, or dual purpose platforms in marine locations, or any similar supporting structures necessary for extraordinary non-marine terrain (such as swamps or tundra);
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> (iii) Completing wells, including by installing lease and well equipment such as pumps, flow lines, separators, and storage tanks, so that wells are capable of producing oil and gas and the production can be removed from the premises;
>
> (iv) Performing a development technique such as, for minerals, stripping, benching and terracing, dredging by dragline,

stopping, and caving or room-and-pillar excavation, and for oil and natural gas, fracturing; and

(v) Constructing and installing gathering systems and custody transfer stations.

D. Mining or Production – Prop. Reg. § 1.7704-4(c)(4)

The Proposed Regulations limit mining to the extraction of minerals or natural resources from the ground and narrows the term "mining and production" by excluding certain oil and natural gas post-production activities that occur prior to the depletion cut-off point and certain "mining processes."[18] Section 7704(d)(1)(E) specifically references the depletion rules under sections 611 and 613, indicating that mining or production with respect to oil and natural gas should include all activities before the depletion cut-off point (which is often after some processing and transport has occurred) and mining with respect to other natural resources should include the mining processes described in section 613(c)(4). In addition, minerals and other natural resources are extracted from waste or residue from prior mining in the ground, and the definition should include this fact.[19] PTPs may also earn income from surface damage payments resulting from mining activities. As these examples illustrate an exclusive list of operations would not encompass all types of mining income, would not allow for changes in technologies, and could not accurately describe all existing technologies or technologies developed in the future.

Accordingly, NAPTP recommends that Prop. Reg. § 1.7704-4(c)(4) be revised as follows:

> (4) Mining or Production. An activity constitutes mining or production if it is performed to extract minerals or other natural resources from the ground or from waste or residue from prior mining. Examples of mining or production activities include:

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[18] Reg. § 1.613-4(f)(1).

[19] Reg. § 1.613-4(i).

(i) Operating equipment to extract natural resources from mines and wells;

(ii) Operating equipment to convert raw mined products or raw well effluent to substances that can be readily transported or stored (for example, passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water);

(iii) Any mining process described in section 613(e)(4); and

(iv) With respect to oil and natural gas, any activity before the depletion cut-off point for purposes of section 611.

E. Processing or Refining – Prop. Reg. § 1.7704-4(c)(5)

In general, the Proposed Regulations treat an activity as processing or refining only if the activity is done to "purify, separate or eliminate impurities". The Proposed Regulations further require that for an activity to be treated as processing or refining, the partnership's designation of the MACRS class life for any of the assets used in the activity must reflect that the activity is processing or refining. Thus, errors in assigning class lives, or even settlement agreements with the IRS as a result of a past audit, could lead to a PTP being taxed retroactively as a corporation.

In addition, the Proposed Regulations impose limitations on "processing or refining" through industry-specific definitions. Those definitions have no statutory support and are contrary to the IRS's interpretations of these terms over the last 27 years, as evidenced by PLRs that have been issued. With respect to natural gas, the Proposed Regulations provide that an activity is processing or refining only if the activity purifies the natural gas or separates the natural gas into its constituents. With respect to ores and minerals, the Proposed Regulations provide that an activity is processing or refining only if it meets the definitions in Reg. §§ 1.613-4(f)(1)(ii) or 1.613-4(g)(6)(iii). With respect to timber, an activity is processing only if it modifies the physical form of the timber.

The Proposed Regulations generally state that "processing or refining" does not include activities that cause a substantial physical or chemical change in a mineral or natural resource or transform extracted minerals or natural resources into new or different mineral products, such as manufactured products. An exception, however, would apply to activities occurring in a petroleum refinery to make a fuel or certain conversions of methane to liquid fuels that are otherwise produced from petroleum.

NAPTP has the following major concerns with the definitions of "processing and refining" in the Proposed Regulations that are discussed below:

- The definitions are inconsistent with section 7704 and with existing Treasury Regulations. The Proposed Regulations unduly restrict the definition of "refining" and essentially read "processing" out of the statute.
- The Proposed Regulations apply different principles for the processing and refining of different natural resources. There is no statutory basis for disparate treatment of different natural resources.
- Processing and refining of natural resources often involve some degree of physical or chemical change, which is often necessary to eliminate impurities from the natural resource, and there is no statutory basis for disqualifying an activity because it involves a substantial physical or chemical change.
- The MACRS classification of the assets used in the activity, and the focus on the production of fuels have no statutory basis.
- The Proposed Regulations create inconsistencies in the treatment of comparable activities where substantially identical processes are used to create the same products.

- Refining partially processed ores and minerals is treated as a qualifying activity but the processing activities that take place prior to refining are treated as non-qualifying activities.
- The restrictive definition of processing and refining as applied to timber does not allow timber to undergo even the most fundamental refining processes, such as the separation of the timber into its constituent parts, as is done in the pulping of wood.

1. **Processing and Refining in General.**

Section 7704(d)(1)(E) provides that qualifying income includes, inter alia, 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. Thus, to constitute qualifying income under the statute, two tests must be met: (i) the income-generating activity must be performed with respect to a "mineral or natural resource"; and (ii) the income must be derived from one or more of the listed activities.

In section 7704(d)(1)(E), Congress explicitly sought to include within the activities producing "qualifying income" every stage of mineral and natural resource production, from the initial steps of identifying and accessing resources ("exploration," "development"), to their extraction ("mining or production"), to rendering the extracted raw materials commercially useful ("processing," "refining"), to delivering and selling them ("transportation," "marketing").

Section 7704(d)(1)(E) was first proposed in the House and initially provided that partnerships engaged in the exploration, development, mining or production, refining, transportation or marketing of minerals or natural resources would be taxed as partnerships. No comparable provision was in the Senate bill. In Conference, "processing" was added to the list of qualifying activities. This confirms that Congress considered "processing" to include more or different activities than "refining." As a result, while "processing" and "refining" may overlap, the legislative history confirms that processing and refining, taken together, encompass a broader range of activities than either processing or refining considered separately.

2. **The No Substantial Chemical or Physical Change Requirement Has No Basis in the Statute or Legislative History**

The basic "processing or refining" definition in the Proposed Regulations states that, except as specifically provided otherwise, an activity would not qualify as processing or refining if the activity "causes 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."[20] When applied to natural gas (including NGLs) and hard minerals, the Proposed Regulations essentially define processing and refining as only those activities that involve <u>no</u> physical or chemical change. There is nothing in section 7704 or the legislative history to support this limitation.

The preamble to the Proposed Regulations suggests that the source of this rule is Reg. § 1.613-4(g)(5), which defines "transformation processes" as "[p]rocesses which effect a substantial physical or chemical change in a crude mineral product, or which transform a crude mineral product into new or different mineral products, or into refined or manufactured products," and characterizes transformation processes as nonmining processes (except to the

[20] Prop. Reg. § 1.7704-4(c)(5)(i).

extent that such processes are specifically allowed as mining processes in section 613(c) or Reg. § 1.613-4(f)).[21]

The purpose of identifying transformative processes in Reg. § 1.613-4(g)(5), however, is to identify processes that are not mining processes includible in determining the depletion cutoff point. Reg. § 1.613-4(g)(5) does not distinguish between activities that qualify as processing or refining of an ore or mineral, which produce qualifying income, and activities that constitute manufacturing.

With respect to oil and gas, the transformative process rule ignores decades-old authorities regarding the definition of refining. Treasury regulations regarding the depletion of crude oil define "refining" as "any operation by which the physical or chemical characteristics of crude oil are changed, exclusive of such operations as passing crude oil through separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and blending crude oil products."[22]

The Treasury Regulations regarding the depletion of crude oil define "crude oil" to include a "[n]atural gas liquid recovered from gas well effluent in lease separators or field facilities before any conversion process has been applied to such production."[23] Thus, existing Treasury Regulations define "refining" of NGLs broadly to include any transformative process, including chemical and physical changes, with certain limited exceptions to recognize activities treated as part of the production of oil or gas.

Further, the definition in the Proposed Regulations of "processing" and "refining" is inconsistent with the established definitions of the terms. The Oxford Dictionaries defines "to

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[21] Preamble to the Proposed Regulations at 7.
[22] Reg. § 1.613A-7(s).
[23] Reg. § 1.613A-7(g)(3).

process" as "to perform a series of mechanical or chemical operations on (something) in order to change or preserve it." "To refine" is defined as "to remove impurities or unwanted elements from (a substance), typically as part of an industrial process."[24] Both "refining" and "processing" contemplate, by their very definitions, physical and chemical changes to the input material.

Many valuable resources, such as copper and iron, are generally found in the earth embedded in compounds which must be chemically changed to recover the resource. For example, the iron in iron ore is generally in the form of iron oxides. To purify the iron ore it must be smelted, which involves the application of heat and a reducing agent to induce chemical reactions that release the oxygen from the iron oxide. Accordingly, processing and refining often include more than merely purifying and separating and frequently cause a substantial physical or chemical change in a mineral or natural resource.

3. Natural Gas and Petroleum.

(a) NGLs Are Qualifying Natural Resources. The Proposed Regulations define "processing or refining" of natural gas to exclude any activities with respect to NGLs beyond separation of the natural gas into its liquid and gaseous components, thus erroneously characterizing NGLs as something other than natural resources.

Oil and gas in place is a complex collection of hydrocarbons under high pressure embedded in rock formations. In the reservoir, all the elements of production are mixed together, which at the time of production are separated into two basic streams: natural gas (including NGLs) and crude oil. The natural gas stream is a combination of methane, ethane, propane, butane, and natural gasoline, and the crude oil stream is a mixture of hundreds of

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[24] Note that the definition of "refining" contemplates that refining is a specific type of process. "Processing" is thus the broader term. This is consistent with usage of these terms in the industry.

different types of hydrocarbon molecules ranging from the lightest hydrocarbons (e.g., methane and the NGLs) to the heavier hydrocarbon molecules (e.g., jet fuel, kerosene, gas oils and asphalt), and are both equally "oil and gas." NGLs are a hydrocarbon component of every barrel of crude oil and every natural gas stream and as such, are clearly natural resources.

NGLs, as part of the production stream of an oil and gas well, are, unquestionably "oil and gas" – a product of a character with respect to which a deduction for depletion is allowable under section 611. Both section 613A(e)(1) and Reg. § 1.613-7(g) define "crude oil" to include NGLs. These authorities recognize that the hydrocarbon continuum is complex and that many different hydrocarbons, including NGLs, fit under the generic term "oil and gas" which is a natural resource.[25]

Moreover, it is clear from the legislative history that NGLs do not lose their status as "natural resources" merely as a result of being separated. The House Report to the 1988 Act[26] explicitly references separated NGLs as "natural resources." The separation process (whether crude oil distillation or NGL fractionation) does not alter the character of the underlying hydrocarbons. Following separation, the underlying components are in exactly the same state as they were in the reservoir. The Proposed Regulations acknowledge this concept in the case of crude oil by permitting refining beyond separation by distillation, but not in the case of natural gas.

(b) The Product Does Not Define the Process. The Proposed Regulations provide that "refining," as applied to hydrocarbon natural resources, should be limited to those activities the primary purpose of which is to produce fuel. The Proposed Regulations contain

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25 H.R. Rep. No. 100-495, at 946-47 (1987) (providing that natural resources include "oil, gas or products thereof"). The legislative history goes on to include a broad, non-exclusive list of basic hydrocarbon products that constitute oil, gas or products thereof.

26 H.R. Rep. No. 100-1104, at 18 (1988).

two primary exceptions to the application of the "processing or refining" standard to petroleum and natural gas: (i) processing will include converting methane in one integrated conversion into liquid fuels, provided that such liquid fuels are otherwise produced from the processing (or presumably refining) of crude oil; and (ii) the production of ethylene, propylene and similar petrochemical feedstocks in a refinery will be qualifying activities, provided such products are refinery grade products that are obtained in the steps required to make fuels.

Neither the statute, the legislative history, nor prior IRS interpretations of the statute support the conclusion that Congress enacted 7704(d)(1)(E) solely to foster in the production of fuels. The statute does not deem an activity to be processing and refining based on the product or output that is produced. Indeed, there is nothing in the statute to indicate that processing and refining of a natural resource into a fuel is any more a qualifying activity than processing and refining the natural resource into a chemical feedstock or lubricating oil. Only with respect to the production of plastics and similar petroleum derivatives does the legislative history restrict the definition of processing and refining, and the final regulations should appropriately include limitations in this regard.

Another part of the legislative history of section 7704, however, appears to be the source of the focus on fuels in the Proposed Regulations. The House Report provides that:

> Specifically, **natural resources include** . . . oil, gas or products thereof . . . . For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. . . .[27] (Emphasis added.)

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[27] H.R. Rep. No. 100-495, at 947 (1987).

This excerpt may be the source of the view adopted by the Proposed Regulations that there are a limited number of acceptable products that may be produced from the processing and refining of oil and gas, and that because many (but not all) of the substances listed are crude oil based fuels, those fuels must have favored status.

The House Report, however, is not describing acceptable products or outputs that may be derived from processing and refining. Instead, it is describing substances that are included in the term "natural resources," i.e., inputs that may still be processed and refined as a qualifying activity.

(c) The Definition of Processing or Refining is Unduly Restrictive. Section 7704(d)(1)(E) provides that the processing and refining of any natural resource is a qualifying activity. Accordingly, once it is determined that NGLs are natural resources under section 7704(d)(1)(E), the processing and refining of NGLs is a qualifying activity. However, under the Proposed Regulations refining does not apply to NGLs, so that qualifying income includes only income from a limited category of processing, i.e., fractionating (separating) the NGL stream into its component parts (ethane, propane, normal butane, isobutane and natural gasoline). No processing (or any refining) of these components is a qualifying activity under the Proposed Regulations, even though the legislative history specifically provides that such components are natural resources.

(d) The Proposed Regulations Inappropriately Favor the Production of Crude Oil-Based Fuel. The Proposed Regulations focus on fuel production that occurs in a petroleum refinery and inappropriately favor fuel and other products derived from crude oil over products derived from NGLs. Under the Proposed Regulations, the production of products that result from a physical or chemical change of a crude oil feedstock (e.g., ethylene, propylene and similar petrochemical feedstocks) in connection with the production of fuel in a refinery is a qualifying activity. The production of identical products from NGLs, which could have come from the same well, would not be a qualifying activity.

