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The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Regulations Under Section 7704(d)(1)(E)

Dear Commissioner Koskinen:

Enclosed please find comments on the proposed regulations addressing the definition of qualifying income under section 7704(d)(1)(E) ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

CCs: William Wilkins, Chief Counsel, Internal Revenue Service
Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
Curt Wilson, Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Caroline Hay, Attorney, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service
Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
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**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

**COMMENTS ON THE PROPOSED REGULATIONS
ADDRESSING THE DEFINITION OF QUALIFYING INCOME
UNDER SECTION 7704(d)(1)(E)**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Barbara Spudis de Marigny of the Section’s Partnerships and LLCs Committee and Todd D. Keator of the Section’s Energy and Environmental Taxes Committee, with significant contributions from Nancy L. Allred, Adam M. Cohen, Mary A. McNulty, Sarah K. Ritchey and Robert A. Swiech. The comments were reviewed by Thomas E. Yearout, Chair of the Partnerships and LLCs Committee, James E. Wreggelsworth, Chair of the Subcommittee on Government Submissions of the Partnerships and LLCs Committee, and Peter Lowy, Chair of the Energy and Environmental Taxes Committee. The Comments were further reviewed by Roberta F. Mann, the Section’s Council Director for the Partnerships and LLCs Committee, Stephen A. Lee of the Section’s Committee on Government Submissions, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: January 4, 2016

On May 6, 2015, the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”) published proposed regulations (the “Proposed Regulations”)¹ under section 7704(d)(1)(E),² addressing the definition of qualifying income from certain mineral and natural resource activities for purposes of satisfying the passive-type income exception to tax treatment as a corporation for publicly traded partnerships (“PTPs”).³ The Preamble to the Proposed Regulations requested comments on all aspects of the Proposed Regulations and, accordingly, we respectfully submit these Comments.⁴

We commend Treasury and the Service for providing proposed regulations in this area, which has been without regulatory guidance since enactment in 1987, and which has seen a marked increase in the number of private letter ruling (“PLR”) requests submitted in recent years. Guidance in this area is necessarily dependent on industry-specific facts, and the Proposed Regulations reflect significant consideration of numerous unique aspects of the mineral and natural resources industry. The Proposed Regulations bring greater clarity and certainty to the determination of “qualifying income” for purposes of section 7704(d)(1)(E). We believe that the promulgation of regulations that provide detailed guidance in this area will greatly assist taxpayers in evaluating their positions and the Service in implementing the tax law.

As tax professionals, we share a common goal with Treasury and the Service of furthering sound administration of the tax law. A key element of sound tax administration is the promulgation of regulations that minimize uncertainty by setting forth rules that are clear and susceptible to precise application, that are administrable without unduly straining resources, that are fair in that they treat similarly situated taxpayers equally and that represent a reasoned interpretation of Code provisions in light of the Congressional purpose in enacting them.⁵ Accordingly, these comments set forth recommendations for consideration by Treasury and the Service when finalizing the Proposed Regulations that focus on instances in which we believe the Proposed Regulations are unclear or difficult to apply, may be challenging to administer, treat similarly situated taxpayers unequally or appear to depart from the language or purpose of the statute as expressed in the legislative history to section 7704. Where possible, we provide suggestions as to alternative possible formulations of an applicable rule or criterion for your consideration.

We consider regulations under section 7704 to carry a particular burden in comparison to many other regulations because there is a premium on the ability to interpret and apply this set of regulations with certainty of outcome. Although all

¹ Prop. Reg. § 1.7704-4, 80 Fed. Reg. 25,970 (2015).

² References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

³ I.R.C. § 7704(c).

⁴ 80 Fed. Reg. at 25,974 (2015).

⁵ See Rev. Proc. 1964-22, 64-1 C.B. 689 (“It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is ‘protecting the revenue.’ The revenue is properly protected only when we ascertain and apply the true meaning of the statute.”).

regulations are important, some have more far-reaching implications, making, in turn, confidence in the outcome all the more crucial. In the case of regulations under section 7704, the application of the rules affects the very essence of the tax treatment of an entity, that is, whether it will be taxed as a corporation or as a partnership, a determination that has pervasive ramifications for all aspects of the entity's tax treatment. Treatment or classification of an entity as a partnership or a corporation for tax purposes is the starting point for all other tax determinations and, in the case of partnerships, affects not just the taxation of the entity but the tax imposed directly on the holders of equity interests in the entity who, in the case of PTPs, number well into the millions.⁶

Parallels can readily be drawn to the promulgation of regulations under section 7701 with respect to entity classification. In 1996, Treasury and the Service abandoned the prior practice of entity classification based on interpretations of characteristics under an entity's governing law by promulgating regulations that included a list naming those foreign entity forms that would be classified as per se corporations and permitting all other forms to be classified based on a default rule with a few precise criteria.⁷ In that way, entity classification determinations became a great deal more certain and also more efficient, substantially abating the need for PLRs. Similarly, with respect to regulations under section 7704(d)(1)(E), Treasury and the Service have an opportunity to provide a set of rules that will enhance the certainty of outcome and, by doing so, will also make such determinations more efficient for both the Service and taxpayers. Accordingly, these Comments highlight points where certainty of outcome may weigh in favor of adoption of a particular formulation of a rule.

These Comments are divided into three major sections. In Part I, we review the applicable legislative history and provide some observations regarding the current practice and marketplace environment with respect to the issues. In Part II, we consider the consequences of implementation of regulations that, on the same facts, will reach a different result than previously issued PLRs. Part III contains a detailed discussion of our recommendations regarding the Proposed Regulations, covering specific provisions that we believe warrant reconsideration in light of the principles described above regarding certainty, fairness, administrative practicality and consistency with legislative intent.

⁶ Estimates put the number of PTP unitholders at approximately 11 million, per data available from PriceWaterhouseCoopers, LLP.

⁷ See Reg. § 301.7701-3, 61 Fed. Reg. 66,584 (1996).

EXECUTIVE SUMMARY

I. We recommend that the regulations, when finalized, set forth guidelines that interpret qualifying income for purposes of section 7704(d)(1)(E) in a manner consistent with previously issued PLRs.

II. With respect to the definition of “mineral or natural resource” for purposes of section 7704(d)(1)(E), we recommend that the regulations, when finalized:

- include the phrase “or products thereof” to clarify that qualifying income may be derived from refining or processing of natural resource products; and
- provide that the partnership need not own the mineral, natural resource or product thereof toward which the activity is directed.

III. With respect to the definition of “qualifying activities,” we recommend that the regulations, when finalized:

- contain a list of qualifying activities that is not exclusive but, rather, is an illustrative list that provides a safe harbor for taxpayers performing such activities; and
- include in any such list of qualifying activities, whether illustrative or exclusive, activities that have been the subject of previously issued PLRs, such as hedging, blending, the sale of renewable identification numbers, the transportation and marketing of propane and income from passive sources such as royalty interests.

IV. With respect to the definition of “exploration and development” and “mining or production” as a qualifying activity, we recommend that the regulations, when finalized:

- define qualifying exploration and development activity to include any activity for which the expenditures are (i) geological or geophysical costs under section 167(h), (ii) intangible drilling costs under section 263(c), or (iii) mine exploration or development costs under sections 616(a) or 617(a); and
- define qualifying mining or production activity as any activity the income from which, or the value added by which, would qualify for percentage depletion under section 613 in the hands of an owner of an economic interest in the mineral or natural resource property.

V. *With respect to the definition of “processing” as a qualifying activity, we recommend that the regulations, when finalized:*

- include a definition of processing that is separate from, and in addition to, the current definition which employs only a description of refining activity;
- define qualifying processing activity by reference to a list of products (that either do or do not give rise to qualifying income) rather than by analysis of the chemical or physical steps, elements and catalysts used in the production process;
- contain a definition of qualifying processing activity distinct from qualifying refining activity;
- reconsider the limitation on processing activities that cause a substantial physical or chemical change or, in fact, any change in a mineral or natural resource;
- remove the requirement that a partnership classify its assets under any particular MACRS designation;
- in the determination of qualifying processing activity, remove the restriction that limits qualifying income from processing of crude oil by chemical conversion to the production of gasoline and other fuels and disallows processing through chemical conversion that occurs in non-fuel production;
- clarify that the processing of natural gas liquids (“NGLs”) gives rise to qualifying income;
- clarify that the production of methanol gives rise to qualifying income;
- exclude from qualifying income the processing of specified products “such as plastics or similar petroleum derivatives” and adopt a list of products for this purpose or, conversely, provide an illustrative list of products that are deemed to be the result of refinery or field facility processing;
- include non-mining processes in the definition of processing by reference to the regulations under section 613;
- clarify that any process that reduces impurities in an ore or mineral (such as coking of coal, thermal smelting of iron ore and calcining) constitutes a qualifying activity; and

- include, with respect to timber, the processing of pulp, multidensity fiberboard and engineered wood products.

VI. With respect to the definition of “transportation” as a qualifying activity, we recommend that the regulations, when finalized:

- clarify that qualifying income arises from the construction of connections to other pipelines, utilities, local distribution companies or any other industrial or governmental consumer, regardless of whether such party is a producer or refiner.

VII. With respect to the definition of “intrinsic activities” as qualifying activities, we recommend that the regulations, when finalized:

- clarify that the performance of a qualifying activity by a subcontractor does not affect the qualifying nature of the activity;
- remove the requirement that tangible property be dedicated to, or have limited utility outside of, a qualifying activity;
- remove the requirement that the provider of injectants both provide and remove or dispose of the injectants that it has provided;
- remove the requirement that the provider of injectants remove or dispose of injectants in accordance with applicable law;
- remove sand from the list of injectants subject to the intrinsic activities requirements;
- remove the “significant services” prong from the intrinsic activities definition; and
- clarify that a partnership’s NAICS code does not control or limit the otherwise qualifying nature of a taxpayer’s activities.

