

IRS and Treasury Finalize Guidance Determining MLP Qualifying Income

Regulations provide rules for determining MLP qualifying income from certain mineral or natural resource-related activities and services.

On January 19, 2017, the US Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) issued final regulations (Regulations) under Internal Revenue Code (Code) Section 7704(d)(1)(E) relating to the classification of income from certain mineral or natural resource-related activities as qualifying income for publicly traded partnerships (PTPs) and master limited partnerships (MLPs). On January 24, 2017, the Regulations were published in the Federal Register — the impact, however, on the Regulations of a regulatory freeze imposed by the incoming administration in a January 20, 2017, White House memorandum is not immediately clear.

The Regulations finalized, with certain modifications, the proposed regulations for PTP and MLP qualifying income that were issued on May 6, 2015 (Proposed Regulations).

Clearer Guidance as Compared to Proposed Regulations

Overall, the Regulations represent a marked improvement to the Proposed Regulations by providing needed clarity and a more flexible approach to analyzing qualifying income while also reflecting many of the substantive comments to the Proposed Regulations submitted by individual investors, industry participants and industry-focused organizations. Listed below are some of the most notable changes:

- **Abandonment of the “exclusive list” concept** — The Regulations provide a general definition of each of the qualifying activities (referred to as “Section 7704(d)(1)(E) Activities” in the Regulations), followed by a non-exclusive list of examples of each activity, as opposed to the exclusive lists found in the Proposed Regulations.
- **Separate definitions for processing and refining** — The Regulations define processing and refining separately, providing a general definition for processing and a mineral or natural resource-specific definition for refining.
- **Abandonment of bias toward fuels** — The Regulations define activities regarding the refining of natural gas and crude oil to the extent that such activities give rise to specified products of the type that are produced in a petroleum refinery or natural gas plant (without regard to the physical location of the actual activity). The Regulations abandon the Proposed Regulations’ bias toward the production of fuels as the sole focus of qualifying activities.

- **Removal of differentiation for certain activities related to oil and gas products** — The Regulations do not differentiate between the refining of natural gas and the refining of crude oil, particularly regarding the creation of olefins and certain liquid fuels.
- **Cleanup of previously missed activities** — The Regulations include activities that were previously not included in the Proposed Regulations, including, as discussed in more detail below, (i) certain reimbursements for costs incurred in the performance of a Section 7704(d)(1)(E) Activity; (ii) income from certain passive interests, such as oil and natural gas production royalties; and (iii) retail sales of liquefied petroleum gas.
- **Intrinsic activities** — As discussed in more detail below, the Regulations clarify certain aspects of intrinsic activities, including the types of personnel that are permitted to provide services and rules relating to injectant services.

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

MLP qualifying income includes income and gains derived from certain mineral or natural resource-related qualifying activities. Generally, minerals and natural resources are timber and the products of mines, oil and gas wells and other natural deposits, although certain products from inexhaustible sources are excluded. Section 7704(d)(1)(E) Activities comprise activities ranging from the search for viable mineral and natural resource deposits through the sale of certain finished products — including, specifically, exploration, development, mining or production, processing, refining, transportation and marketing.

Exploration consists of those activities related to identifying the location and nature of mineral or natural resource deposits, and includes exploratory drilling and surveying. Development involves making minerals and natural resources accessible, including by drilling and completing wells; constructing and installing certain related structures and equipment; performing certain development techniques (*e.g.*, fracturing for oil and natural gas); and constructing and installing gathering systems and custody transfer stations. Mining or production consists of those activities performed to extract minerals or natural resources from the ground.

Processing generally consists of those activities performed to convert raw production into a form that can be stored or transported. This captures the processing that is generally performed at wellheads, mines or other field facilities. Regarding natural gas, processing means purification, such as the removal of non-hydrocarbon gases, oil and water, and separation of the natural gas stream into its constituents, including into both gasses and natural gas liquids. Processing crude oil generally means using certain techniques to remove or separate gas, sediment and water from crude oil. Additionally, the Regulations include specific guidance regarding processing of other ores and minerals, as well as timber.

