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November 24, 2015

Hand-delivered

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

Re: Supplemental Comments -- Section 7704 Regulations Project

Dear Sir or Madam:

It is clear from the manner in which the U.S. Department of the Treasury (the “*Treasury*”) and the Internal Revenue Service (the “*Service*”) conducted the October 27, 2015 hearing (the “*Hearing*”) on the proposed regulations (REG-132634-14) (the “*Proposed Regulations*”) issued under Section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended (the “*Code*”) ¹ that the Treasury and the Service have invested substantial time, effort and thought into reviewing and considering comments they have received to date as they continue to develop regulatory guidance in this important area. In the spirit of continuing this constructive process, we submit this letter to supplement our original comment letter submitted on June 19, 2015 (the “*Original Letter*”).

The primary focus of the questions addressed at the Hearing relates to the terms “mineral or natural resource” as used in Section 7704(d)(1)(E). It is clear from the Hearing that tax professionals in the Treasury and the Service are, quite correctly, attempting to determine when a product of a qualifying processing or refining activity should lose its status as a mineral or natural resource. This is critical because, as explained in our Original Letter and below, that the input of an activity is the key to determining if the activity is a qualifying processing or refining activity within the meaning of Section 7704(d)(1)(E).

After a mineral or natural resource is mined or produced, it is generally purified and transformed into a usable product or products through a series of steps. At some point in this series of steps, the product of the steps loses a majority of the chemical or physical characteristics of its source mineral or natural resource. We believe that is the point at which a product has lost its status as a mineral or natural resource, such that any further activities with

¹ All references to “Sections” herein are references to Sections of the Code unless otherwise indicated.

respect to that product should not be qualifying within the meaning of Section 7704(d)(1)(E), whether those activities be processing, refining, marketing or transportation. This inflection point is the basis for our proposed standard.

Any acceptable standard for determining the point at which a product has lost its character as a mineral or natural resource, whether our proposed standard or otherwise, must meet two requirements. First, the standard must be consistent with Section 7704(d)(1)(E). Second, it must be adequately definitive and practical in its application. As discussed below, we believe our overall proposal (the “*Proposed Standard*”), which focuses on the input of a process or refining activity, meets these requirements. The Proposed Regulations and related commentary are distracted by a focus on the term “manufacturing,” the processes that occur in an activity (chemical and physical change) and the nature of the products produced. We believe this focus will not meet the two requirements necessary for a workable standard.

The following begins with an explanation of why the line drawing standards in the Proposed Regulations are unworkable and inconsistent with Section 7704(d)(1)(E). We then discuss our specific proposal regarding when a product loses its status as a “mineral or natural resource,” and therefore cannot be further processed, refined, marketed or transported within the meaning of Section 7704(d)(1)(E).

Lastly, we set forth our Proposed Standard regarding how to define processing and refining in order to provide context for our specific proposal regarding the terms “minerals” and “natural resources.” Our Proposed Standard is a slightly modified version of the Proposed Standard included in our Original Letter.

I. Fundamental Issues

A. The requirement for a mineral or natural resource input is what limits qualifying processing and refining.

The words of Section 7704(d)(1)(E) and its legislative history make clear that in a system involving input, process and output, it is the input (not the nature of the process or the output) that determines whether the activity is “processing” or “refining” within the meaning of Section 7704(d)(1)(E). Unlike the tests in the Proposed Regulations, there is no need to consider the mechanical or chemical aspects of an activity, whether such activity is manufacturing, or the products of such activity. Thus, as long as the input to a beneficiation activity or transformative activity is a “mineral or natural resource,” that activity generally should qualify as processing or refining within the meaning of Section 7704(d)(1)(E).

Section 7704(d)(1)(E) and its legislative history were not drafted by engineers and scientists, but rather by non-specialists with a reasonable appreciation of the multitude of

activities and products that can result from the multiple forms and various stages of processing or refining of minerals and natural resources. In that light, it is logical that the statute should focus on inputs as a more practical mechanism for defining limits on what is, and is not, a qualifying activity. Notably, the statute imposes no limitations to circumscribe the activities that would constitute processing or refining, but rather defines the terms by reference to natural resource inputs. Neither does the statute define what products would qualify as natural resource inputs other than that (i) the product must have some substantial linkage with a mineral or natural resource that would have been subject to depletion upon its original production or extraction, and (ii) according to the legislative history, that linkage does not extend to plastics and similar petroleum derivatives. The drafters also clearly understood that processing and refining involved multiple steps and that intermediate products could retain their status as minerals or natural resources to be further processed or refined. As a result, we believe that what is a mineral and natural resource is the critical question in further defining processing and refining.

