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Absence Of Final MLP Status Rules Sowing Uncertainty

By **Vidya Kauri**

Law360, New York (September 8, 2016, 9:23 PM ET) -- Final regulations on how service providers in the oil and gas industry can qualify for preferential tax treatment as master limited partnerships have been anticipated for some time, but experts say their failure to materialize is leaving taxpayers who may be impacted by changes in a state of uncertainty.

The Internal Revenue Service proposed controversial regulations in May 2015 on qualifying income that would allow service providers to be treated as MLPs, which are taxed only at the partner level rather than both at the corporation level and partner level, but it has received feedback that its proposals are too restrictive and inconsistent with industry practice and Congress' intentions.

A public hearing on the proposed regulations was held last October and experts are still hoping that final regulations will be issued this month, but so far, it is unclear if certain activities that the IRS had previously indicated would lead to qualifying income for MLP status in private letter rulings will still qualify under the final regulations, experts say.

Mary Lyman, executive director of the Master Limited Partnership Association, said that there are major outstanding issues that the association is hoping to have some clarity on before the end of the Obama administration.

"The IRS has been very open in letting us know where they are in the process, but they have not shared much on what their thinking is and what might change," Lyman said. "It leaves people who could be impacted by the regulation in a state of uncertainty. There are some companies that ... could have their activities disqualified. So, they are quite anxious to see how the final regulations come out."

Spokespeople for the IRS did not answer questions from Law360 on when the final rules may be released.

The proposed regulations are wide-reaching, providing an exclusive list of what activities qualify for MLP treatment along the entire process of mineral and natural resource production, from the exploration, development, mining and processing of resources to refining, transportation and marketing.

The exclusive list is one of the key things the industry has railed against, according to Edward Osterberg of Mayer Brown LLP, who said that not only can items be unintentionally left off the list, but that new technologies would be automatically disqualified as they develop.

"The industry as it develops is going to come up with new processes and new ways of doing things that are not covered in the regulations," Osterberg said. "So, hopefully they would use these examples as just that and not as an exclusive list of qualifying activities."

Lyman pointed out that fracking, for example, is a relatively new technology that may not have qualified a couple of decades ago, but was explicitly granted the favorable tax status in the proposed regulations.

She also said that the exclusive list defeats the IRS' goal of reducing the number of private letter rulings it has to issue.

"We think that having an exclusive list is just going to increase the private letter rulings because if people are doing an activity that's not on the list, they're going to want to find out somehow if they qualify," she said.

The IRS had previously given private rulings to individual fracking services companies saying they could be treated as MLPs. By statute, 90 percent of a publicly traded partnership's income must be qualifying income to be treated as an MLP.

However, the agency began receiving so many requests for private rulings on novel issues that it briefly instituted a hiatus on the rulings until March 2015 so it could study the issue further.

Another controversial subject that the industry is waiting for clarification on relates to the production of olefins such as ethylene and propylene. Under the proposed regulations, the production of these olefins qualifies for getting MLP status if they are produced from crude oil in an oil refinery, but not in a natural gas processing plant or other special-purpose facility.

"I think chemists and business people would agree that at the end of the day, you're processing into the same product. So, the treatment of it as either qualifying or nonqualifying income ought to be the same," Osterberg said.

Natural gas processor Westlake Chemical Partners LP has said in public comments to the IRS that proposed regulations on olefin production unfairly revoke its tax-preferred MLP status which it said it was previously granted in a private letter ruling in June 2013. The ruling prompted the formation of the partnership, Westlake said.

The proposed regulations include a grandfathering rule to give taxpayers 10 years to continue relying on favorable private letter rulings if the final regulations are different from the rulings.

However, Osterberg said the IRS can generally only revoke private letter rulings if either the law or the business's activities have changed. While a grandfathering rule for 10 years may sound reasonable on the surface, the market, in practice, tends to discount the value of the business right away in anticipation of changing activities in 10 years, he said.

"The law hasn't changed, it's just the interpretation of the law," Osterberg said. "If you look at the revenue procedure on obtaining private letter rulings, it basically says the IRS can revoke them if the law changes, but this isn't a law change. Grandfathering doesn't help because the market says you're going to take a big hit on the value of the business."

Taxpayers should be able to permanently rely on private letter rulings even if they are different from

newer final regulations, he added.

Michael Bresson of Baker Botts LLP said that recent private letter rulings issued by the IRS on the regasification of liquefied natural gas, interest rate swaps and other hedging transactions offer few clues on how the agency is likely to interpret an MLP's qualifying income in the final rules.

Whether the IRS reverts to positions it took in private letter rulings or not will be one of the first things that taxpayers will be checking for in the final regulations, he said.

"The IRS has certainly heard a lot of comments and testimony from industry trade groups and others that it's bad policy for them to issue private letter rulings to say something qualifies, and then to change their minds," Bresson said. "We're waiting to see what decisions they'll make after having heard all that."

--Additional reporting by Eric Kroh. Editing by Katherine Rautenberg and Catherine Sum.