With respect to methane, while any activity that results in a physical or chemical change to an NGL would not be a qualifying activity, the exceptions for fuel production would permit the conversion of methane to fuels to be a qualifying activity. While many types of fuel and fuel components are derived from NGLs (e.g., isooctane, alkylates and MTBE), no similar exception would apply even though the methane and the NGLs could have come from the same well.

As a result of the exceptions for fuel production, the Proposed Regulations differentiate between fungible oil and gas products, such as ethylene and propylene, based on (i) the particular natural resource from which they are derived and (ii) the type of facility that produces them. This is made clear by contrasting Prop. Reg. § 1.7704-4(e) Example 1 with Example 2. Example 1 concludes that the conversion of NGLs into olefins (such as ethylene) through steam cracking does not give rise to qualifying income, while Example 2 concludes that the conversion of crude oil into various components (again, such as ethylene) through catalytic cracking does give rise to qualifying income. The NGL steam cracking process described in Example 1 is fundamentally the same as the catalytic cracking process described in Example 2. Each uses essentially the same processes to generate the same products in varying proportions. Cracking is the process of breaking down a hydrocarbon molecule into simpler molecules and removing hydrogen. A steam cracker accomplishes this through the application of heat. Likewise, a catalytic cracker uses heat to break down a hydrocarbon molecule, but also uses a catalyst to speed up the reaction and to influence the ratio of the product mix. Thus, the only difference between steam cracking and catalytic cracking is that the latter is a slightly more complicated process. Dozens of refinery complexes worldwide include both steam crackers and catalytic crackers.

The processing of NGLs and other hydrocarbons can occur either in a crude oil refinery or a steam cracker. Both types of facilities employ processes that result in physical and chemical changes to the hydrocarbon feedstocks. These processes can involve cracking with heat, cooling, compression, separation, blending and other processing steps. In the end, the list of products from a crude oil refinery includes the same products as the list of products from a steam cracker processing NGLs.

As another example, income from the sale of alkylates, isooctane, and MTBE produced in a refinery would generate qualifying income under the Proposed Regulations, but would not generate qualifying income if such products were produced from NGLs. The disparate treatment of products from refineries and gas processing plants cannot be supported.

(e) Crude Oil Refining. The petroleum refining industry began in the United States in 1861 with the opening of the first crude oil refinery and has rapidly evolved to meet consumer demand for petroleum products. Refining processes, which largely evolved between 1870 and the 1970s, include (i) fractionation via distillation processes, (ii) conversion processes, which include separation via thermal and catalytic cracking, unification through alkylation and polymerization, and alteration via isomerization and catalytic reforming; (iii) treatment processes, which are intended to prepare hydrocarbon streams for processing or prepare finished products (iv) formulating and blending processes, which involve mixing and combining hydrocarbons to achieve specific performance characteristics; and (v) other refining operations such as light-ends recovery and hydrogen production. By 1975, refineries were capable of producing a very broad mix of products from a single barrel of crude oil, including kerosene, lubricants, naphtha, tar, asphalt, bunker fuel, distillate fuels, residual fuels, sulfur, petroleum coke, alkylates, aromatics such as benzene, waxes, solvents, mineral oils, petrochemical feedstocks, diesel fuel, gasoline, and high-octane aviation gasoline.

The Proposed Regulations emphasize crude oil fuel production not only to the detriment of processes that utilize other feedstocks, but also to the point of excluding from "refining and processing" those activities that comprise crude oil refining, but do not result in fuel. The legislative history clearly states that all products of "petroleum refineries and field facilities" constitute "oil, gas, and products thereof" for purposes of section 7704. The Proposed Regulations ignore this legislative history by imposing an arbitrary distinction between fuels and non-fuel refinery products. Congress chose not to distinguish between different types of refinery processes on the basis of the product they produce, as neither the statute nor the legislative history limits the products that can be produced in a processing or refining activity, except to the extent such activities result in plastic or other similar petroleum derivatives. Had Congress intended to limit "processing and refining" to fuels production, it could easily have done so: refineries were producing non-fuel products long before the statute was enacted. Instead, the statute is concerned only with whether the input of a refining or processing activity – not its output – is a natural resource.

The limitations with respect to non-fuel refining processes are particularly troublesome given that nearly every product produced by a crude oil refinery exists in a barrel of crude oil. While crude oils from various basins have different compositions (and therefore are each capable of producing a different product mix), refining is simply the process of recovering those products from each barrel of crude oil via purification and extraction processes. Whether those processes result in gasoline or lubricants and waxes is irrelevant to the determination of whether a refining or processing activity constitutes a qualifying activity under section 7704.

Although blending occurs in some fashion with respect to nearly every product of crude oil refining (and, in fact, every natural resource), 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."

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, and the IRS has ruled in numerous PLRs that income from such blending constitutes qualifying income.[28] In addition, the IRS has ruled that blending to achieve the correct percentage of nitrogen in fertilizer products,[29] blending iron ore with binder, limestone and dolomite to produce iron pellets suitable for use in a blast furnace,[30] and blending straight-run asphalt with non-natural resource additives to produce modified asphalt give rise to qualifying income.[31] These PLRs 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.

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28 See, e.g., PLR 201403008 (Sept. 13, 2013) (blending refined petroleum distillates and lube oil base stocks to create greases).

29 See PLR 201331002 (Apr. 16, 2013) (blending liquid urea with water to produce a solution with a nitrogen concentration saleable both as fertilizer and diesel exhaust fluid); PLR 201308004 (Nov. 5, 2012) (similar).

30 PLR 201351009 (Sept. 12, 2013).

31 PLR 200927002 (Mar. 23, 2009).

(f) The Proposed Regulations Create Inconsistent Treatment of Comparable Activities. The Proposed Regulations' distinction based upon the particular natural resource or facility type from which a product is produced results in inconsistent treatment of the same products from the same or substantially similar inputs via essentially the same processes without statutory support. The only limitation that Congress applied to "processing" and "refining" was to prohibit processing and refining activities that result in the production of plastics or similar petroleum products. There is nothing in the legislative history limiting an activity by geography, e.g., to a petroleum refinery or gas processing plant, requiring industry-specific definitions, e.g., by-products from the production of fuel, or limiting refining to the production of a fuel.

The use of the phrase "similar petroleum derivatives" logically would disqualify only those products with characteristics so far removed from oil and gas products as to be similar to plastics, such as polyethylene, polyvinyl chloride (also known as PVC), polypropylene, nylon, styrofoam, fiberglass and other chemical products that differ substantially from, and have more complex molecular structures than, the base petrochemical feedstocks and hydrocarbon sources from which they are produced.

(g) Olefins. Olefins, such as propylene (dehydrogenated propane) or ethylene (dehydrogenated ethane), are naturally occurring in both crude oil and natural gas, but not in marketable quantities. Olefins, however, are derived from the first-stage processing of NGLs, which are natural resources. Neither the input (NGLs) nor the output (olefins) is equivalent to plastic or any similar petroleum derivative. Olefins are hydrocarbon "building blocks" for further processing which may be used for further refinery operations or for use as petrochemical feedstocks, but they are not finished products nor are finished products directly produced from them. In fact, these olefins are similar to, and actually have a simpler molecular structure (typically, having one less hydrogen atom) than, their corresponding NGL. Plastic, however, is a final product that results from many processes and combinations of products that are neither produced nor common in petroleum refineries. Olefins are no more similar to plastic-like petroleum derivatives than flour is to bread.

(h) Alkylate. Alkylate is a hydrocarbon that has high octane, low vapor pressure and low sulfur content and which is an ideal component of gasoline. Alkylate makes up over ten percent of standard U.S. gasoline. Alkylation combines hydrocarbons (primarily isobutane, butane, butylene and propylene), either produced in a petroleum refinery or as a part of natural gas fractionation and processing, with hydrogen in the presence of a catalyst to form high octane-number isomers of trimethylpentane, such as isooctane.

Butane is specifically listed as a natural resource in the legislative history. Isobutane is simply an isomer of butane (i.e., a compound molecule with the same formula but a different arrangement of atoms in the molecule) that also is recovered in both petroleum refineries and field facilities. Butylene and propylene are both natural resources as products which are recovered from petroleum refineries.[32] Other inputs that may be used in alkylation include raffinate, MTBE and ethylene.[33] Notably, alkylate is also a product which is recovered from petroleum refineries and is also therefore a natural resource.[34] Since the hydrocarbons processed in an alkylation unit are natural resources, and alkylation is a refinery process, "processing or refining" should include alkylation whether or not conducted in a crude oil refinery.

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32 See NAISC Code 324110, available at http://www.naics.com/naics-code-description/?code=324110.

33 Raffinate and Ethylene are both products recovered from crude oil in a crude oil refinery. MTBE is also produced in crude oil refineries (and other facilities such as ethylene plants) by reacting methanol with isobutylene.

34 Supra note 32.

Several existing PTPs engage in the processing, transportation, storage and/or marketing of NGLs, olefins and/or refined products. If the Proposed Regulations are finalized with unequal treatment of the same products based on their method of production, PTPs that are engaged in the transportation, storage and marketing of these products will be faced with the impossible task of trying to identify the exact source of the fungible products they handle in order to calculate their gross income from qualifying products and non-qualifying products. For example, a PTP transporting and selling ethylene in many cases would have no way of knowing whether the ethylene was produced from crude oil in a refinery or from NGLs in a gas processing plant.[35]

4. Ores and Minerals

The Proposed Regulations define "processing or refining" of ores and minerals to include only activities that meet the definition of mining processes under Reg. § 1.613-4(f)(1)(ii) or refining under Reg. § 1.613-4(g)(6)(iii). With respect to refining, the Proposed Regulations further state: "Generally, refining of ores and minerals is any activity that eliminates impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as for example the refining of blister copper."[36]

(a) Processing Ores and Minerals Does Not Mean Mining Processes. The definition of "refining" in the Proposed Regulations is the same as the definition of "refining" in Reg. § 1.613-4(g)(6)(iii). The Proposed Regulations, however, define "processing" to include only the mining processes described in Reg. § 1.613-4(f)(1)(ii). Section 613(c)(2) and Reg. § 1.613-4(f)(1) incorporate the mining processes described in that section into the definition of "mining." Those mining processes are the "ordinary treatment processes normally applied by mine owners

[35] See Prop. Reg. § 1.7704-4(e), Examples 1 and 2.
[36] Prop. Reg. § 1.7704-4(c)(5)(iv).

or operators in order to obtain the [first] commercially marketable product"[37] Under section 7704(d)(1)(E), these would constitute "mining or production." In fact, these processes (such as sorting, sizing, concentrating and sintering) are described in the definition of "mining" in the Proposed Regulations ("Operating equipment to convert raw mined products … to substances that can be readily transported and stored"). As applied to processing of ores and minerals, however, the Proposed Regulations inappropriately cut off qualifying income at the depletion cutoff point and effectively write the word "processing" out of the statute.[38]

The section 613 regulations divide "processes" into "mining processes" (which are part of the definition of "mining") and "non-mining processes."[39] Since "mining," "processing," and "refining" are separate qualifying activities under section 7704, "processing" of ores and minerals must mean something other than "mining processes." When Congress enacted section 7704 in 1987, and each time it subsequently amended section 7704, it did so against the backdrop of the definitions in section 613 and the Treasury Regulations thereunder. There is no indication that Congress intended to restrict "processing" to the mining processes in section 613, which have been part of the definition of "mining" since at least 1943.[40]

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37 Reg. § 1.613-4(f)(2) (Emphasis added).

38 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. 100-445, pt. 2, at 424 (1988) ("The reference in the bill to products for which a depletion deduction is allowed is intended only to identify the minerals or natural resources and not to identify what income from them is treated as qualifying income. Consequently, whether income is taken into account in determining percentage depletion under section 613 does not necessarily determine whether such income is qualifying income.").

39 See Reg. § 1.613-4(f)(2),-(6),-4(g).

40 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, 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....").

The reference to the definition of mining processes in Reg. § 1.613-4(f) does not capture all processes that are treated as mining under section 613. In 1974, two years after Reg. § 1.613-4 was promulgated, Congress amended section 613 to clarify that the decarbonation of trona is a mining process. Trona is decarbonized by calcining, which uses heat to remove volatiles, in this case water and carbon dioxide, from the mineral. The IRS confirmed in Rev. Rul. 81-235[41] that the decarbonation of trona is a mining process. However, the Treasury Regulations have not been amended to conform to current law and Reg. § 1.613-4(g)(6)(i) classifies calcining as a non-mining process.

Accordingly, the Proposed Regulations should be revised to define "processing" as applied to ores and minerals in a manner consistent with the definitions in section 613 and the regulations thereunder by incorporating nonmining processes into the definition.

(b) Processing of Ores and Minerals Includes Non-Mining Processes Described in Section 613. Section 613(c)(5) and Reg. § 1.613-4(g)(1) provide a list of nonmining processes, i.e., processes that are performed after mining processes are completed. Those processes include (among others) electrolytic deposition, roasting, calcining, thermal or electric smelting refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, and thermal action.[42]

A number of the listed nonmining processes eliminate impurities from ores or minerals, thus falling squarely within the general definition of "processing or refining" in the Proposed Regulations. For example, Reg. § 1.613-4(g)(6)(ii) defines "thermal smelting" as "processes which reduce, separate, or remove impurities from ores or minerals by the application of heat." Examples of thermal smelting include "the furnacing of copper concentrates" and "the

[41] 1981-2 C.B. 140.

