

Final Qualifying Income Treasury Regulations § 1.7704-4

~~Prop.~~Final Reg. § 1.7704-4 Qualifying income – mineral and natural resources.

(a) In general. For purposes of section 7704(d)(1)(E), qualifying income ~~includes only~~is income and gains from qualifying activities with respect to minerals or natural resources as defined in paragraph (b) of this section. ~~For purposes of section 7704(d)(1)(E), qualifying~~Qualifying activities ~~include~~are section 7704(d)(1)(E) activities (as described in paragraph (c) of this section) and intrinsic activities (as described in paragraph (d) of this section).

(b) Mineral or natural resource. The term mineral or natural resource (including fertilizer, geothermal energy, and timber) means any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, or minerals from sea water, the air, or other similar inexhaustible sources). For purposes of this section, the term mineral or natural resource does not include industrial source carbon dioxide, fuels described in section 6426(b) through (e), any alcohol fuel defined in section 6426(b)(4)(A), or any biodiesel fuel as defined in section 40A(d)(1).

(c) Section 7704(d)(1)(E) activities:==

(1) Definition. Section 7704(d)(1)(E) activities include the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource ~~as limited to those activities described in this paragraph (c) or as provided by the Commissioner by notice or in other forms of published guidance. No other activities qualify as section 7704(d)(1)(E) activities.~~ Solely for purposes of section 7704(d), such terms are defined as provided in this paragraph (c).

(2) Exploration. An activity constitutes exploration if it is performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit including by:==

(i) Drilling an exploratory or stratigraphic type test well;

(ii) Conducting drill stem and production flow tests to verify commerciality of the deposit;

(iii) Conducting geological or geophysical surveys;

(iv) Interpreting data obtained from geological or geophysical surveys; or

(v) For minerals, testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146), (see §601.601(d)(2)(ii)(b) of this chapter) if conducted prior to development activities with respect to the minerals.

(3) Development. An activity constitutes development if it is performed to make accessible minerals or natural resources, including by: ~~==~~

(i) Drilling wells to access deposits of ~~mineral~~minerals or natural resources;

(ii) Constructing and installing drilling, production, or dual purpose platforms in marine locations, or any similar supporting structures necessary for extraordinary ~~non-marine~~nonmarine terrain (such as swamps or tundra);

(iii) Completing wells, including by installing lease and well equipment, such as pumps, flow lines, separators, and storage tanks, so that wells are capable of producing oil and gas, and the production can be removed from the premises;

(iv) Performing a development technique such as, for minerals other than oil and natural gas, stripping, benching and terracing, dredging by dragline, stoping, and caving or room-and-pillar excavation, and for oil and natural gas, fracturing; or

~~(vi [sic-v])~~ Constructing and installing gathering systems and custody transfer stations.

(4) Mining or production. An activity constitutes mining or production if it is performed to extract minerals or ~~other~~ natural resources from the ground including by: ~~(i) Operating operating~~ equipment to extract minerals or natural resources from mines and wells; ~~or, or to extract minerals or natural resources from the waste or residue of prior mining or production allowable under this section. The recycling of scrap or salvaged metals or minerals from previously manufactured products or manufacturing processes is not considered to be the extraction of ores or minerals from waste or residue.~~

~~(ii) Operating equipment~~(5) Processing. An activity constitutes processing if it is performed to convert raw mined or harvested products or raw well effluent to substances that can be readily transported or stored ~~(for example, [passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater treaters that separate raw oil well effluent into crude oil, natural gas, and salt water])~~, as described in this paragraph (c)(5) ~~Processing or refining.~~

~~(i) In general. Except as otherwise provided in paragraph (c)(5) of this section, an activity is processing or refining if it is done to purify, separate, or eliminate impurities. For an activity to be treated as processing or refining for purposes of this section, the partnership's position that an activity is processing or refining for purposes of this section must be consistent with the partnership's designation of an appropriate Modified Accelerated Cost Recovery System (MACRS) class life for assets used in the activity in accordance with Rev. Proc. 87-56, 1987-2 CB 674 (see § 601.601(d)(2)(ii)(b) of this chapter). For example, for an activity to be processing or refining of crude oil under paragraph (c)(5)(iii) of this section, the assets used in that process must also have a MACRS class life of 13.3, Petroleum Refining. Unless otherwise provided in this paragraph (c)(5), an activity will not qualify as processing or refining if the activity causes a substantial physical or chemical change in a mineral or natural resource, or transforms the extracted mineral or natural resource into new or different mineral products or into manufactured products.~~(i) Natural gas. An activity constitutes processing of natural gas if it is performed to--

~~(ii) Natural Gas. An activity constitutes processing of natural gas if it is performed to:~~

(A) Purify natural gas, including by removal of oil or condensate, water, or ~~non hydrocarbon~~nonhydrocarbon gases (~~including such as~~ carbon dioxide, hydrogen sulfide, nitrogen, and helium); and

(B) 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 ~~gas condensate~~); or heavier streams).

