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[Code Sec. 7704]

This is in reply to your letter requesting a ruling that the activities of Partnership and Operating Partnerships are qualifying activities that produce qualifying income under §7704(d)(1)(E) of the Internal Revenue Code.

Partnership is formed under the laws of a State A. It was created to acquire the assets and operate the businesses of Subsidiary Corporation, a wholly-owned subsidiary of Parent Corporation. The Partnership through the Operating Partnerships engages in the purchasing, gathering, transporting, processing, trading, storage, and resale of crude oil and refined petroleum products. Subsidiary Corporation is the sole general partner of the Partnership; an approximately 58% limited partnership interest in the Partnership is owned by various investors who have purchased interests in the Partnership pursuant to a public offering or in the market. Subsidiary Corporation also owns limited partner interests in the Partnership. The Partnership's activities are conducted through several Operating Partnerships of which the Partnership or an Operating Partnership is the 99% limited partner and Subsidiary Corporation is the 1% general partner. Partnership and Operating Partnership are collectively referred to as the Partnership.

Partnership operates three business segments: (1) the gathering and marketing of crude oil, (2) the processing of crude oil through a third-party processing arrangement into light products and asphalt and the related and unrelated marketing of crude oil and refined products, and (3) the refined products business.

Partnership believes that the nature of the crude oil market is changing such that it will be increasingly necessary for crude oil marketers like Partnership to provide an expanded array of services and options to obtain and maintain producer and refiner customers. These new services generally have been and are expected to be ancillary to and integrated with Partnership's purchase of crude oil from producers or Partnership's sale of crude oil and refined products to refiners. In addition, Partnership offers these services independent of the purchase or sale of crude oil by Partnership as part of its business development efforts to recruit new customers for the purchase or sale of crude oil.

Pricing Operations

During 1993, Partnership developed and began marketing various derivative pricing products to its producers and refiners whereby the customer could purchase price protection or price guarantees for crude oil. This program has been expanded in 1994 to include refined products and natural gas. The pricing products include a range of price protection products, such as price floors or ceilings, caps and collars, or fixed or flat purchase price or sale arrangements that provide the purchaser or seller more certainty with regard to the price it will pay or receive for its crude oil, refined products or natural gas. Partnership is offering this program to producers, refiners and distributors in a mix of products, and, in the case of crude oil, at the producer's wellhead price as well as the NYMEX pricing point. Partnership hedges its NYMEX pricing risks in separate transactions with the NYMEX or third parties. Partnership is compensated through (i) a fixed premium and/or

(ii) a share of upside potential and/or (iii) a margin obtained when Partnership hedges its pricing transactions. By providing these pricing products, Partnership is able to offer the convenience of a full service line of price protection to producers, refiners and distributors thereby enhancing its competitive position.

Financing Arrangements

Partnership intends to expand its operations involving volumetric production payment structuring and similar transaction capabilities for producers. Volumetric production payments are described as secured transactions whereby Partnership "purchases" production (measured by a predetermined amount of reserves in the ground) in exchange for advancing funds to the producer. Partnership would "own" the reserves in the ground and credit repayment of the debt as the reserves are produced and received by Partnership at its transportation facilities.

In other transactions, Partnership "prepays" a producer for a volume of production secured only by a long term crude oil purchase agreement with the producer.

These operations help accelerate cash flow for producers. They also enhance Partnerships' business of gathering and marketing crude oil by securing long term, and less volatile, crude oil contracts for Partnership.

Partnership also loans money to producers even when there is no agreement to obtain the right to oil. Partnership earns interest on these loans, which are generally paid with money, not oil. These loans are done in hope of creating future marketing or transportation business.

Inventory Arrangements

Partnership will provide inventory financing, scheduling, and management to refiners. Providing these services enables the refiner to reduce its working capital requirements and internal costs. At the same time, these services enhance Partnership's business as a marketer and transporter by providing the Partnership with information about a refiner's crude oil supply or product production.

Industry Services

Partnership contemplates expanding its division order and other administrative services heretofore provided to producers to other crude oil companies. Such services would include the following: (i) contract administration, (ii) initial set-up of a lease on a data file, (iii) data request reporting, (iv) producer balancing, (v) securing division orders and (vi) regulatory reporting.

Industrial, Commercial and Governmental Sales

Partnership's operations sell refined products to various industrial, commercial and governmental users. The refined products are No. 2 fuel oil, jet fuel, unleaded gasoline and asphalt. Specifically, Partnership sells refined products to (i) farmers and farmer cooperatives to run tractors and other types of farm equipment (ii) state and local governmental entities such as school districts for use in truck fleets, (iii) utility companies for truck fleets, (iv) Amtrak for use in fueling its railway system, (v) certain airlines for fuel and (vi) road paving and roofing companies (all collectively herein referred to as "Industrial, Commercial and Governmental Sales").