[42] Reg. § 1.613-4(g)(1).

heating of iron ores, concentrates or pellets in a blast furnace to produce pig iron." Similarly, Reg. § 1.613-4(g)(6)(i) defines calcining to mean "processes used to expel the volatile portions of a mineral by the application of heat." Another such process, "thermal action," includes "processes which involve the application of artificial heat to ores and minerals, such as … the coking of coal." The coking of coal involves the application of heat in an oxygen-free environment to remove volatiles and other impurities from the coal, creating a purer carbon product.[43]

Given the well-established meaning of "mining" under section 613 and the Treasury Regulations thereunder, for purposes of section 7704(d)(1)(E) Congress reasonably intended "processing" of ores and minerals to include the nonmining processes listed in section 613(c)(5) that are carried out after mining processes have been completed and before refining begins. For example, before copper can be refined, concentrated copper ores (a mixture of copper sulfide, iron sulfide and other metals) must be smelted in a furnace to yield blister copper, which is then refined in an anode furnace to yield pure copper.[44]

The fact that the definition of refining in the Proposed Regulations refers to partially processed or smelted minerals further indicates that nonmining processes, such as smelting, that purify ores or minerals constitute "processing" for purposes of section 7704(d)(1)(E). Otherwise, the Proposed Regulations would create a definitional gap under which refining a smelted mineral, such as blister copper, generates qualifying income, but the smelting of the copper ore concentrate to produce the blister copper, which necessarily precedes the refining of the blister copper, does not generate qualifying income. This result could not have been intended. The Proposed Regulations should be revised to make clear that those

43 Reg. § 1.613-4(g)(6)(viii).

44 U.S. Environmental Protection Agency, Metallurgical Industry, AP 42, ch. 12.3, "Primary Copper Smelting" (1986).

processes that accomplish the same result – removing impurities from ores or minerals – that the Proposed Regulations define as processing or refining are expressly included in the definition of processing in final regulations.

Accordingly, processes applied to ores and minerals up to and including processes that eliminate impurities from ores and minerals, such as roasting, calcining and smelting of ores, and other processes such as the coking of coal, involving the application of heat to expel impurities from the mineral, should be characterized as processing of ores and minerals which produce qualifying income.

5. <u>Timber</u>

The Proposed Regulations state that "[a]n activity constitutes processing of timber if it is performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances." Conversely, an activity does not constitute processing of timber if it "add[s] chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp." The Proposed Regulations also include a non-exhaustive list of products that result and do not result from timber processing:

Qualifying Timber Products	**Non-Qualifying Timber Products**
Wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark, and rough poles.	Pulp, paper, paper products, treated lumber, oriented strand board/plywood, and treated poles.

The approach in the Proposed Regulations presents a sharp departure from the IRS's longstanding interpretations regarding the "processing" of timber, as expressed in eight PLRs, spanning more than twenty years:

PLR	Timber Product	Timber Feedstock	Processes
9008035 (Nov. 24, 1989)	Pulp	Cut Timber	Extracting cellulose fibers, dissolving timber in steam solution of water and chemicals, bleaching, cleaning, drying, and baling.
9105015 (Nov. 1, 1990)	Lumber	Logs	Removing undesired components, such as bark and knots, and cutting logs into lumber lengths and individual boards.
9338028 (June 25, 1993)	Plywood and Fiberboard	Logs, Chips, Saw Dust, and Planer Shavings	Debarking, cutting, steaming, lathing, drying, gluing, hot pressing, trimming, sanding, patching, mixing with resins, and treating with ammonia.
9450029 (Sept. 19, 1994)	Plywood and Lumber	Logs	Debarking, deknotting, cutting into lumber lengths and individual boards, drying in kilns to reduce their moisture content, surfacing by a rotary planer, and chipping waste for sale to pulp or particle board mills.
9822034 (Feb. 26, 1998)	Lumber, Plywood, MDF, and Other Engineered Wood Products (Including Finger Jointed Lumber, Scarfed Plywood, Edge Glued Boards, and Medium Density Overlay)	Logs, Wood Fibers, Shavings, Veneer Panels, Low Grade Studs, and Finished Lumber	Debarking, cutting, surfacing, grading steaming, peeling, drying, applying adhesive, bonding veneer sheets, patching panels, sanding, pressing the refined wood fibers and resin at high temperatures, processing with ammonia, bonding with glue, heat, and pressure, removing defects from studs, scoring studs, chipping scraps, cutting board ends to create fingers, applying heated glue, serrated cutting, bonding sheets of heavy kraft paper that have been impregnated with phenolic resin to panels of plywood using heat and pressure, shaping, painting, packaging and shipping.
9822035 (Feb. 26, 1998)	Lumber and Poles	Lumber and Poles	Sale of wood products third party application of preservatives or fire retardants by applying the treatment to the wood under pressure and application of four to eight coats of a sealant.
199932024 (Aug. 16, 1999)	Glued Products	Cut Timber and Lumber	Gluing small pieces of wood together, gluing together wood veneers, bonding the sheets in a hot press, grading, sanding, bonding wood chips, sawdust, and planer shavings, combining, softening, mixing with resins, drying, pressing, treating with ammonia; blending wood wafers together with resins, forming the materials into panels, binding and forming fine wood chips, shaping in the form of panels or boards.
201201002 (July 7, 2011)	Logs, Wood Chips, Lumber Scraps,	Cut Timber, Chipped Wood,	Sorting, chipping, grounding into a fine wood powder, drying, pelleting with a die,

PLR	Timber Product	Timber Feedstock	Processes
	Sawdust, and Wood Pellets	Lumber Scraps, Sawdust, and Pulpwood	cutting, transporting, storing, marketing, and distributing.

Because there is no basis in the statute or its legislative history for giving the terms "processing" and "refining" different meanings for different natural resource inputs, final regulations should adopt standards for the terms "processing" and "refining" that apply to all natural resources. In the context of timber, there is no difference in the composition of logs, lumber, poles, or wood chips: each is comprised of cellulose fibers, lignin, and hemicelluloses. The Proposed Regulations focus on limiting the products which can be derived from the "processing" and "refining" of timber has no support in section 7704 or its legislative history as described above. The requirement that the input of a process be a natural resource aligns with the plain meaning of section 7704.

(a) Pulping Is a Form of Separation and Purification.

As described in more detail below, PLRs approving the treatment of lumber and the pulping of cut timber, issued shortly after the enactment of section 7704, correctly applied the plain meaning of "processing" to timber, and correctly concluded that income from the sale of pulp and treated lumber and poles constitutes "qualifying income". These activities are no different than common processing and refining activities with respect to crude oil, natural gas, and products thereof (such as separation, purification, and blending activities).

The Proposed Regulations list wood pellets as a product that results from timber processing. However, the Proposed Regulations prohibit the addition of chemicals or other foreign substances to timber "to manipulate timber's physical or chemical properties." As discussed above, the final regulations should permit the addition of small amounts of additives that enhance or protect the intrinsic properties of the natural resource.

Although wood pellets are commonly made without the addition of any non-timber additives (other than water),[45] it is possible, if not likely, that customers or regulators may require the addition of an additive to reduce the emissions profile of wood pellets. For example, if environmental regulators determine that an additive would reduce the impact of burning wood pellets, the regulators may require the application of such an additive to all wood pellets sold to utilities within the regulated jurisdiction. Such regulations would likely be similar to the regulations that currently require the application of additives to gasoline.[46] The addition of a relatively small amount of additives to protect or enhance the intrinsic properties of the wood should not affect whether processing of timber into wood pellets generates qualifying income.

In PLR 9008035, the IRS concluded that "the pulping of cut timber constitutes the processing of a natural resource within the meaning of section 7704(d)(1)(E) of the Code, and that Partnership will derive qualifying income from the manufacture and sale of pulp." There, the partnership owned a mill that extracted pulp from cut timber using the kraft process. First, either the mill or an outside producer debarked logs and cut them into wood chips. Next, in a pressure vessel known as a digester, the mill dissolved lignin from the chips in a steam-heated solution of water and chemicals. The mill then washed the separated cellulose fibers in water and passed the wet pulp solids ("brown stock") through knotters, which caught any undigested chips. Finally, the mill bleached, cleaned, dried, baled, and sold the brown stock in bulk to paper producers. On

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[45] Although water is added to the timber feedstocks that make up pellets, the net result of the pelleting process is, in almost all cases, a reduction in the water present in the timber making up the pellets.

[46] See 40 C.F.R. § 80.161(a)(iii).

these facts, the IRS concluded that the pulping of cut timber constitutes the processing of timber, and thus income from the manufacture and sale of pulp constitutes qualifying income.

The Proposed Regulations depart from this interpretation[47] by defining "processing" as an activity "done to purify, separate, or eliminate impurities." Under this general definition, the pulping of cut timber should constitute "processing". Raw timber consists of three components, apart from water: cellulose fibers; lignin; and hemicelluloses. Wood pulp is comprised almost entirely of pure cellulose fibers. The pulping process separates the cellulose fibers from the lignin and hemicelluloses. The exclusion of pulping on the basis that using a digester "add[s] chemicals…to timber to manipulate its physical or chemical properties"[48] is contrary to the general definition of "processing" in the Proposed Regulations, because pulping purifies, separates, and eliminates impurities in the timber. In so doing, the definition of "processing" for timber also arbitrarily prejudices PTPs that process timber, rather than other natural resources, such as crude oil.

The Proposed Regulations should be revised to allow PTPs to separate the components of all natural resources, including timber. The Preamble acknowledges that petroleum refineries not only separate the components of crude oil, but also add chemicals and foreign substances to manipulate crude oil's physical or chemical properties.[49] As in the separation of crude oil, the input in pulping is a natural resource. The composition of wood chips is identical to the

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[47] Note that the first PLR issued by the IRS regarding section 7704(d)(1)(E) addressed the pulping of timber, and concluded that pulping was within the meaning of "processing" of timber for the purposes of section 7704(d)(1)(E). The ruling was issued less than two years after the enactment of section 7704(d)(1)(E), when it would have been possible for those working at the IRS to have either participated in the legislative process or to have had contemporaneous conversations with those who did.

[48] Preamble to Proposed Regulations at 9.

[49] Proposed Regulations Preamble at 8 ("An activity that chemically converts the physically separated components is processing or refining of crude oil only 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 (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline.)").

composition of timber. Any foreign substances in the pulping process are catalysts, rather than inputs. That is, the foreign substances in the pulping process temporarily facilitate separation of the timber but do not permanently adhere to or combine with the input, like resin adheres to wood fibers in the production of MDO.

The Proposed Regulations should be revised to treat activities, such as pulping, that separate natural resource inputs into their constituent components as generating qualifying income. Therefore, "pulp" should be listed as an example of a product that results from timber processing or refining.

(b) Treatment of Lumber and Poles Constitutes the Processing of Timber.

In PLR 9105015, the IRS ruled that "processing" includes the sawmilling of timber to (1) remove undesired components, such as bark and knots, from logs, (2) cut the logs into lumber lengths, and (3) further cut the logs into individual boards that are sold on a wholesale basis. In PLR 9822035, the IRS ruled that "processing" also includes treating softwood and hardwood lumber and timber poles. Treatment of lumber involves applying a preservative or fire retardant to the wood under pressure, then sealing the wood by applying coats of a sealant. Poles are simply timber logs which have been debarked and, in some cases, cut to standard lengths. The treatment process for poles is the same as for lumber.

The Proposed Regulations list "treated lumber" and "treated poles" as products that are not the result of timber processing, while "rough lumber" and "rough poles" are listed as qualifying products.[50] The general definition of "processing" in the Proposed Regulations states, "an activity will not qualify as processing...if the activity causes a substantial physical or

[50] The Proposed Regulations are unclear about what constitutes "rough lumber" and "rough poles." Lumber, by definition, is timber that has been cut into boards and, sometimes, planed and sanded. While the Proposed Regulations apparently endorse such lumber as a qualifying product, the term "rough" in this context has the potential to create uncertainty.

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."[51] Thus, the standard for timber is more stringent than the general standard, as the definition of "processing" for timber includes activities with no foreign substances, and excludes activities that add any foreign substances "to manipulate timber's physical or chemical properties." Any standard in the final regulations should be uniform for all natural resources.

The definition of "processing" for timber and other natural resources should not prohibit processes that effect a chemical change, substantial or otherwise. Rather, as discussed above, "processing" should include activities with inputs that are natural resources.

Note that treated lumber and poles should be listed as products of timber processing even under the existing standard in the Proposed Regulations. Treatment processes protect, rather than manipulate, the timber's physical and chemical properties, generally from fire and other environmental hazards. The lack of consistency in applying the general timber processing standard to determine the list of excluded products demonstrates the Proposed Regulations' focus on excluding outputs, rather than inputs, of processing. Moreover, the determination of whether a chemical or foreign substance is added to manipulate timber's physical or chemical properties is unclear.

(c) Additives

"Processing" should also permit the addition of additives to enhance or protect the intrinsic properties of the natural resource or to enhance the marketability of the product, such as the treatment of lumber to protect the underlying wood, or the addition of detergents, rust inhibitors, octane enhancers and other additives to gasoline, lubricants and other refined

[51] Prop. Reg. § 1.7704-4(c)(5)(i) (emphasis added).

products. Many products require the application of a nominal amount of additives to meet environmental and other regulatory standards. For example, the EPA requires the addition of certain detergent additives to gasoline and diesel to control fuel injector and intake valve deposits.[52] The addition of these additives qualifies as "processing" of "oil, gas, or products thereof."[53] Although processing and refining includes blending, blending is also carried out at terminals as discussed below. Likewise, the addition of additives should qualify as "processing" of timber. To create a consistent standard that accords with the plain language of section 7704 and its legislative history, the final regulations' definition of "processing" should permit the addition of small amounts of additives to meet regulatory requirements or improve the marketability of the natural resource.

6. The MACRS Limitation Is Inappropriate

Even in situations where a taxpayer engages in a processing or refining activity that meets the first two requirements of the "processing or refining" definition, the final requirement of the definition would deny qualifying income status to income derived from that activity if the taxpayer fails to use "an appropriate" MACRS class life for purposes of depreciation of the assets used in that activity. This rule would apply even if the taxpayer's failure was reasonable, inadvertent, isolated, or the result of the IRS's refusal to grant consent to change to an appropriate depreciation method.[54] Requiring a PTP to have appropriately classified all assets used in the activity under MACRS has no statutory support and would create great uncertainty for PTPs and their investors because qualifying income from processing or refining would be dependent upon an IRS audit determination that an asset was properly classified under MACRS.

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52 See 40 C.F.R. § 80.161(a)(iii).

53 "Oil, gas, or products thereof" includes gasoline. See H.R. Rep. No. 100-495, at 947 (1987).

54 See Reg. § 1.446-1(e)(2)(iii), Ex. 14 (requiring IRS consent to change the MACRS class life for an asset).

The insertion of a MACRS class life requirement into any definition of processing or refining is inconsistent with the language of section 7704(d)(1)(E). Regardless of the precise interpretation of the statutory terms "processing" and "refining," a processing or refining activity cannot become something else merely because a taxpayer uses a specific depreciation method or uses a different asset to accomplish the same result. Under the Proposed Regulations, two taxpayers who do exactly the same things for exactly the same reasons in exactly the same manner could be treated as performing different activities based on the depreciation method they might elect.

