

Vinson & Elkins
Established 1917

JANUARY 2017

AN MLP UPDATE:
THE FINAL
REGULATIONS ON
QUALIFYING INCOME
AND RECENT
DELAWARE SUPREME
COURT OPINIONS

Energy Series

velaw.com



TODAY'S PANEL



DAVID PALMER OELMAN
CAPITAL MARKETS AND
MERGERS & ACQUISITIONS

 +1.713.758.3708

 doelman@velaw.com

Partner, Houston



L. PRICE MANFORD
TAX

 +1.713.758.2038

 pmanford@velaw.com

Partner, Houston



JOHN EDWARD LYNCH
TAX

 +1.713.758.1050

 jlynch@velaw.com

Partner, Houston



RYAN K. CARNEY
TAX

 +1.713.758.4720

 rcarney@velaw.com

Partner, Houston

TODAY'S PANEL



MICHAEL C. HOLMES
SHAREHOLDER LITIGATION &
ENFORCEMENT

 +1.214.220.7814

 mholmes@velaw.com

Partner, Dallas




CRAIG E. ZIEMINSKI
COMMERCIAL & BUSINESS
LITIGATION

 +1.214.220.7865

 czieminski@velaw.com

Partner, Dallas

SAVE THE DATE



Vinson & Elkins

V&E Energy Series

Seminars and Continuing Legal Education Courses

ENERGY FINANCE
Alternative Capital: 144A Equity Offerings and Special Purpose Acquisition Companies (SPACs)
Wednesday, February 22, 2017

TABLE OF CONTENTS

The Final Regulations on Qualifying Income	06
Recent Delaware Supreme Court Opinions	19

THE FINAL
REGULATIONS ON
QUALIFYING
INCOME



TIMELINE

IRS PAUSE TO FINAL REGULATIONS

2014

February 15



Normal IRS interaction regarding potential qualifying income PLRs.

February 28

IRS attorneys begin notifying taxpayers of a “pause” in considering qualifying income PLRs.

March 28

IRS attorney publicly acknowledges the “pause” and indicates that it applies to all qualifying income.

2015

May 5



IRS and Treasury release proposed regulations, requesting all comments thereto by August 4, 2015.

August 4

All comments to proposed regulations due, with approx. 140 comments submitted to the IRS.

~95 from investors

~45 from MLPs, operating companies, and other organizations

October 27

Public hearing on final regulations held at IRS.

All comments to the proposed regulations are available at www.velaw.com/MLPQualifyingIncome

TIMELINE

PUBLICATION OF THE FINAL REGULATIONS

2017

January 19

January 20

January 23

January 24

Final regulations are filed with the Federal Register.

President Donald J. Trump imposes a government-wide regulatory freeze by having the White House Chief of Staff issue a memorandum directing heads of executive departments and agencies to immediately withdraw regulations that have been filed with the Federal Register, but not yet published.

Federal Register includes the final regulations in its public inspection document, which it is required to do at least one-day before publication in the Federal Register.

Final regulations are published in the Federal Register.

HIGHLIGHTS

- The final regulations are largely viewed as an improvement over the proposed regulations. They address favorably many, but not all, of the comments to the proposed regulations, but do so largely within the framework of the proposed regulations.
- The most significant changes are as follows:
 - No more “exclusive list”
 - Greater clarity on qualifying nature of some activities:
 - LNG liquefaction and regasification
 - Transportation and sale of propane to retail customers
 - Pipeline compression services
 - Many blending and additization activities
 - Reimbursement of costs
 - Hedging activities subject to further guidance

HIGHLIGHTS

- The most significant changes are as follows (con't):
 - Simplified analysis of oil and gas products:
 - “Good list” approach to processing and refining of oil and gas
 - Olefins generate qualifying income
 - Methanol does not generate qualifying income
 - Narrow interpretation of hard mineral processing depending on the type of ore
 - Excludes coking of coal, steelmaking, and aluminum smelting
 - Oilfield services still qualify
 - Basin-by-basin approach for oil field service providers; and clarification that an MLP’s subcontractors are treated as partnership personnel

HIGHLIGHTS

Proposed Regulations

IN:

- Transportation and storage of crude oil, natural gas, NGLs, and fuels
- Field gas processing and NGL fractionation
- Affiliated-controlled water supply and disposal
- Saltwater disposal services
- Wholesale sales
- Wood pellets
- Gas-to-liquid fuels

OUT:

- NGL processing into olefins
- Non-refinery olefin transportation and storage
- Methanol production
- Pulp, containerboard, and paper
- Gas-to-liquids (anything other than methane-to-liquid fuels)
- Non-affiliated water supply

ON THE FENCE:

- Hard mineral processing
- Royalty income
- Compression services
- Propane distribution
- CNG and LNG

Final Regulations

IN:

- Transportation and storage of crude oil, natural gas, NGLs, and fuels
- Field gas processing and NGL fractionation
- Saltwater disposal services
- Wholesale sales
- Wood pellets
- *Gas-to-liquids (refinery products)*
- *NGL processing into olefins*
- *Non-refinery olefin transportation and storage*
- *Frac water supply with local disposal business*
- *Royalty income*
- *Compression services*
- *Propane distribution*

- *CNG and LNG*
- *Hard mineral processing – mining processes*

OUT:

- Methanol production
- Pulp, containerboard, and paper
- *Frac water supply without local disposal business*
- *Hard mineral processing – beyond mining*

PROCESSING AND REFINING

- Under the proposed regulations, the activities of processing and refining were combined in one definition.
- Many commenters argued that the proposed regulations' use of a joint definition for processing and refining wrongly read the term "processing" out of the statute.
- The final regulations adopt the suggestion of separately defining processing and refining to better clarify what activities generate qualifying income.
- However, the final regulations retain separate standards for these activities when applied to different natural resources.

PROCESSING

- **General Rule:** An activity constitutes processing if its performed to convert raw mined or harvested products or raw well effluent to substances that can be readily transported or stored.
- **Specific Rules:**

<u>Natural Gas</u>	<u>Crude Oil</u>	<u>Ores and Minerals</u>	<u>Timber</u>
<p>An activity performed to:</p> <ul style="list-style-type: none"> • Purify natural gas, including by removal of oil or condensate, water, or non-hydrocarbon gases. • 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 heavier streams). 	<p>An activity performed to separate produced fluids by:</p> <ul style="list-style-type: none"> • Passing crude oil through mechanical separators to remove gas. • Placing crude oil in settling tanks to recover basic sediment and water. • Dehydrating crude oil. • Operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water. 	<p>An activity that meets the definition of mining processes under the Treasury Regulations to Section 613.</p>	<p>An activity performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances.</p>

REFINING

- **General Rule:** A general rule is not provided for refining.
- **Specific Rules:** Note that specific rules are not provided for **timber**.

<u>Natural Gas and Crude Oil</u>	<u>The following are not products of natural gas or crude oil refining:</u>	<u>Ores and Minerals</u>
<ul style="list-style-type: none"> • The further physical or chemical conversion or separation processes of products resulting from processing activities, and the blending of certain petroleum hydrocarbons, <u>to the extent they give rise to a product included in the non-exclusive list</u>; and • The further physical or chemical conversion or separation processes and blending <u>of the products listed in the non-exclusive list, to the extent the resulting product is also in the list</u>. 	<ol style="list-style-type: none"> 1) Any product that results from further chemical change of a product listed in the non-exclusive list that does not result in the same or another product also in the list (such as, the upgrading of petroleum coke to calcined coke). 2) Heat, steam, or electricity produced by processing or refining. 3) Products obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts sold. 4) Plastics or similar petroleum derivatives. 	<ul style="list-style-type: none"> • A processes performed subsequent to a mining process to eliminate impurities or foreign matter <u>and which is a necessary step in achieving a high degree of purity from metallic ores and minerals which are not customarily sold in the form of the crude mineral product</u>. • The final regulations indicate that the following constitute ores and minerals not customarily sold in the form of the crude mineral product: lead, zinc, copper, gold, silver, and any other ores or minerals the Commissioner may identify through published guidance.

