Hydraulic Fracturing Services Are Qualifying Income for MLPs

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The IRS has issued a number of favorable private letter rulings that determined that income from providing hydraulic fracturing services is "qualifying income" for purposes of a master limited partnership. Although qualifying income generally includes passive income, it can also include income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or the marketing of any mineral or natural resource. This article discusses the rulings in greater detail.

Background

A master limited partnership (MLP), sometimes called a publicly traded partnership, is an attractive business entity because it is treated as a partnership for federal income tax purposes, although the ownership interests in it are publicly traded.[1] The income of the MLP is subject to a single level of tax at the partner level; moreover, ordinary business deductions flow through the MLP and reduce the partners' MLP taxable income. By contrast, corporate income, other than that of an S corporation, is subject to tax at the corporate level, and the net after-tax income of the corporation is subject to a second level of tax when distributed as dividends to shareholders.

To obtain its favorable tax treatment, the MLP must meet certain requirements. For example, 90 percent or more of the MLP's gross income for each tax year must consist of qualifying income.[2] Failure to meet that requirement can result in treatment of the MLP as a corporation for federal income tax purposes. Qualifying income generally includes passive income such as interest, dividends, and real property rents.[3] When the qualifying income comes from natural resources, however, it also includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products created from the gas or oil), or marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). That is sometimes referred to as the natural resource exception.[4] The IRS has issued many taxpayer-favorable private letter rulings that say income from various sources qualifies for the natural resource exception, including several recent letter rulings that discuss income generated from providing hydraulic fracturing services and other income related to hydraulic fracturing. Those letter rulings are discussed in greater detail below.

Hydraulic Fracturing Services

In LTR 201322024, released on May 31, the IRS ruled on the income of an MLP that, as successor to the business operations of its sponsor, provides well stimulation services to the oil and gas industry. The MLP, itself or through affiliated operating entities treated as partnerships or disregarded entities for

[1] *See* section 7704.
[2] *See* section 7704(c)(2).
[3] *See* section 7704(d)(1)(A)-(C).
[4] *See* section 7704(d)(1)(E).

federal income tax purposes, provides high-pressure hydraulic fracturing services to exploration and production companies. The MLP's hydraulic fracturing services enhance the production of oil and natural gas from unconventional oil and natural gas basins (that is, geologic formations such as shale and other tight formation reservoirs where natural flow is restricted). To provide those services, the MLP uses mobile hydraulic fracturing units and associated heavy equipment that it owns and that is operated by its employees and independent contractors. The hydraulic fracturing equipment is designed to pump specially formulated fracturing fluid into a perforated well casing or tubing under high pressure.

The letter ruling describes the fracturing process as one that is completed in multiple stages or horizontal zones. Sand, bauxite, resin-coated sand, or ceramic particles, each referred to as a proppant or propping agent, are suspended in the fracturing fluid and prop open the cracks created by the fracturing process in the underground formation. That propping causes the underground formation to fracture, allowing the hydrocarbons to flow more freely into the wellbore. In its ruling request, the MLP represented to the IRS that those hydraulic fracturing services are integral to the production of oil and natural gas because without them, the production of those natural resources would be significantly curtailed.

The MLP entered into a contract with an independent exploration and production company, the E&P Co., engaged in the acquisition, development, and production of unconventional natural gas resources in the United States. Under that contract, the MLP will provide hydraulic fracturing services to E&P Co. in a specific geographic location over a 24-month period. The contract requires the MLP to provide an initial fleet of a specified number of pumps and to perform a minimum number of stages per day for a set number of days per month, which result in a minimum number of fracturing stages per quarter. The MLP's fee categories for providing those hydraulic fracturing services include (1) mobilization fees based on mileage from the location of the MLP's hydraulic fracturing fleet, charged at the initial stage of each job; (2) operating stage/well/day rates; (3) standby time rates and downtime rates when E&P Co. does not provide the MLP with the minimum number of quarterly stages through no fault of the MLP; (4) *force majeure* payment rates and payments in the event a governmental body or regulatory agency issues a mandate that either makes it impossible for the MLP to continue operations or causes an increase in the MLP's rate; and (5) reimbursable costs for hydraulic fracturing related material, equipment, work, or services that are to be furnished by the MLP at E&P Co.'s request, plus a percentage of those costs for handling.