7. <u>Proposed Revision</u>

For the reasons discussed above, NAPTP recommends that Prop. Reg. § 1.7704(c)(5) be revised as follows:

> (5) <u>Processing or refining</u>. An activity constitutes "processing" or "refining" if the activity effects a physical or chemical change in a mineral or natural resource (including through the use of temperature, pressure, mechanical action, and/or a catalyst), regardless of where the activity occurs, but excludes the polymerization of a natural resource which is not a fuel, fuel additive, lubricant, or asphalt.

F. Transportation – Prop. Reg. § 1.7704-4(c)(6)

The Proposed Regulations provide the following definition of transportation activities:

> (6) <u>Transportation</u>. Transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4) or (5) 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. Retail customers do not include a person who acquires oil or gas for refining or processing, or a utility. The following activities qualify as transportation –
>
> (i) Providing storage services;

(ii) Terminalling;

(iii) Operating gathering systems and custody transfer stations;

(iv) Operating pipelines, barges, rail or trucks; and

(v) Construction of a pipeline only to the extent that a pipe is run to connect a producer or refiner to a preexisting interstate or intrastate lineowned by the publicly traded partnership (interconnect agreements).

An exclusive list of operations that comprise the definition of transportation does not allow for changes in technologies and cannot accurately describe all existing technologies or technologies developed in the future. NAPTP recommends that the definition of transportation activities be expanded as described below to include other activities that are consistent with the standards in PLRs issued over the last 27 years and industry practice which has evolved based on such PLRs. In addition, the terms "retail customer" and "terminalling" should be defined as described below.

1. Operating Activities

The Proposed Regulations provide that "operating" a gas gathering system, custody transfer station, pipeline, barge, rail, or truck in the transportation of natural resources is a transportation activity. NAPTP agrees that such operations generate qualifying income and notes that such a determination is consistent with IRS ruling practice.

As discussed above, the operation of any section (d)(1)(E) activity generates qualifying income regardless of whether the PTP conducting the activity owns the assets or business. Specific to Prop. Reg. § 1.7704-4(c)(6), there are three items that need to be clarified.

First, the term "operating" should be clarified to include a contract operator who manages the transportation function using property owned by others.

Second, whether or not the person who is conducting the operations owns the property, the term "operating" should include all of the operational functions associated with conducting those operations, including back office functions. For example, the IRS has ruled that metering natural gas, monitoring specifications of natural gas, conducting plant maintenance, hiring plant personnel, purchasing supplies, and handling the billing, accounting, financial reporting and treasury functions for the plants constituted a qualifying activity.[55] The final Regulations should clarify that "operating" includes conducting these back office functions that deliver the complete package of transportation services.

Third, the final Regulations should clarify that management fees or cost reimbursements received for performing transportation operations on behalf of others are qualifying income -- whether those receipts are properly included in income or are treated as a reduction of operating costs and expenses by the person conducting the operation.[56]

2. Construction Activities

PTPs regularly encounter various situations in which they are the party in the best position to design, construct, relocate or install assets that facilitate the transportation, storage or terminalling of minerals or natural resources. NAPTP recommends that each of the common situations described below be included among the examples of transportation activities.

The Federal Energy Regulatory Commission ("FERC") regulates the natural gas interstate pipeline industry, and state and local authorities (such as state utility commissions) regulate intrastate and offshore pipelines. A core tenet of FERC, and often other authorities, is that pipeline companies are required to cooperate and connect with others to facilitate the flow of natural gas "from the wellhead to the burner tip" efficiently and without duplication. As such, an important part of the transportation of natural gas is the connection of one pipeline to another (referred to as an "interconnect"). In addition to interconnects required by FERC or other

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[55] PLR 201132012 (Apr. 29, 2011).
[56] Id.

authorities, interconnects are commonly agreed to by PTPs because interconnects are often mutually beneficial to the PTP and the other interconnecting party. In accordance with the FERC policy that seeks to connect interstate pipelines for efficiency, non-regulated pipelines may interconnect, for example, to provide a pipeline company access to additional customers or to provide access to additional destinations for existing customers. Consequently, the construction of interconnects is a fundamental part of the pipeline transportation business for qualified products to provide for the receipt into and delivery out of a pipeline system, whether or not required by FERC or other authorities.

In addition to interconnects, a PTP may be asked or required to relocate a pipeline or transportation asset from time to time. Third parties, such as governmental agencies, private surface owners, lessees, property developers or utilities, on a regular basis ask PTPs to relocate assets hindering surface construction or development, and a PTP often wants to (or is legally or contractually required to) cooperate with these third parties as individuals, businesses and authorities that have regular dealings with the PTP and co-exist in the same geographic areas. For example, a governmental agency may ask or require that a pipeline be moved in connection with a road expansion project. A relocation request will often result in a relocation agreement, whereby the PTP will abandon an existing asset, such as a portion of a pipeline, and construct (or contract for the construction of) a similar asset in a new location. Under a typical agreement, the requesting party will reimburse the PTP for all of the costs incurred associated with construction (including a gross up for taxes paid by the PTP's partners related to the reimbursement). The PTP in these instances is not seeking to earn income from constructing assets for unrelated third parties; the purpose of the reimbursements is simply to make a PTP whole for relocating its assets to satisfy a government request, as a courtesy to a person operating in the same geographic areas, or otherwise to aid commerce in the area.

Finally, storage assets and terminalling assets facilitate the transportation of a mineral or natural resource including natural gas and other qualified products. The importance of storage and terminalling is without doubt, and the legislative history, the Proposed Regulations and PLRs include storage as a transportation activity.[57] The Proposed Regulations also recognize the long-held understanding that terminalling activities are an essential part of transportation. Often a PTP is the party in the best position to construct, or oversee the construction, of other facilities or infrastructure required to connect another system or customer to the PTP's transportation or storage assets to allow the PTP to provide transportation and storage services to customers ("facility expansions"). For example, when a new customer contracts with a PTP to transport or store a qualifying product (or an existing customer contracts to store additional volumes), infrastructure assets such as docks, tankage, and related manifolds and piping may be required to facilitate the added volumes. Like interconnects, the sole purpose of the expanded facilities is the efficient and effective transportation, storage or terminalling of a qualifying product. Because of the high cost of infrastructure assets, the connecting party may reimburse the PTP for associated costs.

Importantly, the IRS has ruled that gross income from each of the above described activities constitutes qualifying income. Specifically, the IRS has ruled that gross income from (i) reimbursements for pipeline extension costs when a customer desires to connect to existing transportation pipeline,[58] (ii) the design, construction and installation of butane blending

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[57] See, e.g., PLR 200921010 (Feb. 10, 2009); PLR 200422023 (Feb. 10, 2004); PLR 199904025 (Nov. 2, 1998); PLR 9452013 (Sept. 26, 1994); and PLR 9416033 (Jan. 24, 1994).

[58] PLR 200845035 (July 31, 2008).

equipment at a customer's terminal in connection with providing butane blending services,[59] (iii) the construction of pipelines to connect a PTP to a customer or terminalling, storage, or transportation assets to facilitate a customer's terminalling, storage, and transportation requests,[60] (iv) the relocation of pipelines and related facilities used to transport minerals or natural resources to accommodate requests from third parties (*e.g.*, to accommodate surface construction or subsurface development), [61] and (v) the construction of pipeline interconnects, [62] constitutes qualifying income. These rulings appropriately acknowledge that such services are practical and necessary parts of the transportation, storage, and/or terminalling of a mineral or natural resource.

How interconnects and facility expansions are negotiated and accomplished is a complex process that can vary significantly based on the experience of the parties involved, the anticipated relative benefit of the interconnect or facility expansion to each party, the requirements of applicable regulations, the ownership of the resulting infrastructure and other factors. Therefore, the scope of work of these arrangements is wide-ranging and can include design, acquisition of materials, installation or construction, and/or the management or oversight of construction. Similarly, compensation for managing or constructing the interconnect or facility expansion may vary and may include: (i) full or partial cost reimbursement; (ii) reimbursement of third party costs incurred by the PTP; and/or (iii) allocations of direct and indirect costs for expenses like overhead and "back office" functions. Alternatively, the interconnect or expansion arrangement may be structured as a flat-fee or a cost-plus arrangement such that the PTP may earn a profit.

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[59] PLR 201132020 (May 6, 2011).
[60] PLR 201314029 (Nov. 28, 2012).
[61] PLR 201328005 (Apr. 2, 2013).
[62] Id.

Requests for interconnects, relocations and facility expansions may be from transportation customers, but may also be from someone who is not a transportation customer. For example, interconnect agreements may be with another pipeline, a gathering system, a utility, a power generation facility, a refinery, or other industrial or governmental consumer or a local distribution company that delivers natural gas owned by others. A relocation agreement may be with a governmental agency or a land owner with which a pipeline has a right of way agreement. As such, a PTP may earn income from interconnects, relocations and facility expansion that is not from a producer, refiner or direct customer.

NAPTP recommends that the Proposed Regulations be clarified to provide that gross income (including cost reimbursements) derived by a PTP from the construction and installation of pipeline interconnects and storage and terminal facility expansions is qualifying income. Such gross income is **derived** from the business of transporting a mineral or natural resource or products thereof as required by section 7704(d)(1)(E).

Prop. Reg. § 1.7704-4(c)(6)(v) provides that qualifying transportation activities include "Construction of a pipeline only to the extent that a pipe is run to connect a producer or refiner to a preexisting interstate or intrastate line owned by the publicly traded partnership (interconnect agreements)." In contrast, Prop. Reg. § 1.7704-4(c)(3)(vi) provides that qualifying development activities include "Constructing and installing gathering systems and custody transfer stations."

NAPTP recommends that the Proposed Regulations be modified to provide that gross income (including cost reimbursements) derived from the design, construction, relocation and/or installation of a pipeline, storage facility or terminalling asset (and related assets and services) to the extent the asset or service provided is intended to facilitate the transportation, storage, or terminalling of a mineral or natural resource directly or indirectly by the PTP constitutes qualifying income. This recommendation is limited to the situation where a PTP owns the resulting assets or provides services with respect to facilities connected with a PTP's assets and is not intended to allow for unlimited construction of pipelines and other assets by otherwise disinterested third parties.

3. <u>Terminalling</u>

In general, terminals are centralized facilities where natural gas or crude oil, other natural resources, or natural resource products are transferred to or from storage or a transportation network (pipeline, rails, trucks, etc.) for distribution. Terminalling services provided at the terminals include: (1) receiving products from pipelines, trucks, barges, vessels, or railcars; (2) storing products; (3) inventory management; and (4) loading products to pipelines, trucks, or railcars for distribution. In addition, because terminals serve as a transportation hub, terminals are often the most efficient place to ensure product specifications through the activities discussed below.

(a) <u>Testing, Blending, Treating and Additization Activities</u>

Terminal operators are often called upon to ensure product specifications of the products that they throughput. In many instances, terminals are required to test the products at the terminal and blend feedstocks, conduct product treatments and inject additives into the natural resources to maintain or achieve product specifications. Blending, treating and additization activities can vary based on the natural resource handled at the terminal and requirements specific to the product, the customer, the jurisdiction or the time of year. In some cases, terminal customers are required to prove that their products satisfy product specifications, and the terminal operator may conduct such tests or outsource the testing and charge the terminal customer a fee for such tests.

For crude oil, a terminal may be required to blend different grades of crude oil together to achieve the desired grade or quality of crude oil. A crude oil terminal may also be required to blend a diluent (such as diesel fuel, or a lighter grade of crude oil) into heavier crude oil to achieve a level of viscosity appropriate for the subsequent mode of transportation or add an anti-corrosion agent designed to protect the pipes in which the products are transported. Coal terminals conduct similar blending activities to mix or homogenize grades of coal from different mines or even different mining regions with different characteristics (e.g., higher sulfur coal and lower sulfur coal) to achieve coal that meets product specifications. In the winter, coal may also be treated at a terminal with chemicals designed to prevent freeze damage. Sand terminals may similarly treat sand with a detergent to prevent dust as the sand travels by rail or truck to its final destination. In many cases, terminals charge separate fees for these blending and treating activities. Terminals may also charge fees for heating product (e.g., heavy crude) to achieve or maintain appropriate product flows throughout the terminal. Terminals may also charge customers fees for sending product to the terminal that does not satisfy specifications and could cause damage to the terminal, requiring tank cleaning or even repair of filters and pumps.

Refined products terminals also have numerous blending and additization requirements. Most refined product terminal owners or operators inject additives into refined products as the product is being loaded into packages or over the "rack" and into delivery vehicles.[63] These additives, which may not be natural resources for the purposes of section 7704, are often required by government regulations or are otherwise injected to enhance the refined product based on customer specifications. Typical additives for gasoline and diesel fuels include

[63] A "rack" is the complex of equipment necessary to load a delivery vehicle with fuel. The rack consists of loading arms, pumps, meters, shutoff valves, relief valves and other piping and valves necessary to fill the delivery vehicles. Reg. § 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."

detergents, dyes, cetane improvers, cold flow improvers, fuel oil stabilizers, isotopic markers, lubricity/conductivity improvers, anti-icing agents and proprietary gasoline additives.[64] The additives are delivered from various sources, typically by truck, and off-loaded in bulk or pumped from drums into segregated storage vessels and are subsequently injected into the fuel as it is transported by pipe into the delivery vehicles at the rack. In the case of detergent additives, for example, prior to loading delivery vehicles with gasoline, the terminal operator determines the "brand" of detergent additive required by the customer to be added to that gasoline. Certain major oil companies may have their own proprietary additives, such as those advertised at major retail gas stations. Other customers may instead use generic additives that often perform a similar function as proprietary brands. In either case, the additives are injected into the gasoline as it is being loaded over the rack and into delivery vehicles. Terminals will charge a fee for injecting additives which may include the cost of the additive.

