NEW MLP RULES PROVIDE BRIGHT LINES AND NEW CHALLENGES

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Tax Alert

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On May 5, 2015, the Internal Revenue Service ("IRS") released proposed regulations that, if finalized, would provide guidance on qualifying income from minerals and natural resources activities for master limited partnerships ("MLPs").[1] For the oil and gas industry, the proposed regulations provide welcome formalization of some views that the IRS has expressed in past private letter rulings. While generally good news, the proposed regulations are potentially troublesome in some respects. Income from certain hydraulic fracturing activities has been "blessed," but there are some important limitations on fracking income that some in the industry may find onerous. Also of potential concern, the proposed regulations narrow the scope of some activities such as processing of natural gas and petroleum products.[2] Finally, because the new rules establish an exhaustive list of qualifying activities, there is the very real risk that some current practices are left out and that future innovations will not be covered.

The proposed regulations under section 7704(d)(1)(E) of the Internal Revenue Code would replace a cumbersome but flexible ruling practice with a defined and exclusive list of activities that give rise to qualifying income. Activities that do not fit within the definitions under final regulations would not qualify, risking the application of entity-level tax for natural resources MLPs. The IRS is inviting comments until August 4, 2015, concerning whether additional activities should be included. Companies should review the list and consider whether current or future activities and technologies that are not clearly covered in the proposed definitions should be brought to the attention of the IRS.

Regardless of the industry sector, companies considering a MLP structure should make sure that their activities fit squarely within the proposed regulations. Even though the IRS has resumed issuing letter rulings with respect to activities that produce qualifying income, it will not issue comfort letter rulings and it remains to be seen whether the IRS will take an expansive view of qualifying activities under the new regulations. Although the proposed regulations provide a 10-year transition period for existing MLPs, MLPs should not wait to review their activities for compliance in case any restructuring needs to be accomplished during the transition period.

SUMMARY

A MLP is a publicly traded partnership ("PTP") that is taxed as a partnership rather than a corporation because it meets the qualifying income exception in section 7704(d). A PTP meets the qualifying income exception when at least 90% of its income is qualifying income, which generally includes passive sources of income (*e.g.*, dividends and interest) and under section 7704(d)(1)(E), income from the "exploration, development, mining or production, processing, refining, transportation . . . , or the marketing of any mineral or natural resource."

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Under current practice, oil and gas MLPs can seek private letter rulings from the IRS concerning the application of the broad statutory categories to their particular activities.[3] The proposed regulations refine those broad statutory categories by providing an exclusive list of qualifying activities within each category, as well as "intrinsic activities," as follows:

- Qualifying Activities-
  - Exploration - an activity performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development state of the natural deposits
  - Development - an activity performed to make minerals or natural resources accessible.
  - Mining or production - an activity performed to extract minerals or other natural resources from the ground.
  - Processing or refining - generally, an activity that is done to purify, separate or eliminate impurities but industry-specific rules are given for the following industries: natural gas, petroleum, ores and minerals, and timber.
  - Transportation - the movement of minerals or natural resources and products produced from processing and refining, including by pipeline, barge, rail, or truck.
  - Marketing - the activities undertaken to facilitate the sale of minerals or natural resources or products produced from processing and refining.
- Intrinsic Activities - certain limited support activities intrinsic to section 7704(d)(1)(E) activities, which must be specialized to support, essential to the completion of, and require the provision of significant services to support the section 7704(d)(1)(E) activity.

10-YEAR TRANSITION PERIOD

The proposed regulations will apply to income earned in a taxable year that begins on or after the date on which the regulations are finalized. However, a 10-year transition period will also begin once the regulations are finalized. Existing MLPs that received a private letter ruling from the IRS prior to May 6, 2015 holding that a certain activity generates qualifying income will have 10 years until they can no longer rely on those determinations. MLPs that treated their activities as giving rise to qualifying income under section 7704(d)(1)(E) based on a reasonable interpretation of that statute will also have 10 years during which they can rely on those interpretations. Upon expiration of the 10-year transition period, these MLPs will need to satisfy the tests set forth in the regulations in order to maintain their tax treatment as MLPs.

