

# International Partnerships, Joint Ventures and Hybrids

## The New Regulations on Qualifying Income for Master Limited Partnerships

*By Edward C. Osterberg, Jr.*

### Background

A Master Limited Partnership or MLP (referred to as a publicly traded partnership, or PTP, in Code Sec. 7704<sup>1</sup>) is an attractive business entity because it is treated as a partnership for federal income tax purposes even though the ownership interests in the MLP are publicly traded. Thus, 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' taxable income from the MLP. By contrast, income of a corporation (other than an S corporation<sup>2</sup>) 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 its shareholders.

In order to obtain this favorable tax treatment, the MLP must meet certain requirements, one of which is that 90 percent or more of the MLP's gross income for each tax year must consist of "qualifying income."<sup>3</sup> Failure to meet this requirement could 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.<sup>4</sup> However, with respect to natural resources, qualifying income also 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<sup>5</sup> (including fertilizer, geothermal energy and timber), industrial source carbon dioxide or the transportation or storage of certain fuels, alcohol fuel and biodiesel fuel<sup>6</sup>; this is sometimes referred to as the "natural resource exception."<sup>7</sup>

There are no regulations currently in effect that define qualifying income in the context of the natural resource exception. Instead, income qualifying for the natural resource exception has been defined by a number of private letter rulings issued by the IRS over the years to the effect that income from various sources qualifies for the natural resource exception.<sup>8</sup>



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On May 6, 2015, Treasury and the IRS published proposed regulations under Code Sec. 7704(d)(1)(E) that address the issue of qualifying income in the context of the natural resource exception.<sup>9</sup> This article summarizes those proposed regulations.

## The Proposed Regulations

### Overview

Much of the proposed regulations is devoted to the definition of terms that comprise qualifying income. Thus, under the proposed regulations qualifying income for purposes of the natural resource exception includes only income and gains from “Qualifying Activities,” which in turn is comprised of “Section 7704(d)(1)(E) Activities” and “Intrinsic Activities.”

### Section 7704(d)(1)(E) Activities

Section 7704(d)(1)(E) Activities include the exploration, development, mining or production, processing, refining, transportation or marketing of any mineral or natural resource as described in the regulations or as provided by the IRS by notice or other published guidance. No other activities qualify as Section 7704(d)(1)(E) Activities.<sup>10</sup>

An activity constitutes “Exploration” if it is performed to ascertain the existence, location, extent or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit by (i) drilling an exploratory or stratigraphic type test well, (ii) conducting drill stem and production flow tests to verify commerciality of the deposit, (iii) conducting geological or geophysical surveys, (iv) interpreting data obtained from geological or geophysical surveys or (v) conducting certain types of activities with respect to minerals described in Rev. Rul. 70-287.<sup>11</sup>

An activity constitutes “Development” if it is performed to make accessible minerals or natural resources by (i) drilling wells to access deposits of mineral or natural resources; (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); (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, stoping, and caving or room-and-pillar excavation, and

for oil and natural gas fracturing; or (v) constructing and installing gathering systems and custody transfer stations.<sup>12</sup>

An activity constitutes “Mining or Production” if it is performed to extract minerals or other natural resources from the ground by (i) operating equipment to extract natural resources from mines and wells or (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).<sup>13</sup>

Generally an activity constitutes “Processing” or “Refining” if it is done to purify, separate or eliminate impurities. For an activity to be treated as Processing or Refining, the MLP’s position that an activity is Processing or Refining must be consistent with the MLP’s designation of an appropriate MACRS<sup>14</sup> class life for assets used in the activity in accordance with Rev. Proc. 87-56.<sup>15</sup> For example, for an activity to be Processing or Refining of crude oil, the assets used in that process must also have a MACRS class life of 13.3 (Petroleum Refining). Generally, an activity will 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.<sup>16</sup>

With respect to natural gas, an activity constitutes “Processing” if it is performed to (i) purify natural gas, including by removal of oil or condensate, water or non-hydrocarbon gases (including carbon dioxide, hydrogen sulfide, nitrogen and helium); (ii) separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane and gas condensate); or (iii) convert methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.<sup>17</sup>

With respect to petroleum, an activity constitutes Processing or Refining if the end products of these processes are not plastics or similar petroleum derivatives and the activity is performed to (i) physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes and similar products; (ii) chemically convert the physically separated components if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost-effective production of gasoline or other fuels (for example, gas oil converted to

naphtha through a cracking process that is hydrotreated and combined into gasoline); or (iii) physically separate products created through activities described in the preceding clause (i) or (ii).<sup>18</sup>