B. The term “manufacturing” is an unworkable boundary to define what is, and what is not, qualifying processing and refining because manufacturing is a word with an extremely broad meaning that is not used in Section 7704(d)(1)(E) or its legislative history in juxtaposition to what is processing or refining.

The intent of the Proposed Regulations (as implied by multiple questions posed at the Hearing) is to erroneously shift the focus away from whether the input of a process is a mineral or natural resource and instead attempt to differentiate between processing and refining on the one hand and manufacturing on the other. This approach incorrectly presupposes that “manufacturing” and “processing and refining” are mutually exclusive. Neither Section 7704(d)(1)(E) nor its legislative history make any reference to “manufacturing.” The only restrictive language in the statute is in the legislative history, which does not refer to manufacturing. It refers instead to the kinds of products that lose their status as a mineral or natural resource. The legislative history, in explaining the application of Section 7704(d)(1)(E) to the oil and gas industry, cuts off refining and processing oil, gas and products thereof at “further processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives.” Further, the language in the legislative history clearly provides only examples, not an exclusive list, of products that lose their status as a natural resource.

The word “manufacturing” should not be used in contrast with the words “processing” and “refining.” Each of these words has a very broad meaning and they overlap one another in scope. For example, one can “process” silicone into the key components of a computer chip or one can “manufacture” a computer chip. Describing either as “processing” or as “manufacturing” would not be a wrong common sense usage. Moreover, regardless of the word used, neither of those activities would be a qualifying activity under Section 7704(d)(1)(E).

Similarly, processing and refining of minerals and natural resources are also commonly considered to be manufacturing activities. The U.S. Energy Information Administration, for example, defines a “refinery” as “an installation that *manufactures* finished petroleum products from crude oil, unfinished oils, natural gas liquids, other hydrocarbons, and oxygenates [emphasis added].” The relevant NAICS code, which is cited in the preamble to the Proposed Regulations as an example of qualifying activities, also recognizes that oil refining is a type of manufacturing. NAICS code 324110 uses the word “manufacturing” to describe several of the listed petroleum refining activities, such as “kerosene manufacturing,” “aviation fuels manufacturing,” and “fuel oils manufacturing.” As kerosene and fuel oil are among the products that the legislative history identifies as “oil, gas or products thereof,” attempting to exclude processes because they involve “manufacturing” would produce a rule that is inconsistent with the commonly understood meaning of the term “refining.” There is no suggestion in the legislative history that this language provides a special exemption for petroleum refineries. Even plastics production, which is clearly not a qualifying activity, could be referred to either as a processing activity or a manufacturing activity. Neither term would clearly be wrong from the perspective of common usage. Indeed, dictionary definitions of “manufacturing” are so broad as to include virtually anything involving intentionally making something.²

Since the commonly accepted meanings of the words “processing” and “refining” clearly overlap with the commonly accepted meanings of the word “manufacturing” it does not seem possible that the word manufacturing can help define what is or is not processing or refining within the meaning of Section 7704(d)(1)(E). In most cases, the meanings of these words overlap more than they differ. Further, “processing,” “refining” and “manufacturing” are not technical or scientific terms used by scientists or engineers to identify and differentiate different types of activities. This makes it clearer to us that the input of an activity is the only practical place to find that limitation.

Further, the Proposed Regulations attempt to distinguish “processing” and “refining” from “manufacturing” by generally excluding from the former terms any activity that “causes a substantial physical or chemical change in a mineral or natural resource, or transforms the extracted mineral or natural resource into new or different mineral products or into manufactured products.” The Proposed Regulations implicitly recognize that processing and refining inherently involve physical and chemical changes by providing exceptions for certain specifically identified activities. However, instead of establishing a dividing line that derives support from Section 7704(d)(1)(E) and its legislative history, the Proposed Regulations would exclude many mineral and natural resource processing and refining activities. As testimony at the Hearing and a number of commenters have pointed out, processing and refining of minerals and natural

² Common definitions include “to make by hand or, especially, by machinery” “to work into usable form,” “the making of something in any way, especially when regarded as merely mechanical.” Webster’s New World Dictionary.

resources inherently involve substantial physical and chemical changes. In fact, Treasury Regulation Section 1.613A-7(s) of the depletion regulations dealing with oil and gas defines “refining” as “any operation by which the physical or chemical characteristics of crude oil are changed,” and for this purpose “crude oil” includes natural gas liquids.