To produce cleaner-burning fuels, oxygenates (compounds containing oxygen in a chain of carbon and hydrogen atoms) are blended into gasoline in one of two forms: alcohols; or ethers. Ethanol is the most commonly-used alcohol oxygenate and according to the U.S. Department of Energy; more than 95% of U.S. gasoline contains ethanol, typically E10 (10% ethanol, 90% gasoline). Ethanol is also available as E85 (also known as flex-fuel), which is a high-level ethanol-gasoline blend containing 51%-83% ethanol, depending on the geography and the season, and qualifies as an alternative fuel under the Energy Policy Act of 1982. Another blend, E15 (a low-level blend composed of 10%-15% ethanol and gasoline), has been

[64] Each additive injected into a fuel has one or more functions. For example, detergents are required by section 211(l) of the Clean Air Act to prevent the accumulation of deposits in motor vehicle engines and fuel-supply systems. Dyes used in diesel fuel and kerosene are required by the Code to distinguish taxable product from product that is not taxed. Cetane improvers, cold flow improvers, fuel oil stabilizers, lubricity/conductivity improvers and anti-icing agents are each additives that may be added to a fuel to enhance the property of that fuel, often for a specific application or market (i.e., cold weather conditions or to meet premium fuel standards).

approved for use in newer vehicles and is slowly becoming available. Ethanol is blended into gasoline to satisfy federal environmental regulatory guidelines. In addition, the Energy Policy Act of 2005 mandated that 7.5 billion gallons of renewable fuel (ethanol/biodiesel) be blended into gasoline by 2012.

Similarly, biodiesel is often blended into diesel fuel to produce cleaner-burning replacement fuel. Biodiesel is a liquid fuel often referred to as B100 or neat biodiesel in its pure, unblended form. Like petroleum diesel, biodiesel is used to fuel compression-ignition engines, which run on petroleum diesel. Biodiesel can be blended and used in many different concentrations. The most common biodiesel blends in the United States are: B20 (20% biodiesel, 80% petroleum diesel); B5 (5% biodiesel, 95% petroleum diesel); and B2 (2% biodiesel, 98% petroleum diesel). Biodiesel is blended pursuant to industry quality standards and specifications, such as those set by ASTM International.[65] Ethanol and biofuel can make up a significant percentage of the blended motor fuel stock (for example, up to 15% ethanol and up to 20% biodiesel are common blends), while other additives tend to make up a very small portion of the blended stock (typically, less than 1%).

Lubricating oils, waxes and other refined products are also blended together and with additives to provide increased anti-wear protection, reduced friction, extended oil life, improved corrosion protection, the ability to separate from water, and reduced energy usage. Lubricants are also blended with a detergent and a thickener to produce greases in multiple grades and for many uses.

The IRS has ruled in numerous PLRs that income derived from additization and blending activities give rise to qualifying income within the meaning of section 7704.

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[65] Formerly the American Society for Testing and Materials, an international standards organization that develops and publishes voluntary consensus technical standards.

(b) RINs

As discussed above, many refined product terminals blend biofuels into traditional fuels to meet environmental specifications. The EPA uses renewable identification numbers ("RINs") to track renewable transportation fuels. The RIN system allows the EPA to monitor compliance with the Renewable Fuel Standard ("RFS"), a federal program that requires transportation fuels sold in the United States to contain minimum volumes of renewable fuels. The RFS program assigns obligated parties (fuel refiners, blenders, and importers) a renewable volume obligation ("RVO"). The RVO for each party is the volume of renewable fuels it is obligated to sell, based on a percentage of the company's total fuel sales.

A RIN is a 38-character number assigned to each physical gallon of renewable fuel produced or imported. The RIN identifies, among other things, the company producing the renewable fuel, the facility in which the fuel was produced, the year in which the fuel was produced and a five digit batch number assigned by the producer. The RIN is attached to the physical gallon of renewable fuel as it is transferred to a fuel blender. After blending, RINs are "separated" from the blended gallon and are used by the obligated parties as proof that they have sold renewable fuels to meet their RFS mandated volumes. Entities blending renewable fuels and traditional fuels may sell RINs they generate. Thus, a PTP that owns or operates a terminal and blends biofuels into traditional fuels at its terminal accumulates RINs. The PTP may then sell its excess RINs to third parties through a broker involved in trading RINs or directly to a producer or importer of conventional fuel. Typically, the PTP will charge its customer a reduced terminal blending fee because the PTP will accumulate RINs from the blending activity and then sell the RINs for additional revenue. The revenue derived from RINs sale represents economically additional fees that the PTP would have otherwise received from the blending service.

The IRS has ruled that income derived from the sale of RINs gives rise to qualifying income within the meaning of section 7704(d)(1)(E).[66]

(c) Typical Blending Arrangements

PTPs may earn different types of income attributable to testing, blending, and treating activities. A PTP that owns the underlying products to be blended at terminals and delivered to its customers derives income from the marketing of a natural resource. On the other hand, a PTP that does not own the underlying products and is solely a service provider with respect to its customers' products derives income from providing terminalling and transportation services (including testing, blending and treating services) to its customers. Many PTPs are engaged in terminal operations and transportation services other than to facilitate the sale of their own natural resources and thus blending activities should not solely be considered as part of "marketing." Prior to the issuance of the Proposed Regulations, the IRS has ruled a number of times that various blending activities at terminals constitute qualifying income.[67] The Proposed Regulations continue to treat blending activities as qualifying income but include such activities under "marketing" in section 1.7704-4(c)(7).

NAPTP agrees that blending additives should be included in the definition of "marketing" as drafted in the Proposed Regulations, but because testing, blending and treating occurs at the terminals as a fundamental part of terminalling and transportation services, such activities should also qualify as a part of the "terminalling" activity and therefore constitute

[66] PLR 201411004 (Nov. 8, 2013); PLR 201232020 (Apr. 27, 2012).

[67] PLR 201403004 (Sept. 16, 2013); PLR 201403008 (Sept. 13, 2013); PLR 201232008 (Apr. 19, 2012); 201206004 (Oct. 31, 2011); PLR 200921010 (Feb. 10, 2009); PLR 200712002 (Dec. 7, 2006); PLR 200638018 (June 13, 2006); and PLR 200422023 (Feb. 10, 2004).

"transportation" for qualifying income purposes. Testing, blending, treating, and additization are common activities for all natural resources, including fuels. Accordingly, NAPTP recommends that the language in the definition of marketing reference the testing, blending, treating, and additization of natural resources. Both the "transportation" and "marketing" definitions should also include as examples the blending of renewable fuels with gasoline, as these activities are also a fundamental part of terminalling activities.

NAPTP also recommends that income derived from the sale of RINs be added as examples to both the "transportation" and "marketing" definitions, because RINs are "separated" from the applicable renewable fuels as a result of being blended at the terminals as part of the terminalling activities described above. The treatment of the income derived from RINs should follow the treatment of income generated from the blending activities at the terminals. This comports with the two PLRs ruling that the sale of RINs generates qualifying income for purposes of section 7704(d)(1)(E)[68] when such RINs are separated and accumulated as a result of the blending activities performed by the terminal operators. NAPTP recommends that the Proposed Regulations be clarified in accordance with these PLRs to specifically add separating RINs from the applicable fuels for sale as examples of a qualifying activity under "transportation" and "marketing."

4. Compression

In order to transport natural gas from the wellhead to the processing plant, persons operating a gathering system, pipeline or storage facility will often engage a contract operator to provide compression services to maintain a constant pressure in the line or to move the natural gas into and out of the storage facility. Natural gas transported through a pipeline loses pressure

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[68] See PLR 201411004 (Nov. 8, 2013); PLR 201232020 (Apr. 27, 2012).

over the length of the pipeline. Compression is staged along the pipeline to increase capacity and boost pressure to overcome the friction and hydrostatic losses inherent in normal operations.

For the same reasons that the Proposed Regulations have included gathering systems, pipelines, and storage and terminalling facilities in the list of activities that constitute "transportation" activities, compression services should also be included as examples of transportation of minerals or natural resources. There would no movement of the natural gas through the gathering system, through the pipeline, and into and out of the storage facility without the addition of compression. Compression services are a core activity in the gathering and pipeline transportation process.

5. Liquefaction and Regasification

Liquefaction and regasification of natural gas are each essential elements in the transportation of natural gas. Raw natural gas produced from an oil well or from a natural gas well typically consists primarily of methane, but also may contain varying amounts of natural gas liquids (including ethane, propane, butane, isobutane), acid gases (such as carbon dioxide, hydrogen sulfide, methyl mercaptan, ethyl mercaptan), other gases (such as nitrogen and helium), water vapor, liquid water, natural gasoline, and/or crude oil. The methane in raw natural gas may then be largely separated from the other components of natural gas in field separation units or natural gas processing plants. After being transported from the wellhead and treated in the field or at a processing facility, the natural gas (consisting primarily of methane) may be liquefied to prepare it for long haul transportation. Liquefaction terminals receive natural gas by pipeline and convert the natural gas to a liquid by cooling the natural gas to a cryogenic temperature of approximately minus 260 degrees Fahrenheit. The liquefaction process does not chemically change the natural gas, but rather reduces the volume of the natural gas molecules to 1/600th of their original size, facilitating the cost-effective transportation of natural gas by specially designed ocean-going tankers to locations where pipelines are not available. Upon arriving at the port, the LNG is often stored in specialized storage vessels.

Because there is no distinct commercial application for liquefied natural gas, LNG must be returned to its gaseous state in a process called "regasification" prior to transportation by pipelines for industrial, commercial, or residential use. Regasification is the process whereby LNG is warmed through a series of vaporizers until the LNG is converted into pipeline quality natural gas. Regasification is usually done at or near a terminal facility where the gas can be placed into storage or directly into a pipeline for transport.

Section 7704(d)(1)(E) treats income from the transportation of any mineral or natural resource as qualifying income. Liquefaction and regasification are processes that are critical to the transportation of natural gas and simply compress or expand the natural gas so it can be transported. The IRS has previously issued favorable private letter rulings on these issues.[69]

In addition, other Treasury Regulations support the characterization of liquefaction as a part of the transportation of natural gas. Section 863 and the Treasury Regulations issued thereunder provide special sourcing rules with respect to certain income. In applying these rules to the sale and transportation of natural gas, Reg. § 1.863-1(b)(7), Example 2 provides that liquefaction of natural gas is an activity done in preparation of transportation of natural gas:

> Example (2). No additional production. US Gas, a U.S. corporation, extracts natural gas within the United States, and transports the natural gas to a U.S. port where it is liquefied in preparation for shipment. The liquefied natural gas is then transported via freighter and sold without additional production activities in a foreign country. Liquefaction of natural gas is not an additional production activity because liquefaction prepares the natural gas for transportation from the export terminal. Therefore, under paragraph (b)(1) and (b)(1)(ii) of this

[69] PLR 200551002 (Sept. 20, 2005); PLR 201224023 (June 15, 2012).

> section, gross receipts equal to the fair market value of the liquefied natural gas at the export terminal will be from sources within the United States, and excess gross receipts will be from sources without the United States." (Emphasis added.)

The reasoning in the Example above applies to both liquefaction and regasification of LNG into natural gas so it can be transported into the pipeline systems. Therefore, NAPTP recommends including liquefaction and regasification with respect to liquefied natural gas as examples of qualifying activities under "transportation."

6. <u>Tanker Ships and Vessels</u>

The Proposed Regulations include a barge as a mode of conveyance for minerals or natural resources, but do not include tanker ships and other vessels that operate on the water. This oversight again highlights the problems with an "exclusive list" of qualifying activities and is addressed in NAPTP's proposed revision to Prop. Reg. § 1.7704-4(c)(6).

7. <u>Propane</u>

PTPs engaged in the distribution and marketing of propane often deliver and/or sell propane to retail customers. Section 7704(d)(1)(E) generally provides that qualifying income includes income and gains derived from "transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource…." As noted above, the Conference Report accompanying the 1987 Act, in discussing the types of qualifying income described in section 7704(d)(1)(E), states:

> Income and gains from certain activities with respect to minerals or natural resources are treated as passive-type income. Specifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional

> processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. Income of certain partnerships whose exclusive activities are transportation and marketing activities is not treated as passive-type income. For example, the 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 products (e.g., gas station operations) is not intended to be treated as passive type income.[70]

While transportation of refined petroleum other than by pipelines and retail marketing with respect to refined petroleum products generally do not give rise to qualifying income, the legislative history provides a narrow exception with respect to liquefied petroleum gas—primarily propane. Specifically, Congressman Dan Rostenkowski, Chairman of the House Ways and Means Committee, stated:

> I would like to clarify for the record the scope of the provision in the bill treating certain publicly traded partnerships as corporations as it applies to a specific partnership. The partnership that I am concerned about primarily engages in the purchase, transportation, storage, distribution, and retail and wholesale marketing of liquefied [sic] petroleum gas – primarily propane – and other oil and gas products. These products are transported in trucks and rail cars that are owned or leased by the partnership and by third party pipelines with which the partnership makes arrangements for transportation. It is my understanding that the income derived by the partnership from these activities would be included within the definition of passive-type qualifying income.[71]

Furthermore, Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, stated:

> Finally, I would like to clarify the definition of passive type income. Under the conference agreement, income of a partnership from the purchase, transportation, storage, distribution, and retail and wholesale marketing of liquefied [sic] petroleum gas –

[70] H.R. Rep. No. 100-495, at 946-47 (1987).

[71] 133 Cong. Rec. H11967-68 (daily ed. Dec. 21, 1987).

> primarily propane – and other oil and gas products is passive-type income, even though such products are transported in trucks and rail cars that are owned or leased by the partnership and transported by third party pipelines with which the partnership contracts for transportation.[72]

Both of the Bentsen and Rostenkowski statements with respect to retail sales of propane were acknowledged and confirmed in the legislative history of the 1988 Act in which the retail limitation as applied to transportation and marketing activities was clarified. The Conference Report to the 1988 Act notes that "income from transporting refined petroleum products by truck to retail customers is not qualifying income."[73] However, a footnote to such statement in the Conference Report provides that "[i]ncome from transportation and marketing of liquefied petroleum gas in trucks and rail cars or by pipeline, however, may be treated as qualifying income."[74] The footnote refers to the statements of Congressman Rostenkowski and Senator Bentsen.[75] The Senate Report also contains a similar footnote.[76]

The IRS in Chief Counsel Advice 200749012 concluded that "income derived from the distribution and marketing of propane to end users at the retail level constitutes qualifying income under [section] 7704(d)(1)(E)."[77] In reaching this conclusion, the IRS specifically cited the legislative history discussed above, and referred to the statements of Congressman Rostenkowski and Senator Bentsen.[78] The IRS stated: "These two coordinated statements, issued by the chairmen of the House Ways and Means Committee (Congressman

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72 133 Cong. Rec. S18651-02, (daily ed. Dec. 22, 1987).

