January 14, 2016

Via Hand Delivery

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 under Section 7704(d)(1)(E)

This letter provides comments on the proposed regulations (REG-132634-14) under section 7704(d)(1)(E) (the "Proposed Regulations") relating to qualifying income from exploration, development, mining or production, processing, refining, transportation, and marketing of minerals or natural resources.

This letter focuses primarily on whether the processing or refining of ores and minerals is qualifying income under section 7704(d)(1)(E). Specifically, we believe that limiting the definition of "processing or refining" to the "mining processes" listed in Treas. Reg. § 1.613-4(f)(1)(ii) or refining within the meaning of Treas. Reg. § 1.613-4(f)(6)(iii) is inconsistent with section 7704(d)(1)(E), its legislative history, and previously issued private letter rulings.

With respect to ores and minerals, we recommend that the common meaning of the term "processing" should continue to apply. Alternatively, if Treasury determines that some further definition of the term is necessary, we believe the definition of "processing" should be expanded to include the "nonmining processes" listed in Treas. Reg. § 1.613-4(g) and other similar processes performed on minerals and ores.

I. Summary of Present Law and Proposed Regulations

A. Statute and Legislative History

Section 7704, enacted as part of the Omnibus Budget Reconciliation Act of 1987 ("OBRA"), generally provides that a publicly traded partnership ("PTP") shall be taxed as a corporation. Section 7704(c) provides an exception to the general rule if 90 percent or more of the partnership's gross income for the taxable year consists of "qualifying income."

Qualifying income is defined in section 7704(d) to include certain passive-type income (e.g., interest, dividends, real property rents, and certain gains) and:

> 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), 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).

Congress provided further insight into its intent with respect to the term "natural resources" in the conference report to OBRA. According to the conference report:

> [N]atural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. . . . 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.[1]

B. Proposed Regulations

On May 5, 2015, IRS and Treasury issued the Proposed Regulations, addressing qualified income derived from minerals or natural resources by a PTP. The Proposed Regulations provide an exclusive list of activities that are qualifying activities. The Proposed Regulations define exploration, development, mining or production, processing, refining, transportation, or marketing of minerals or natural resources for purposes of qualifying income. Also, the Proposed Regulations provide a new framework for determining whether oilfield services are qualifying activities. In general, the Proposed Regulations apply to income earned by a partnership in a taxable year beginning on or after the regulations are finalized and provide for a transition period.

1. Mining and Processing or Refining of Minerals and Ores under the Proposed Regulations

The Proposed Regulations provide definitions for the various activities enumerated in section 7704(d)(1)(E), including mining or production. Mining or production is defined as an activity performed to extract minerals or other natural resources. The Proposed Regulations combine the terms "processing" and "refining" and provide a single definition of the term "processing or refining." Generally, the Proposed Regulations provide that an activity is processing or refining if it is done to purify, separate, or eliminate impurities. An activity constitutes processing or refining of ores and minerals if it meets the definition of "mining processes" under § 1.613-4(f)(1)(ii) or refining under § 1.613-4(g)(6)(iii).

2. Transition Rules

The Proposed Regulations provide that a partnership may treat income from an activity as qualifying income for ten years after the regulations are finalized if: (i) the PTP has obtained a private letter ruling from the government prior to publication of the final regulations that provides the activities addressed give rise to qualifying income under section 7704(d)(1); (ii) prior to the issuance of the Proposed Regulations, the PTP was engaged in the activity, treated the activity as giving rise to qualifying income, and that income was qualifying

[1] H.R. Rep. No. 495, 100th Cong., 1st Sess. at 946-7 (1987).

income under the statute as reasonably interpreted; or (iii) the PTP "[relies] on these proposed regulations between the date they are issued and the date final regulations are published."

II. Discussion and Recommendations with respect to Minerals and Ores

A. Definition of "Processing and Refining" with respect to Ores and Minerals

1. The Proposed Regulations' definition of "processing and refining" breaks the links between activities producing qualifying income in a manner inconsistent with Congressional intent.

a. In general

"Processing" is a link in the chain of activities producing qualifying income set forth in the statute that begins with exploration for minerals or natural resources and ends with marketing of a refined or processed product. Given this statutory approach, each activity in this chain should not be viewed in isolation; rather it is more appropriate to consider how an activity relates to the activities that precede and follow it.

We believe the ordered list of activities in the statute was meant to embrace a series of connected steps that begins with finding a mineral or natural resource, extracting it, changing it physically and/or chemically through processing and refining, transporting the processed mineral or natural resource and marketing it. Defining any processing or refining activity in a manner that interrupts the chain and that prevents a necessary step between exploration and transportation of a processed or refined mineral or ore from producing qualifying income seems contrary to Congressional intent, which is to treat each step as a source of qualifying income.

b. Examples

For example, consider copper extraction. The refining of "blister copper" is the only illustrative example referenced in Prop. Reg. § 1.7704-4(c)(5)(iv) (addressing the processing and refining of ores and minerals). One widely accepted description of copper extraction techniques describes the process as follows:

> As in all mining operations, the ore must usually be beneficiated (concentrated). To do this, the ore is crushed. Then it must be roasted to convert sulfides to oxides, which are smelted to produce matte. Finally, it undergoes various refining processes, the final one being electrolysis.[2]

As explained in the same article, matte is 30-70 percent pure copper, produced in the smelter; "blister copper" is the 98-percent pure copper produced by blowing air through molten matte to remove the sulfur. The blister copper is refined in an anode furnace. In the

[2] Wikipedia, Copper extraction techniques, https://en.wikipedia.org/wiki/Copper_extraction_techniques.

last step in the refining process, the anodes cast from the blister copper are refined by electrolysis.