However, the following products are not obtained through Processing of petroleum and thus do not constitute Qualifying Activities: (i) heat, steam or electricity produced by the refining processes; (ii) products that are obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts are sold; and (iii) any product that results from further chemical change of the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil (for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as to anode-grade coke) does not qualify because it is further chemically changed).<sup>19</sup>

With respect to ores and minerals, an activity constitutes Processing or Refining if it meets the definition of mining processes or refining in the existing regulations.<sup>20</sup> 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.<sup>21</sup>

With respect to timber, an activity constitutes Processing 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. Processing of timber does not include activities that add chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp. Products that result from the Processing of timber include wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark and rough poles. Products that are not the result of timber Processing include pulp, paper, paper products, treated lumber, oriented strand board/plywood and treated poles.<sup>22</sup>

“Transportation” is the movement of minerals or natural resources and products produced by Mining or Production, Processing, or Refining, including by pipeline, barge, rail or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers. A retail customer does not include a person who acquires oil or gas for refining or processing, or a utility.<sup>23</sup> 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 line owned by the MLP (an interconnect agreement).<sup>24</sup>

An activity constitutes “Marketing” if it is performed to facilitate sale of minerals or natural resources and products produced by Mining or Production, Processing or Refining, 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 include, but are not limited to, operation of gasoline service stations, home heating oil delivery services and local gas delivery services.<sup>25</sup>

## Intrinsic Activities

Generally an activity is an Intrinsic Activity only if the activity (i) is specialized to support a Section 7704(d)(1)(E) Activity, (ii) is essential to the completion of the Section 7704(d)(1)(E) Activity, and (iii) 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.<sup>26</sup>

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An activity is a specialized activity if (i) the MLP 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, and (ii) to the extent that the activity includes the sale, provision or use of property, either (A) the property is primarily tangible property that is dedicated to, and has 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, or (B) the 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 MLP 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.<sup>27</sup>

An activity is essential to the Section 7704(d)(1)(E) Activity if it is required to (i) physically complete a Section 7704(d)(1)(E) Activity (including in a cost effective manner, such as by making the activity economically viable), or (ii) comply with federal, state or local law regulating the Section 7704(d)(1)(E) Activity. Legal, financial, consulting, accounting insurance, and other similar services do not qualify as essential to a Section 7704(d)(1)(E) Activity.<sup>28</sup>

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 MLP's personnel at the site or sites of the Section 7704(d)(1)(E) Activities. Alternatively, those services may be conducted offsite if the services are performed on an ongoing or frequent basis and are offered exclusively to those engaged in one or more Section 7704(d)(1)(E) Activities. Whether services are conducted on an ongoing or frequent basis is determined based on all the facts and circumstances, including recognized best practices in the relevant industry. MLP personnel perform significant services only if those services are necessary for the MLP 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. An activity does not constitute significant services with respect to a Section 7704(d)(1)(E) Activity if the activity principally involves the design, construction, manufacturing, repair, maintenance, lease, rent or temporary provision of property.<sup>29</sup>

## Examples

The proposed regulations contain six examples, the conclusions of which are summarized below.

In Example 1, an MLP chemically converts a mixture of ethane and propane (obtained from physical separation of natural gas) into ethylene, propylene and other gases through use of a steam cracker. These activities chemically convert physically separated components of natural gas. The chemical conversion of physically separated components of natural gas (ethane and propane) is not a Section 7704(d)(1)(E) Activity.

In Example 2, an MLP owns a petroleum refinery. It classifies its assets under MACRS class 13.3 (Petroleum Refining). The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic

cracking unit to chemically convert the heavy gas oil into a liquid stream suitable for gasoline blending and a gas stream containing ethane, ethylene and other gases. The refinery also further physically separates the gas stream without additional chemical change, resulting in refinery grade ethylene. The MLP sells the ethylene to a third party. These activities are performed to physically separate crude oil into its component parts and to chemically convert the separated heavy gas oil into a liquid stream for recombining with other physically separated components of crude oil. Income received from the liquid stream is qualifying income. The further physical separation of the gas stream produces ethane, ethylene and other gases; income received from the physically separated gases is qualifying income because the heavy gas oil was chemically converted as part of a processing activity.

