



August 4, 2015

CC:PA:LPD:PR (REG-132634-14)
Room 5203
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Regulations (REG-132634-14) under Section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended, With Respect to the Status of Income as “Qualifying Income”

Cypress Energy Partners, L.P. (“CELP”) respectfully submits this letter in response to the request for comments on the proposed regulations published in the Federal Register (*see* 80 Fed. Reg. 25970 (to be codified at 26 C.F.R. pt. 1)) on May 6, 2015 (the “Proposed Regulations”) under section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended (the “Code”),¹ relating to qualifying income from the exploration, development, mining or production, processing, refining, transportation and marketing of minerals or natural resources. We recognize the efforts of the Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”) to implement a comprehensive definition of qualifying income as it relates to minerals and natural resources, and we believe that input from participants in the mineral and natural resources industries will result in improved final Treasury Regulations.

Further, please consider this letter to be CELP’s timely, written request for a public hearing regarding the Proposed Regulations.

I. Executive summary

Our comments principally address the scope of activities that the Proposed Regulations treat as transportation of minerals or natural resources. We believe that the Proposed Regulations should make explicit the concept plainly stated in the legislative history to section 7704 that transportation by pipeline of minerals or natural resources is not subject to the retail customer restriction provided for in the legislative history to section 7704. This result is clearly intended by Congress. In addition, our comments request that the Proposed Regulations recognize that infrastructure inspection services are of a type of activity that should constitute an intrinsic activity under the standards set forth in Section 1.7704-4(d) of the Proposed Regulations, as infrastructure inspection services are specialized and essential to the ongoing integrity of the physical infrastructure used in the

¹ Unless otherwise noted, references to “Section” or “§” are references to the Code or the Treasury regulations promulgated thereunder (the “Treasury Regulations”).

exploration, development, mining or production, processing, refining, transportation or marketing of minerals or natural resources.

II. CELP's business

CELP is a publicly-traded partnership (a "PTP") that provides, among other services, a comprehensive suite of essential infrastructure inspection and integrity services. For example, in the upstream segment of the oil and gas industry, assets such as downhole tubulars, specialized equipment, blowout preventers, storage facilities, and drilling rigs are the subject of infrastructure inspection services. In the downstream segment of the oil and gas industry, assets such as refineries, separators, and related equipment associated with the cracking of hydrocarbons are the subject of essential infrastructure inspection services. In the midstream segment of the oil and gas industry, assets such as pipelines, gas processing plants, compression stations, and related equipment associated with the transportation of hydrocarbons are the subject of infrastructure inspection services. CELP's customers include (A) oil and natural gas companies, (B) oil, NGL, refined fuels, and natural gas pipeline operators, (C) electric utility companies and (D) natural gas utility companies (also known as local distribution companies ("LDCs") or public utility companies ("PUCs")), in connection with assets associated with the transportation of natural gas or other refined fuels, hydrocarbons, such as pipelines, gas processing plants, compression stations, terminals and gas dehydration plants. In 2013, CELP received a private letter ruling from the Service concluding, among other things, that CELP's income derived from the provision of pipeline integrity and inspection services to customers engaged in drilling, exploration and production, transportation or mining of minerals or natural resources, excluding income earned from providing such services to end users at the retail level, will constitute qualifying income within the meaning of section 7704(d)(1)(E). In January 2014, CELP conducted an initial public offering of common units representing limited partner interests in CELP. CELP common units are publicly traded on the New York Stock Exchange.

In addition to providing pipeline inspection and integrity services to oil and natural gas companies and oil and natural gas pipeline operators as described and ruled upon in its private letter ruling, CELP provides such services to (A) (i) oil and natural gas companies in connection with the transportation of natural gas or other hydrocarbons to electric utility companies by pipelines owned by the oil and natural gas companies, (ii) oil and natural gas pipeline operators in connection with the transportation of natural gas or other hydrocarbons to electric utility companies by pipelines owned by the oil and natural gas pipeline operators and (iii) electric utility companies in connection with the transportation of natural gas or other hydrocarbons to electric utility companies by pipelines owned by the electric utility company, in all such instances, to power the turbines owned by the electric utility companies that generate electricity and (B) LDCs or PUCs (i) in connection with the transportation of natural gas or other hydrocarbons to such natural gas utility companies at the city gate by both intrastate and interstate transmission and transportation pipelines owned by the natural gas utility company and (ii) in connection with the transportation of natural gas or other hydrocarbons by distribution mainlines to commercial, industrial, and residential consumers of the natural gas beginning at the

citygate.² These infrastructure inspection services include the inspection of full pipeline systems and related entities, such as process plants, pump and compressor stations, terminals and tanks.