~~(C) Convert methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.~~(ii) Crude oil~~(A) Qualifying activities [. An activity constitutes processing] of crude oil if it is performed to separate produced fluids by [passing crude oil through mechanical separators to~~

~~remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water)]~~.

~~(iii) Petroleum.~~

~~(A) Qualifying activities~~[~~. An activity constitutes processing~~] ~~or refining of petroleum if the end products of these processes are not plastics~~[~~or similar petroleum derivatives~~] ~~and the activity is performed to:~~

~~(1) Physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes and similar products;~~

~~(2) Chemically convert the physically separated components if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline); or~~

~~(3) Physically separate products created through activities described in paragraph (e)(5)(iii)(A)(1) or (2) of this section.~~

~~(B) Non-qualifying activities. For purposes of this section, the following products are not obtained through processing of petroleum:~~

~~[(1) Heat, steam, or electricity produced by]~~ ~~the refining processes;~~

~~[(2) Products that are obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts are sold]; and~~

~~[(3) Any product that results from further chemical change of]~~ ~~the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil~~ [~~for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as] to anode-grade~~[coke) does not qualify because it is further chemically changed]].

~~(iv)(iii)~~ Ores and minerals other than natural gas or crude oil. An activity constitutes processing ~~or refining~~ of ores and minerals other than natural gas or crude oil if it meets the definition of mining

processes under § 1.613-4(f)(1)(ii) ~~or refining under, without regard to~~ § 1.613-4(g)(6)(iii). ~~Generally, refining of ores and minerals is any activity that eliminates impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as for example the~~ ~~refining of blister copper.~~ f(2)(iv).

~~(v)~~ (iv) Timber. An activity constitutes processing of timber if it is performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances. Processing of timber does not include activities that add chemicals or other foreign substances to timber to manipulate its physical or chemical properties, such as using a digester to produce pulp. Products that result from timber processing include wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark, and rough poles. Products that are not the result of timber processing include pulp, paper, paper products, treated lumber, oriented strand board/plywood, and treated poles.

~~(vi) Fertilizer. [Reserved]~~

~~(6) Transportation. 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.] The following activities qualify as transportation-~~ (6) Refining. An activity constitutes refining if the activity is set forth in this paragraph (c)(6).

(i) Natural gas and crude oil.

(A) The refining of natural gas and crude oil includes the further physical or chemical conversion or separation processes of products resulting from activities listed in paragraph (c)(5)(i) and (ii) of this section, and the blending of petroleum hydrocarbons, to the extent they give rise to a product listed in paragraph (c)(5)(i) or (ii) of this section or to the products of a type produced in a petroleum refinery or natural gas processing plant listed in this paragraph (c)(6)(i)(A).

Refining of natural gas and crude oil also includes the further physical or chemical conversion or separation processes and blending of the products listed in this paragraph (c)(6)(i)(A), to the extent that the resulting product is also listed in this paragraph (c)(6)(i)(A). The following products are of a type produced in a petroleum refinery or natural gas processing plant:

- (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 as provided in §48.4081-1(c)(3) of this chapter.

(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 401°F end-point.

(36) Other products of a refinery that the Commissioner may identify through published guidance.

(B) For purposes of this section, the products listed in this paragraph (c)(6)(i)(B) are not products of refining:

[(1) Heat, steam, or electricity produced by]~~the refining processes;~~processing or refining.

[(2) Products that are obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts are sold];~~and.~~

(3) Any product that results from further chemical change of] a product listed in paragraph (c)(6)(i)(A) of this section that does not result in the same or another product listed in paragraph (c)(6)(i)(A) of this section[(for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as] ~~to anode-grade to calcined~~[coke) does not qualify because it is further chemically changed)]~~]- and does not result in the same or another product listed in paragraph (c)(6)(i)(A) of this section).~~

(4) Plastics[or similar petroleum derivatives].