In Example 3, an MLP chemically converts methane into methanol and synthesis gas, and further chemically converts those products into gasoline and diesel fuel. It receives income from sales of gasoline and diesel created during the conversion processes, as well as from sales of methanol. With respect to the production of gasoline or diesel, the MLP is engaged in the processing of natural gas. The production and sale of methanol, an intermediate product in the conversion process, is not a Section 7704(d)(1)(E) Activity because methanol is not a liquid fuel otherwise produced from the processing of crude oil.

In Example 4, an MLP sells diesel and lubricating oils to a government entity at wholesale prices and delivers those goods in bulk. The sale of refined products to the government entity is a Section 7704(d)(1)(E) Activity because it is a bulk transportation and sale and is not a retail sale.

In Example 5, an MLP owns interstate and intrastate natural gas pipelines. It built a water delivery pipeline along the existing right of way for its natural gas pipeline to deliver water for use in a third-party's fracturing activity to develop a natural gas reserve in a cost-efficient manner. The MLP earns income for transporting natural gas in the pipelines and for delivery of water. The MLP's income from transporting natural gas in its interstate and intrastate pipelines is qualifying income from Transportation. The water delivery is not a Section 7704(d)(1)(E) Activity, but may be an Intrinsic Activity. However, the provision of water used in a Section 7704(d)(1)(E) Activity is specialized to that activity only if the MLP also collects and cleans, recycles or otherwise disposes of the water after use in accordance with federal, state or local regulations concerning waste products from mining or production activities. Because the MLP does not collect and clean, recycle or otherwise dispose of the delivered water after use, the MLP's water delivery activities are not specialized



to narrowly support the Section 7704(d)(1)(E) Activity and thus are not an Intrinsic Activity.

In Example 6, the facts are the same as Example 5, except that the MLP also collects and treats flowback at the drilling site in accordance with state regulations as part of its water delivery services and transports the treated flowback away from the site. It provides personnel to perform these services on an ongoing or frequent basis that is consistent with best industry practices, and it has provided these personnel with specialized training regarding the recovery and recycling of flowback which is of limited utility other than to perform or support the development of natural gas. Because the MLP's water delivery services are specialized, essential and require the provision of substantial services, the MLP's water delivery services are an Intrinsic Activity.

## Effective Date

Generally the proposed regulations would apply to income earned by an MLP in a tax year beginning on or after the date the regulations are published as final regulations. However, during the period which ends on the last day of an MLP's tax year that includes the date that is 10 years after the date that the regulations are published as final

regulations (the "Transition Period"), the MLP may treat income from an activity as qualifying income if: (i) the MLP received a private letter ruling from the IRS holding that the income from that activity is qualifying income; (ii) prior to May 6, 2015, the MLP was publicly traded, engaged in the activity and treated the activity as giving rise to qualifying income under Code Sec. 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of the proposed regulations; or (iii) the MLP is publicly traded and engages in the activity after May 6, 2016, but before the date the regulations are published as final regulations and the income from that activity is qualifying income under the proposed regulations. In determining whether an interpretation was reasonable, the legislative history and interpretations applied by the IRS prior to the issuance of the proposed regulations are taken into account; however, an interpretation was not reasonable merely because an MLP had a reasonable basis for that position. With respect to an activity undertaken prior to May 6, 2015, no inference is intended that an activity that is not described in the proposed regulations as a Qualifying Activity did or did not produce qualifying income under the statute and legislative history.<sup>30</sup>

## ENDNOTES

<sup>1</sup> All references herein to the Code are to the Internal Revenue Code of 1986, as amended (the "Code").

<sup>2</sup> See Code Sec. 1361.

<sup>3</sup> Code Sec. 7704(c)(2).

<sup>4</sup> Code Sec. 7704(d)(1)(A)-(C).

<sup>5</sup> For this purpose "mineral or natural resource" means any product of a character with respect to which a deduction for depletion is allowable under Code Sec. 611, except that such term does not include any product described in subparagraph (A) or (B) of Code Sec. 613(b)(7) (i.e., soil, sod, dirt, turf, water or mosses, or minerals from seawater, the air or similar inexhaustible source).

<sup>6</sup> These fuels are described in subsection (b), (c), (d) or (e) of Code Sec. 6426 and in Code Sec. 40A(d)(1).

<sup>7</sup> Code Sec. 7704(d)(1)(E).

<sup>8</sup> Several recent private letter rulings deal with income from the provision of hydraulic fracturing services or other income related to hydraulic fracturing. See LTR 201322024 (released May 31, 2013); LTR 201234005 (released Aug. 24, 2012); and LTR 201233009 (released Aug. 17, 2012), modified by LTR 201316005 (released Apr. 19, 2013).