Oil and natural gas companies, as well as pipeline operators, which include electric utility companies, LDCs and PUCs, are required by law at both the federal and the state level to inspect their pipelines and gathering systems on a regular basis in order to protect the environment and ensure the public safety. Such regulations render the ownership and operation of these systems impossible without regularly conducted inspections. In addition, all of these entities, as a part of their normal course of business, administer routinely scheduled pipeline integrity maintenance programs that call for the type of infrastructure inspection and testing services that are provided by CELP.

III. Detailed discussion

A. *The Qualifying Income Exception*

Section 7704(a), enacted by the Revenue Act of 1987, generally treats a PTP as a corporation for federal income tax purposes. However, section 7704(c)(1) contains an exception that exempts from treatment as a corporation any PTP for any taxable year if the PTP met the gross income requirement set forth in section 7704(c)(2) for that taxable year and each preceding taxable year beginning after December 31, 1987, during which the PTP or any predecessor was in existence. A PTP meets the gross income requirements of section 7704(c)(2) for any taxable year if 90% or more of the gross income of the partnership for that taxable year consists of “qualifying income.”

Under section 7704(d)(1)(E), the broadest category of qualifying income is income derived with respect to minerals or natural resources. Such qualifying income 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 (including fertilizer, geothermal energy, and timber), [or] industrial source carbon dioxide, or the transportation or storage of any fuel described in subsection (b), (c), (d), or (e) of section 6426 or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1).

For purposes of section 7704(d)(1)(E), the phrase “mineral or natural resource” is defined to mean, generally, any product of a character with respect to which a deduction for depletion is allowable under section 611. Soil, sod, turf, water, mosses and minerals from seawater, air and other similar inexhaustible sources are, however, explicitly excluded.

² A “citygate,” or a “gate station,” is a delivery point established at a specific place along a pipeline distribution network, where such products are metered and delivered to customers through a distribution network of local gas mains, small-diameter service lines and, ultimately, customer meters.

Crude oil and natural gas (*i.e.*, methane) do constitute natural resources for purposes of section 7704(d)(1)(E).³

The Senate Report accompanying the Technical and Miscellaneous Revenue Act of 1988 provides:

With respect to marketing of minerals and natural resources (*e.g.*, oil and gas and products thereof), the Committee intends that qualifying income be income from marketing at the level of exploration, development, processing or refining the mineral or natural resource. By contrast, income from marketing minerals and natural resources to end users at the retail level is not intended to be qualifying income. For example, income from retail marketing with respect to refined petroleum products (*e.g.*, gas station operations) is not intended to be treated as qualifying income.⁴

The Conference Report accompanying the Technical and Miscellaneous Revenue Act of 1988, specifically provides:

In the case of transportation activities with respect to oil and gas and products thereof, the conferees intend that, in general, income from transportation of oil and gas and products thereof to a bulk distribution center such as a terminal or a refinery (whether by pipeline, truck, barge or rail) be treated as qualifying income. Income from any transportation of oil or gas or products thereof by pipeline is treated as qualifying income. Except in the case of pipeline transport, however, transportation of oil or gas or products thereof to a place from which [they are] dispensed or sold to retail customers is generally not intended to be treated as qualifying income. Solely for this purpose, 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, nor does a retail customer include a utility providing power to customers. For example, income from transporting refined

³ For this purpose, oil, gas or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane and similar products which are recovered from petroleum refineries or field facilities. Oil, gas or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. H.R. Rep. No. 495, 100th Cong., 1st Sess. 946-47 (1987).