(ii) Ores and minerals other than natural gas or crude oil.

(A) An activity constitutes refining of ores and minerals other than natural gas or crude oil if it is one of the various processes performed subsequent to mining processes (as defined in paragraph (c)(5)(iii) of this section) to eliminate impurities or foreign matter and which are necessary steps 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, as specified in paragraph (c)(6)(ii)(B) of this section. Refining processes include: fine pulverization, electrowinning, electrolytic deposition, roasting, thermal or electric smelting, or substantially equivalent processes or combinations of processes used to separate or extract the specified metals listed in paragraph (c)(6)(ii)(B) of this section from the ore for the primary purpose of producing a purer form of the metal, as for example the smelting of concentrates to produce Doré bars or[refining of blister copper.]

(B) For purposes of this section, the specified metallic ores or minerals which are not customarily sold in the form of the crude mineral product are—

(1) Lead;

(2) Zinc;

(3) Copper;

(4) Gold;

(5) Silver; and

(6) Any other ores or minerals that the Commissioner may identify through published guidance.

(C) Refining does not include the introduction of additives that remain in the metal, for example, in the manufacture of alloys of gold. Also, the application of nonmining processes as defined in §1.613-4(g) in order to produce a specified metal that is considered a waste or by-product of production from a non-specified mineral deposit is not considered refining for purposes of this section.

(7) Transportation—(i) General rule. An activity constitutes transportation if it is performed to move minerals or natural resources, and products under paragraph (c)(4), (5), or (6) of this section, including by pipeline, marine vessel, rail, or truck. Except as provided in paragraph (c)(7)(ii) of this section, transportation does not include the movement of minerals or natural resources, and products produced under paragraph (c)(4), (5), or (6) of this section, directly to retail customers or 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.]Transportation includes the following activities:

~~(i) Providing storage services;~~A) Providing storage services.

~~(ii) Terminalling;~~B) Providing terminalling services, including the following: receiving products from pipelines, marine vessels, railcars, or trucks; storing products; loading products to pipelines, marine vessels, railcars, or trucks for distribution; testing and treating, as well as blending and additization, if income from such activities would be qualifying income pursuant to paragraph (c)(10)(iv) and (v) of this section; and separating and selling excess renewable identification numbers acquired as part of additization services to comply with environmental regulations.

~~(iii) Operating~~C) Moving or carrying (whether by owner or operator) products via pipelines, gathering systems, and custody transfer stations;

~~(iv) Operating pipelines, barges, rail, or trucks; and~~(D) Operating marine vessels (including time charters), railcars, or trucks.

~~(v) Construction of a pipeline only to the extent that a pipe is run to connect a producer or refiner to a preexisting interstate or intrastate line owned by the publicly traded partnership (interconnect agreements).~~

(E) Providing compression services to a pipeline.

(F) Liquefying or regasifying natural gas.

(ii) Transportation to retail customers or to a place that sells to retail customers. Transportation includes the movement of minerals or natural resources, and products under paragraph (c)(4), (5), or (6) of this section, via pipeline to a place that sells to retail customers. Transportation also includes the movement of liquefied petroleum gas via trucks, rail cars, or pipeline to a place that sells to retail customers or directly to retail customers.

~~(78) Marketing--(i) General rule. An activity constitutes marketing if it is performed to facilitate the bulk sale of minerals or natural resources, and products produced under paragraph (c)(4) or (5), or (6) of this section, including blending additives into fuels. Marketing. Except as provided in paragraph (c)(8)(ii) of this section, marketing does not include activities and assets involved primarily in retail sales (sales made in small quantities directly to end users), which includes, but is not limited to, the operation of gasoline service stations, home heating oil delivery services, and local natural gas delivery services.~~

(ii) Retail sales of liquefied petroleum gas. Retail sales of liquefied petroleum gas are included in marketing.

(iii) Certain activities that facilitate sale. Marketing also includes certain activities that facilitate sales that constitute marketing under paragraphs (c)(8)(i) and (ii) of this section, including packaging, as well as and blending and additization, if income from blending and additization would be qualifying income pursuant to paragraph (c)(10)(iv) and (v) of this section.

(9) Fertilizer. [Reserved]

(10) Additional activities. The following types of income as described in paragraph (c)(10)(i) through (v) of this section will be considered derived from a section 7704(d)(1)(E) activity.