VIII. With respect to the definition of qualifying activity related to fertilizer, we recommend that the regulations, when finalized:

- provide a definition of fertilizer;
- clarify that qualifying income is derived from fertilizer regardless of the identity of the purchaser or the use to which the fertilizer is put;
- clarify that revenue from the sale of by-products of fertilizer production is not non-qualifying income; and

- provide that sales of fertilizer in excess of one ton are not retail sales to end users.

IX. With respect to the transition rule applicable to implementation of the final regulations, we recommend that the regulations, when finalized:

- clarify the grandfathering requirement that a PTP's current position be a "reasonable interpretation"; and
- formally identify, through notice or announcement, those PLRs that the Service would consider to be revoked upon implementation of the regulations in their final form.

DISCUSSION

I. Background: Qualifying Income from Natural Resource Activities

The evolution of the tax law applicable to PTPs and specifically the definition of “qualifying income” is atypical. As discussed below, Congress enacted section 7704 in 1987. No regulations regarding qualifying income from natural resources under section 7704(d)(1)(E) were issued at any time prior to the release of the Proposed Regulations. Instead, in the absence of any regulatory guidance, in order to be assured of the qualifying nature of their income, PTPs have regularly obtained PLRs from the Service with respect to the specific activities conducted by the requesting PTPs. As a result, in the time since enactment, numerous PLRs have been issued to PTPs covering income from a wide range of activities and sources. Even though a PLR technically may only be relied upon by the taxpayer to whom it is issued, in the absence of regulatory guidance, taxpayers and practitioners have looked to the PLRs for guidance as to the Service’s view of the definition of qualifying income.

Because of the long delay between statutory enactment and the issuance of the Proposed Regulations and the existence of a large body of PLRs interpreting the definition of qualifying income, we believe it is important first to review the legislative history of section 7704 and the impact of the Service’s practice of issuing PLRs.

A. Statute and Legislative History

Congress enacted section 7704 in 1987⁸ in response to the perception that PTPs represented an attempt to avoid corporate-level tax by businesses that otherwise would normally have been conducted in corporate form.⁹ Section 7704(a) therefore provides that, as a general rule, PTPs are treated as corporations for tax purposes. Congress included in section 7704, however, an exception from this rule for partnerships that have certain types of income, specifically, traditionally passive types of income, real property rental income and, importantly for present purposes, income from natural resources, in recognition of the fact that these activities were typically conducted in a form not subjected to corporate tax.¹⁰ Under the exception, corporate tax treatment would not apply if 90% or more of the partnership’s gross income were from “qualifying income.” Section 7704(d)(1) itemizes the categories of qualifying income and in subparagraph (E) defines qualifying income from natural resources as follows:

- (E) 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

⁸ Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330.

⁹ H.R. REP. NO. 100-391, pt. 2, at 1065-66 (1987).

¹⁰ *Id.*

6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1).¹¹

Section 7704(d)(1)(E) requires a two-part analysis to determine whether income qualifies in this category: first, there must be a determination as to whether the income or gain was derived from a mineral or natural resource, followed by a determination that the activity that generated the income or gain was a qualifying activity. With respect to qualifying minerals and natural resources, the last sentence of section 7704(d) provides that for this purpose “mineral or natural resource” means a product of a character that is, at the time of its production or extraction, subject to depletion under section 611 but excluding any product described in section 613(b)(7)(A) or (B). Fertilizer, geothermal energy and timber receive *de jure* classification as a mineral or natural resource by their specific inclusion in section 7704(d)(1)(E).

The statute excludes from the definition of “mineral or natural resources” (by excluding products described in section 613(b)(7)(A) or (B)) soil, sod, dirt, turf, water, mosses, and minerals from sea water, the air, or similar inexhaustible sources. The report of the Senate Finance Committee to the 1988 amendment to section 7704 (the “Senate Report”) noted that qualifying income does not include the products of farming, ranching, and fishing and that power generated from hydroelectric, nuclear, solar and wind sources does not qualify as a mineral or natural resource.¹²

The second part of the two-part analysis required by section 7704(d)(1)(E) calls for a determination that the revenue is produced by an activity identified in the statute,¹³ that is, exploration, development, mining or production, processing, refining, transportation or marketing of a mineral or natural resource or from the transportation or storage of certain fuels. There is no requirement that the PTP own the mineral or natural resource.

The enactment of section 7704 and subsequent amendments to the provision have been accompanied by a number of committee reports and floor statements that comprise a robust legislative history for section 7704. The Conference Report to the enactment of section 7704 speaks directly to the nature of qualifying income 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, fertilizer includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the

¹¹ Current section 7704(d)(1)(E) includes amendments made by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, and the Emergency Economic Stabilization Act, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

¹² S. REP. NO. 100-445, at 424 (1988).

¹³ *Id.* The Committee Report underscores the two-pronged nature of the test for qualifying income (that is, the need for both a qualifying activity and the performance of such activity with respect to a qualifying mineral or natural resource) in stating that the clarification of the products for which a depletion deduction is allowed is intended only to identify the qualifying minerals or natural resources and not to identify the income from them that is treated as qualifying income.

production of crops and phosphate-based livestock feed. 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.¹⁴

The legislative history also speaks to the meaning of “transportation,” making clear that any form of transportation gives rise to qualifying income in transporting natural resources or products thereof to a bulk distribution facility (i.e., a fuel terminal) but, downstream of a bulk distribution facility, only pipeline transportation will do so. A partnership whose exclusive activity is transporting refined petroleum products by truck downstream of a fuel terminal (which is the most common means of delivering gasoline to a retail service station) does not generate qualifying income.¹⁵

Income from marketing at the level of exploration, development, processing, or refining the mineral or natural resource also is considered qualifying income.¹⁶ Income from marketing minerals and natural resources “to end users at the retail level” is not qualifying income.¹⁷ Thus, the legislative history makes clear that the term “marketing” does not include its most commonly understood definition: retailing. The Senate Report also contains an explicit statement that income from retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as qualifying income.¹⁸

Other statements of legislative intent in the committee reports include statements with respect to the qualifying nature of fertilizer and propane sales. In the case 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.¹⁹ It appears that the 1-ton dividing line also applies to phosphate-based livestock feed, which was clarified to be included in the term “fertilizer.”²⁰

¹⁴ H.R. REP. NO. 100-495, at 946-47 (1987) (Conf. Report).

¹⁵ *Id.* at 947.

¹⁶ *Id.*

¹⁷ S. REP. NO. 100-445, at 425 (1988).

¹⁸ *Id.* at 424.

¹⁹ H.R. REP. NO. 100-1104, at 18 (1988) (Conf. Report).

²⁰ H.R. REP. NO. 100-495, at 947 (1987) (Conf. Report).

With respect to propane transportation and marketing, the legislative history makes clear that income from transportation and marketing of “liquefied petroleum gas” or propane in trucks, as well as in railcars or by pipeline, is qualifying income.²¹ The legislative history also makes clear that the transportation and marketing of propane to retail customers (homeowners) is qualifying income.²² A retail customer does not include a person who acquires oil or gas for refining or processing, a person who acquires partially refined or processed products thereof for further refining or processing, or a utility providing power to customers.²³

B. Development of PLR Practice

In the years since the enactment of section 7704 in 1987, the Service has issued a significant number of PLRs under section 7704(d)(1)(E), creating a body of interpretation that has constituted the only guidance available to taxpayers as to the Service’s view of the definition of qualifying income. When a partnership seeks to issue public units and thereby become publicly traded, it files a Form S-1 registration statement with the Securities and Exchange Commission. With every Form S-1, the registrant must necessarily disclose to potential investors its anticipated tax classification. In this regard, it has become standard practice for PTP registrants, in describing their tax classification, to state that they have obtained either a PLR or a “will-level” tax opinion from outside tax counsel as to the qualifying nature of their income. In practice, both tax practitioners issuing tax opinions for Forms S-1, as well as the Office of Chief Counsel when issuing PLRs, look to past PLRs for guidance as to the Service’s interpretation of qualifying income under section 7704(d)(1)(E). Most importantly, however, because investors’ decisions to invest in PTPs are based on the information presented in the Form S-1, as a practical matter, it is not just the PTP receiving a PLR that relies on it, but, indirectly, the investing public as well.

II. Implications of Proposed Regulations That Apply a Different Standard Than Applied in Previously Issued PLRs.

The Preamble to the Proposed Regulations implies that an objective of issuing the regulations is to reduce the number of PLR requests by providing a definition of “qualifying income” under section 7704(d)(1)(E) on which taxpayers can rely.²⁴ Such objective logically could be accomplished by synthesizing the existing body of PLRs into a set of rules that provide clear and principled criteria as to what constitutes qualifying income. The Proposed Regulations for the most part achieve this synthesis, and we commend Treasury and the Service for this effort.

²¹ H.R. REP. NO. 100-1104, at 17-18 (1988) (Conf. Report).

²² The following floor statement is quoted in the legislative history to contrast the treatment of propane with that of petroleum products other than propane transported by truck to retail customers, which do not give rise to qualifying income: “Income from transportation and marketing of liquefied petroleum gas in trucks (as well as in rail cars or by pipeline), however, may be treated as qualifying income. *See* Statement of Mr. Rostenkowski, 133 Cong. Rec. 11,968 (Dec. 21, 1987); *see also* Statement of Senator Bentsen, 133 Cong. Rec. 18,651 (Dec. 22, 1987) (substantially similar language).” S. REP. NO. 100-445, at 425 (1988). *See also* CCA 200749012 (Dec. 7, 2007).