LAW

Section 7704(a) of the Code, enacted by the Revenue Act of 1987 (the "1987 Act"), generally treats publicly traded partnerships as corporations for federal tax purposes. Section 7704(b) provides that the term "publicly traded partnership" means any partnership if (1) interests in such partnership are traded on an established securities market or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) exempts from treatment as a corporation any publicly traded partnership for any taxable year if the partnership meets the gross income requirements of §7704(c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987 during which the partnership (or any predecessor) was in existence. Section 7704(c)(2) provides that a partnership meets the gross income requirements of §7704 for any taxable year if 90% or more of the gross income of such partnership for such taxable year consists of qualifying income.

Section 7704(d)(1)(E) defines "qualifying income" to include 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) (the "Natural Resources Exception"). The Conference Report accompanying the 1987 Act in discussing the type of qualifying income described in §7704(d)(1)(E) , states as follows:

Income and gains from certain activities with respect to minerals or natural resources are treated as passive-type income. Specifically, natural 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. Income of certain partnerships whose exclusive activities are transportation and marketing activities is not treated as passive-type income. For example, the income of a partnership whose exclusive activity is transporting refined petroleum products by pipeline is intended to be treated as passive-type income, but the income of a partnership whose exclusive activities are transporting refined petroleum products by truck, or retail marketing with respect to refined petroleum products (e. g., gas station operations) is not intended to be treated as passive type income.

H.R. Rep. No. 495, 100th Cong., 1st Sess. 947 (1987), 1987-3 C.B. 946-947.

The next year, Congress clarified the scope of the rule for income from the transportation and marketing of oil and gas. The Conference Report accompanying the 1988 Act provides:

In addition, the conference agreement follows the legislative history of the House bill with respect to income from certain transportation activities, with certain modifications. 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 the transportation of oil or gas or products thereof to a place from which 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 petroleum products by truck to retail customers is not qualifying income.

The conference agreement also clarifies that, in the case of income from marketing of fertilizer, bulk or truckload sales to farmers in amounts of 1 ton or more are not considered retail sales giving rise to non-qualifying income.

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

The Senate Report accompanying the 1988 Act states:

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 oil and gas. 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.

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

ANALYSIS

Pricing Operations

The issue is whether Partnership's sale of derivative pricing products in oil and gas to owners of oil and gas is a qualifying activity that produces qualifying income under §7704(d)(1)(E) . Owners of oil and gas buy derivative pricing products to protect the value of their oil and gas inventory from shifts in price. Partnership does not own the oil and gas products for which it sells the derivative products. One type of these derivative pricing products is a "hedge." Section 1.1221-2 of the Income Tax Regulations provides rules for determining when buying a hedge is part of a taxpayer's normal course of business, and, therefore, ordinary income. For this purpose, a hedging transaction is defined under §1.1221-2(b) "as a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business primarily--

(1) To reduce risk of price changes ... with respect to ordinary property ... that is held or to be held by the taxpayer; or

(2) To reduce risk of interest rate or price changes ... with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer."

This hedging definition and the §7704(d)(1)(E) legislative history suggest that if owners of oil and gas directly purchase derivative products of oil and gas for the above purposes, income from these products is integral to a qualifying activity and may be qualifying income under §7704(d)(1)(E) . Accordingly, income earned by the Partnership from derivative products which hedge the Partnership's price risks with respect to crude oil or other ordinary property constitutes qualifying income under §7704(d)(1)(E) . However, where the Partnership is not the owner of the oil and gas for which price protection is desired, the Partnership is not buying and selling the derivative products to reduce the risk of price or interest rate changes for its oil and gas business. Therefore, the sale of the derivative products does not produce qualifying income under §7704(d)(1)(E) .

Financing Arrangements

The next issue is whether Partnership's provision of financing arrangements to oil and gas owners is a qualifying activity. Sometimes Partnership provides financial services in connection with its current or future purchase of oil and gas. The arrangement may be as simple as Partnership prepaying an oil and gas producer to obtain the producer's future production of oil and gas in the ground. At other times, Partnership lends money to producers unconnected with any right to obtain oil. Partnership does this primarily in hopes of generating future business. As part of these arrangements, generally Partnership provides money to the producer and the producer uses the money to drill for the oil and gas.

In some arrangements, Partnership secures the repayment of this money with the oil and gas in the ground. Partnership states "it would own the reserves in the ground and credit repayment of the debt as the reserves were produced." In other arrangements, Partnership's loan to an oil and gas owner is secured by a long term, crude oil purchase agreement with the producer. In both cases, Partnership eliminates any price risk for the

prepaid production by selling a like volume of oil and gas on the futures market or through a derivative contract.

If the owner of oil and gas reserves borrows money for the direct purpose of developing their oil and gas reserves, then the borrowing is part of a qualifying activity under §7704(d)(1)(E) . Likewise, if Partnership enters financing arrangements as a borrower and uses the proceeds to directly purchase its own oil and gas reserves, this activity is a qualifying activity under §7704(d)(1)(E) .

Here, Partnership is not borrowing money to purchase or develop its own oil and gas reserves. Instead, Partnership is acting as a lender of money to the owners of oil and gas reserves. To the extent Partnership advances or lends money in connection with the obtaining of oil and gas or the right to transport the oil and gas, this lending is part of its qualifying oil and gas marketing and transportation activity. In this regard we note that Partnership's financing arrangements under which loans are secured by the oil and gas in the ground appear to be carved out production payments under §636 . Whether these production payments are treated as mortgage loans or as an economic interest (when carved out for exploration or development), the production payments may be part of Partnership's qualifying oil and gas marketing and transportation activity. Accordingly, income from lending transactions, such as volumetric production payments and production prepayments, where the Partnership obtains crude oil constitutes qualifying income under §7704(d)(1)(E) .