73 H.R. Rep. No. 100-1104, at 18.

74 Id. at n.1.

75 Id.

76 S. Rept. No. 100-445, at 424 n.11 (1988). ("Income from transportation and marketing of liquefied petroleum gas in trucks (as well as in railcars or by pipeline), however, may be treated as qualifying income. See Statement of Mr. Rostenkowski, 133 Cong. Rec. H11968 (daily ed. Dec. 21, 1987); see also Statement of Senator Bentsen, 133 Cong. Rec. S18,651-02 (daily ed. Dec. 22, 1987) (substantially similar language)").

77 C.C.A. 200749012 (Dec. 7, 2007).

78 Id.

Rostenkowski) and the Senate Finance Committee (Senator Bentsen), respectively, evidence a clear intention to treat income derived from the retail marketing of propane as qualifying income," and that "[i]t is clear from the committee reports that these joint statements were viewed as authoritative pronouncements concerning the scope of the legislation." (Emphasis added.)[79]

The legislative history clearly evidences Congressional intent to treat income derived from the transportation and marketing of liquefied petroleum gas, including propane, as qualifying income. NAPTP therefore recommends that the Proposed Regulations be revised to treat income from transportation and marketing of liquefied petroleum gas as qualifying income.

8. Proposed Revision

For the reasons stated above, NAPTP recommends that Prop. Reg. § 1.7704-4(c)(6) be revised as follows:

> (6) Transportation. Transportation is the movement, conveyance, terminalling or storage of minerals or natural resources, including by pipeline, barge, vessel, tanker ship, rail, or truck, except for transportation (not including pipeline transportation or any transportation with respect to liquefied petroleum gas) to a place that sells or dispenses to retail customers. The following are examples of activities that qualify as transportation --
>
> (i) Providing storage services;
>
> (ii) Operating a terminal (including receiving, loading and unloading activities, blending renewable fuels (such as ethanol and biodiesel) or additives into fuels or minerals or natural resources, and separating renewable identification numbers (RINs) from the applicable fuel for sale);
>
> (iii) Operating gathering systems, interconnects and custody transfer stations;
>
> (iv) Designing, constructing, relocating, or extending of a gathering system to connect a producing site to a pre-existing gathering system;

79 Id.

(v) Operating pipelines, barges, vessels, tanker ships, rails and railcars, or trucks;

(vii) Designing, constructing, relocating and/or installing a pipeline, storage facility or terminalling asset (and related assets and services) to the extent the asset or service provided directly or indirectly by a PTP is intended to facilitate the transportation, storage, or terminalling of a mineral or natural resource directly or indirectly by such PTP;

(viii) Providing liquefaction services with respect to natural gas; and

(ix) Providing regasification services with respect to liquefied natural gas into natural gas; and

(x) Providing compression services with respect to natural gas.

In conducting these activities, it is not necessary for the PTP conducting the operating activity or providing the service to own the equipment used in the activity. The term "operating" includes the provision of services of maintenance, metering, monitoring specifications, staffing, purchasing supplies, billing, accounting, financial reporting, treasury and other back office functions directly related to those operations. Income from these activities includes the management fees earned and the reimbursement of costs incurred by the PTP in conducting the operating activity or providing the service whether or not the amount received is properly included in the taxable income of the PTP.

G. Marketing – Prop. Reg. § 1.7704-4(c)(7)

The Proposed Regulations provide the following definition of marketing activities and an example with respect to certain sales:

> (7) Marketing. 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 fuels. Marketing does not include activities and assets involved primarily in retail sales (sales made in small quantities directly to end users), which includes, but is not limited to, operation of gasoline service stations, home heating oil delivery services, and local gas delivery services.

# # #

Prop. Reg. § 1.7704-4(e), Example 4:

> Delivery of refined products. (i) X, a publicly traded partnership, sells diesel and lubricating oils to a government entity at wholesale prices and delivers those goods in bulk. (ii) X's sale of refined products to the government entity is a section 7704(d)(1)(E) activity because it is a bulk transportation and sale as described in paragraphs (c)(6) and (7) of this section and is not a retail sale.

Unlike other sections of the Proposed Regulations, Prop. Reg. § 1.7704-4(c)(7) does not attempt to list each activity that may constitute marketing, but rather makes a general statement that a marketing activity is "performed to facilitate sale" that is not a retail sale. As described in further detail below, NAPTP recommends that the definition of "marketing" be clarified to: (i) better reflect the common meaning of "marketing" and the common meaning of "retail;" (ii) specify that the retail sale of propane and other liquefied petroleum gas is a qualifying marketing activity and that the pipeline transportation of natural resources to retail consumers is a qualifying transportation activity; (iii) specifically include packaging activities and commodity hedging as qualifying marketing activities; and (iv) include the sale of RINs, as discussed above in the section dealing with Transportation activities.

1. Marketing Activities

Section 7704(d)(1)(E) provides that income derived from the marketing of a natural resource is qualifying income. Section 7704 contains no definition of the term marketing. In the absence of a statutory definition, the Supreme Court has established accepted principles of interpretation whereby Congress is presumed to have intended the ordinary, common meaning of the word.[80] Dictionary definitions provide that marketing is generally the "act of selling."[81] As a

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[80] See Old Colony R.R. Co. v. Comm'r, 284 U.S. 552 (1932) ("the legislature must be presumed to use words in their known and ordinary signification"); United States v. Merriam, 263 U.S. 179 (1923); Witco Chem. Corp. v. United States, 742 F.2d 615 (Fed. Cir. 1984).

[81] Webster's New Int'l Dictionary (2d ed. 1952).

result, under the plain meaning of the statute, sales of minerals or natural resources to any customer generate qualifying income.

It is significant to note that Congress used the term "marketing" rather than the term "sale" in section 7704(d)(1)(E). In contrast, section 7704(d)(1)(D) uses the term "sale," suggesting a different meaning. Arguably, the term "marketing" connotes more effort in promoting a transaction than does the term "sale". "Sale" may suggest simply a conveyance of ownership for consideration — not implying any activity designed to encourage or promote the transaction as the term "marketing" suggests. Indeed, the term "marketing" would seem to encompass both selling and providing services related to a sale, such that a PTP can market minerals and natural resources on its own behalf or can market minerals and natural resources for others.

Prop. Reg. § 1.7704-4(c)(7) states that an activity constitutes marketing "if it is performed to facilitate sale . . . ." Prop. Reg. § 1.7704-4(e) Example 4, however, describes the sale and delivery of diesel and lubricating oils to a governmental entity at wholesale prices as the transportation and marketing of a natural resource (by referencing Prop. Reg. §§ 1.7704-4(c)(6) and (7), respectively). The phrase "performed to facilitate sale" inadvertently excludes the act of selling itself and the proposed revision makes this needed clarification.

2. Retail Exception

The legislative history of the 1987 Act contains language which limits the kind of marketing income which would be qualifying income under section 7704(d)(1)(E). As noted above, the Senate and House Reports to the 1988 Act make similar statements with respect to marketing. The Senate Report states:

> With respect to marketing of minerals and natural resources (e.g., oil and gas and products thereof), the Committee intends that

> qualifying income be income from marketing at the level of exploration, development, processing or refining the mineral or natural resource. By contrast, income from marketing minerals and natural resources to end users at the retail level is not intended to be qualifying income. For example, income from retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as qualifying income.[82]

The Conference Report to the 1988 Act follows the Senate Report with respect to the marketing of minerals and natural resources and provides an example, stating, "[t]he conference agreement also clarifies that, in the case of income from marketing of fertilizer, bulk or truckload sales to farmers in amounts of 1 ton or more are not considered retail sales giving rise to non-qualifying income."[83]

(a) Propane

Retail sales of propane (and other liquefied petroleum gas) have consistently been considered the "marketing" of a natural resource since the enactment of section 7704(d)(1)(E). The legislative intent with respect to retail propane sales is clear. As noted above, immediately prior to the enactment of the 1987 Act, Chairman Rostenkowski of the House Ways and Means Committee and Chairman Bentsen of the Senate Finance Committee, both stated that income derived from the retail and wholesale marketing of liquefied petroleum gas, primarily propane, was qualifying income.[84] The Conference Report to the 1988 Act, which clarified the scope of

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82 S. Rep. No. 100-445, at n.11 (1988). See also H.R. REP. NO. 100-795 (1988) ("Similarly, with respect to marketing of oil and gas, the Committee intends that qualifying income from marketing oil and gas be income from marketing at the level of exploration, development, processing or refining oil and gas. By contrast, income from marketing oil and gas and products thereof to end users, or at the retail level, is not intended to be qualifying income. For example, income from retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as qualifying income.").

83 H.R. Rep. No. 100-1104, pt. 2, at 18 (1988).

84 Specifically, Congressman Rostenkowski stated, "I would like to clarify for the record the scope of the provision in the bill treating certain publicly traded partnerships as corporations as it applies to a specific partnership. The partnership that I am concerned about primarily engages in the purchase, transportation, storage, distribution, and retail and wholesale marketing of liquified [sic] petroleum gas-primarily propane- and other oil and gas products. These products are transported in trucks and rail cars that are owned or leased by the partnership and by third

section 7704(d)(1)(E) with respect to the transportation and marketing of oil and gas, reinforced the exception with respect to retail propane sales in a footnote to an example that transporting refined petroleum products by truck to retail customers is not qualifying income. The footnote states that "[i]ncome from transportation and marketing of liquefied petroleum gas in trucks and rail cars or by pipeline, however, may be treated as qualifying income," cross-referencing the statements of Congressman Rostenkowski and Senator Bentsen.[85]

Chief Counsel Advice 200749012 memorializes the IRS's longstanding position with respect to the legislative history, concluding that income derived from the distribution and marketing of propane and liquefied petroleum gas to end users at the retail level constitutes qualifying income under section 7704(d)(1)(E) and that Congressman Rostenkowski and Senator Bentsen's coordinated statements were "authoritative pronouncements concerning the scope of the legislation."[86]

(b) Pipeline Delivery

The Proposed Regulations specify that "local gas delivery services" is an example of "activities and assets involved primarily in retail sales" and thus are not included as marketing under the statute. This example in proposed regulations, however, conflates the legislative history's limitations with respect to retail sales (i.e., marketing) with the limitations with respect to transportation to retail customers (i.e., transportation). The legislative history makes clear that income from any pipeline transportation (not sale) of oil, gas, or products thereof constitutes

party pipelines with which the partnership makes arrangements for transportation. It is my understanding that the income derived by the partnership from these activities would be included within the definition of passive-type qualifying income." 133 Cong. Rec. H11967 (daily ed. Dec. 21, 1987). Similarly, Senator Bentsen stated, "Under the conference agreement, income of a partnership from the purchase, transportation, storage, distribution, and retail and wholesale marketing of liquified [sic] petroleum gas-primarily propane- and other oil and gas products is passive-type income, even though such products are transported in trucks and rail cars that are owned or leased by the partnership and transported by third party pipelines with which the partnership contracts for transportation." 133 Cong. Rec. S18651-02 (daily ed. Dec. 22, 1987).

[85] H.R. Rep. No. 100-1104, 17-18 (1988).

[86] C.C.A. 200749012 (Dec. 7, 2007).

qualifying income. This should include, for example, the delivery of natural gas to retail customers by local distribution companies in unregulated utility markets.[87] As such, the use of "local gas delivery services" as an example of an activity excluded from marketing creates significant confusion. A delivery service, as the name itself implies, is properly treated as a transportation activity and the legislative history clarifies that any pipeline transportation of oil, gas, or products thereof is a qualifying activity. This activity is distinct from retail natural gas sales, which are limited by the retail sales exception.

In the Conference Report to the 1988 Act discussed above, two explicit statements evidence the clear intent of the legislature that income from pipeline transportation of oil, gas, or products thereof is qualifying income regardless of the purchaser. The Report states:

> In the case of transportation activities with respect to oil and gas and products thereof, the conferees intend that, in general, income from transportation of oil and gas and products thereof to a bulk distribution center such as a terminal or a refinery (whether by pipeline, truck, barge, or rail) be treated as qualifying income. <u>Income from any transportation of oil or gas or products thereof by pipeline is treated as qualifying income.</u> <u>Except in the case of pipeline transport</u>, however, transportation of oil or gas or products thereof to a place from which it is dispensed or sold to retail customers is generally not intended to be treated as qualifying income. Solely for this purpose, a retail customer does not include a person who acquires the oil or gas for refining or processing, or partially refined or processed products thereof for further refining or processing, nor does a retail customer include a utility providing power to customers. For example, income from transporting refined petroleum products by truck to retail customers is not qualifying income.[88]

The Conference Report provides a general rule that income from <u>any</u> transportation of oil or gas by pipeline is treated as qualifying income, and, for further clarification, also specifically excludes pipeline transportation from the transportation-based limitation on transporting minerals or natural resources to places where the product is dispensed or sold to retail customers.

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[87] In unregulated utility markets, a local distribution company often transports natural gas to retail customers that is sold to the customers by a third party and receives a transportation fee for this service.

[88] H.R. Rep. No. 100-1104, at 17-18 (1988) (emphasis added).

Prop. Reg. § 1.7704-4(c)(6) acknowledges this fact, stating, "[t]ransportation is the movement of minerals or natural resources . . . including by pipeline, barge, rail, or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers.[89]

(c) Needed Clarifications to Excluded Retail Sales

Prop. Reg. § 1.7704-4(c)(7) provides that "Marketing does not include activities and assets involved primarily in retail sales (sales made in small quantities directly to end users), which includes, but is not limited to, operation of gasoline service stations, home heating oil delivery services, and local gas delivery services."

The phrase "activities and assets involved primarily in retail sales" is overly complex and leads to significant questions. As "marketing" is an activity, the use of the word "assets" creates uncertainty.[90] Similarly, the verb "involved" with respect to marketing activities could imply that any activity involved primarily in marketing with respect to retail sales excludes non-retail sales employing the same service or technique. A more direct approach is to state that "marketing does not include retail sales".