²³ H.R. REP. NO. 100-795, at 400-401 (1988).

²⁴ 80 Fed. Reg. at 25,971 (2015).

In some areas, however, the Proposed Regulations deviate from prior PLRs, even though there has been no intervening change in the law or facts. In an effort to address investor and market expectations, Proposed Regulation section 1.7704-4(f) would provide a 10-year transition period for income from an activity of a partnership that, before May 6, 2015, was publicly traded, engaged in the activity, and treated the income from the activity as qualifying income, and that income qualified under the statute as reasonably interpreted prior to the issuance of the Proposed Regulations.²⁵

Given the de facto reliance by PTPs and the investing public on previously issued PLRs, we believe that taking a position in the Proposed Regulations that is inconsistent with such prior interpretations may be damaging to the public's confidence in the administration of the tax law. We recommend that Treasury and the Service either promulgate rules consistent with the positions taken in previously issued PLRs or, if those positions are to be changed, provide an explanation of the policy determination behind the change and a clear statement of grand-fathering under the 10-year transition rule.

Even though, technically, a PLR may be relied upon only by the taxpayer to whom it is issued, in this particular area of the law, PLRs have played a more significant role. Because no regulations were previously issued in this area, PLRs have been the only source of guidance and consequently have become the de facto interpretation of the applicable law. Thus, the absence of regulations has created a situation in which PTPs, the investing public, and practitioners all rely upon the Service's determinations in PLRs issued under section 7704. We recognize that PLRs are issued solely to the requesting taxpayer, that the recipient taxpayer is the only person who is entitled to rely on the PLR and that issued PLRs contain disclaimers to that effect. However, because the requesting PTPs are either publicly traded or intend to become publicly traded, the determination with respect to any single requesting PTP potentially affects the decision to invest and, in that sense, is indirectly relied upon by hundreds of thousands of investors in the requesting PTP.

We also recognize that the Service has the technical authority to revoke its rulings, even the day after units are issued to the public in reliance on a ruling. It is extremely unsettling to taxpayer confidence, however, to find that PLRs are in essence revoked by promulgation of regulations unaccompanied by a thorough explanation of the error that is believed to have been made in previous interpretations of the statute and the statutory support for the new interpretation or change in policy. Although the Preamble to the Proposed Regulations describes the new standards in general terms, it does not explain why Treasury and the Service felt compelled to draft rules that in some instances reach different conclusions than prior PLRs.

Moreover, changes in interpretation may result in transition difficulties. For PTPs that received a PLR (or relied on a PLR issued to a taxpayer in an identical business), but would lack sufficient qualified income under the Proposed Regulations, the likely result is a disruption in the reasonable expectations of investors and the

²⁵ We comment on this transition rule below.

financial markets. Even the ten-year grandfathering rule appears to be insufficient to mitigate meaningfully the adverse market effects on affected partnerships.²⁶ Conversely, from the perspective of new entrants in the same industry, the grandfathered PTPs will have an effective monopoly for conducting their business in a form that has tax advantages not available to new entrants.

The lack of clarity as to which PLRs are being revoked is also problematic in terms of tax administration. While one goal of the Proposed Regulations may be to reduce the number of PLR requests, the change in interpretation evident in the Proposed Regulations is likely to lead at least some taxpayers that previously received a PLR to request a new PLR to confirm the continuing validity of their prior PLR. If the regulations, when finalized, were written in a manner that does not change the standards previously applied in PLRs, such concerns would be greatly mitigated.

Although the examples of new or changed rules in the Proposed Regulations are numerous, we provide below a few of the most striking examples of previous PLR interpretations that would change if the Proposed Regulations were finalized in their current form.

- **Conversion of Methane into Methanol**

The Proposed Regulations include certain natural gas processing activities in the list of qualifying activities but, with respect to methane, limit qualifying processing to “one integrated conversion into liquid fuels that are otherwise produced from petroleum.”²⁷ Therefore, under the Proposed Regulations, the production and sale of methanol would not be a qualifying activity because methanol is not a liquid fuel “otherwise produced from the processing of petroleum.” This result is contrary to a 2013 PLR ruling that the production and sale of methanol was a qualifying activity.²⁸

- **Processing of Timber into Common Wood Products and Pulp**

The Proposed Regulations also provide that “processing” 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.”²⁹ Contrary to this proposed rule, the Service previously issued PLRs concluding that both pulp-making and the production of medium-density fiberboard and engineered wood products generate qualifying income.³⁰

²⁶Even though the change in status is prospective, with a 10-year horizon, the prospect of the change is clearly impacting investment decisions today. For a description of the capital markets effect of the release of the regulations on one PTP, see the comment letter to the Service from Westlake Chemical Partners, L.P., dated July 28, 2015, p. 25.

²⁷ Prop. Reg. § 1.7704-4(c)(5)(ii)(C).

²⁸ PLR 201346007 (July 18, 2013).

²⁹ Prop. Reg. § 1.7704-4(c)(5)(v).

³⁰ See e.g., PLR 9008035 (Nov. 24, 1989); PLR 9822034 (Feb. 26, 1998); PLR 9338028 (June 25, 1993).

- **Production of Olefins**

Under a hypothetical example in the Proposed Regulations, a PTP that chemically obtains ethane or propane from the physical separation of natural gas and processes it into the olefins ethylene and propylene through the use of a steam cracker does not generate qualifying income through the sale of the olefins.³¹ The example contradicts a 2012 PLR in which the Service concluded that the sale of olefins derived from the processing of ethane and propane through a cracking process constitutes qualifying income.³² The position signaled by the Proposed Regulations in this area is a salient example of a retroactive change in position by the Service. We discuss further below the reasons why we believe the Proposed Regulations regarding processing misinterpret the statute and legislative history in this regard.

- **Smelting of Metals**

The Proposed Regulations' definition of processing or refining as applied to ores and minerals incorporates the definition of "refining" in the depletion regulations under section 613,³³ but does not incorporate other non-mining processes such as smelting of metals.³⁴ Unless smelting is considered to be encompassed in the definition of refining, this provision would contradict a 1995 PLR in which the Service concluded that smelting alumina to produce raw metal aluminum produces qualifying income.³⁵

- **Supply of Fluids for Fracking**

The Proposed Regulations provide that, if a PTP supplies property (such as water) for use as an injectant to perform a section 7704(d)(1)(E) activity, the PTP also must collect and clean, recycle, or otherwise dispose of the injectant in accordance with federal, state, or local regulations concerning mining or production waste.³⁶ The Service has previously issued PLRs concluding that supplying fresh water to natural gas producers for use in fracking wells, without more, produced qualifying income.³⁷

- **Omitted Activities**

As discussed below, certain activities have been omitted from the exclusive list of qualifying activities. To the extent such activities were the subject of a previously issued PLR, the Proposed Regulations would appear to be revoking such PLRs. Examples of activities that now have an uncertain status include: hedging³⁸, blending³⁹, sale of RINs (renewable identification numbers),⁴⁰ and retail delivery of propane.⁴¹ The

³¹ Prop. Reg. §1.7704-4(e), Ex. 1.

³² PLR 201241004 (July 2, 2012).

³³ Reg. § 1.613-4(g)(6)(iii).

³⁴ Prop. Reg. §1.7704-4(c)(5)(iv).

³⁵ PLR 9538016 (Sept. 22, 1995).

³⁶ Prop. Reg. §1.7704-4(d)(2)(ii)(B).

³⁷ See e.g., PLR 201234005 (Aug. 24, 2012).

³⁸ See e.g., PLR 9619011 (May 10, 1996).

³⁹ See e.g., PLR 201301010 (Jan. 1, 2013).

⁴⁰ See e.g., PLR 201232020 (Aug. 10, 2012).

determination that all of these activities gave rise to qualifying income was and is based on a reasoned, clear and logical analysis of the statute and legislative history.⁴²

In summary, we recommend that Treasury and the Service consider whether the promulgation of regulations that would revoke prior determinations is inconsistent with the principles of sound tax administration. In light of the potential for damage to taxpayer and investor confidence in the certainty of administration of the tax law, we recommend that the Proposed Regulations, when promulgated in final form, set forth guidelines that interpret qualifying income in a manner consistent with previous PLRs or, to the extent that they do not, explain the policy determinations that compel the change in interpretation.

III. Comments With Respect to Specific Aspects of the Proposed Regulations

We have the following comments regarding specific aspects of the Proposed Regulations.

A. The Definition of Mineral or Natural Resource

Proposed Regulation section 1.7704-4(b) provides the following definition of a mineral or natural resource:

(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, 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).

The definition in the Proposed Regulations does not include the phrase “products thereof” in the definition of mineral or natural resources even though the statute and the legislative history explicitly do so.

Section 7704(d)(1)(E) provides that 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

⁴¹ See CCA 200749012 (Dec. 7, 2007).

⁴² To avoid recounting here the analysis supporting determinations as to income from these activities, we refer to the detail presented in both the PLRs cited above as well as in the following letters to the Service on the Proposed Regulations from the National Propane Gas Association (July 31, 2015) (propane), Buckeye Partners, L.P. (July 31, 2015) (RINs), Calumet Specialty Products Partners, L.P. (Aug. 4, 2015) (hedging) and Martin Midstream Partners, L.P. (Aug. 3, 2015) (blending).

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). (Emphasis added.)