OIL AND GAS PRODUCTS LIST

1. Ethane
2. Ethylene
3. Propane
4. Propylene
5. Normal butane
6. Butylene
7. Isobutane
8. Isobutene
9. Isobutylene
10. Pentanes plus
11. Unfinished naphtha
12. Unfinished kerosene and light gas oils
13. Unfinished heavy gas oils
14. Unfinished residuum
15. Reformulated gasoline with fuel ethanol
16. Reformulated other motor gasoline
17. Conventional gasoline with fuel ethanol – Ed55 and lower gasoline
18. Conventional gasoline with fuel ethanol – greater than Ed55 gasoline
19. Conventional gasoline with fuel ethanol – other conventional finished gasoline
20. Reformulated blendstock for oxygenate (RBOB)
21. Conventional blendstock for oxygenate (CBOB)
22. Gasoline treated as blendstock (GTAB)
23. Other motor gasoline blending components defined as gasoline blendstocks in the Treasury Regulations, *e.g.*, alkylate, raffinate, reformate, isomerate, toluene, transmix containing gasoline
24. Finished aviation gasoline and blending components
25. Special naphthas (solvents)
26. Kerosene-type jet fuel
27. Kerosene
28. Distillate fuel oil (heating oils, diesel fuel, and ultra-low sulfur diesel fuel)
29. Residual fuel oil
30. Lubricants (lubricating base oils)
31. Asphalt and road oil (atmospheric or vacuum tower bottom)
32. Waxes
33. Petroleum coke
34. Still gas
35. Naphtha less than 401F end-point
36. Other products of a refinery that the Commissioner may identify through published guidance

INTRINSIC ACTIVITIES

- The Treasury Department and the IRS agreed with commenters that the injections exception should be revised to account for industry practice in which a producer may not hire the same company to provide both water delivery and disposal services.
- Accordingly, the regulations relax the “well-by-well” matching requirement for the provision of water and other injectants for use in oil and gas exploration.
- Instead, the final regulations allow for the provision of water or injectant if the MLP is also in the trade or business of collecting, cleaning, recycling, or otherwise disposing of injectants within the same “geographic area.”

INTRINSIC ACTIVITIES

- Under the final regulations, qualifying income includes income from intrinsic activities. An activity is an intrinsic activity only if it:
 - is **specialized** to support a qualifying activity,
 - Requires that the partnership provide personnel to support a qualifying activity and that those personnel have received training “that is unique to the mineral or natural resource industry.”
 - Requires that to the extent the activity involves the use of specific property, that the property is dedicated to performing qualifying activities and is not easily converted to another use.
 - is **essential** to the completion of the qualifying activity, and
 - An activity is essential if it is required to physically complete a qualifying activity (including in a cost-effective manner, such as by making the activity economically viable).
 - requires **significant services** to support the qualifying activity.
 - Requires that services provided are conducted on an ongoing or frequent basis by the partnership’s personnel at the site or sites of the qualifying activity.
 - Services are not significant with respect to a qualifying activity if the services principally involve the design, construction, manufacturing, repair, maintenance, lease, rent or temporary provision of property.

TRANSITION RULE

10-YEAR TRANSITION PERIOD

- A partnership may treat income from an activity as qualifying income during the 10-year transition period if:
 - 1) The partnership has a PLR.
 - 2) The partnership is publicly traded and engaged in the activity after May 6, 2015, but before January 19, 2017, and the income from that activity is qualifying income under the proposed regulations.
 - 3) Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as generating qualifying income under a reasonable interpretation.
 - 4) Prior to May 6, 2015, the partnership had entered into a binding agreement for the construction of assets to be used in an activity that generated qualifying income under a reasonable interpretation.

RECENT DELAWARE
SUPREME COURT
OPINIONS



DELAWARE SUPREME COURT CAVEAT EMPTOR

“[T]he unitholders were investors in a limited partnership under a statute that permits limited partnership agreements to eliminate fiduciary duties and restrict investors to relying upon the agreement’s terms for protection. As we and the Court of Chancery have long noted, investors in these agreements must be careful to read those agreements and to understand the limitations on their rights.”

The Haynes Family Trust v. Kinder Morgan G.P., Inc., 135 A.3d 76, 2016 WL 912184, at *1 (Del. Mar. 10, 2016).

DELAWARE SUPREME COURT “BEST INTERESTS” STANDARD

“In a detailed, ***well-reasoned decision***, the Court of Chancery held that a conflicts committee approved a conflict transaction that it ***did not believe was in the best interests*** of the limited partnership it was charged with protecting. In fact, the court found that the committee—and the committee’s ***financial advisor in particular***—knew the transaction was unduly favorable to the limited partnership’s general partner....***\$171 million was a conservative estimate*** of the overpayment approved by the committee and used that figure as the basis for its damages award.”

El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff, --- A.3d ----, 2016 WL 7380418, at *1 (Del. Dec. 20, 2016) (reversing on standing grounds).

MLP PARTNERSHIP AGREEMENT

“SAFE HARBOR” PROVISIONS

SECTION 7.9. Resolution of Conflicts of Interest; Standards of Conduct and Modification of Duties.