We believe that Section 7704(d)(1)(E) and its legislative history establish a recognizable line between qualifying activities and nonqualifying activities by focusing on the natural resource input. The statute makes clear that, except for fertilizer, a mineral or natural resource must be of a character subject to depletion at the point it is extracted or produced. The legislative history goes on to provide that the reference to depletion is not intended to restrict the activities that can be treated as generating qualifying income,³ and provides examples of products from oil and gas refining and processing that remain natural resources after their refining and processing and specify that plastics and other similar petroleum derivatives are excluded from this category.

C. Our Proposed Standard uses, as we believe the statute requires, the input of an activity as the critical limiting factor and sets forth a practical standard that will provide meaningful guidance and is consistent with years of practice and prior private letter rulings.

To provide an appropriate and workable standard that can be used regardless of the particular type of mineral or natural resource involved, we proposed in the Original Letter that a product loses its status as a mineral or natural resource when that product no longer retains a majority of either the physical or chemical attributes it had when it was mined or produced. Consistent with the legislative history, this standard excludes from qualification products which are different-in-kind from depletable natural resources, such as plastics and similar petroleum derivatives. We provided several examples of the application of such a standard, as well as how the mixing of an additive with a product could be addressed. We recognize that there is some subjectivity in our Proposed Standard, but the language of Section 7704(d)(1)(E) makes the crafting of limitations and line-drawing on this topic an inherently subjective process.

Our Proposed Standard is consistent not only with Section 7704(d)(1)(E) and its legislative history, but also with the approach used by the Service in the private letter rulings relating to Section 7704(d)(1)(E) that have been issued in the past and with the application of these rules by publicly traded partnerships for nearly 30 years. Our Proposed Standard is based on a workable conceptual standard, which precludes the need for an exclusive list. Any included list should be non-exclusive and consistent with this standard. An exclusive list creates an

³ This conclusion is self-evident because income from many types of processing and all income from refining, transporting or marketing of natural resources does not qualify for depletion under Section 611 *et seq.* Any other interpretation would write processing, refining, transportation and marketing out of Section 7704.

artificially narrow limitation which is inconsistent with the broad concepts embedded in Section 7704(d)(1)(E).

In short, efforts to convert depletable natural resource inputs to usable outputs involve a series of steps, some very complicated and capital-intensive, and others which are more simple. At some point along this continuum of steps, the original natural resource input will necessarily lose its identifiable character and subsequent steps can no longer be considered as applicable to a natural resource. The challenge is to identify by regulation a breaking point along that continuum that delineates between a natural resource and something which is not a natural resource, which breakpoint is both (a) consistent with the statute and its legislative history and (b) able to be interpreted fairly and consistently. Neither a breakpoint which is set too early or too late in the continuum, or one which is too subjective in its application, would meet both parts of this dual test.

We believe that our Proposed Standard meets both parts of the test, namely consistency with the statute and its legislative history and ability to be interpreted fairly and consistently.

II. Proposed Standard

Consistent with the plain language of Section 7704 and its legislative history we proposed a standard for processing and refining that could be holistically applied to any mineral or natural resource input. Based on public comments and discussions at the Hearing, we have modified the standard that we proposed in our Original Letter. As modified, our specific proposal regarding when a mineral or natural resource loses its status as a mineral or natural resource is set forth below. We are resubmitting our overall proposal for two reasons. First, our specific proposal as to when a product should or should not retain its status as a mineral or natural resource should be viewed in the context of our overall proposal regarding what are qualifying processes and activities. Second, our overall proposal presents a definition that is neither too restrictive nor too expansive and is consistent with the statute and its legislative history, as well as the private letter rulings addressing qualifying income and the vast majority of comment letters. Our proposed standard is as follows:

Qualifying activities:

- A. Processing, as used in Section 7704(d)(1)(E), means one or a series of mechanical or chemical operations applied to a mineral or natural resource of a single type in order to change, enhance or preserve it.