Thus, “gas, oil or products thereof,” as well as “fertilizer, geothermal energy and timber,” are examples of minerals or natural resources in the statute. The flush language of section 7704(d)(1) provides that:

the term “mineral or natural resource” means any product of a character with respect to which a deduction for depletion is allowable under section 611; except that such term shall not include any product described in subparagraph (A) or (B) of section 613(b)(7).

The legislative history to section 7704(d)(1)(E) discusses minerals and natural resources as follows:

Specifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer, includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. 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.⁴³

Taken together, the statute and legislative history provide the basis for determining whether an item is a mineral or natural resource. With the exception of fertilizer (which is the subject of a special rule), the product must be “of a character” that is at the time of its production or extraction subject to depletion under section 611.⁴⁴ The examples of “gas, oil and products thereof” in section 7704(d)(1)(E) and the legislative history delineate the Congressional intent to treat “products” of oil and gas as natural resources and indicate that a mineral or natural resource does not lose its status as a natural resource solely by being processed or refined for purposes of section 7704(d)(1)(E). This intention is further evidenced by the legislative history’s explanation that “whether income is taken into account in determining percentage depletion under section 613 does not necessarily determine whether income is qualifying income.”⁴⁵

⁴³ H.R. REP. NO. 100-495 at 946-47 (1987) (Conf. Report).

⁴⁴ Certain products are specifically excluded from the definition, such as soil, sod, dirt, turf, water, or mosses and minerals from sea water, the air, or similar inexhaustible sources.

⁴⁵ S. REP. NO. 100-445, at 424 (1988).

We recognize that the Proposed Regulations state that products produced through the mining or production, refining or processing activities listed in the Proposed Regulations may be transported or marketed.⁴⁶ However, the exclusion of similar language as to refining and processing would mean (especially in an “exclusive list” system) that qualifying income cannot be derived from processing or refining of products of natural resources, which we do not believe to be consistent with the legislative history. Thus, we recommend that the Proposed Regulations, when adopted in final form, modify the definition of “mineral or natural resource” to expressly include “products thereof.” At a minimum, as expressly provided in the legislative history, the definition should include “products” of oil or gas. We also recommend that the final regulations under section 7704(d)(1)(E) state that the PTP need not own the mineral, natural resource or product thereof toward which a qualified activity is directed.

B. Qualifying Activity: Exclusive List

The Proposed Regulations set forth an “exclusive list” of operations that comprise each of the activities that produce qualifying income.⁴⁷ The effect of the exclusive list is that activities absent from the list cannot give rise to qualifying income. We recommend that the Proposed Regulations when adopted in final form, be revised so that the list becomes an illustrative, exemplar or safe-harbor list that does not preclude all activities not on the list from giving rise to qualifying income.

We understand, that in considering the framework for this part of the Proposed Regulations, note was taken of the principle of statutory construction that exceptions are generally construed narrowly.⁴⁸ In the case of section 7704(d)(1)(E), however, Congress enacted an extremely broad provision which explicitly includes within the activities that give rise to qualifying income, *every stage* of mineral and natural resource production, from the initial steps of identifying and accessing resources (“exploration,” “development”), to their extraction (“mining or production”), to rendering the extracted raw materials commercially useful (“processing,” “refining”), to delivering and selling them (“transportation,” “marketing”). While the qualifying income rule may be an exception to the general rule that PTPs are taxed as corporations, we believe that it is clear that Congress drafted this exception very broadly in order to encompass an entire industry. Promulgation of an exclusive list would be inconsistent with this apparent Congressional intent to describe an entire industry.

We question whether an exclusive list can be effectively employed as a method of regulatory drafting in the case of section 7704(d)(1)(E). Use of an exclusive list is appropriate when the universe of items or matters to be included or excluded is known and defined since the implication of such a list is that all matters have been considered and categorized. In that case, the list can present a definitive determination of all items or matters to be considered. We question whether, in the case of section 7704(d)(1)(E)

⁴⁶ Prop. Reg. §1.7704-4(c)(6) - (7).

⁴⁷ Prop. Reg. §1.7704-4(a); 80 Fed. Reg. at 25,974, Explanation of Provisions, Sec. 1 (2015).

⁴⁸ See *Phillips, Inc. v. Walling*, 324 U.S. 490, 493 (1945) (“To extend an exemption to other than those plainly and unmistakably within its terms and spirit is to abuse the interpretative process and to frustrate the announced will of the people.”); see also *Commissioner v. Clark*, 489 U.S. 726, 739 (1989).

activities, it is possible for the Service to have information regarding all current activities taking place in the industry in order for the exclusive list to represent a considered determination with respect to each possible activity; inevitably, there will be activities that are omitted either inadvertently or because they are not fully understood. Our view is that the Proposed Regulations omit a number of activities or categories of activities that should be treated as producing qualifying income.

Moreover, we are concerned that adoption of an exclusive list will create practical problems with implementation. A static list ignores the dynamic nature of the industry and fails to account for technological advances, thereby preventing businesses that use such advances from accessing capital markets through PTPs and thus discouraging cost-effective production of mineral and natural resources and products thereof. Although the Preamble to the Regulations indicates that the Service intends to periodically update the list or issue guidance to account for new developments,⁴⁹ we are concerned that there could be delays between identification of such activities and publication of guidance. As long as the regulations limit qualifying income solely to listed activities, taxpayers and practitioners will be precluded from interpreting the law to include other activities and may find themselves unable to qualify under section 7704. At the same time, practitioners could not provide opinions to support a PTP's position that it is not taxable as a corporation: in the face of a list that is exclusive and absolute, there would be no room for advice and interpretation.

We recommend that, rather than using an exclusive list of operations, the Proposed Regulations, when finalized, provide a general description of qualifying activities followed by a list of examples of qualifying activity (an illustrative or safe-harbor list) and, where appropriate, non-qualifying activities but not preclude all non-listed activities from being qualifying activities. The safe-harbor approach would provide the flexibility to allow the regulations to account for technological innovation. Also, to the extent that activities that should have been on the list are inadvertently overlooked and left off, such an approach would provide a means by which a taxpayer could reach a reasoned conclusion to support its position that the activity is a qualifying activity, which could reduce the number of PLR requests as compared to an exclusive list.

We believe that Treasury and the Service are aware that there are many activities in which PTPs are currently engaged that are not on the exclusive list in the Proposed Regulations. Assuming the Service did not intend to signal a change in position by leaving these activities off of the list, their absence from the list was an inadvertent omission. This situation is causing significant anxiety to those PTPs conducting such activities because their treatment as partnerships for tax purposes may be dependent upon such activities generating qualifying income. Some of the more salient examples of activities that are currently conducted by PTPs, but that are not on the exclusive list in the Proposed Regulations, include: (i) hedging⁵⁰; (ii) blending⁵¹; (iii) sale of RINs⁵²; (iv)

⁴⁹ 80 Fed. Reg. at 25,971 (2015).

⁵⁰ See e.g., PLR 9619011 (May 10, 1996).

⁵¹ See e.g., PLR 201301010 (Jan. 1, 2013).

⁵² See e.g., PLR 201232020 (Aug. 10, 2012).

retail delivery of propane⁵³; and (v) non-operating mineral interests as defined in section 614(e)(2), such as royalty interests, bonus payments, minimum royalties, overriding royalty interests, net profit interests, overriding net profits interests and production payments not treated as loans under section 636. If a decision is taken to retain the structure of an exclusive list in the final regulations, we would encourage Treasury and the Service to, at a minimum, include these activities in the exclusive list.

C. Definitions of Qualifying Activities of Exploration, Development, and Mining or Production

The definition of qualifying activities in the Proposed Regulations with respect to exploration, development, and mining or production covers specific activities in these categories. If an exclusive list is retained it would be helpful if the list included any activity the payment for which is (i) a geological or geophysical cost under section 167(h), (ii) an intangible drilling cost under section 263(c), or (iii) a mine exploration or development cost under section 616(a) or section 617(a). The costs that are covered by such Code provisions are quite clear, the law in the area is well developed and these provisions are generally well understood by both taxpayers and the Service. For example, if the costs to prepare a drill site, drill a water well to supply water for drilling, and construct physical facilities necessary for drilling give rise to intangible drilling costs, then the provision of services giving rise to such costs would yield qualifying income under this rule. Although we do not recommend that the list of qualifying activities in this area be confined to those activities covered by the referenced Code sections, a statement that such activities are included in the exclusive list would provide additional clarity and certainty.

The terms “mining” and “production” have well-established meanings under sections 611 *et seq.* of the Code and, given the explicit reference to depletion in section 7704, it would be appropriate to use the depletion rules to interpret the meaning of “mining or production” in section 7704(d)(1)(E). Thus, we recommend that the regulations provide that “mining or production” includes any activity the income from which, or the value added by which, would qualify for percentage depletion under section 613 (i.e., the activity is within the depletion cut-off point) in the hands of an owner of an economic interest in the mineral or natural resource property. Thus, both owners of economic interests as well as service companies (*e.g.*, contract miners or operators) could generate qualifying income from mining or production. Examples of “mining or production” could include the application of “mining processes,” mechanical separation of a “wet” stream of natural gas, or field-level gathering.

D. Definition of Processing or Refining

We consider the portion of the Proposed Regulations that addresses the activities of refining and processing to present the following concerns: (i) it is based on a questionable interpretation of the statute and its intent as reflected in legislative history; (ii) it treats similarly situated taxpayers dissimilarly by favoring fuel producers over

⁵³ See *e.g.*, PLR 200749012 (Dec. 7, 2007).

other product producers without statutory or legislative history support for such a distinction; and (iii) it contains proposed criteria the application of which will present a severe administrative problem. Each of these concerns is discussed below in greater detail.