The MLP represented to the IRS that its contract with E&P Co. is illustrative of the contractual relationships that the MLP expects to have with other exploration and production companies. The fee structure of those additional contracts is expected to be similar to the fees charged in the E&P Co. contract. In some instances, the MLP may also source chemicals and proppants that are consumed during the fracturing process and charge its exploration and production customers a fee for providing those materials. Those charges for materials generally will reflect the cost of the materials plus a markup and will be based on the actual quantity of materials used in the fracturing process. The MLP may charge its other exploration and production customers a handling fee for chemicals and proppants supplied by the customers.

Based on the facts submitted and representations made, the IRS ruled that the gross income the MLP derives from providing hydraulic fracturing services will be qualifying income.

Other Income Related to Hydraulic Fracturing

LTR 201234005, released on August 24, 2012, involves an MLP engaged in the transportation and processing of natural gas within the United States through affiliated operating subsidiaries treated as partnerships or disregarded entities for federal income tax purposes. To facilitate its transportation and processing, the MLP owns natural gas gathering pipelines, processing systems, and pipeline rights of way associated with each pipeline.

The MLP's customers are natural gas producers that use hydraulic fracturing to extract natural gas from geological formations. This hydraulic fracturing involves the injection of fluids, primarily water mixed with a proppant, into an oil or gas well at high pressure to fracture geological formations and open pathways for the oil or gas to flow. The fracturing process requires large volumes of water.

To meet the water needs of its customers, the MLP formed a subsidiary operating limited partnership (OLP) to develop, construct, own, and operate a water delivery pipeline system. The pipeline system will supply fresh water to the MLP's customers and other natural gas producers for their use in producing natural gas through hydraulic fracturing. The pipeline will run primarily parallel to the trunk line of the MLP's natural gas-gathering pipelines and will share the MLP's existing rights of way. The OLP will earn income from long-term pipeline capacity and supply agreements with the MLP's customers. The OLP expects to enter into additional long-term pipeline capacity and supply agreements with other natural gas producers in the region. Under those agreements, natural gas producers will pay the OLP for the pipeline supply and transportation of fresh water to water impoundment ponds designated by the natural gas producers.

The MLP represented to the IRS that the supply and transportation of fresh water to natural gas producers for use in hydraulic fracturing are integral to the exploration and production of natural gas from shale formations and the preservation and growth of the MLP's existing activity of natural gas transportation. The MLP, through the OLP, is uniquely situated to supply fresh water efficiently through a pipeline because of its existing rights of way and expertise in pipeline transportation. The OLP intends to provide the water supply solely to natural gas producers operating in proximity to the MLP's natural gas-gathering assets, many of which are either current or prospective customers of the MLP's natural gas-gathering services.

Based on the facts submitted and representations made, the IRS ruled that the MLP's distributive share of the gross income derived by the OLP from the supply and transportation of water to oil and gas producers for use in the exploration, development, and production of oil or natural gas is qualifying income.

In LTR 201233009, released on August 17, 2012 and modified by LTR 201316005, released on April 19, 2013, the IRS ruled that income derived by an MLP from the mining and marketing of silica for sale to oil field service companies for injection as a proppant in the production of crude oil and natural gas constitutes qualifying income.

Conclusion

The only taxpayer that can rely on a letter ruling is the one that obtained it. However, letter rulings may provide insight into determinative facts and concluding analysis. Given the IRS's favorable disposition toward the natural resource exception and the dire tax consequences of failing the qualifying income requirement, MLPs engaged in or considering the kinds of activities described above should evaluate with their tax advisers the desirability of obtaining their own letter rulings. Taxpayer-favorable letter rulings would confirm that the income derived from those activities will indeed constitute qualifying income.