Partnership also plans to enter into lending transactions that are not part of a transaction to obtain oil or gas. These loans will be made to improve goodwill and in the hope the lending activity will lead to future oil and gas business. For Partnership, lending money for this purpose produces income that is not integral to its business of purchasing and transporting oil and gas. Partnership's provision of financing arrangements to oil and gas owners that is not integral to the purchase or transportation of oil and gas is not a qualifying activity under 7704(d)(1)(E).

We recognize that the financing activities of Partnership may improve its relationships with other oil and gas producers and help secure its supply of oil and gas. Nevertheless, lending money, even if it may indirectly help generate oil and gas business, is not a qualifying activity under §7704(d)(1)(E) . No opinion is expressed or implied concerning the federal tax consequences of the above described facts under §7704(d)(1)(A) .

Inventory Arrangements

Partnership performs certain inventory financing, scheduling and management for refiners. These services may or may not be connected with Partnership's obtaining oil or gas for transportation or marketing. Income from inventory services is not qualifying income under section 7704(d)(1)(E) .

Industry Services

The issue is whether providing the services of division ordering, data reporting, regulatory reporting and state tax reporting to oil and gas producers is a qualifying activity that produces qualifying income under §7704(d)(1)(E) . Sometimes, Partnership factors the cost of providing these services to a producer into the price it pays a producer for its crude oil production. Other times the Partnership charges a fee for these services and may not even purchase oil and gas from the producer.

The activities of division ordering, data reporting, regulatory reporting and state tax reporting may produce income separate and apart from the marketing and transportation of oil and gas. If Partnership owned the oil and gas in addition to performing the reporting activities related to the oil and gas, then the reporting activities would be qualifying activities. But because Partnership does not own the oil and gas for which the reporting services are performed, Partnership's reporting activities are not qualifying activities. This conclusion is not changed by combining the cost of the services and the cost of crude oil in the same contract. Partnership's provision of industry services to oil and gas producers is not a qualifying activity under §7704(d)(1)(E) .

Industrial, Commercial and Governmental Sales

The issue is whether Partnership's selling of refined products to (i) farmers and farmer cooperatives to run tractors and other types of farm equipment (ii) state and local governmental entities such as school districts for use in truck fleets, (iii) utility companies for truck fleets, (iv) Amtrak for use in fueling its railway system, (v) certain airlines for fuel and (vi) road paving and roofing companies, is a qualifying activity that produces qualifying income under §7704(d)(1)(E) .

Farmers and Farmer Cooperatives

Legislative history provides that sales to end users at the retail level are not qualifying activities under §7704 (d)(1)(E) . Farmers use the refined products to power their equipment and therefore qualify as end users at the retail level. Partnership's marketing of refined products to farmers or farmer cooperatives is not a qualifying activity. The bulk sale rule for farmers is limited to fertilizer.

State and Local Governmental Entities

The state and governmental units use the refined products to power their buses and truck fleets. Consequently, they are end users at the retail level. Therefore, Partnership's marketing of refined products to State and Local Governmental Entities is not qualifying income.

Utility Companies for Truck Fleets

The legislative history provides that a retail customer does not include a "utility providing power to its customers." However, in this case, the utility does not use the refined products to produce power for its customers but rather to provide fuel for its trucks. Arguably, the trucks are part of the process of providing power to its customers. However, a better reading of the legislative history is that Congress intended to qualify bulk deliveries of oil and gas for the production of power but not for the operation of a fleet of trucks. Therefore, Partnership's income from this activity is not qualifying income.

Amtrak for Use in Fueling Railway System

Amtrak uses the refined product, fuel, to power its railroads. Consequently, they are end users at the retail level. Therefore, Partnership's marketing of a refined product to Amtrak is not qualifying income.

Certain Airlines for Fuel

For the same reasons the sales to Amtrak do not qualify, the sales to certain airlines do not qualify.

Road Paving and Roofing Companies

Legislative history states that income from marketing natural resources to end users at the retail level is not intended to be qualifying income. Here, however, Partnership is delivering an oil and gas product, asphalt, to a manufacturer or processor not to end users at the retail level. Therefore, Partnership's marketing activity is a qualifying activity that produces qualifying income under §7704(d)(1)(E) .

Except as specifically set forth above, no opinion is expressed or implied concerning the federal tax consequences of the above-described facts under any other provision of the Code. In particular, no opinion is expressed as to whether Partnership or Operating Partnership are classified as partnerships for federal tax purposes.

A copy of this letter should be attached to Partnership and Operating Partnership's next federal income tax return. A copy is provided for that purpose.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that the

ruling may not be used or cited as precedent.

Sincerely yours, William P. O'Shea, Chief, Branch 3 Office of the Assistant Chief Counsel (Passthroughs and Special Industries).