1. Unsupported Interpretation

In our view, the portion of the Proposed Regulations that addresses the activities of refining and processing includes a number of provisions that are not supported by statutory construction or legislative history. Those provisions restrict qualifying income from processing or refining to activities that purify, separate or eliminate impurities. This approach appears to encapsulate “refining,” but seems to ignore the separate meaning associated with the use of the word “processing” in the statute. The Proposed Regulations exclude from the definition of processing or refining any activities that cause a “substantial physical or chemical change” in a mineral or natural resource, except as otherwise specifically permitted in the regulations. They also exclude activities that transform a mineral or natural resource into a new or different mineral product or a manufactured product, again except as otherwise specifically permitted in the regulations. Further, the Proposed Regulations exclude an activity if the assets used in the activity are not depreciated using a specified MACRS class life. We do not believe that these provisions are consistent with applicable principles of statutory construction or the relevant legislative history.

Section 7704(d)(1)(E) provides that qualifying income consists of “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.” Use of both “processing” and “refining” in this list implies that both words have meaning in this context, that is, that a natural resource could be both processed and refined (in contrast to use of the phrase “mining or production” which implies that some natural resources are mined and others are produced). The Proposed Regulations set forth a definition that is based on the common meaning of the word “refining” (to remove impurities or unwanted substances from a material⁵⁴), but not the common meaning of the word “processing,” thereby in essence removing income from the activity of processing from qualifying income and unduly narrowing the scope of the provision. We recommend that the Proposed Regulations, when adopted in final form, be revised to include a definition of processing that is separate from, and in addition to, the proposed definition that employs only a description of refining activity.

We also recommend that, in describing the activity of “processing,” the Proposed Regulations, when adopted in final form, be revised to make clear that the fact that the processing activity causes some change in the mineral or natural resource does not prevent the processing activity from giving rise to qualifying income. We note that a

⁵⁴ New Oxford American Dictionary, 1431 (2001 ed.).

layman's definition of the word "processing" references "change."⁵⁵ As discussed below, the legislative history indicates that some changes (a change into plastics being an example) are *not* intended to constitute processing; accordingly, if a certain change is not qualifying processing, the implication is that certain change can be qualifying. We find no indication in the statute or the legislative history that Congress intended for the word "processing" to have a meaning other than its common meaning when used in section 7704.⁵⁶

For example, the legislative history describes "oil, gas or products thereof" in a manner that clearly indicates that processing includes a substantial physical, chemical, or transformative change in appropriate circumstances:

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, fertilizer includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. 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.⁵⁷

The fourth and fifth sentences of this passage make clear that qualifying processing is more than refining and can include any or all physical, chemical, or transformative changes. Consequently, we believe that the Proposed Regulations are too narrow in defining processing or "change" activities as including only an exclusive, specifically listed, set of activities.

We recommend that the Proposed Regulations, when adopted in final form, be revised to remove the general limitation on activities that cause a substantial physical or chemical change in a mineral or natural resource. For the reasons described above, we do not believe that the statute and the legislative history should be read to restrict

⁵⁵ New Oxford American Dictionary, 1307 (2001 ed.) ("To perform a series of mechanical or chemical operations on, in order to change or preserve it").

⁵⁶ *Perrin v. United States*, 444 U.S. 37, 42, (1979) ("A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning.").

⁵⁷ H.R. REP. NO. 100-495, at 946-47 (1987) (Conf. Report).

qualifying income to products that do not “change” a natural resource. We note that it appears that the reference to a “substantial physical or chemical change” may have been adopted from the same phrase in Treasury Regulation section 1.613-4(g)(5), which defines a “transformation process” for purposes of determining whether a process is a mining process for which depletion is allowable. While we can appreciate that “transformation” may seem relevant to defining the limits of qualifying processing activity, the application of a standard used for depletion seems inappropriate in this context, especially given the absence of any indication in the statute or legislative history that qualifying processing activity is limited to non-transformative processing or that the degree of “change” is determinative of qualifying processing activity.

The portion of the Proposed Regulations that addresses processing and refining also require that, in order for an activity to be treated as processing or refining, the partnership’s designation of the MACRS class life for the assets used in the activity must reflect that the activity is processing or refining.⁵⁸ Interpreting the definition of processing and refining activity to include only activities with respect to which the taxpayer has used assets classified under a separate system governed by a separate statutory provision with a different purpose is not supported by section 7704(d)(1)(E) or the related legislative history. We also believe that requiring a specific MACRS designation introduces uncertainty into the qualifying income analysis. Errors in the MACRS classification or changes in the classification on audit could cause the related income to no longer be qualifying and jeopardizes the taxpayer’s treatment as a partnership for tax purposes. Worse, to the extent a PTP engages in the activity of transportation and the qualifying nature of its income is dependent upon its transporting natural resources or products thereof, the PTP would be unable to determine the qualifying nature of its own income without knowing the MACRS classification of the assets of the processor that has shipped the products.

It appears that the introduction of the reference to MACRS was intended to provide a shortcut for determinations of the qualifying activity of processing or refining. We are concerned, however, that this requirement creates more issues than it resolves. We recommend below that, if a shortcut is desired, consideration be given to using a list of products the refining or processing of which will not give rise to qualifying income.

2. Dissimilar Treatment of Similarly Situated Taxpayers

The Proposed Regulations have introduced a restriction into the definition of the qualifying activities of processing and refining that turns on whether the end product of the processing or refining activity is fuel.⁵⁹ The Proposed Regulations condition the qualifying nature of processing activity that involves chemical conversion of crude oil upon the production of gas or other fuels, whereas processing that involves only the physical separation of crude oil into its component parts need not be directed to the

⁵⁸ Prop. Reg. § 1.7704-4(c)(5).

⁵⁹ Prop. Reg. § 1.7704-4(c)(5)(iii).

production of fuel.⁶⁰ This provision gives preferential treatment to fuel producers and processors over other producers and processors.

We do not read the statute or legislative history as evidencing an intent to favor fuel producers over producers of other products, such as chemical feedstock or lubricating oil. Although there are references to fuels in the Conference Report,⁶¹ those references are included in a listing of natural resources that may be the subject of qualifying processing activity and not as the required *result* of the processing activity. Accordingly, by favoring fuel production, the Proposed Regulations reflect an interpretation of the legislative history that we believe would be difficult to support.

A second example of a restriction in the Proposed Regulations that appears to draw a distinction between otherwise similar taxpayers and products is the restrictive position applied to the production and processing of NGLs. It appears that, although the production of fuel from crude in a refinery gives rise to qualifying income, the production of similar products from NGLs does not.⁶² We recommend reconsideration of this distinction.

With respect to fuel, under the Proposed Regulations, we note that the production of methanol does not give rise to qualifying income because methanol “is not a liquid fuel.”⁶³ Although we disagree that production of fuel should be a determinant of qualifying income, we note that, even under such a standard, methanol would give rise to qualifying income because methanol in fact is used as a fuel. Methanol can be used directly as fuel in flex-fuel cars (including hybrid and plug-in hybrid vehicles) using existing internal combustion engines. Methanol has a high octane rating and is often used in high performance engines. For example, until the end of the 2006 season, all vehicles in the Indianapolis 500 had to run on methanol. Methanol can be converted to gasoline and synthesis gas can be converted to dimethyl ether DME, premium diesel fuel (cetane number of 55-60) and diesel fuel (cetane number of 45-55). If use as a fuel continues to be a relevant criterion under the regulations as finalized, methanol would satisfy that criterion.

3. Problem of Administration

We foresee administrative problems if the proposed criteria for qualifying income from processing and refining are finalized in their current form. Application of the proposed criteria would require scientific expertise in chemical formulae and processing steps and an extraordinarily detailed examination of the specific chemistry of

⁶⁰ Prop. Reg. § 1.7704-4(c)(5)(iii).

⁶¹ “[N]atural resources include . . . 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.” H.R. REP. NO. 100-495, at 946-47 (1987) (Conf. Report).

⁶² Compare Prop. Reg. § 1.7704-4(e), Ex. 1 (concluding the conversion of NGLs into its components, including ethylene, through a steam cracker does not give rise to qualifying income) with Prop. Reg. § 1.7704-4(e), Ex. 2 (concluding the conversion of crude oil into its components, including ethylene, through a refinery’s catalytic cracker does give rise to qualifying income).

⁶³ Prop. Reg. § 1.7704-4(e), Ex. 3 (ii).

every product that undergoes or results from processing or refining to determine whether the criteria are satisfied. Such an understanding and the corresponding analysis of any particular product will be foreign to almost all tax professionals both in and out of the Service.

Application of criteria that involve assessment of chemical formulae is difficult in even relatively simple processes. Although it is tempting to assume that processing is a linear operation that can be evaluated by reviewing steps, order, temperature, pressure, catalysts, etc., as a practical matter, many processing operations have a circular element in that products or by-products from an early stage are treated and reintroduced. As a result, it quickly becomes difficult to determine the precise point in the process at which the original substance could be considered to have changed. At a minimum, determination of the nature of any product under the proposed standards would be time-consuming. In addition, we foresee confusion and uncertainty when tax professionals, whether in private practice or at the Service, are asked to apply a standard that they do not have the training to interpret. While the involvement by petrochemical engineers in developing the Proposed Regulations is understandable, it is not in the interest of the Service to create rules whose application requires the constant involvement of engineers.⁶⁴

The rise in the number of PLR requests in recent years was noted in the Preamble to the Proposed Regulations, implying that one of the Service's goals in issuing regulations is to reduce the demand for PLRs by providing clear rules that would enable taxpayers confidently to make their own determinations as to the nature of their income.⁶⁵ However, the portion of the Proposed Regulations addressing processing may undermine that goal. The standard proposed for processing and refining is so dependent on application of scientific analysis that we consider it highly likely that, if the Proposed Regulations are finalized in their current form, taxpayers could only have confidence in a determination if the Service spoke to application of the standard by issuing a PLR or other administrative guidance. As a result, the regulations actually might have an effect that is the opposite of what is intended: an increase in the demand for PLRs. Moreover, the issuance of a PLR that applies the standards in the Proposed Regulations would necessarily demand input not just from the Service's tax professionals, but also from the Service's personnel with a technical engineering background, putting further strain on the Service's resources.