⁴ S. Rep. No. 445, 100th Cong., 2nd Sess. 424 (1988).

petroleum products by truck to retail customers is not qualifying income.⁵

B. *Transportation of Minerals or Natural Resources by Pipeline*

In the legislative history to section 7704, Congress stated that the transportation of oil and gas and products of oil and gas by pipeline generates qualifying income. Specifically, the legislative history states, “income from any transportation of oil or gas or products thereof by pipeline is treated as qualifying income.”⁶ This general rule is limited by language in the legislative history stating that the transportation of oil and gas and products of oil and gas to a retail outlet, other than by pipeline, does not generate qualifying income.⁷ However, the legislative history to section 7704 makes clear that utility companies are not considered end users at the retail level (*i.e.*, retail customers).⁸ As such, (i) income derived from the transportation of oil and gas and products of oil and gas by pipeline to any customer, even a retail customer or retail outlet, constitutes qualifying income, and (ii) income derived from any form of transportation (*e.g.*, pipeline, truck, rail, barge) of oil and gas and products of oil and gas to a utility providing power to customers constitutes qualifying income; but (iii) income derived from the transportation of oil and gas and products of oil and gas by truck, rail or barge to a retail customer or retail outlet does not constitute qualifying income.

C. *The Proposed Regulations Should Explicitly Treat Income Derived from ANY Transportation of Minerals or Natural Resources by Pipeline as Qualifying Income*

The Proposed Regulations are intended to provide guidance on what constitutes “qualifying income” from minerals or natural resources under section 7701(d)(1)(E) and provide, in relevant part, “transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section, including by pipeline, barge, rail, or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers. Retail customers do not include a person who acquires oil or gas for refining or processing, or a utility.”⁹

In the case of transmission and transportation pipelines owned by LDCs and PUCs that are transporting natural gas and other hydrocarbons to the citygate, pipeline inspection and integrity services will be required with respect to the transmission and transportation pipelines all the way along the transportation route up to the citygate. In the case of distribution pipelines owned by LDCs and PUCs that are transporting natural gas and other hydrocarbons from the citygate, where ownership of the natural gas and other hydrocarbons passes to the LDC or PUC, through the distribution system to end-user customers, pipeline

⁵ H.R. Rep. No. 1104, 100th Cong., 2d Sess. II-17-18 (1988), 1988-3 C.B. 507-508.

⁶ H.R. Rep. No. 1104, 100th Cong., 2d Sess. II-17-18 (1988), 1988-3 C.B. 507-508.

⁷ *Id.*

⁸ *Id.*

⁹ Prop. Treas. Reg. § 1.7704-4(c)(6).

inspection and integrity services are required with respect to the mainlines, which are pipelines that range in size from two inches to 24 inches in diameter, and with respect to the service lines, which are small diameter pipelines that connect the mainlines to a home or a business. In unregulated utility markets, an LDC or PUC often receives a transportation fee for the service of transporting natural gas to customers. Such natural gas is typically sold to the retail customer by a third party, and the LDC or PUC does not earn any income from the marketing aspect of such transaction.

The Proposed Regulations provide a framework by which to determine if certain activities, which are not Section 7704(d)(1)(E) activities, generate qualifying income.¹⁰ An activity is an intrinsic activity if the activity is specialized to narrowly support a section 7704(d)(1)(E) activity, is essential to the completion of a section 7704(d)(1)(E) activity and requires the provision of significant services to support a section 7704(d)(1)(E) activity. If pipeline inspection and integrity services that are provided to the midstream segment of the oil and gas industry are performed in such a way as to satisfy the definition of an intrinsic activity, the identity and legal characterization of (1) the entity that owns and operates the pipeline that transports the natural gas or other hydrocarbons to the citygate or within the citygate or (2) the customer that receives the natural gas or other hydrocarbons does not change the nature of the income earned through the provision of pipeline integrity and inspection services for purposes of the gross income test of section 7704 of the Code because such income is earned in support of transportation of natural gas or other hydrocarbons by pipeline, which is not subject to the retail customer restriction provided for in the legislative history to section 7704 of the Code. As such, the income derived from the provision of pipeline integrity and inspection services to LDCs or PUCs in connection with (1) the transportation of natural gas or other hydrocarbons to such LDCs or PUCs prior to the city gate by both intrastate and interstate transmission and transportation pipelines owned by the LDC or PUC or (2) the transportation of natural gas or other hydrocarbons by distribution mainlines and service lines to residential, commercial and industrial consumers of the natural gas beginning at the citygate is qualifying income within the meaning of 7704(d)(1)(E) to the extent such services are performed in such a way as to satisfy the definition of intrinsic activity.