Refining crude oil and natural gas includes the physical or chemical conversion or separation of products resulting from processing crude oil or natural gas, and the blending of petroleum hydrocarbons, into one of 35 products specified in the Regulations that are of the type produced in petroleum refineries and gas processing plants. This list, reproduced below, was derived from a list compiled by the US Energy Information Administration; the Commissioner of the IRS may expand the list in the future through published guidance.

Products of a Type Produced in a Petroleum Refinery or Natural Gas Processing Plant

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| <ul style="list-style-type: none"> • Ethane • Ethylene • Propane • Propylene • Normal butane • Butylene • Isobutane • Isobutene • Isobutylene • Pentanes plus • Unfinished naphtha • Unfinished kerosene and light gas oils • Unfinished heavy gas oils • Unfinished residuum • Reformulated gasoline with fuel ethanol • Reformulated other motor gasoline | <ul style="list-style-type: none"> • Conventional gasoline with fuel ethanol—Ed55 and lower gasoline • Conventional gasoline with fuel ethanol—greater than Ed55 gasoline • Conventional gasoline with fuel ethanol—other conventional finished gasoline • Reformulated blendstock for oxygenate (RBOB) • Conventional blendstock for oxygenate (CBOB) • Gasoline treated as blendstock (GTAB) • Other motor gasoline blending components defined as gasoline blendstocks as provided in Treasury Regulation Section 48.4081-1(c)(3) | <ul style="list-style-type: none"> • Finished aviation gasoline and blending components • Special naphthas (solvents) • Kerosene-type jet fuel • Kerosene • Distillate fuel oil (heating oils, diesel fuel, and ultra-low sulfur diesel fuel) • Residual fuel oil • Lubricants (lubricating base oils) • Asphalt and road oil (atmospheric or vacuum tower bottom) • Waxes • Petroleum coke • Still gas • Naphtha less than 401°F end-point |
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Refining other ores and minerals entails eliminating impurities or foreign matter that are necessary to achieve a high degree of purity from five specified metallic ores and minerals that are not customarily sold as a crude mineral product — lead, zinc, copper, gold and silver — along with any other ores or minerals that the Commissioner of the IRS may identify through published guidance. The following list provides examples of certain refining activities the Regulations indicate to either be qualifying or not qualifying:

Qualified Refining Activity	Not a Qualified Refining Activity
<ul style="list-style-type: none"> • Producing gasoline or diesel from methane • Chemically converting a mixture of ethane and propane into ethylene and propylene through use of a steam cracker • Using a catalytic cracker to chemically convert heavy gas oil into a liquid stream suitable for gasoline blending, and gas stream containing ethane, ethylene and other gases • Producing petroleum coke from heavy (refinery) residuum 	<ul style="list-style-type: none"> • Producing methanol (an intermediate product derived in the process of converting methane into gasoline or diesel) • Converting purchased methanol into gasoline or diesel • Upgrading petroleum coke, such as to calcined coke • Coking coal • Producing activated carbon

Transportation, generally, consists of moving extracted, processed or refined minerals or natural resources, such as by pipeline, ship, rail or truck. Transportation also includes the provision of storage, terminalling and pipeline compression services and the liquefaction and regasification of natural gas. Although transportation, generally, does not include moving products to retailers or directly to retail customers, two exceptions apply. First, transportation includes moving liquefied petroleum gas directly to retailers or retail customers. Second, transportation includes moving extracted, processed or refined minerals or natural resources by pipeline to retailers (but not retail customers).

Marketing consists of the bulk sale of extracted, processed or refined minerals or natural resources, as well as certain facilitating activities (e.g., packaging). Marketing does not include retail sales (sales made in small quantities directly to end users), other than retail sales of liquefied petroleum gas.

The Regulations also treat certain additional income as derived from a Section 7704(d)(1)(E) Activity. Such income includes certain cost reimbursements (e.g., for designing, constructing, installing and maintaining an asset used to perform a Section 7704(d)(1)(E) Activity); income from certain passive or non-operating oil and natural gas interests (e.g., production royalties, net profits interests, delay rentals and lease-bonus payments); and certain blending and additization activities.