(i) Cost reimbursements. If the partnership is in the trade or business of performing a section 7704(d)(1)(E) activity, qualifying income includes income received to reimburse the partnership for its costs in performing that section 7704(d)(1)(E) activity, whether imbedded in the rate the partnership charges or separately itemized. Reimbursable costs may include the cost of designing, constructing, installing, inspecting, maintaining, metering, monitoring, or relocating an asset used in that section 7704(d)(1)(E) activity, or providing office functions necessary to the operation of that section 7704(d)(1)(E) activity (such as staffing, purchasing supplies, billing, accounting, and

financial reporting). For example, a pipeline operator that charges a customer for its cost to build, repair, or schedule flow on the pipelines that it operates will have qualifying income from such activity whether or not it itemizes those costs when it bills the customer.

(ii) Hedging. [Reserved]

(iii) Passive Interests. Qualifying income includes income and gains from a passive interest or non-operating interest, including production royalties, minimum annual royalties, net profits interests, delay rentals, and lease-bonus payments, if the interest is in a mineral or natural resource as defined in paragraph (b) of this section. Payments received on a production payment will not be qualifying income if they are properly treated as loan payments under section 636.

(iv) Blending. Qualifying income includes income and gains from performing blending activities or services with respect to products under paragraph (c)(4), (5), or (6) of this section, so long as the products being blended are component parts of the same mineral or natural resource. For purposes of this paragraph (c)(10)(iv), products of oil and natural gas will be considered as from the same natural resource. Blending does not include combining different minerals or natural resources or products thereof together. However, see paragraph (c)(10)(v) of this section for rules concerning additization.

(v) Additization. Qualifying income includes income and gains from providing additization services with respect to products under paragraph (c)(4), (5), or (6) of this section to the extent specifically permitted in this paragraph (c)(10)(v). The addition of additives described in paragraph (c)(10)(v)(A) through (C) of this section is permissible if the additives aid in the transportation of a product, enhance or protect the intrinsic properties of a product, or are necessary as required by federal, state, or local law (for example, to meet environmental standards), but only if such additives do not create a new product.

(A) The addition of additives to products of natural gas and crude oil is permissible, provided that such additives constitute less than 5 percent (except that ethanol or biodiesel may be up to 20 percent) of the total volume for products of natural gas and crude oil and are added into the product by the terminal operator or upstream of the terminal operator.

(B) In the case of ores and minerals other than natural gas or crude oil, the addition of incidental amounts of material such as paper dots to identify shipments, antifreeze to aid in shipping, or compounds to allay dust as required by law or reduce losses during shipping is permissible.

(C) In the case of timber, additization of incidental amounts to comply with government regulations is permissible, to the extent such additization does not create a new product. For example, the pressure treatment of wood is impermissible because it creates a new product.

(d) Intrinsic activities:—

(1) General requirements. An activity is an intrinsic activity only if the activity is specialized to support a 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. Whether an activity is an intrinsic activity is determined on an activity-by-activity basis.

(2) Specialization. An activity is a specialized activity if:—

(i) The partnership provides personnel ~~to perform or~~(including employees of the partnership, an affiliate, subcontractor, or independent contractor performing work on behalf of the partnership) to support a section 7704(d)(1)(E) activity and those personnel have received training in order to support the section 7704(d)(1)(E) activity that is unique to the mineral or natural resource industry ~~that is~~and of limited utility other than to perform or support a section 7704(d)(1)(E) activity; and

(ii) To the extent that the activity ~~includes~~involves the sale, provision, or use of specific property, either:—

(A) The property is primarily tangible property that is dedicated to, and has limited utility outside of, section 7704(d)(1)(E) activities and is not easily converted (as determined based on all the facts and circumstances, including the cost to convert the property) to another use other than supporting or performing the section 7704(d)(1)(E) activities (except that the use of non-specialized property typically used incidentally in operating a business will not cause a partnership to fail this paragraph (d)(2)(ii)(A)); or

(B) ~~The~~If the property is used as an injectant to perform a section 7704(d)(1)(E) activity that is also commonly used outside of section 7704(d)(1)(E) activities (such as water, ~~and~~ lubricants, ~~and sand~~) ~~and, as part of the activity, the partnership also collects and cleans, recycles, or otherwise disposes of the injectant~~, the partnership provides the injectants exclusively to those engaged in section 7704(d)(1)(E) activities; the partnership is also in the trade or business of collecting, cleaning, recycling, or otherwise disposing of injectants after use in accordance with ~~federal~~Federal, state, or

local regulations concerning waste products from mining or production activities; and the partnership operates its injectant delivery and disposal services within the same geographic area.