“(a) Unless otherwise expressly provided in this Agreement or any Group Member Agreement, whenever a potential conflict of interest exists . . . such conflict of interest shall be permitted and deemed approved by all Partners, and shall not constitute a breach of this Agreement . . . of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is:

- (i) approved by Special Approval,
- (ii) approved by the vote of a majority of the Common Units (excluding Common Units owned by the General Partner and its Affiliates),
- (iii) on terms no less favorable to the Partnership than those generally being provided to or available from unrelated third parties, or
- (iv) fair and reasonable to the Partnership....”

DELAWARE SUPREME COURT

THE IMPLIED COVENANT AND THE “SAFE HARBOR” PROVISIONS

“[T]he express terms of the LP Agreement did not address, one way or another, whether the General Partner could use false or misleading statements to enable it to reach the safe harbors. ***We find that implied in the language of the LP Agreement’s conflict resolution provision is a requirement that the General Partner not act to undermine the protections afforded unitholders in the safe harbor process.***”

Dieckman v. Regency GP LP, --- A.3d ----, 2017 WL 243361, at *7
(Del. Jan. 20, 2017).

MLP PARTNERSHIP AGREEMENT

“CONFLICTS COMMITTEE” DEFINITION

SECTION 1.1 Definition of Conflicts Committee.

“Conflicts Committee” means a committee of the Board of Directors of the general partner of the General Partner composed entirely of two or more directors who are not

- (a) security holders, officers or employees of the General Partner,
- (b) officers, directors or employees of any Affiliate of the General Partner or
- (c) holders of any ownership interest in the Partnership Group other than Common Units

and who also meet the independence standards required of directors who serve on an audit committee of a board of directors established by the Securities Exchange Act of 1934, as amended, and the rules and regulations of the Commission thereunder and by the National Securities Exchange on which the Common Units are listed or admitted to trading.”

DELAWARE SUPREME COURT

THE IMPLIED COVENANT AND THE “CONFLICTS COMMITTEE” DEFINITION

The Conflicts Committee definition “is reasonably read by unitholders to imply a condition that a Committee has been established whose members genuinely qualified as unaffiliated with the General Partner and ***independent at all relevant times***. Implicit in the express terms is that the Special Committee membership be genuinely comprised of ***qualified members*** and that deceptive conduct not be used to create the false appearance of an unaffiliated, independent Special Committee.”

Dieckman v. Regency GP LP, --- A.3d ----, 2017 WL 243361, at *8 (Del. Jan. 20, 2017).

BEST PRACTICES

MLP CONFLICT-OF-INTEREST TRANSACTIONS

- Conflicts Committee
 - Appointment of new directors
 - Routine independence checks
- Unitholder approval
 - Assume common law duty of disclosure applies
 - Count and report unaffiliated votes
- Financial advisors
 - Management's involvement in the Conflicts Committee's selection of an advisor
 - Independence is of paramount importance
- "Best interests" standard
 - More cases will turn on whether the General Partner and Conflicts Committee have satisfied the Partnership Agreement's "best interests" standard.

BEST PRACTICES

MLP CONFLICT-OF-INTEREST TRANSACTIONS

- Match process to significance of transaction and degree of conflict.
- Determine appropriate level of authority to provide committee.
 - Authority should match requirements of MLP partnership agreement at a minimum.
 - Full authority to review, consider, negotiate and approve?
 - Consideration of alternatives?
 - Who does committee represent: the MLP only or the MLP and its Limited Partners?
- Advisors must not fall into “rubber stamp” mode.
- Establish communication protocol for communications between management and Committee.
- Provide all material information to the Committee and allow full access.
 - Handle projections with care and designate appropriately.
- Continually document process.
 - The trial record is not limited to the minutes and advisor presentations.
 - If a director has a concern, the resolution of that concern should be well documented.
- In repeat assignments, be careful not to fall into a pattern, and ensure that advisors are aware of prior analysis and valuations.



THANK YOU

Austin

T +1.512.542.8400

Beijing

T +86.10.6414.5500

Dallas

T +1.214.220.7700

Dubai

T +971.4.330.1800

Hong Kong

T +852.3658.6400

Houston

T +1.713.758.2222

London

T +44.20.7065.6000

Moscow

T +7.495.544.5800

New York

T +1.212.237.0000

Palo Alto

T +1.650.687.8200

Richmond

T +1.804.327.6300

Riyadh

T +966.11.250.0800

San Francisco

T +1.415.979.6900

Taipei

T +886.2.2176.5388

Tokyo

T +81.3.3282.0450

Washington

T +1.202.639.6500