IV. Recommendations

We believe that the final regulations should be amended as follows:

1. Section 1.7704-4(c)(6) of the Proposed Regulations should be amended, as follows, to plainly state that the transportation of minerals and natural resources by pipeline to any customer, even a retail customer or retail outlet, constitutes a Section 7704(d)(1)(E) activity.

Transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section. For purposes of this paragraph (c)(6), transportation does not include transportation by any means, other than by pipeline, to a place that sells or dispenses to retail customers. For the avoidance of doubt,

¹⁰ See Prop. Treas. Reg. § 1.7704-4(d).

transportation by pipeline to any location, including a place that sells or dispenses to retail customers, constitutes transportation for purposes of this paragraph (c)(6). Retail customers do not include a utility or a person who acquires oil or gas for refining or processing. The following activities qualify as transportation

2. Given the importance of infrastructure inspection and integrity services in the energy industry, and in particular with respect to the different participants in the energy industry who use such services, as described in Part II herein, we recommend that one or more examples be added to Section 1.7704-4(e) of the Proposed Regulations to provide specific guidance with respect to the application of the intrinsic activity standard to infrastructure inspection and integrity services. Specifically, Section 1.7704-4(e) of the Proposed Regulations should be amended to add the following examples.

Example (7). Pipeline Inspection and Integrity Services.

(i) X, a publicly-traded partnership, provides infrastructure inspection and integrity services on pipelines owned by customers engaged in the transportation of natural gas to utility companies to power the turbines owned by the electric utility companies that generate electricity. X's customers are (a) oil and natural gas companies, (b) oil, NGL, refined fuels, and natural gas pipeline operators and (c) utility companies.

(ii) The income X obtains from its infrastructure inspection and integrity services is not a section 7704(d)(1)(E) activity as provided in paragraph (c) of this section. However, because X's infrastructure inspection and integrity services support its customers' transportation of natural gas, a section 7704(d)(1)(E) activity, X's income from infrastructure inspection and integrity services may be qualifying income for purposes of section 7704(c) if the infrastructure inspection and integrity service is an intrinsic activity as provided in paragraph (d) of this section. An activity is an intrinsic activity if the activity is specialized to narrowly support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. X provides specially trained personnel that use specially designed equipment and techniques to perform such services. Further, the services that X provides are required by law at either the federal or the state level and are required to be performed on an ongoing and frequent basis. Thus, X's infrastructure inspection and integrity services are an intrinsic activity, and the income earned by X in the provision of such services is qualifying income for purposes of section 7704(d)(1)(E).

Example (8). Pipeline Inspection and Integrity Services.

(i) X, a publicly-traded partnership, provides infrastructure inspection and integrity services on pipelines owned by customers engaged in (a) the transportation of natural gas or other hydrocarbons to such customers at the citygate by both intrastate and interstate transmission and transportation pipelines owned by the customers and (b) the transportation of natural gas or other hydrocarbons by distribution mainlines and service

lines to residential, commercial and industrial consumers of the natural gas beginning at the citygate. X's customers are natural gas utility companies (also known as local distribution companies ("LDCs") or public utility companies ("PUCs")).

(ii) The income X obtains from its infrastructure inspection and integrity services is not a section 7704(d)(1)(E) activity as provided in paragraph (c) of this section. However, because X's infrastructure inspection and integrity services supports its customers' transportation of natural gas, a section 7704(d)(1)(E) activity, X's income from infrastructure inspection and integrity services may be qualifying income for purposes of section 7704(c) if the infrastructure inspection and integrity service is an intrinsic activity as provided in paragraph (d) of this section. An activity is an intrinsic activity if the activity is specialized to narrowly support the section 7704(d)(1)(E) activity, is essential to the completion of the section 7704(d)(1)(E) activity, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. X provides specially trained personnel that use specially designed equipment and techniques to perform such services. Further, the services that X provides are required by law at either the federal or the state level and are required to be performed on an ongoing and frequent basis. Thus, X's infrastructure inspection and integrity services are an intrinsic activity, and the income earned by X in the provision of such services is qualifying income for purposes of section 7704(d)(1)(E).

We believe that the foregoing changes will result in a clear application of "transportation" with respect to pipelines that is consistent with the original language of section 7704(d)(1)(E) and original Congressional intent as expressed in the legislative history.

Sincerely,

A handwritten signature in blue ink, appearing to read "Richard M. Carson".

Richard M. Carson
Vice President & General Counsel