The parenthetical defines retail sales as "sales made in small quantities directly to end users". While the parenthetical correctly establishes the size of the sale (i.e., small quantities), it does not adequately frame the intent of the retail purchaser by referring to the retail purchaser simply as an "end user."[91] The Supreme Court has differentiated between end-user sales and

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[89] Prop. Reg. § 1.7704-4(c)(6) (emphasis added).

[90] Query whether a percentage-of-use test for assets is to be employed such that marketing to a wholesaler would be excluded under the retail exception if, for example, the telephone employed by the salesman making the wholesale sale is primarily used to make retail sales.

[91] While the Senate Report to the 1988 Act states that "income from marketing minerals and natural resources to end users at the retail level is not intended to be qualifying income," the use of "end user" in the report does not modify or explain the definition of retail. Rather, "at the retail level" narrows the potential purchasers affected by the limitation only to retail purchasers. See S. Rep. No. 100-445, 100th Cong., 2d Sess. (1988).

retail sales by holding that a "retail sale" is one "in which the purchaser is actuated solely by a desire to satisfy his own personal wants or those of his family or friends through the personal use of the commodity . . . purchased."[92] As opposed to retail, the Supreme Court considered wholesaling to include "all marketing transactions in which the purchaser is actuated solely by a profit or business motive in making the purchase."[93] Courts have routinely relied on the Supreme Court's differentiation between end user sales and retail sales in Roland Electric.[94] Specifically, the Court of Federal Claims in Witco Chemical Corp. v. United States held that "'[r]etail' is a common word . . . , the meaning of which is well understood by persons familiar with the English language. It means sales made in small quantities to ultimate consumers to meet personal needs, rather than for commercial or industrial uses of the articles sold."[95] In addition to the size of the sale, the intent of the retail purchaser is important. As such, the proposed modification below clarifies that retail sales are sales "to ultimate consumers to meet personal needs, rather than for commercial or industrial uses of the articles sold."

As discussed above, the Proposed Regulations should clearly reflect that retail propane sales are a qualifying activity.

3. Packaging Activities

Packaging a natural resource is one of the primary examples of an activity that is "performed to facilitate sale of minerals or natural resources." Whether in a barrel, container, crate or tube, a mineral or natural resource must be separated into a known, saleable and

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92 Roland Elec. Co. v. Walling, 326 U.S. 657, 674 (1946).

93 *Id.*

94 See, e.g., Witco Chemical Corp. v. United States, 2 Cl. Ct. 504 (1983), aff'd, 742 F.2d 615 (Fed. Cir. 1984) (interpreting "retail" in the context of percentage depletion); Torti v. United States, 249 F.2d 623 (7th Cir. 1957) (excluding commercial end-user sales from excise taxes based on the intent of the purchaser not being for personal consumption); Gellman v. United States, 235 F.2d 87 (8th Cir. 1956) (same).

95 Witco, 2 Cl. Ct. at 507, aff'd, 742 F.2d 615 (Fed. Cir. 1984) (citing Roland Electric, Torti and Webster's New Int'l Dictionary for such conclusion).

transportable quantity in order to be sold. Further, with respect to sales to wholesalers or in bulk quantities, the re-packaging of a mineral or natural resource for further resale is often inefficient and duplicative.

The activities of PTPs regularly include packaging, and the IRS has ruled that the packaging of a mineral or natural resource is a qualifying activity in at least three instances. For example, in PLR 201129028 (Apr. 7, 2011), the PTP purchased refined petroleum distillates and lube oil base stocks from crude oil refineries, blended and processed the base stocks (in some cases adding non-petroleum additives of less than a% of the total lube blend) and packaged and marketed the resulting specialty lubricants to wholesale distributors.[96] Recognizing the activity of packaging as either a transportation or marketing activity, the IRS ruled that the PTP's activities generated qualifying income. This conclusion is consistent with the substance of the activity, because customers ultimately are assigning value to the underlying mineral or natural resource – and not the packaging itself – and thus, the income derive from any packaging activity more properly is attributable to transportation or marketing of the mineral or natural resource.

Because packaging is clearly a part of either transportation or marketing and is appropriately considered as an activity "to facilitate sale," the recommended revision adds packaging as an example of a qualifying activity in Example 4 of Prop. Reg. § 1.7704-4(e).

4. Passive Ownership Interests

Owners that benefit from the sale of a mineral or natural resource include owners with operating interests in the mineral or natural resource and owners with passive, non-operating interests in the mineral or natural resource. Typical non-operating, or non-working, interests in

[96] See also PLR 201301010 (Sept. 28, 2012) (refining, processing, blending, packaging, and marketing, including bulk end users sales, of refined products and lubricants); PLR 200848018 (Nov. 28, 2008) (marketing, packaging and distribution of refined products to non end-user customers for further processing and through distributors and sales agents for resale).

minerals or natural resources include royalty interests, net profits interests, and the rights to production payments, delay rental payments, and lease bonus payments..

Non-operating interest owners receive compensation for their interest in various ways, each of which is directly related to either selling a natural resource, or otherwise facilitating the sale of a natural resource. For example, a non-operating interest owner may receive a royalty payment, which is a direct payment from the sale of a natural resource. A non-operating interest owner may also receive a payment such as a delay rental payment that compensates the non-operating interest owner for an action (or lack of action) by the operating interest owner relating to the potential development or sale of a natural resource. This delay rental payment facilitates the sale of the natural resource in the future by, in a typical scenario, allowing the operator to maintain its lease and keep the mineral or natural resource in commerce for future development. In each case, payments to non-operating interests owners relate to the value attributable to producing a mineral or natural resource – whether derived from production itself (e.g., a royalty payment), delays in production or decisions not to produce at the time (e.g., a delay rental or shut-in royalty), an upfront payment for the right to produce (e.g., a lease bonus), or similar circumstances.

Income from non-operating interests is clearly intended to be qualifying income under the statute. For example, the House Report to the 1987 Act states:

> publicly traded partnerships are treated as corporations for Federal income tax purposes. An exception is provided for certain partnerships, 90 percent or more of whose gross income is passive-type income (as defined for purposes of the provision)....
>
> Passive-type income, for purposes of the provision, is defined as certain interest, dividends, real property rents, gains from the sale or other disposition of real property, and income and gains from certain natural resources activities....
>
> 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. (Emphasis added.)[97]

All payments to a non-operating interest owner, typically from a working interest owner, are undoubtedly passive-type income that is "income and gains derived from the exploration, development, mining or production . . . or marketing of any mineral or natural resource " under section 7704(d)(1)(E). Often these payments relate specifically to a point of sale with respect to a natural resource. However, these payments may also represent current compensation for production that may (or may not) occur in the future. In any case, such payments should be recognized as qualifying income. As such, income derived by non-operating interest owners relating to the sale of a mineral or natural resource should be included in the definition of marketing.

5. Commodity Hedging Transactions

PTPs (and their subsidiaries) engaged in the section 7704(d)(1)(E) activity of marketing oil, gas, and products thereof often manage risks with respect to commodity price fluctuations through the use of hedging transactions, such as forward sales, swaps, puts, calls, and collars. The Proposed Regulations fail to address the status of income derived from such hedging transactions.

Commodity prices are volatile and many PTP businesses would not exist if they bore such risk. PTP investors demand consistent growth in distributions, which would be an impossible demand if PTPs bore 100% commodity risk. The ability of a PTP to hedge such risks

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[97] H.R. Rep. No. 100-391 (1987) (Conf. Rep.).

to ensure consistent cash flows is essential to the PTP's survival, both from an operational and working capital perspective and from an investor demand perspective.

It has long been the case that PTPs have considered income from hedging transactions that meet the requirements for ordinary income treatment under section 1221 to constitute qualifying income within the meaning of section 7704(d)(1)(E) because the income is essentially the same as the income derived from marketing the oil, gas or products thereof. Section 1221(a)(7) and predecessor authorities clearly treat the income from properly identified hedging transactions as having the same character as the income of the underlying business.

The earliest expression of this concept was in G.C.M. 17322,[98] which held that income from futures contracts, which are normally capital assets, when entered into for the sole purpose of insuring against risks inherent in the taxpayer's business is to be considered ordinary income.

In Corn Products Refining Co. v. Commissioner,[99] the Supreme Court held that corn future contracts entered into by a manufacturer to manage its risk of price changes with respect to corn used in its manufacturing business were not "capital assets" under the predecessor of section 1221. The Court relied in part on the lower courts' factual findings that the corn hedges were an "integral part of [the manufacturer's] business."[100] The Court noted that while hedge contracts were not "actual inventory," the definition of capital asset should be read narrowly, and its exclusions broadly, to give effect to the Congressional purpose to treat profits and losses from everyday business operations as ordinary income or loss rather than capital gain or loss.

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98 XV-2 C.B. 151 (1936).
99 350 U.S. 46 (1955).
100 Id. at 50.

Arkansas Best Corp. v. Commissioner,[101] substantially restricted the scope of Corn Products by limiting it to the inventory exception to "capital asset" status under section 1221. The Supreme Court stated that "although the corn futures were not 'actual inventory,' their use as an integral part of the taxpayer's inventory-purchase system led the Court to treat them as substitutes for the corn inventory such that they came within a broad reading of 'property which would be included in the inventory of the taxpayer' in [section] 1221."[102]

In 1994, Treasury issued final Regulations under section 1221 setting forth the circumstances under which hedging contracts would be treated as "capital assets" after the Arkansas Best decision. In 1999, Congress amended section 1221 to add section 1221(a)(7), which creates a separate exclusion from "capital asset" status and affords ordinary income treatment for "any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated or entered into (or such other time as the Secretary may by regulations prescribe)."[103]

Reg. § 1.1221-2 provides rules for determining when buying a hedge is part of a taxpayer's normal course of business, and, therefore ordinary income. For this purpose, a hedging transaction is defined under Reg. § 1.1221-2(b) as "any transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily—

> To manage risk of price changes . . . with respect to ordinary property . . . that is held or to be held by the taxpayer; or
> To manage risk of interest rate or price changes . . . with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

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101 485 U.S. 212 (1988).

102 Id. at 221.

103 Section 1221(a)(7).

These authorities treat income from a properly identified hedging transaction as akin to the income associated with the risk to be hedged (the ordinary business income).

The issue under section 1221 (and its regulations) of whether hedging contracts with respect to inventory are "capital assets" is closely analogous to the question under section 7704(d) of whether income from hedge contracts with respect to a publicly traded partnership's exploration, production, and marketing of oil and gas is "qualifying income."

It should be noted that Reg. § 1.7704-3(a)(1) provides that qualifying income includes capital gain from the sale of stock, income from holding annuities, income from notional principal contracts[104] and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership.[105] That regulation does not apply to income earned in the ordinary course of a trade or business.[106]

However, the exclusion of income earned in the ordinary course of a trade or business from the scope of income treated as "qualifying income" under Reg. § 1.7704-3(a)(1) does not suggest that income from section 1221 hedges of crude oil and natural gas produced and sold by a taxpayer is not qualifying income.

First, the preamble to Prop. Reg. § 1.7704-3(a) (which is substantially identical to the final version of the regulation) indicates that the regulation was intended to address "several new types of financial instruments … developed [after the enactment of section 7704] that generate

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[104] The term "notional principal contact" for this purpose includes swaps but does not include options. Reg. § 1.446-3(c)(1).

[105] Reg. § 1.7704-3(a)(1).

[106] Reg. § 1.7704-3(a)(2).

passive-type income similar to interest and dividends."[107] The 1998 Preamble reads as if the restriction applies *only* to brokers, market makers and dealers: "the proposed regulations also provide that qualifying income (as defined in the proposed regulations) does not include income derived in the ordinary course of a trade or business by a broker, dealer, or market maker."[108]

Further, the 1998 Preamble states that "[t]he proposed regulations, including the trade or business restriction, are consistent with the legislative history of section 7704, which indicates that the exception for passive income was intended to distinguish between partnerships engaged in investment activities and those partnerships engaged in active business activities that are more typically conducted in corporate form."[109] However, the legislative history cited by the proposed regulations also characterizes marketing of oil and gas (and other activities covered by section 7704(d)(1)(E)) as "passive" and the statute clearly provides that those activities produce qualifying income.

The concern with respect to financial PTPs trading such passive type instruments in the ordinary course is alleviated where the hedging transaction meets the requirements for a hedging transaction under section 1221(a)(7). Detailed regulations in section 1221 already prevent speculative trading and require proper identification of a hedging transaction.[110] If a PTP meets those requirements with respect to a hedging transaction related to oil, gas or products thereof, the PTP's hedging transaction should be viewed as substituting income from a qualifying marketing activity.

In PLR 9619011 (May 10, 1996), a PTP was engaged in certain oil and gas activities, but sold derivative pricing products to third parties in the oil and gas business to allow these

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[107] 1998 Preamble at 1998-1 C.B. 589.
[108] Id. at 1998-1 C.B. 590.
[109] Id.
[110] See Reg. § 1.1221-2(f).

customers to purchase price protection and price guarantees. In turn, the PTP hedged its risk from the sale of these derivative pricing products in separate transactions with third parties. In evaluating whether this hedging income was qualifying income, the IRS relied on the definition of "hedging transaction" in Reg. § 1.1221-2(b), which focuses on managing particular types of risk.[111] The IRS interpreted this definition to suggest that when oil and gas was owned by the PTP, the derivatives hedged the PTP's risk and the income was therefore "integral" to the partnership's oil and gas activities, as described in section 7704(d)(1)(E), and thus constituted qualifying income. However, where the hedging income received was unrelated to the income that the PTP earned from qualifying activities (specifically, oil and gas income), the IRS concluded that the hedging income was not qualifying income:

> [I]ncome earned by the Partnership from derivative products which hedge the Partnership's price risks with respect to crude oil and other ordinary property constitutes qualifying income under Section 7704(d)(1)(E). However, where the Partnership is not the owner of the oil and gas for which price protection is desired, the Partnership is not buying and selling the derivative products to reduce the risk of price or interest rate changes for its oil and gas business. Therefore, the sale of the derivative pricing products does not produce qualifying income under Section 7704(d)(1)(E).

