



## MLPs – Proposed Regulations Provide Both Clarity and Uncertainty

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*2015-Issue 19*—The subject of master limited partnerships (MLPs) has made its way back into the tax headlines recently because of the Treasury and IRS's issuance of proposed regulations in early May 2015 (see Federal Register, Vol. 80, No. 87 or 26 CFR Part 1). The proposed regulations — while specifically targeting MLPs whose operations are focused in the minerals and natural resources industry — provide for both added clarity and an apparent narrowing of the type of business activities that qualify for treatment as an MLP.

First, a brief background on MLPs (previously discussed in *Tax Advisor Weekly*, "[The ABCs of MLPs](#)," dated February 19, 2013), which I suspect many of you who are investors in such publicly traded partnerships are aware of. MLPs have in many cases been very desirable investments given their typically attractive distributions and yield. Furthermore, from a tax perspective, MLPs provide an opportunity to avoid an entity-level tax at the partnership level for federal income tax purposes, with the partners receiving the benefits of "flowthrough" taxation (i.e., single vs. double taxation). They also provide the ability to purchase stock that is publicly traded and receive current distributions that in many cases are currently shielded from taxation (with the initial distributions being largely treated as return of capital). However, with these benefits also come certain requirements to qualify for such treatment, including the requirement that the entity generate at least 90 percent of its gross income in the form of qualified income or activities.

Generally, income from qualifying activities consists of passive income, income and capital gains from commodity investments, and income and gains from active businesses engaged in minerals and natural resources, as well as other enumerated activities set forth in the Internal Revenue Code. The 2015 proposed regulations provide further clarification with respect to businesses engaged in minerals and natural resources, which can be found in IRC Section 7704(d)(1)(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 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1).*

Prior to the proposed regulations, there were no clear guideline tests companies could use when determining what activities would be treated as qualifying income with respect to minerals or natural resources, and the general business community had been exploring how expansive the definition of an MLP might be. Accordingly, in the past, any issues relating to the application of Section 7704(d)(1)(E) have been addressed via private letter rulings.

However, due to the volume of the private letter rulings over the last several years and the business community's more expansive interpretation of what might qualify as qualifying income, the Treasury Department and the IRS were determined to resolve the

issue once and for all by suspending the issuance of such rulings during the first part of 2014 and studying the topic further. This has resulted in the proposed regulations and a list of qualified activities, as well as several tests for activities that were deemed to be supporting, or “intrinsic.”

### **Qualified Activities Under the Proposed Regulations**

The proposed regulations spell out that if an MLP directly engages in the following six activities (given that they relate to minerals or natural resources), the income produced will be considered to be qualifying income:

1. 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 stage of the natural deposit.
2. Development — an activity performed to make minerals or natural resources accessible.
3. Mining or Production — an activity performed to extract minerals or other natural resources from the ground.
4. Processing or Refining — generally, an activity done to purify, separate or eliminate impurities, with industry-specific guidelines for natural gas, crude oil, petroleum and plastics, ores and minerals, and timber.
5. Transportation — the movement of minerals or natural resources and products produced from processing and refining, including by pipeline, barge, rail or truck.
6. Marketing — the activities undertaken to facilitate sale of minerals or natural resources, or products produced from processing and refining, as well as additive blending into fuels provided to a customer’s specifications.

Note that this list is meant to be an *exclusive* list, and activities not so listed should not qualify.

### **Intrinsic Activities**

In the oil and gas industry, companies have struggled at times with fracturing (“fracking”) activities being considered qualified. The requirements for an intrinsic activity will be beneficial for these purposes, as the taxpayer can now determine whether the activity meets each of the following three requirements:

1. Specialized — requires both the personnel performing the activity and any property used in the activity or sold to the customer who is performing the Section 7704(d)(1)(E) activity to be specialized. In addition, for these purposes the personnel and property must be used only in connection with Section 7704(d)(1)(E) activities and have limited use outside of such activities and generally not be easily converted to a use other than performing or supporting a Section 7704(d)(1)(E) activity.
2. Essential — necessary to physically complete the Section 7704(d)(1)(E) activity or comply with federal, state or local law regulating the Section 7704(d)(1)(E) activity.
3. Significant Services — taxpayer personnel have an ongoing or frequent presence at the site (rotating presence at multiple sites is allowed) of the Section 7704(d)(1)(E) activity, and the activities of those personnel are necessary for the partnership to provide its services or to support the Section 7704(d)(1)(E) activity.

### **IRS Rulings Contradicted by Proposed Regulations**

Although the proposed regulations have created some “bright lines” in the areas of minerals and natural resources, there have been several areas identified in which they are in direct contradiction of past private letter rulings. Based on these new regulations, the IRS has indicated that certain activities should not qualify, such as the pulp production activities and the processing of certain petroleum-related products.

### **Timing & Transition Period**

For those MLPs that had previously received a private letter ruling that is inconsistent with the proposed regulations or that were treating income as qualifying income prior to the issuance of the proposed regulations based on a reasonable interpretation of the statute, a transition period has been put into place to allow these businesses to continue to treat the income as qualifying until the end of the 10th year after the final regulations are published. An MLP is eligible for this transition period only if it was in existence before May 6, 2015.

The IRS has requested comments on the proposed regulations by August 4, 2015, and a public hearing will likely be held as well.

## **Alvarez & Marsal Taxand Says:**

While these proposed regulations provide clarity in certain respects regarding what activities and income will fall within the requirements of “qualifying income” for treatment as an MLP, the regulations also present a narrowing in some respects. As a result, we anticipate there will be considerable comments on those activities that are not clearly specified as qualifying as well as how the transition period would work, particularly in the context of an MLP that has received a prior ruling that its income is “qualifying income.”

If your company operates in this space or is potentially contemplating converting to an MLP, we recommend that you review these proposed regulations closely to understand whether your business would continue to qualify or qualify in the future under such new rules. This may also affect your current monitoring of your income and activities to ensure that they continue to qualify.

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