⁶⁴ An example of an area that quickly devolves into a chemistry discussion is the question of whether the upgrading of petroleum coke is qualifying processing of petroleum. The Proposed Regulations, applying the "no chemical change" standard, provide that any upgrading of petroleum coke, such as to anode-grade coke, is not a qualifying activity because the coke "is further chemically changed." Prop. Reg. §1.7704-4(c)(5)(iii)(B)(3). The upgrade apparently increases the carbon percentage of the coke by removing impurities while not destroying the physical or chemical identity of the carbon. So, although there is a chemical reaction involved in the processing, the essential chemical nature of the natural resource is unchanged. Application of the Proposed Regulation standard to such facts would seem to necessitate an investigation into and understanding of chemistry beyond normal standards of regulation administrability.

⁶⁵ 80 Fed. Reg. at 25,971 (2015).

4. Alternative Approach: List of Non-Qualifying Products

We recommend consideration of an alternative approach that would be much easier to administer, yet still reflect Congressional intent as expressed in the legislative history. Specifically, the regulations could provide that qualifying income does not include income from processing or refining of products such as “plastics or similar petroleum derivatives” and could adopt a list of excluded products for this purpose.⁶⁶ Income from processing or refining of natural resources, including products of natural resources, would be qualifying income unless the product is a listed one. From an administrative standpoint, we consider this to be an area for which a specific list of products that do not give rise to qualifying income could be used to great advantage. The regulations could acknowledge the legislative history by providing specifically and clearly that income from production of plastics or similar petroleum derivatives is not qualifying income but could go a step further by specifying by name the products considered to be plastics or similar petroleum derivatives for this purpose.

Obviously, the list need not be static, but could be updated as it becomes apparent that newly developed products belong on the list. However, it would not be necessary for every product of every processor or refiner to be evaluated through an examination of its chemical formula or production process. Taxpayers would know if their activity was qualifying based on the nature of the product produced (or, in the case of those partnerships that qualify on the basis of transportation or marketing activity, for example, by knowing the nature of the product being transported or sold without having to inquire into the steps of the chemical process that produced it). Thus, taxpayers whose products are on the list, by definition, are engaged in a non-qualifying activity, but those whose products are not on the list could be confident that their income was qualifying without attempting to engage in a technical analysis of the chemistry involved in the production process. An analysis of the steps involved in the process, the formulas used, or the amount of “change” or “transformation” would be unnecessary.

In defining, for example, plastics for purposes of such a list, reference could be made to the common definition of plastic⁶⁷ as well as to numerous publicly available descriptions of the substances that constitute or are similar to plastics.⁶⁸

⁶⁶ To continue the analogy to the check-the-box regulations, such a list of products that would be *per se* plastics or petroleum derivatives might be somewhat analogous to the list of *per se* corporations in the entity classification rules of Regulation section 301.7701-3.

⁶⁷ “Plastic” is defined in the Oxford Dictionary as: “a synthetic material made from a wide range of organic polymers such as polyethylene, PVC, nylon, etc., that can be molded into shape while soft and then set into a rigid or slightly elastic form.” New Oxford American Dictionary, 1358 (2001 ed.) *See also* Webster’s Tenth New Collegiate Dictionary: “processed materials that are mostly thermoplastic or thermosetting polymers of high molecular weight and that can be molded, cast, extruded, drawn or laminated into objects, films, or filaments.” Webster’s Collegiate Dictionary, 888 (10th ed. 2000).

⁶⁸ *See e.g.*, the list maintained by the Society of the Plastics Industry (SPI), which can be accessed at: <http://www.plasticsindustry.org/AboutPlastics/content.cfm?ItemNumber=656&navItemNumber=1128> (last visited October 19, 2015); *PlasticsEurope*, <http://www.plasticseurope.org/what-is-plastic/types-of-plastics-11148.aspx> (last visited Oct. 19, 2015); American Chemistry Council, <http://plastics.americanchemistry.com/Education-Resources/Plastics-101/How-Plastics-Are-Made.html#types> (last visited Oct.

In considering what constitutes “similar petroleum derivatives” in the Conference Report’s reference to “plastics or similar petroleum derivatives,” a logical interpretation would be that the phrase refers to products that occupy a position in the production hierarchy that is parallel to that of plastics, that is, that are as far removed in time, place, or number or complexity of processing steps from the original processing of oil, gas, or products thereof as are plastics. Such a list would include products that have the complex structures of plastics, such as styrofoam and fiberglass, but would not include base petrochemical feedstocks that are produced from first-stage processing such as ethylene or propylene produced in a steam cracker. Inclusion of base petrochemical feedstocks in the category of “similar petroleum derivatives” would read the reference to “products thereof” out of the statute and legislative history.

Alternatively, the regulations could approach the definition of qualifying income from processing by referencing a list of products that qualify because they are the product of processing at “refineries and field facilities,” which would comport with the reference in the legislative history. Products of refineries are catalogued and maintained by the U.S. Energy Information Agency and include all the usual oil and gas products, as well as petrochemical feedstocks such as ethylene and propylene and many other less common products.⁶⁹

Regardless of whether the list of products is a list of non-qualifying products (e.g., plastics) or a list of qualifying refinery and field facility products, identifying by name the products of processing that do not give rise to qualifying income (or that do give rise to qualifying income) would avoid an inquiry into the nature and extent of the production process in order to determine whether income is qualifying income. We recommend that, in order for the regulations to be administrable, they be revised to eliminate criteria that are based on an analysis of the production process.

5. Processing of Ores and Minerals

The discussion above focuses on the definition of qualifying processing activity with respect to oil and gas. The Proposed Regulations also define processing or refining of ores and minerals for purposes of section 7704(d)(1)(E) and do so by referencing the definition of mining processes or refining in the regulations promulgated under section 613.⁷⁰ We believe that this cross-reference is incorrect, however, because “mining processes” are considered part of mining, not processing or refining, under section 613 and should be similarly treated for purposes of section 7704. We recommend that when adopted in final form, the first sentence of Proposed Regulation section 1.7704-

19, 2015); American Chemistry Council, <http://plastics.americanchemistry.com/Education-Resources/Plastics-101/Lifecycle-of-a-Plastic-Product.html#majorplastics> (last visited Oct. 19, 2015); British Plastics Foundation, <http://www.bpf.co.uk/plastipedia/polymers/default.aspx> (last visited Oct. 19, 2015).

⁶⁹ See the list of refinery products maintained by the U.S. Energy Information Administration, available at: U.S. Energy Information Administration, http://www.eia.gov/dnav/pet/pet_pnp_pct_dc_nus_pct_m.htm (last visited Oct. 19, 2015). The refinery product list, however, would need to be expanded to encompass fuels such as methanol and DME which are typically not produced at refineries.

⁷⁰ Prop. Reg. § 1.7704-4(a)(5)(iv).

4(c)(5)(iv) be amended to reference non-mining processes as follows: “An activity constitutes processing or refining of ores and minerals if it meets the definition of non-mining processes, including refining, under § 1.613-4(g)(1) and (6).” In addition, it would be helpful if the final regulations provide that any process that reduces impurities in an ore or mineral (such as coking of coal, thermal smelting of iron ore and calcining) constitutes a qualifying activity.

6. Processing of Timber

The Proposed Regulations also provide that processing is not a qualifying activity with respect to timber for “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.”⁷¹ This rule would change the Service’s longstanding interpretation of the statute that pulp-making, medium-density fiberboard and engineered wood products give rise to qualifying income. For the reasons described above, we recommend that the Proposed Regulations, when finalized, be revised to provide rules that will reach results consistent with the long line of PLRs in this area. If, however, a determination is made that the qualifying nature of these activities should be changed as a matter of policy, then we recommend that the rule implemented by the final regulations not be a rule that demands an inquiry into the extent or nature of substances involved in the processing or the physical or chemical properties of the products. Rather, as was the case for oil and gas processing, we recommend that the products generating qualifying income (or not generating qualifying income) be identified by name.

E. Definition of Transportation

The Proposed Regulations are helpful in providing a list of qualifying transportation activities which includes accepted activities such as operating pipelines and terminalling.⁷² However, we disagree with the limitation that treats construction of a pipeline as a qualifying activity “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).”⁷³ We believe this limitation is inconsistent with industry practice. Pipeline companies often are required by FERC to connect with other pipelines, but not necessarily with pipelines of producers and refiners, as is required by the Proposed Regulations. Depending on the construction agreement, it is possible that a PTP would have revenue from a construction project (such as in the case of a cost-plus contract). Under the Proposed Regulations, non-qualifying income would arise from the construction of FERC-mandated connections to other pipelines, utilities, local distribution companies or any other industrial or governmental consumer that does not qualify as a “producer or refiner.” We do not believe this limitation is logical and recommend that it be removed.