<sup>9</sup> REG-132634-14, 80 Fed. Reg. 25970 (May 6, 2015).

<sup>10</sup> See Proposed Reg. §1.7704-4(c)(1). The proposed regulations do not address the transportation or storage of any fuel described in Code

Sec. 6426(b), (c), (d), or (e), any biodiesel fuel as defined in Code Sec. 40A(d)(1), or activities with respect to industrial source carbon dioxide. Comments concerning whether guidance is also needed with respect to those activities are requested. The proposed regulations also "reserve" as to fertilizer. See Proposed Reg. §1.7704-4(c)(5)(vi).

<sup>11</sup> Rev. Rul. 70-287, 1970-1 CB 146. See Proposed Reg. §1.7704-4(c)(2).

<sup>12</sup> See Proposed Reg. §1.7704-4(c)(3).

<sup>13</sup> See Proposed Reg. §1.7704-4(c)(4).

<sup>14</sup> Modified Accelerated Cost Recovery System under Code Sec. 168.

<sup>15</sup> Rev. Proc. 87-56, 1987-2 CB 674.

<sup>16</sup> See Proposed Reg. §1.7704-4(c)(5)(i). Compare Reg. §1.613-4(g)(5) (Processes 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, are generally nonmining processes).

<sup>17</sup> See Proposed Reg. §1.7704-4(c)(5)(ii). According to the preamble to the proposed regulations, it is generally anticipated that activities that create the products listed in the 2012 version of the North American Industry Classification System (NAICS) code 211112 concerning natural gas liquid extraction will be Qualifying Activities.

<sup>18</sup> See Proposed Reg. §1.7704-4(c)(5)(iii)(A). According to the preamble to these proposed

regulations, it is generally anticipated that activities within a refinery that create the products that are listed in the 2012 version of the NAICS code 324110 concerning petroleum refineries will be a Qualifying Activity, if those products are refinery grade products that are obtained in the steps required to make fuels, lubricating base oils, waxes and similar products. Additionally, physically separating any product that is itself generated by the processing or refining of crude oil is a Code Sec. 7704(d)(1)(E) Activity.

<sup>19</sup> See Proposed Reg. §1.7704-4(c)(5)(iii)(B). The production of plastics and similar petroleum derivatives does not give rise to qualifying income derived from processing or refining. See H.R. Rep. No. 100-495, at 947 (1987).

<sup>20</sup> See Reg. §§1.613-4(f)(1)(ii) and 1.613-4(g)(6)(iii).

<sup>21</sup> See Proposed Reg. §1.7704-4(c)(5)(iv).

<sup>22</sup> See Proposed Reg. §1.7704-4(c)(5)(v).

<sup>23</sup> Specifically, 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, or a utility providing power to customers. By contrast, transporting refined petroleum products by truck to retail customers is not a Qualifying Activity. See H.R. Rep. No. 100-1104, vol. 2, at 18 (1988). However, Transportation includes bulk transportation, so long as the transportation is not to a place that sells or dispenses oil and gas (or oil and gas products) to retail customers. See S. Rep. No. 100-445,

at 424 (1988).

<sup>24</sup> See Proposed Reg. §1.7704-4(c)(6).

<sup>25</sup> Marketing does not include activities and assets involved primarily in sales to end users at the retail level. S. Rep. No. 100-445, at 424 (1988). Therefore, Marketing does not include retail sales (sales made in small quantities directly to end users). For example, gas station operations are not included in Marketing. However, Marketing includes bulk and wholesale sales made to end users. See H.R. Rep. 100-1104,

at 18 (1988) incorporating in footnote 1, 133 Cong. Rec. 37957 (Dec. 22, 1987) (statement of Sen. Bentsen with respect to propane).

<sup>26</sup> See Proposed Reg. §1.7704-4(d)(1).

<sup>27</sup> See Proposed Reg. §1.7704-4(d)(2). Catering services provided to employees at a drilling site would not give rise to qualifying income because catering services do not require skills (or equipment) limited to supporting a Section 7704(d)(1)(E) Activity. As such, catering services are not Intrinsic Activities and any

income from those services is not qualifying income.

<sup>28</sup> See Proposed Reg. §1.7704-4(d)(3). Legal, financial, consulting, accounting, insurance and other similar services are not essential to a Section 7704(d)(1)(E) Activity because the connection to completion of the Section 7704(d)(1)(E) Activity is too attenuated.

<sup>29</sup> See Proposed Reg. §1.7704-4(d)(4).

<sup>30</sup> See Proposed Reg. §1.7704-4(f).

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