By referencing the definition of hedging transaction under Reg. § 1.1221-2(b), the ruling required that the hedge qualify under Reg. § 1.1221-2(b) in order to be qualifying income. Thus, where the hedging transaction sufficiently relates to an activity that generates qualifying income (i.e., the exploration, production, and marketing of oil and gas) and reduces the risk with respect

[111] When PLR 9619011 was issued, Reg. § 1.1221-2(b) defined a hedging transaction, in part, "as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily to—(1) To reduce risk of price changes . . . with respect to ordinary property . . . that is held or to be held by the taxpayer; or (2) To reduce risk of interest rate or price changes . . . with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer." The definition of a hedging transaction in Reg. § 1.1221-2(b) has been modified slightly subsequent to the issuance of PLR 9619011. Congress altered this standard from "reduce" to "manage" when it enacted section 1221(b)(2)(A) in 1999, and the regulations were amended in 2002 to conform to the statute. Reg. § 1.1221-2(b), 67 FR 12863-01, 2002-1 CB 707 (Mar. 20, 2002). Regardless, the standard continues to cover both of the risks described above.

to such qualifying activity, the ruling suggests that income derived from such hedging transaction is qualifying income.[112]

Where a PTP is engaged in the exploration, production, and marketing of oil and gas and enters into hedging transactions for the purpose of managing risk, and the PTP meets the requirements of section 1221 to treat, for federal income tax purposes, the income from the hedging transactions as ordinary income, such income constitutes a substitute for income from a qualifying activity (i.e., the exploration, production and sale of oil and gas) and should be included among qualifying income under section 7704(d)(1)(E).

As noted above, managing the risk of commodity price volatility is paramount to the survival and growth of a PTP's business. Without the ability to hedge such risk (and earn qualifying income from such hedging activities), many PTPs could not survive. Nothing in the legislative history to section 7704(d)(1)(E) indicates that Congress sought to limit a PTP's ability to manage these kinds of risks through traditional hedging arrangements that meet the requirements for ordinary income treatment under general tax principles.

Accordingly, the Proposed Regulations should clarify that income derived from any hedging transaction with respect to oil, gas or products thereof that (i) is entered into by a PTP in the normal course of its trade or business that (ii) manages the PTP's risk with respect to price fluctuations of oil, gas or products thereof held, or to be held, and (iii) is timely and properly identified as a hedging transaction within the meaning of section 1221(a)(7) should be included among marketing income under section 7704(d)(1)(E).

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[112] See also PLR 9339014 (June 28, 1993).

6. Proposed Revision

For the reasons stated above, NAPTP recommends that Prop. Reg. § 1.7704-4(c)(7) and Prop. Reg. § 1.7704-4(e), Example 4 be revised as follows:

> (7) Marketing.
> An activity constitutes marketing if it is selling or performing an activity to facilitate sale of minerals or natural resources, including blending renewable fuels (such as ethanol or biodiesel or additives into fuels and RINs from the applicable fuel), packaging minerals or natural resources for further transportation and sale, and income derived by non-operating interest owners relating to the sale of a mineral or natural resource. Except with respect to the retail sales of liquefied petroleum gas (*e.g.*, propane), marketing does not include retail sales (sales made in small quantities directly to ultimate consumers to meet personal needs, rather than for commercial or industrial uses of the articles sold), which includes, but is not limited to, the operation of gasoline service stations. Income derived from any hedging transaction with respect to minerals or natural resources that (i) is entered into by a publicly traded partnership in the normal course of its trade or business, (ii) manages the partnership's risk with respect to price fluctuations and resulting gross income from the natural resource held, or to be held, and (iii) is treated as ordinary income under section 1221 and the applicable regulations thereunder also constitutes marketing.
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> \# # #
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> Example 4. Delivery of refined products. (i) X, a publicly traded partnership, packages and sells lubricating oils to a government entity at wholesale prices and delivers those goods in bulk. (ii) X's sale of refined products to the government entity is a section 7704(d)(1)(E) activity because it is a bulk transportation and sale as described in paragraphs (c)(6) and (7) of this section and is not a retail sale.

V. INTRINSIC ACTIVITIES – Prop. Reg. § 1.7704-4(d)

Prop. Reg. § 1.7704-4(d) provides that qualifying income includes an intrinsic activity only if 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.

A. Indirect Activities Are Essential to a Section 7704(d)(1)(E) Activity if Performed by a PTP that Directly or Indirectly Co-Owns Assets That Generate Qualifying Income

Prop. Reg. § 1.7704-4(d)(3)(ii) states that the provision of legal, financial, consulting, accounting, insurance, and other similar services does not qualify as essential to a section 7704(d)(1)(E) activity. NAPTP supports such a rule when these functions are performed by service providers without any direct or indirect ownership interest in the assets that are used in performing section 7704(d)(1)(E) activities. However, in certain important cases, such activities are essential to managing a section 7704(d)(1)(E) activity. Specifically, if a PTP is a direct or indirect co-owner of a business performing section 7704(d)(1)(E) activities and the PTP provides services, such as legal, financial or accounting services, the income received by the PTP for providing such services should be treated as income derived from a qualifying activity.

A PTP is often composed of several operating businesses, some of which are owned 100% by the PTP and others that are owned as a partnership interest with others (that may include other PTPs). For operating efficiency, a PTP partner may be engaged to provide some or all of the services needed for the partnership to function as a business, with such services including the direct field activities that are described elsewhere in the proposed regulations, along with the general management and back office services (which include engineering, legal, financial, consulting, accounting, insurance, human resources, information technology and other similar services).

The general exclusion of income from such services from qualifying income status is understandable, and NAPTP supports such a rule. However, when services are provided by a co-owner that is a PTP, all fees and income of the PTP from providing such services should constitute qualifying income of the PTP. For the service providing PTP, such gross income is **derived** from the investment that generates qualifying income as defined in section 7704(d)(1)(E).

The Proposed Regulations should be modified to provide that qualifying income includes income from management services or back office services that are essential for operating a business that generates qualifying income where such services are performed by a PTP in its capacity as a partner of a partnership that generates qualifying income.

B. Management Activities

As discussed above, income from providing management services with respect to activities that constitute section 7704(d)(1)(E) activities should be treated as income from a section 7704(d)(1)(E) activity without regard to ownership. The Proposed Regulations should clarify that the provision of services by a PTP generates qualifying income when the services provided are part of overall management services provided to a qualifying activity, as demonstrated by the following examples.

Example 1: (i) V, a PTP, is a partner in partnership Z. Z owns interstate and intrastate natural gas pipelines. Z enters into an agreement with V whereby V agrees to provide management services to Z in exchange for a fee. The management services include all services necessary to manage the qualifying activities of Z.

(ii) V's allocable share of Z's income from transporting natural gas in its interstate and intrastate pipelines is qualifying income for purposes of section 7704(c) because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(6).

(iii) V's receipt of a fee for providing management services constitutes qualifying income for purposes of section 7704(c) because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(6) and V is engaged in the section 7704(d)(1)(E) activity.

Example 2: (i) W, a PTP, enters into an agreement with Z, a partnership that owns an interstate natural gas pipeline. W does not own an interest in Z. Z enters into an agreement with W whereby W agrees to provide management services to Z in exchange for a fee. The management services include all services necessary to manage the qualifying activities of Z.

(ii) W's receipt of a fee for providing management services constitutes qualifying income, as Z's income from transporting natural gas in its interstate pipeline is qualifying income for purposes of section 7704(c). This is because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(6) and W is engaged in the section 7704(d)(1)(E) activity.

C. Injectant "Well by Well" standard

The Proposed Regulations and their examples generally provide that a PTP's water delivery services will only qualify as an intrinsic activity to the extent the PTP also collects and cleans, recycles or otherwise disposes of that delivered water after use.

Prop. Reg. § 1.7704-4(d)(2)(ii)(e) provides that an activity is a specialized activity if the activity includes the sale, provision, or use of property and "[t]he property is used as an injectant to perform a section 7704(d)(1)(E) activity that is also commonly used outside of section 7704(d)(1)(E) activities (such as water, lubricants, and sand) and, as part of the activity, the partnership also collects and cleans, recycles, or otherwise disposes of the injectant after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities."

Example 6 under Prop. Reg. § 1.7704-4(d)(4)(e) further provides in part that "the water delivery and recovery and recycling activities require significant services to support the development activity because X's personnel provide services necessary for the partnership to perform the support activity at the development site on an ongoing or frequent basis that is consistent with best industry practices."

Although NAPTP generally supports the Proposed Regulations in their effort to provide a framework for the types of oilfield service activities that would generate qualifying income, as a practical matter, a requirement that a PTP perform both the water delivery and disposal activities at each well or development site in order for that water delivery service to qualify would have limited actual application and would obviate the intended purpose of the regulations - that is to permit PTPs that focus on providing services to traditional section 7704(d)(1)(E) activities, and are not mere suppliers of goods, to generate qualifying income from their active support activities.

NAPTP understands that it is common in the industry for a well operator to source its water supply and disposal service requirements with multiple providers and that it may be difficult or impossible for a PTP to satisfy the necessary "well by well" factual determination required by the Proposed Regulations.

NAPTP recommends that water delivery services should qualify as an intrinsic activity only to the extent exclusively provided by a PTP to those engaged in one or more section 7704(d)(1)(E) activities in cases where the PTP's operations also include the conduct of necessary water disposal services on an ongoing or frequent basis.

D. Tangible Property Should Not Have to Be "Specialized"

Prop. Reg. § 1.7704-4(d)(2)(ii)(A) states that if a PTP provides or uses tangible property in conjunction with performing an Intrinsic Activity, such property must be "dedicated to, and [have] limited utility outside of, section 7704(d)(1)(E) activities and is not easily converted (based on all the facts and circumstances, including the cost to convert the property) to another use other than supporting or performing the section 7704(d)(1)(E) activities." (Emphasis added.)

The Preamble to the Proposed Regulations provides an example of catering equipment used to feed to workers at a drill site as "non-specialized" equipment.[113] Costs related to feeding and housing workers do not give rise to qualifying income because they are not directly related to exploration and development activities. There are, however, many items of equipment that are used in section 7704(d)(1)(E) activities that could be used for non-section 7704(d)(1)(E) activities. For example, a bulldozer used for site preparation at a drilling site is directly involved in the exploration and development activities. The fact that the bulldozer could be used in non-section 7704(d)(1)(E) is irrelevant.

NAPTP recommends that the requirement that tangible property, when used in connection with an Intrinsic Activity to directly support a section 7704(d)(1)(E) activity, be of limited utility outside section 7704(d)(1)(E) activities be removed from the regulations.

E. Reference to Sand Should be Removed

Prop. Reg. § 1.7704-4(d)(2)(ii)(B) provides that if a PTP provides or uses an injectant, such as water, lubricants, and sand, in a section 7704(d)(1)(E) activity, such property will only

[113] Proposed Regulations Preamble at 12.

be considered "specialized" for purposes of section 7704 if as part of the activity, the PTP also collects and disposes of the injectant after use in accordance with applicable law.

Sand is a natural resource subject to depletion under section 611, and therefore the sale of sand generates qualifying income under section 7704(d)(1)(E) provided such sale is not a retail sale. In the case of providing sand to an industrial user, such as to an oilfield services company for use in fracking operations, such sale is a "bulk or wholesale" sale to an industrial user. Accordingly, the reference to the provision of sand in Prop. Reg. § 1.7704-4(d)(2)(ii)(B) should be removed, because the sale of sand in this context produces qualifying income under section 7704(d)(1)(E), regardless of whether such sand is collected and disposed of after its use.

F. <u>Proposed Revision</u>

For the reasons stated above, NAPTP recommends that Prop. Reg. §1.7704-4(d) be revised as follows:

> (d) <u>Intrinsic Activities</u>-- (1) <u>General requirements</u>. An activity is an intrinsic activity only if (A) 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, or (B) provides business services that are essential to the administration of the business of operating assets or conducting activities that generate qualifying income and are directly or indirectly co-owned by the PTP providing the services, or (C) is a service provided as part of the overall management services provided to conduct a qualifying activity. Whether an activity is an intrinsic activity is determined on an activity-by-activity basis.
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> # # #
>
> (2) (ii) To the extent that the activity includes the sale, provision, or use of property, the property is used as an injectant to perform a section 7704(d)(1)(e) activity that is commonly used outside of section 7704(d)(1)(E) activities (such as water and lubricants) and the partnership also is engaged in the business of collecting, recycling or otherwise

disposing of injectants after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities.

# # #

(5) Business Services - qualifying income includes compensation for providing direct or indirect activities or management of such activities that support a business engaged in qualifying activities where the service provider is a partner of a partnership or a co-owner of assets from which qualifying income is derived. Direct activities include activities that are required as part of the functions necessary to perform section 7704(d)(1)(E) activities. Indirect activities include the provision of legal, financial, consulting, accounting, insurance, and other similar services that otherwise do not qualify as essential to a section 7704(d)(1)(E) activity.

V. <u>TRANSITION RULE – Prop. Reg. § 1.7704-4(d)</u>

Prop. Reg. § 1.7704-4(f) provides a 10-year transition period for PTPs to treat certain income as qualifying income in the following situations:

> (A) The partnership received a private letter ruling from the IRS holding that the income from that activity is qualifying income;
>
> (B) Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as giving rise to qualifying income under section 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of these proposed regulations; or
>
> (C) The partnership is publicly traded and engages in the activity after May 6, 2015 but before the date these regulations are published as final regulations in the Federal Register, and the income from that activity is qualifying income under these proposed regulations.

A. <u>PTPs with a Private Letter Ruling from the IRS</u>

As discussed above, NAPTP recommends that existing PLRs be permanently grandfathered.

B. Engaging in Activities After to May 6, 2015

PTPs may be subject to commitments with respect to purchasing or constructing new assets. The Proposed Regulations ignore the commercial reality that PTPs have invested significant amounts of capital with respect to facilities that take years to place in service. Accordingly, NAPTP recommends that any transition rule should allow income from projects undertaken prior to May 6, 2015 to be eligible for transition relief.

C. Treating Income as Qualifying Income Prior to May 6, 2015

It is unclear what is meant by the requirement that a PTP has "treated the activity as giving rise to qualifying income." Moreover, there may not yet have been income from a project that is under construction. Accordingly, NAPTP recommends that any transition rule should apply to income if the income in question was qualifying income under the statute as reasonably interpreted prior to the issuance of the Proposed Regulations.

* * *

NAPTP appreciates the opportunity to comment on the Proposed Regulations and would be pleased to answer any questions.

Sincerely,

Linda Carlisle

Linda E. Carlisle
On Behalf of NAPTP