- B. Refining, as used in Section 7704(d)(1)(E), means one or a series of mechanical or chemical operations applied to remove impurities or unwanted elements from a mineral or natural resource of a single type.
- C. Operations that are processing and/or refining within the meaning of Section 7704(d)(1)(E) include, but are not limited to, the following:
1. With respect to operations in which oil and gas and the products thereof are the source material:
 - a. an operation that physically or chemically separates oil and gas, or the products thereof, into their component parts,
 - b. an operation that recombines such separated component parts, whether or not they have been further processed,
 - c. an operation that changes oil and gas, or the products thereof, into chemical feedstock such as olefins, whether or not performed in a crude oil refinery,
 - d. an operation that mixes additives with refinery products such as gasoline, diesel fuel or lubricating oil to enhance their inherent characteristics,
 - e. an operation that produces fuel or fuel components derived from oil and gas and the products thereof,
 - f. an operation that produces sulfur from hydrogen sulfide removed from “sour” natural gas streams, or
 - g. other operations of the type performed in a crude oil petroleum refinery or similar facility to produce oil and gas products.
 2. With respect to operations in which minerals and ores are the source material:
 - a. the non-mining processes specified in Treas. Reg. §§ 1.613-4(g)(1), or
 - b. the addition of an additive to an ore or mineral to enhance the inherent characteristics of the mineral or ore.
 3. With respect to operations in which timber is the source material:

- a. an operation that converts timber into wood chips, sawdust, lumber, veneers, wood pellets, wood bark, poles or pulp, or
- b. the addition of an additive to timber or the products thereof to enhance the inherent characteristics of the timber or product.

Non-qualifying activities.

D. Operations that are not processing or refining within the meaning of Section 7704(d)(1)(E) include, but are not limited to, the following:

1. operations in which any significant source material is something other than a mineral or natural resource of a single type, subject to C.1.d., C.2.b. and C.3.b.,
2. operations that have the primary purpose to produce heat, steam or electricity,
3. operations that use oil, gas or the products thereof, including chemical feedstocks such as olefins, to make products such as plastics or similar petroleum derivatives,
4. operations that use smelted or refined metals to make products like bars or wires, or
5. operations that use timber or timber products to make products such as housing frames, plywood, oriented strand board or paper.

Operating Rules

E. For purposes hereof:

1. “A mineral or natural resource of a single type” includes all minerals or natural resources commonly resulting directly from a particular source of production or mining, such as a well or mine.
2. Oil, gas and the products thereof are deemed to be a natural resource of a single type. If oil, gas and the products thereof (or other types of minerals or natural resources) are separated into their component parts and recombined (whether or not the components were subject to further

processing and refining before recombination), the recombination operation is processing and/or refining.

3. An operation involving two or more inputs where each input is either oil, gas or a product thereof (other than plastics or similar petroleum derivatives) is processing and/or refining.
4. Water or other matter that is included in the input of a process for the purpose of transporting the mineral or natural resource through the process or for the purpose of helping to separate the mineral or natural resource is ignored.
5. The rearrangement of the molecules (or the atoms in the molecules) in a mineral or natural resource, or the addition (or removal) of oxygen and/or hydrogen atoms to (or from) a molecule in a mineral or natural resource during an operation does not affect whether or not the operation is processing or refining.
6. The physical mixing of two or more products of processing or refining, such as the mixing of asphalt with aggregates to produce road paving material is processing, provided that the primary purpose of the mixing is to enhance the inherent use of each of the products mixed.
7. A product of an operation that is processing or refining will no longer be considered a mineral or natural resource for the purposes hereof if the product does not retain a majority of the physical and chemical characteristics of the mineral or natural resource from which it was produced; as a result, any further independent operation with that product as the input will not be processing or refining of a mineral or natural resource. An independent operation is an operation that is not an integral part of an operation that commenced with a mineral or natural resource. Further refining of a smelted or partially processed ore or mineral is not an independent operation.
8. Products that do not retain a majority of both the physical and chemical characteristics of the minerals or natural resources from which they are produced include, but are not limited to, the following:
 - a. Hydrogen and petroleum coke,

- b. Smelted or refined metals (except for those not produced from oxidized ores, such as gold),
 - c. Products from coal that are generally fungible with the products of oil and gas included in this subsection 8, and
 - d. Lumber (except for treating with additives), poles (except for treating with additives), veneers and all the products of pulping wood chips, including pulp.
9. Products that retain a majority of both the physical and chemical characteristics of the minerals or natural resources from which they are produced include, but are not limited to, the following:
- a. Asphalt, lubricating oil, waxes, solvents, gasoline, kerosene, number 2 fuel oil, diesel fuel, methane, butane, propane, propylene, ethylene, and similar products of oil and gas,
 - b. Pure (unworked) gold,
 - c. Wood pellets, wood chips and sawdust, and
 - d. Products from coal that are generally fungible with the products of oil and gas included in this subsection 9.”

Thank you for your consideration of the foregoing. We would be happy to address any questions or comments you have regarding the materials herein or in our prior submissions.

Respectfully submitted,