Treasury and the IRS reserved on the treatment of income derived from fertilizer and from hedging activities.

Intrinsic Activities

Intrinsic activities are intended to represent certain limited activities that support Section 7704(d)(1)(E) Activities and generate qualifying income because such income is so closely related to a Section 7704(d)(1)(E) Activity that the income is considered derived from such activity. The Regulations adopt, with only minor modifications, the rules relating to intrinsic activities contained in the Proposed Regulations. An activity is an intrinsic activity if all of the following apply:

- The activity is specialized to support a Section 7704(d)(1)(E) Activity
- The activity is essential to the completion of a Section 7704(d)(1)(E) Activity
- The activity requires the provision of significant services to support the Section 7704(d)(1)(E) Activity

An activity is specialized to support a Section 7704(d)(1)(E) Activity if the partnership provides personnel to support the activity, and those personnel have received training to support the activity that is unique to the mineral or natural resource industry and of limited value aside from supporting the Section 7704(d)(1)(E) Activity. Notably, the Regulations differ from the Proposed Regulations in that the Regulations allow the partnership to provide its own employees or those of an affiliate, subcontractor or independent contractor acting on behalf of the partnership.

If a specialized activity involves the sale, provision or use of specific property, such property must generally be dedicated to and have limited utility outside of the activity, and not be easily converted to another use. In the case of injectants, the Proposed Regulations provided that the service provider must also collect, clean and recycle or otherwise dispose of the injectant. By contrast, the Regulations are clearer as they adopt a basin-by-basin approach and specify that the service provider need only provide such collection, cleaning and recycling services within the same geographic area in which it provides injectant delivery services, rather than at each well.

Generally, an activity is essential to the completion of a Section 7704(d)(1)(E) Activity if the activity is required to physically complete a Section 7704(d)(1)(E) Activity, or to comply with Federal, state or local law.

Finally, an activity generally requires significant services to support a Section 7704(d)(1)(E) Activity if the services (other than design, construction, manufacturing and similar services, which are not intrinsic activities) are conducted on an ongoing or frequent basis, either at the site of a Section 7704(d)(1)(E) Activity, or offsite if the services are offered to those engaged in one or more Section 7704(d)(1)(E) Activities.

Effective Date and Transition Period

The Regulations will apply to income earned by a PTP or MLP in a taxable year that begins on or after January 19, 2017. The Regulations also provide for a 10-year transition period ending on the last day of the taxable year of a PTP or MLP that includes January 19, 2027. A technical termination under Section 708(b)(1)(B) will not terminate the 10-year transition period.

The transition period will be relevant in four instances. A PTP or MLP can treat income from an activity as qualifying income during the 10-year transition period if:

- The PTP or MLP has received a private letter ruling (PLR) from the IRS holding that its income constitutes qualifying income within the meaning of Section 7704(d)(1)(E)
- Prior to May 6, 2015, the partnership was (a) publicly traded; (b) engaged in the specific activity; (c) treated such activity as giving rise to qualifying income within the meaning of Section 7704(d)(1)(E); and (d) such income constitutes qualifying income under a reasonable interpretation of Section 7704(d)(1)(E) prior to May 6, 2015
- Prior to May 6, 2015, the partnership was (a) publicly traded and (b) had entered into a binding agreement for construction of assets to be used in an activity that would give rise to qualifying income under a reasonable interpretation of Section 7704(d)(1)(E) prior to May 6, 2015
- The partnership is (a) publicly traded and (b) engaged in such activity after May 6, 2015, but prior to January 19, 2017, provided that such income constituted qualifying income under the Proposed Regulations

The additional guidance on the classification of income from certain mineral or natural resource-related activities as qualifying income is likely to be critically important to many PTPs, MLPs and their partners. Taxpayers should consult their tax advisors and consider carefully the potential impact of these changes on transactions and arrangements currently being planned or undertaken.

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