Applying the rules of the Proposed Regulations to this fact pattern illustrates the problem with adopting a narrow definition of processing for ores and minerals. The first step in the process, beneficiation of the ore, produces qualifying income, because that process is included in the definition of "mining processes" in Treas. Reg. § 1.613-4(f)(1)(ii) (specifically for copper in Treas. Reg. § 1.613-4(f)(2)(i)(d)). The last steps in the refining process, refining of the blister copper in an anode furnace and by electrolysis, also produce qualifying income, as specifically provided in the Proposed Regulations.[3] But the intermediate processing required to move from the beneficiated ore to the blister copper, namely roasting and smelting, do not produce qualifying income under the Proposed Regulations.

This result is illogical. The rules in the Proposed Regulations in effect require an integrated producer to separately calculate profits from each step of production, since some, but not all, of its processing activities produce qualifying income. The problem is not unique to copper extraction. Activities that take place before the "refining" of coal and iron ore, such as coking and smelting, present the same concern under the Proposed Regulations.

Also consider the application of this approach with respect to zinc. Zinc ore, mined from the ground, contains the mineral sphalerite, which is largely zinc sulfide, frequently found in a mixed lead-zinc sulfide. The ore is mined by hard rock mining, similar to rock salt mining. The processing of the ore begins with grinding and separation of the waste minerals (and lead sulfide) by froth flotation to make a zinc sulfide concentrate. The concentrate is roasted in air so that the zinc sulfide is oxidized to impure zinc oxide and sulfur dioxide. The sulfur dioxide is converted into aqueous sulfuric acid. Next, the impure zinc oxide is leached with sulfuric acid to make a zinc sulfate solution. This solution then is purified to remove trace metal impurities that would interfere with the subsequent electrolysis. Finally, the pure zinc sulfate solution, acidified with sulfuric acid, is electrolyzed so that pure zinc is deposited on a substrate cathode (aluminum plate). Oxygen is produced at the anode. The pure electrolytic zinc, 99.95 percent, is stripped from the plate, melted, and cast into ingots for use.

The Proposed Regulations appear to preclude several of the steps required to turn zinc ore into zinc from producing qualifying income (e.g., roasting and electrolysis). Even if such processes produce qualifying income, the whole series of steps by which zinc sulfide becomes pure zinc appears to violate the "no substantial physical or chemical change" requirement of the Proposed Regulations.

In the case of salt (sodium chloride), the effect of the Proposed Regulations is to disqualify not just some processing income, as is the case with copper and zinc, but *all* income from the most common processing procedure. In general, mined salt (also known as rock salt) is processed for use in one of three ways. Some is purified for human consumption in food and beverages, and some is ground for use as road salt. However, at the time section 7704 was enacted in 1987 and thereafter, most mined salt has been processed into caustic soda (sodium hydroxide), chlorine, and hydrogen using electrolysis (a "chlor alkali process"). In fact, in 1987 approximately half of the 40 million tons of salt used in the United States was

[3] *See* Prop. Reg. § 1.7704-4(c)(5)(iv).

processed using the chlor alkali process.[4] In a chlor alkali process, which is similar to electrolytic deposition, salt is dissolved in water and an electric current is passed through the saltwater brine, causing it to break down into caustic soda, chlorine, and hydrogen. Under the Proposed Regulations, the grinding of salt is a mining process that produces qualifying income, but the most common process–electrolysis of brine—might not fall within the Proposed Regulations' definition of processing or refining due to the use of regulations under section 613 to define processing and refining for ores and minerals (i.e., limiting "processing" to "mining processes").

c. Relationship to regulations under section 613

Section 613 of the Code provides rules for percentage depletion. The regulations in Treas. Reg. § 1.613-4 were drafted to define the depletion cutoff point (i.e., the end point of mining processes qualifying for depletion). Using these rules without further modification to define processing and refining for purposes of section 7704 would produce odd results such as those described above.

To the extent that IRS and Treasury believe it is appropriate to follow the regulations under section 613 to define the boundaries of permissible processing and refining activities for minerals and ores under section 7704(d), we agree with the recommendation of other commenters that the definition of processing should be expanded to include the non-mining processes in Treas. Reg. § 1.613-4(g)(1), i.e., electrolytic deposition, roasting, calcining, thermal or electric smelting, refining, polishing, fine pulverization, blending with other materials, treatment effecting a chemical change, thermal action, and molding or shaping ("non-mining processes").