(3) Essential. (i) An activity is essential to the section 7704(d)(1)(E) activity if it is required to--

(A) Physically complete a section 7704(d)(1)(E) activity (including in a ~~cost effective~~cost effective manner, such as by making the activity economically viable), or

(B) Comply with ~~federal~~Federal, state, or local law regulating the section 7704(d)(1)(E) activity.

(ii) Legal, financial, consulting, accounting, insurance, and other similar services do not qualify as essential to a section 7704(d)(1)(E) activity.

(4) Significant services.

(i) An activity requires significant services to support the section 7704(d)(1)(E) activity if ~~it~~those services must be conducted on an ongoing or frequent basis by the partnership's personnel at the site or sites of the section 7704(d)(1)(E) activities. Alternatively, those services may be conducted offsite if the services are performed on an ongoing or frequent basis and are offered to those engaged in one or more section 7704(d)(1)(E) activities. If the services are monitoring, those services must be offered exclusively to those engaged in one or more section 7704(d)(1)(E) activities. Whether services are conducted on an ongoing or frequent basis is determined based on all the facts and circumstances, including recognized best practices in the relevant industry.

(ii) ~~Partnership personnel~~Personnel perform significant services only if those services are necessary for the partnership to perform an activity that is essential to the section 7704(d)(1)(E) activity, or to support the section 7704(d)(1)(E) activity. Personnel include employees of the partnership, an affiliate, subcontractor, or independent contractor performing work on behalf of the partnership.

(iii) ~~An activity does~~Services are not ~~constitute~~ significant services with respect to a section 7704(d)(1)(E) activity if the ~~activity~~services principally ~~involves~~involve the design, construction, manufacturing, repair, maintenance, lease, rent, or temporary provision of property.

(e) Interpretations of section 611 and section 613. This section and interpretations of this section have no effect on interpretations of sections 611 and 613, or other sections of the Code, or the regulations thereunder; however, this section incorporates some of the interpretations under section 611 and 613 and the regulations thereunder as provided in this section.

(f) Examples. The following examples illustrate the provisions of this section:

Example ~~(1)~~-1. Petrochemical products sourced from an oil and gas well.

(i) Z, a publicly traded partnership, chemically converts a mixture of ethane and propane (obtained from physical separation of natural gas) into ethylene, and propylene, ~~and other gases~~ through use of a steam cracker. Z sells the ethylene and propylene in bulk to a third party.

(ii) ~~Z's activities chemically convert physically separated components of natural gas. The chemical conversion of physically separated components of natural gas (ethane and propane) is not an activity that gives rise to qualifying income under paragraph (c)(5)(ii).~~ Ethylene and propylene are products of refining as provided in paragraph (c)(6)(i) of this section. ~~Therefore, the~~ therefore, Z is engaged in a section 7704(d)(1)(E) activity.

The income Z receives from the sale of ethylene and propylene is ~~not~~ qualifying income for purposes of section 7704(d)(1)(E).

Example ~~(2)~~-2. Petroleum streams chemically converted into refinery grade olefins byproducts.

(i) Y, a publicly traded partnership, owns a petroleum refinery. ~~Y classifies Y's assets used in the activity described in this paragraph under MACRS class 13.3 (Petroleum Refining).~~ The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic cracking unit to chemically convert the heavy gas oil into a liquid stream suitable for gasoline blending and a gas stream containing ethane, ethylene, and other gases. The refinery also further physically separates the gas ~~steam without additional chemical change~~ stream, resulting in refinery -grade ethylene. Y sells the ethylene in bulk to a third party.

(ii) ~~Y's activities are performed to physically separate crude oil into its component parts and to chemically convert the separated heavy gas oil into a liquid stream for recombining with other physically separated components of crude oil. Y has classified its assets used in that activity under an appropriate MACRS code pursuant to paragraph (c)(5)(i) of this section. Income Y receives from the liquid stream is qualifying income pursuant to paragraph (c)(5)(iii)(A)(2) of this section. Y's further physical separation of the gas stream produces ethane, ethylene, and other gases. Pursuant to paragraph (c)(5)(iii)(A)(3), income Y receives from the physically separated gases is qualifying income because the heavy gas oil was chemically converted as part of a processing activity pursuant~~

~~to paragraph (e)(5)(iii)(A)(2) of this section.~~ s activities give rise to products of refining as provided in paragraph (c)(6)(i) of this section; therefore, Y is engaged in a section 7704(d)(1)(E) activity.