INTRINSIC ACTIVITIES AND THE OIL AND GAS INDUSTRY

Intrinsic activities are not listed in section 7704(d)(1)(E) but appear to be the IRS' effort to incorporate the "integral to" doctrine used in past private letter rulings. Activities that taxpayers represented as "integral to" an activity listed in section 7704(d)(1)(E), but that otherwise may not have generated qualifying income independently, were

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treated as producing qualifying income. These letter rulings often involved taxpayers in the oil and gas industry and fall into two broad categories: (1) taxpayers that engaged in an activity that clearly fit within the list of section 7704(d)(1)(E) activities and also engaged in complementary services to those activities[4] and (2) taxpayers that provided complementary services to customers engaging in section 7704(d)(1)(E) activities but that were not themselves engaging in those activities.[5]

Even though the use of "intrinsic activities" in the proposed regulations appears to be an attempt to preserve the past "integral to" doctrine, the proposed regulations change and pare back activities that might have been informally considered to be qualifying activities in the past. One such area is fracking services. Examples in the proposed regulations show that a water delivery service for fracking will not be treated as an intrinsic activity unless the servicer also collects and treats the flowback. In those examples, the taxpayer owns natural gas pipelines but also built a water delivery pipeline to use in hydraulic fracturing. In contrast, PLR 201234005 concluded that a water delivery service was a qualifying activity, but the facts presented in the PLR do not indicate that collecting and treating flowback were part of the service. In this PLR, the taxpayer represented that its water delivery service was "integral to" the exploration and production of natural gas.

As noted above, an intrinsic activity must be one that is specialized to support, essential to the completion of, and requires the provision of significant services to support the section 7704(d)(1)(E) activity. An activity is specialized if the partnership's personnel are provided to support a section 7704(d)(1)(E) activity and those personnel have received unique training that is of limited utility other than to support the section 7704(d)(1)(E) activity. An activity requires significant services if it must be conducted on an ongoing basis by the partnership's personnel at the site of the section 7704(d)(1)(E) activity, or if offsite, the services are offered exclusively to those engaged in a section 7704(d)(1)(E) activity. The proposed regulations define as essential an activity that is required to physically complete a section 7704(d)(1)(E) activity ("including in a cost effective manner, such as by making the activity economically viable") or an activity required to comply with laws regulating the section 7704(d)(1)(E) activity. It is unclear how activities that contribute to cost effectiveness or efficiency (for example, by increasing the rate of mineral recovery) of an otherwise economically viable project will fare under the regulatory standard. Because the proposed regulations provide an exclusive list of qualifying activities, this proposed standard could prove to be a formidable obstacle for new methods and products.

CONCLUSION

The proposed regulations incorporate many of the IRS' views from past private letter rulings, but some areas are more narrowly drawn. Existing MLPs and companies looking to form MLPs should review their current activities and make sure they fit within the proposed definitions of section 7704(d)(1)(E) activities or intrinsic activities. Given that the list of qualifying activities in the proposed regulations is exclusive, companies using processes not described in the proposed regulations or developing new technologies may wish to consider submitting comments to the IRS in an effort to expand the scope of the proposed regulations.

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[1] A copy of the proposed regulations is available at http://www.gpo.gov/fdsys/pkg/FR-2015-05-06/pdf/2015-10592.pdf (last visited May 7, 2015). Note that the proposed regulations would not change the current treatment

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of income with respect to renewable, or inexhaustible, resources such as soil, air, mosses, and minerals from sea water. Income derived from renewable resources still would not be treated as qualifying income.

[2] For example, under the proposed regulations, the chemical conversion of natural gas components into ethylene and propylene through the use a steam cracker would not give rise to qualifying income. Yet, in PLR 201241004, the IRS determined that income derived from processing natural gas components into olefins by using a gas-fired cracking furnace gave rise to qualifying income. Also, for the timber industry, the proposed regulations depart from past determinations as processing pulp and treating lumber would no longer qualify.

[3] On March 28, 2014, the IRS announced a temporary pause on issuing private letter rulings concerning qualifying income activities but resumed its practice nearly a year later on March 6, 2015. The purpose of the pause was to give the IRS and the Treasury time to develop clearer rules.

[4] For example, in PLR 200909006, the taxpayer was engaged in the business of acquiring (both by conducting its own surveys and by purchasing existing surveys from third parties) and licensing seismic data to oil and gas producers. The taxpayer represented that its seismic data services were "integral to" exploration for oil and gas. Although any data produced by the taxpayer itself would have been easily classified as exploration of a mineral or natural resource, a section 7704(d)(1)(E) activity itself, income from licensing purchased data was also viewed as qualifying income. On its own, licensing purchased seismic data does not constitute a section 7704(d)(1)(E) activity.

[5] In PLR 201226018, the taxpayer operated an extractive logistics business, providing several services to customers engaged in oil and gas drilling, including the delivery and sale of refined petroleum products, maintenance and inspection of drilling rig equipment, and the supply of fracturing fluid and tanks to well sites. The taxpayer's services on their own did not clearly fit within the section 7704(d)(1)(E) activities, but the taxpayer represented that its services were "integral to" the exploration, production, and development of oil and gas resources by others. The IRS determined that the taxpayer's income from its extractive logistics business was qualifying income but only to the extent attributable to its customers' activities that would generally be expected to qualify as section 7704(d)(1)(E) activities. For example, income from the sale of products to farms and construction sites would not have been qualifying income.

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