⁷¹ Prop. Reg. § 1.7704-4(c)(5)(v).

⁷² Prop. Reg. § 1.7704-4(c)(6).

⁷³ Prop. Reg. § 1.7704-4(c)(6)(v).

F. Intrinsic Activities Test

Under the Proposed Regulations, if an operation or activity is not specifically enumerated in the exclusive list of qualifying activities, the operation or activity may still give rise to qualifying income if it qualifies as an “Intrinsic Activity.” Proposed Regulation section 1.7704-4(d) provides an activity qualifies as 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.

We recognize that, in drafting the Proposed Regulations, Treasury and the Service are grappling with an area in which industry practices have changed significantly since enactment of the statute. We agree that, in order for the regulations to provide helpful guidance, they need to address a wide variety of supporting activities that, at the time of enactment of the statute, may not have been regularly performed. However, the Proposed Regulations contain several restrictions that are inconsistent with prior PLRs or which we consider to be unduly burdensome because they do not take into consideration industry practice. We also believe clarification is needed as to when service providers are subject to the Intrinsic Activities test.

1. Subcontractors Not Necessarily Subject to Intrinsic Activities Test

We are concerned that, as drafted, the Proposed Regulations could be read to imply that providers of oilfield services must always test for qualifying income under the definition of Intrinsic Activities. We recommend that the Proposed Regulations, when adopted in final form, clarify that oil field service company activities can qualify as qualifying activities as defined with respect to exploration, development or production, regardless of whether the PTP owns the mineral rights, or is the operator or a subcontractor to the owner or the operator.

Taking as an example the classic activity in this area – that of drilling a well – the list of activities subcontracted to one or multiple oilfield service companies could include: preparing the well site, performing seismic data exploration and review, spudding the well, operating the drilling rig, providing and controlling the drilling muds (switching from water-based mud to oil-based mud and adding certain chemicals as needed), installing the surface casing, choosing and mixing the appropriate cement for the casing, logging the well bore, moving the drilling rig off and installing a completion rig, and completing the well for production (by installing production tubing in the well, installing a “Christmas tree” on the well, perforating the wellbore and perhaps fracturing the formation).⁷⁴ In a broad sense, all of these activities could be considered to be the qualifying activity of either “exploration” or “drilling a well” and thus could qualify as a “qualifying activity” as defined in the Proposed Regulations. However, because the

⁷⁴ 80 Fed. Reg. at 25,973 (2015). Attachment A hereto provides a representative list of drilling services that are frequently provided as part of the activity of drilling an oil or gas well.

owner of the mineral rights has subdivided the effort among numerous subcontractors, a possible interpretation of the Proposed Regulations would be that each is only “supporting” the qualifying activity and thus each subcontractor must test its activity under the definition of Intrinsic Activities. We suggest that the basic definition of “qualifying activities” make clear that an activity is no less a qualifying activity because it is performed by a subcontractor or consists of a subset of the tasks that comprise the conduct of a larger qualifying activity.

2. Tangible Property Should Not Have to Be “Specialized”

Proposed Regulation section 1.7704-4(d)(2)(ii)(A) provides, as part of the test for whether an activity is “specialized,” that, if a PTP sells, provides or uses tangible property in conjunction with performing an Intrinsic Activity, such property must be “dedicated to, and [have] limited utility outside of, section 7704(d)(1)(E) activities and is not easily converted (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.”

The Preamble to the Proposed Regulations provides an example of catering equipment used to provide food for workers at a drill site as “non-specialized” equipment. The Preamble states that catering services would not give rise to qualifying income because catering services do not require specialized skills or equipment.⁷⁵

We question whether it is appropriate and useful to make the determination of the character of services contingent upon the nature of the property used in performance of those services. The performance of almost all services requires the “use” of at least some non-specialized property (for example, a computer or a telephone), if not the sale or provision of such property. However, highly specialized services may use simple, non-specialized equipment. For example, the service of drilling site preparation performed as part of the activity of exploration and development may call for the use of a bulldozer. The bulldozer could be used in other construction activity, but the service of pad site preparation would appear to be very specialized to the activity of exploration and development.

When services do require knowledge or experience regarding the use of specialized equipment (for example, seismic equipment), that fact may well suggest that the service itself is specialized; however, we do not believe that the converse is necessarily true, that is, that the use of mundane equipment means that the service cannot be specialized. It is the application of the service provider’s skill, knowledge, experience and analysis that make a service specialized. For example, a geologist may use only a rock hammer and yet clearly the services are specialized because of the geologist’s knowledge and experience.

As a result, we recommend that the Proposed Regulations, when adopted in final form, not contain a requirement that, in order for a service to be specialized, the property

⁷⁵ 80 Fed. Reg. at 25,973 (2015).

used (or sold or provided) in the performance of the service be similarly specialized. Instead, we would suggest that consideration be given to referencing the use of specialized equipment as indicative of the performance of specialized services while not being a prerequisite therefor.

3. **Injectant Standards: Tying Delivery and Disposal is Unnecessary**

Proposed Regulation section 1.7704-4(d)(2)(ii)(B) provides that an activity is a specialized activity if the activity includes the sale, provision, or use of property and:

[t]he 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, lubricants, and sand) and, as part of the activity, the partnership also collects and cleans, recycles, or otherwise disposes of the injectant after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities.

Example 6 under Proposed Regulation section 1.7704-4(e) further provides in part that “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.” However, in Example 5, the delivery of water alone failed to produce qualifying income.

As a practical matter, a requirement that a partnership perform *both* the water delivery and disposal activities at each well or development site in order for that water delivery service to qualify would severely reduce the universe of providers having qualifying income. We understand that it is so common in the industry as to be almost universal for a well operator to source its water supply and disposal service requirements with multiple providers. Consequently, it will be very difficult or impossible for a partnership to satisfy the necessary water in *and* water out factual determination required by the Proposed Regulations.

It is recommended that water delivery services should qualify as an Intrinsic Activity to the extent provided by a partnership to those engaged in one or more section 7704(d)(1)(E) activities, even in cases in which the partnership’s operations do not also include the water disposal services on an ongoing or frequent basis. In the alternative, we recommend that a PTP be able to derive qualifying income from water delivery if the water enhances the producers’ ability to produce oil or gas (as opposed to water provided for other purposes).

The Proposed Regulations also appear to make qualifying under this rule contingent on disposal in compliance with environmental laws; the activity is qualifying only if the partnership “cleans . . . in accordance with federal, state or local regulation”⁷⁶ Although we can certainly hope that the providers behave in

⁷⁶ Prop. Reg. § 1.7704-4(d)(2)(ii)(B).

accordance with governing law, making a tax determination contingent on such compliance introduces a standard that would be difficult to administer. The Service is not tasked with ensuring compliance with federal, state or local environmental laws and should not be taking on this analysis merely to determine if the income is qualifying.

4. Injectants: Sand Qualifies as a Natural Resource

With respect to income from the sale and delivery (“marketing”) of sand to be used as an injectant, the qualifying nature of such income should not be dependent upon satisfaction of the test applied to other injectants. Sand is itself a natural resource for purposes of section 7704(d)(1)(E) because it is subject to depletion under section 611.⁷⁷ Therefore, the activity of providing sand, even for use as an injectant, would give rise to qualifying income as income from the marketing of a natural resource. As a result, we recommend that income from the marketing of sand (or any other natural resource) not be subjected to the proposed standards for injectants.

5. Significant Services Requirement

Proposed Regulation section 1.7704-4(d)(4) describes the third requirement of the definition of Intrinsic Activity, that is, significant services, by providing as follows:

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

The “significant services” prong of the Intrinsic Activity definition adds an additional requirement to the test previously applied in numerous PLRs to determine whether income from services was derived from a section 7704(d)(1)(E) activity. Imposing this additional requirement fails to recognize industry practice.

⁷⁷ I.R.C. § 7704(d); *see also* Rev. Rul. 69-466, 1969-2 C.B. 140.

In the PLRs that have been issued to date in the area of oil field services, it appears that a two-prong test has been used, that is: (1) whether the service was “integral to” the core activity (*i.e.*, would the exploration, development, and production of oil, gas, or coal be “significantly curtailed” in the absence of the service or activity at issue), and (2) whether the service or activity at issue either (a) did not have commercial application outside the primary qualifying activity, or (b) if it did, then the service or activity enhanced the ability of the partnership to produce qualifying income from a more dominant primary qualifying activity.⁷⁸

This two-prong test focused on the needs and activities of the operator, rather than the activities of the service provider. The presence of personnel at the site or the ongoing or frequent nature of the services does not appear to have been considered relevant to the determination. The frequency with which an activity is performed does not necessarily affect or change the underlying nature of that activity. We therefore recommend that the “significant services” prong be removed from the definition of Intrinsic Activity.

G. NAICS Codes

The Preamble to the Proposed Regulations contains statements that reference the North American Industry Classification System (NAICS),⁷⁹ indicating that activities that create the products listed in NAICS codes 211112 and 324110 will be qualifying activities. However, there is no reference to NAICS codes in the text of the Proposed Regulations. References to NAICS in the Preamble without coordinating provisions in the regulations will lead to confusion as to the import of a taxpayer’s NAICS classification. More importantly, however, we do not believe that the regulations should reference or use NAICS codes in any way to categorize qualifying activities. We consider it inappropriate for a non-regulatory system to be determinative of the meaning of statutory terms. The NAICS system was not designed to address tax classification and the NAICS codes do not cover all the activities that may be undertaken by taxpayers under section 7704. We strongly recommend that, when final regulations are promulgated, the preamble thereto make clear that a taxpayer’s NAICS code does not control or limit the otherwise qualifying nature of a taxpayer’s activities.