The income Y receives from the sales of ethylene is qualifying income for purposes of section 7704(d)(1)(E).

Example ~~(3).~~ 3. Converting methane gas into synthetic fuels through chemical change.

(i) Y, a publicly traded partnership, chemically converts methane into methanol and synthesis gas, and further chemically converts those products into gasoline and diesel fuel. Y receives income from bulk sales of gasoline and diesel created during the conversion processes, as well as from sales of methanol.

(ii) With respect to the production of gasoline or diesel, ~~Y is engaged in the processing of natural gas from methane.~~ gasoline and diesel are products of refining as provided in paragraph (c)(~~5~~)(~~ii~~)(~~C~~) of this section; therefore, Y is engaged in a section 7704(d)(1)(E) activity. Y's income from the sale of gasoline and diesel is qualifying income for purposes of section 7704(d)(1)(E).

(iii) The ~~production and~~ income from the sale of methanol, an intermediate product in the conversion process, is not a qualifying income for purposes of section 7704(d)(1)(E) ~~activity~~ because methanol is not a ~~liquid fuel otherwise produced from the processing of crude oil.~~ product of processing or refining as defined in paragraph (c)(5) and (6) of this section.

Example 4. Converting methanol into gasoline and diesel.

(i) Assume the same facts as in Example 3 of this paragraph (f), except Y purchases methanol and synthesis gas and chemically converts the methanol and synthesis gas into gasoline and diesel. (ii) The chemical conversion of methanol and synthesis gas into gasoline and diesel is not refining as provided in paragraph (c)(6)(i) of this section because it is not the physical or chemical conversion or the separation or blending of products listed in paragraph (c)(6)(i)(A) of this section. Accordingly, the income from the sales of the gasoline and diesel is not qualifying income for purposes of section 7704(d)(1)(E).

Example ~~(4).~~ 5. Delivery of refined products.

(i) X, a publicly traded partnership, sells diesel ~~and lubricating oils~~ to a government entity at wholesale prices and delivers those goods in bulk.

(ii) X's sale of a refined ~~products~~ product to the government entity is a section 7704(d)(1)(E) activity because it is a bulk transportation and sale as described in ~~paragraphs~~ paragraph (c)(~~67~~) and (~~78~~) of this section and is not a retail sale.

Example ~~(5). Delivery of water.~~ 6. Constructing a pipeline.

(i) X, a publicly traded partnership, operates interstate and intrastate natural gas pipelines. Y, a corporation, is a construction firm. X pays Y to build a pipeline. X later seeks reimbursement for its cost to build the pipeline from A, a refiner who contracts with X to transport gasoline. (ii) X, as an operator of pipelines, is engaged in transportation pursuant to paragraph (c)(7)(i)(C) of this section.

The reimbursement X receives from A for X's cost to build the pipeline is qualifying income pursuant to paragraph (c)(10)(i) of this section because X receives the income to reimburse X for its costs in performing X's transportation activity and reimbursable costs may include construction costs. In contrast, Y is not in the trade or business of performing a 7704(d)(1)(E) activity, thus income Y received from X for building the pipeline is not qualifying income to Y.

Example 7. Delivery of water.

(i) X, a publicly traded partnership, owns interstate and intrastate natural gas pipelines. X built a water delivery pipeline along the existing right of way for its natural gas pipeline to deliver water to A for use in A's fracturing activity. A uses the delivered water in fracturing to develop A's natural gas reserve in a cost-efficient manner. X earns income for transporting natural gas in the pipelines and for delivery of water.

(ii) X's income from transporting natural gas in its interstate and intrastate pipelines is qualifying income for purposes of section 7704(c) because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(~~67~~)(i)(C) of this section.

(iii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph (c) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery 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. Under paragraph (d)(2)(ii)(B) of this section, the provision of water ~~used for use as an injectant~~ in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership ~~also collects and cleans, recycles, or otherwise disposes~~ (1) provides the water exclusively to those engaged in section 7704(d)(1)(E) activities. (2) is also in the trade or business of cleaning, recycling, or otherwise disposing of ~~the~~ water after use in accordance with ~~federal~~ Federal, state, or local regulations concerning waste products from mining or production activities. ~~Because X does not collect and clean, recycle, or otherwise dispose of the delivered water after use, X,~~ and (3) operates these disposal services within the same geographic area as that in which it delivers water. Because X does not perform such disposal services, X's water delivery activities are not specialized to ~~narrowly~~ support the section 7704(d)(1)(E) activity. Thus, X's water delivery is not an intrinsic activity. Accordingly, X's income from the delivery of water is not qualifying income for purposes of section 7704(c). ~~Example (6).~~

Example 8. Delivery of water and recovery and recycling of flowback.