In addition, we believe that the list of non-mining processes in Treas. Reg. § 1.613-4(g)(1) should not be treated as an exclusive list. Any exclusive list is bound to overlook certain processes normally applied to a specific mineral or ore, resulting in inappropriate (and presumably unintended) tax preferences for processing and refining only certain minerals and ores. Thus, we also recommend that activities similar to the non-mining processes be treated as activities that produce qualifying income.

Permitting non-mining processes and similar processes to produce qualifying income should repair the "broken links" in the copper and zinc extraction examples highlighted above by making income from roasting and smelting qualifying income.[5] In addition, such a change appropriately would permit other activities typically considered to be processing of natural resources, such as the electrolysis of brine, to generate qualifying income.

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4 *See* 1 U.S. Bureau of Mines, Minerals Yearbook Metals and Minerals 733-734 (1987).

5 We believe that electrolysis, which is one of the refining procedures for zinc and copper and is very similar to electrolytic deposition, is one such "similar process" that should be treated as "processing" for purposes of this definition.

2. Providing a single definition of the terms "processing" and "refining" effectively writes processing out of the statute.

We believe treating processing and refining as a single activity with respect to minerals and ores is inconsistent with the statute and fails to give effect to every word in the statute. Moreover, the definition selected to cover both terms, namely, "purification, separation, and elimination of impurities," essentially is the dictionary definition of "refining." (Merriam Webster defines "refine" as "to free . . . from impurities or unwanted material."[6]) Thus, an activity that is separately listed in the statute effectively has been written out of the Proposed Regulation's definition.[7]

3. The proposed requirement that refining or processing not cause a substantial physical or chemical change in a natural resource adds restrictions not contained in the statute.

We do not believe that either the statute or legislative history suggests or indicates that processing or refining should exclude physical and chemical changes to a natural resource, as provided in the Proposed Regulations. Several activities with respect to natural resources that typically are considered processing make chemical changes to a natural resource (e.g., the extraction of zinc from sphalerite and electrolysis of brine described above). We cannot find any suggestion from Congress that these activities should be excluded from qualifying activities. Moreover, as discussed below, physical and chemical changes that occur in refineries and field facilities are clearly contemplated in the legislative history, and there is no apparent reason for applying a different standard to oil and natural gas on the one hand and minerals and ores on the other.

B. Broad, common meanings for listed activities should be used if possible, and any limitations should be focused on what constitutes a "natural resource."

With respect to ores and minerals, the common meaning of the term "processing" should be used. Merriam-Webster defines a "process" as "a series of actions or operations conducing to an end; especially: a continuous operation or treatment especially in manufacture."[8] Processing is the application of some continuous operation or treatment to an item. The legislative history to section 7704 focuses, appropriately in our view, on defining the nature of that item, i.e., the natural resource, while not limiting the nature of the myriad operations or treatments that might be performed on natural resources.

Although there may be examples of continuous processes that begin with natural resources and result in a product that may be sold to an end user (e.g., turning copper into copper wire or wood into a toothpick), most manufacturing of consumer goods involves multiple operations performed by different entities, and the processes that transform a natural resource into a finished product rarely are continuous. Congress expressed concern only with respect to "additional processing," i.e., the manufacture of plastics or similar petroleum

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6 Available at: http://www.merriam-webster.com/dictionary/refine.

7 Similarly, limiting the definition of processing with respect to ores and minerals to mining processes eliminates the distinction between mining and processing.

8 Available at: http://www.merriam-webster.com/dictionary/process.

derivatives. Therefore, by implication, other processing of natural resources should not raise special concerns and should produce qualifying income.

Even if the legislative history statement regarding the production of plastics from oil and gas was understood to reflect a broader expression of concern about allowing manufacturing activities beyond processing, refining, etc., to produce qualifying income, the statement nevertheless makes it clear that income from the production in refineries or similar facilities of feedstock for manufacturing processes is qualifying income—even if the processes result in physical or chemical changes to crude oil or natural gas liquids. Thus, the straightforward interpretation of the legislative history is that if a process begins with a natural resource and results in the production of feedstock for other manufacturing processes (e.g., chlorine, hydrogen, and caustic soda produced from the processing of salt), then it should produce qualifying income.

C. Impact on Private Letter Rulings

Finally, it is our belief that the revocation of private letter rulings, especially those recently issued to taxpayers, can undermine the faith of taxpayers in tax administration. We recognize that the IRS and Treasury may change their interpretation of the law or the manner in which it is administered. However, we believe that the effective revocation of private letter rulings and other public and private guidance generally should be limited to situations in which there have been legislative changes, clear error in the prior guidance's analysis, or a clear articulation of compelling policy concerns about the guidance. We believe that employing such a standard would help to maintain faith and respect in the overall process and administration of the law. In the case of the Proposed Regulations, we do not believe that this standard has been met. Thus, if the Proposed Regulations were finalized in their current form, the IRS and Treasury should grandfather (in perpetuity and not just during the transition period) recipients of private letter rulings that are adversely affected.

Thank you for your consideration of our comments. If you have any questions, please contact Brian Meighan, Audrey Ellis, or Michael Hauswirth.

Very truly yours,

PricewaterhouseCoopers LLP

Signed by: Brian A. Meighan
Brian A. Meighan