⁷⁸ See *e.g.*, PLR 200909006 (Feb. 27, 2009); PLR 201234005 (Aug. 24, 2012); PLR 201226018 (June 29, 2012).

⁷⁹ The Preamble to the Proposed Regulations provides that “[i]t is generally anticipated that activities that create the products listed in [the most recent version] of . . . NAICS code 211112 concerning natural gas liquid extraction will be qualifying activities.” Similarly, with respect to refining, the Preamble states that “[i]t is generally anticipated that activities within a refinery that create the products that are listed in [the most recent version] of NAICS code 324110 concerning petroleum refineries will be qualifying activities” 80 Fed. Reg. at 25,972 (2015).

H. Fertilizer

The Proposed Regulations reserve the provisions relating to fertilizer. Treasury and the Service have requested comments as to the possible parameters of regulatory guidance with respect to income from activities relating to fertilizer.

Section 7704(d)(1)(E) provides that the term “natural resources” includes “fertilizer.” The Conference Report accompanying the Omnibus Budget Reconciliation Act of 1987 stated:

[s]pecifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed.⁸⁰

The report of the House Ways and Means Committee accompanying the Omnibus Budget Reconciliation Act of 1987 also contained the following statement: “For purposes of this provision, refining any natural resource is intended to include the production of fertilizer.”⁸¹

Because fertilizer is a natural resource for purposes of section 7704(d)(1)(E), it stands to reason that any of the qualifying activities performed with respect to fertilizer (development, production, processing, refining, transportation, and marketing) would give rise to qualifying income. To the extent that the Regulations speak to the question of qualifying income that may be derived from fertilizer, and especially if the exclusive list of qualifying activities is retained, we recommend that the Regulations be revised to make clear that any of these activities performed with respect to fertilizer give rise to qualifying income.

To further the goals of Treasury and the Service in promulgating these regulations, it would be helpful for the regulations addressing the topic of fertilizer: (1) to define fertilizer for this purpose and (2) to clarify that income from the sale of fertilizer is not dependent upon the identity of the purchaser or the use to which the fertilizer is put. As to the first point, given the complexity of the industry, it would be helpful if the Service were to provide a description of the substances or chemicals that it will acknowledge as recognized fertilizers.

As to the second point, once it is clear that the sales are not retail sales,⁸² it is our view that the inquiry into the use of the fertilizer should stop. Because it is possible for some fertilizers to be used for nonagricultural purposes (such as explosives or, in the case of urea, a nitrogen-based fertilizer, as a diesel exhaust fluid), the regulations should clarify that it is the nature of the product that is determinative and not the use to which it

⁸⁰ H.R. REP. NO. 100-495, at 946-47 (1987) (Conf. Rep.).

⁸¹ H.R. REP. NO. 100-391 at 1065-66 (1987).

⁸² Note that the Conference Report clarified 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. 100-1104, at 18 (1988). Thus, in the case of fertilizer, even when the sale is to an end user (the farmer), the sale is not considered a retail sale if it is of sufficient size.

is put by a third party. The statute and legislative history are clear that fertilizer is a natural resource for purposes of section 7704(d)(1)(E). Fertilizer's status as a natural resource should make irrelevant the use that is made of it. In a similar vein, the qualifying nature of the income from an oil or gas product is not dependent upon the use that the purchaser makes of it. Accordingly, if the final regulations address this issue, we recommend that they make clear that qualifying income is derived from the designated activities with respect to fertilizer, regardless of the use to which the fertilizer is put by a partnership's customer.

Additionally, we recommend that the regulations, when addressing the topic of qualifying income from fertilizer activities, clarify the nature of income from by-products produced in the process of making fertilizer or components of fertilizer. It is our understanding that the production of fertilizer frequently results in the production of by-products, such as nitric acid. As a policy matter, a rule that the by-products do not give rise to qualifying income would put fertilizer producers in a tenuous situation: their fertilizer revenue would be qualifying but the sale of the by-products could be sufficiently large to disqualify the partnership for not having 90% or more qualifying income (unless the producer made the uneconomic choice not to sell the by-products). This dilemma could readily be resolved by clarifying that revenue from the sale of by-products of fertilizer production is not non-qualifying income and we recommend that the regulations so provide.

We recommend that the regulations also make clear that, as with other products, retail sales do not include sales in bulk. The legislative history makes clear that sales of fertilizer in excess of a ton are not retail sales to end users. We recommend that the regulations incorporate this legislative history.

I. Transition Period

Proposed Regulation section 1.7704-4(f) provides a 10-year transition period for PTPs to treat certain income as qualifying income in the following situations:

- (A) The partnership received a PLR from the IRS holding that the income from that activity is qualifying income;
- (B) 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
- (C) 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, and the income from that activity is qualifying income under these Proposed Regulations.

Further clarification is necessary regarding the application of the phrase "as reasonably interpreted" to qualify for the 10-year transitional period protection. The

Preamble to the Proposed Regulations states that the legislative history and interpretations by the Service issued prior to the Proposed Regulations should be taken in account, but that more than a reasonable basis is required.⁸³ Is a formal opinion necessary? Does a “will,” “should” or “more likely than not” tax opinion that is reasonably relied upon by the partnership count as a reasonable interpretation of the statute? Does the level of the opinion matter at all or is “reasonability” determined solely by the reasonability of the analysis on which the opinion was based? Is it sufficient if the PTP’s interpretation is consistent with PLRs issued to other taxpayers? How is this interpretation to be documented or evidenced by the partnership?

As described above, if the Proposed Regulations are finalized in the form proposed, it appears that the PLRs of certain, perhaps many, partnerships will be, in effect, revoked in part or whole, to the extent they involve reclassified income, following expiration of the 10-year transition period. Because the application and meaning of the proposed rules in many areas is uncertain, however, a partnership and its investors may be uncertain whether, or even completely unaware that, its tax status will change at the end of the 10-year transition period. In many instances, the examples provided in the Proposed Regulations contain insufficient information to determine whether the Service intended to follow existing guidance or modify the outcome. It is highly inefficient from an administration perspective to cause all prior PLR recipients to seek a new PLR to ascertain if a previously issued PLR is still valid.

Therefore, to provide greater certainty as to the intended modifications to existing law, we suggest that the Service consider formally stating through notice or announcement which PLRs the Service would consider to be invalid following the expiration of the transition period upon implementation of the regulations in their final form.

IV. Conclusion

In sum, we commend Treasury and the Service for issuing the Proposed Regulations in an effort to bring greater clarity and certainty to the definition of “qualifying income” under section 7704(d)(1)(E). However, to the extent that the Proposed Regulations are inconsistent with previous Service positions as indicated in PLRs, we recommend reconsideration of the new standards proposed. Where new standards are adopted after full consideration, we urge Treasury and the Service to provide notice of, and explanation of the reasons for, the specific position changes, presumably in the preamble to the final regulations. We also recommend that consideration be given to revising the Proposed Regulations before they are adopted in final form, as to the specific points described above in order to properly reflect legislative intent, ensure that similarly situated taxpayers are treated equally and optimize administration of this set of rules.

⁸³ 80 Fed. Reg. at 25,974 (2015).

Attachment A

Representative Drilling Services

- Acidizing
- Borehole Imaging
- Borehole Seismic Analysis
- Cased Hole Logging
- Casing and Cement
- Casing Equipment
- Cement Evaluation
- Cementing
- Cementing Products and Processes
- Cementing Solutions
- Coiled Tubing
- Completion Equipment and Services
- Completion Fluids and Filtration
- Completion Solutions
- Consulting Services
- Conventional - Drill Bits
- Coring
- Deep Water Cementing
- Density Logging
- Deployment and Risk Avoidance
- Directional - Drill Bits
- Directional Drilling
- Directional Drilling Software
- Downhole Drilling Motors
- Downhole Drilling Tools
- Drill Bits
- Drilling
- Drilling Engineering Solutions
- Drilling Fluid Additives
- Drilling Fluids
- Drilling Optimization
- Drilling Optimization Software
- Drilling Performance
- Drilling Performance Workflow
- Expandable Liner Hanger
- Fixed Cutter Bits
- Fluids Engineering
- Fluids Support Services
- Fluids, Solids Control
- Formation Evaluation
- Fracturing
- Gamma Logging
- Gas Analysis - Surface Data Logging
- Geosteering

- Hard Rock Drilling
- Intelligent Completions
- Intervention
- Magnetic Ranging
- Materials, Chemicals & Additives
- Multilateral Completion Systems
- Multilateral Milled Exit Systems
- Multilateral Pre-milled Window Systems
- Measurement while drilling
- Open Hole Wireline
- Optimization Services
- Optimized Pressure Drilling
- Perforating Solutions
- Pressure Control
- Prevention
- Project Management
- Real Time Centers
- Real Time Services
- Real-Time & Automation Services
- Remote Open Close Technology
- Reservoir Fluids Solutions
- Reservoir Testing & Analysis (Reservoir Testing & Sampling)
- Logging while drilling
- Roller Cone Bits
- Rotary Steerables
- Sand Control
- Shale Production
- Solids Control
- Specialty Products
- Stimulation
- Subsea Safety Systems
- Surface Data Logging
- Swell Technology
- Telemetry
- Testing and Sampling
- Underbalanced Drilling
- Vibration Monitoring
- Waste Management
- Well Control
- Well Engineering Solutions
- Wellbore Pressure Monitoring
- Wellbore Service Tools
- Wellbore Surveying
- Wireline and Perforating