(i) Assume the same facts as in Example ~~5,7~~ of this paragraph (f), except that X also collects and treats flowback at the drilling site in accordance with state regulations as part of its water delivery services and transports the treated flowback away from the site. In connection with these services, X provides personnel to perform these services on an ongoing or frequent basis that is consistent with best industry practices. X has provided these personnel with specialized training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas.

(ii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph ~~(d)~~ of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section.

(iii) 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. Under paragraph (d)(2)(ii)(B) of this section, the provision of water ~~used for use as an injectant~~ in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership ~~also collects and cleans, recycles, or otherwise disposes~~ (1) provides the water exclusively to those engaged in section

7704(d)(1)(E) activities. (2) is also in the trade or business of cleaning, recycling, or otherwise disposing of the water after use in accordance with ~~federal~~Federal, state, or local regulations concerning waste products from mining or production activities. ~~X', and (3) operates these disposal services within the same geographical area as where it delivers water. X's~~ provision of personnel is specialized because those personnel received training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas. The provision of water is also specialized because water is an injectant used to perform a section 7704(d)(1)(E) activity, and X also collects and treats flowback in accordance with state regulations as part of its water delivery services. Therefore, X meets the ~~specialized~~specialization requirement. The delivery of water is essential to support A's development activity because the water is needed for use in fracturing to develop A's natural gas reserve in a cost-efficient manner. Finally, the water delivery and recovery and recycling activities require significant services to support the development activity because X's personnel provide services necessary for the partnership to perform the support activity at the development site on an ongoing or frequent basis that is consistent with best industry practices. Because X's delivery of water and X's collection, transport, and treatment of flowback is a specialized activity, is essential to the completion of a section 7704(d)(1)(E) activity, and requires significant services, the delivery of water and the transport and treatment of flowback is an intrinsic activity. X's income from the delivery of water and the collection, treatment, and transport of flowback is qualifying income for purposes of section 7704(c).

~~(f) Proposed (g) Effective/~~Applicability Date and Transition Rule~~applicability date and transition rule.~~

~~(i)1) In general.~~ Except as provided in paragraph ~~(fg)(i)2)~~ of this section, this section ~~is proposed to apply~~applies to income earned by a partnership in a taxable year beginning on or after ~~the date these regulations are published as final regulations in the Federal Register.~~January 19, 2017. Paragraph ~~(fg)(i)2)~~ of this section applies during the ~~Transition Period, which~~period that ends on the last day of the partnership's taxable year that includes ~~the date that is ten years after the date that these regulations are published as final regulations in the Federal Register.~~January 19, 2027 (Transition Period).

~~(i)2) Income during Transition Period.~~ A partnership may treat income from an activity as qualifying income during the Transition Period if: ==

(~~A~~i) The partnership received a private letter ruling from the IRS holding that the income from that activity is qualifying income;

(~~B~~ii) Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as giving rise to qualifying income under section 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to ~~the issuance of these proposed regulations; or~~ May 6, 2015;

(iii) Prior to May 6, 2015, the partnership was publicly traded and had entered into a binding agreement for construction of assets to be used in such activity that would give rise to income that was qualifying income under the statute as reasonably interpreted prior to May 6, 2015; or

(~~C~~iv) The partnership is publicly traded and engages in the activity after May 6, 2015 but before ~~the date these regulations are published as final regulations in the Federal Register,~~ January 19, 2017, and the income from that activity is qualifying income under ~~these~~ the proposed regulations (REG-132634-14) contained in the Internal Revenue Bulletin (IRB) 2015-21 (see <https://www.irs.gov/pub/irs-irbs/irb15-21.pdf>).

(3) Relief from technical termination. In the event of a technical termination under section 708(b)(1)(B) of a partnership that satisfies the requirements of paragraph (g)(2) of this section without regard to the technical termination, the resulting partnership will be treated as the partnership that satisfies the requirements of paragraph (g)(2) of this section for purposes of applying the Transition Period.