

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-132634-14]

RIN 1545-BM43

Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 7704(d)(1)(E) of the Internal Revenue Code (Code) relating to qualifying income from exploration, development, mining or production, processing, refining, transportation, and marketing of minerals or natural resources. The proposed regulations affect publicly traded partnerships and their partners.

DATES: Comments and requests for a public hearing must be received by August 4, 2015.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-132634-14), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-132634-14), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent

electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-132634-14).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Caroline E. Hay at (202) 317-5279; concerning the submissions of comments and requests for a public hearing, Regina Johnson at (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 7704(d)(1)(E) regarding qualifying income from certain activities with respect to minerals or natural resources.

Congress enacted section 7704 in the Omnibus Budget Reconciliation Act of 1987, Public Law 100–203 (101 Stat. 1330 (1987)), due to concerns that the rapid growth of certain publicly traded partnerships was eroding the corporate tax base. See H.R. REP. NO. 100-391, at 1065 (1987). Section 7704(a) provides that, as a general rule, publicly traded partnerships will be treated as corporations. In section 7704(c), Congress provided an exception from this rule if 90 percent or more of the partnership’s gross income is “qualifying income.” Qualifying income is generally passive-type income, such as interest, dividends, and rent. Section 7704(d)(1)(E) provides, however, that qualifying income also includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or marketing of minerals or natural resources. Section 7704(d)(1) defines the term “mineral or natural resource” as any product for which a deduction for depletion is allowed under section

611, except soil, sod, dirt, turf, water, mosses, or minerals from sea water, the air, or other similar inexhaustible sources.

Regulations have been published providing guidance on (1) when a partnership is publicly traded (§ 1.7704-1), (2) transition rules for partnerships in existence prior to the effective date of section 7704 (§ 1.7704-2), and (3) qualifying income from certain financial products (§ 1.7704-3). No regulations have been issued under section 7704(d)(1)(E). Instead, questions about the specific application of section 7704(d)(1)(E) generally have been resolved by private letter ruling. However, the number of private letter ruling requests received has increased steadily from five or fewer requests per year for most years before 2008 to more than 30 requests received in 2013. Many of these requests seek rulings that income from support services provided to businesses engaged in the section 7704(d)(1)(E) activities is qualifying income for purposes of section 7704. The Treasury Department and the IRS are issuing these proposed regulations in response to this increased interest in the application of section 7704(d)(1)(E).

These proposed regulations provide guidance on whether income from activities with respect to minerals or natural resources as defined in section 7704(d)(1) is qualifying income. These regulations do not address the transportation or storage of any fuel described in section 6426(b), (c), (d), or (e), or activities with respect to industrial source carbon dioxide, any alcohol fuel defined in section 6426(b)(4)(A), or any biodiesel fuel as defined in section 40A(d)(1). The Treasury Department and the IRS request comments concerning whether guidance is also needed with respect to those activities and, if so, the specific issues such guidance should address.

Explanation of Provisions

These proposed regulations use the term “qualifying activities” to describe activities relating to minerals or natural resources that generate qualifying income. Qualifying activities include: (1) the exploration, development, mining or production, processing, refining, transportation, or marketing of minerals or natural resources (section 7704(d)(1)(E) activities), and (2) certain limited support activities that are intrinsic to section 7704(d)(1)(E) activities (an “intrinsic activity”). These proposed regulations set forth the requirements under which an activity is a qualifying activity.

1. Section 7704(d)(1)(E) activities

Section 7704(d)(1)(E) activities represent different stages in the extraction of minerals or natural resources and the eventual offering of products for sale. These stages include exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), and marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). Each of these stages involves various types of operations. Based in part on discussions with IRS engineers specializing in the various oil and natural resource fields, the proposed regulations provide an exclusive list of operations that comprise the section 7704(d)(1)(E) activities for purposes of section 7704. This list may be expanded by published guidance. The Treasury Department and the IRS intend that this list represents only those activities that would be undertaken by an exploration and development company, a mining or production company, a refiner or processor, or a

transporter or marketer of a mineral or natural resource. Services provided to those businesses are not section 7704(d)(1)(E) activities, although they may qualify as intrinsic activities. The Treasury Department and the IRS request comments concerning whether additional activities should be included in the list of section 7704(d)(1)(E) activities.

A. Exploration

These proposed regulations define exploration as 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. A partnership is engaged in exploration if the partnership: (i) drills an exploratory or stratigraphic type test well; (ii) conducts drill stem and production flow tests to verify commerciality of the deposit; (iii) conducts geological or geophysical surveys; or (iv) interprets data obtained from geological or geophysical surveys. For minerals, exploration also includes testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146) if conducted prior to development activities with respect to the minerals.

B. Development

These proposed regulations define development as an activity performed to make minerals or natural resources accessible. A partnership is engaged in development if the partnership: (i) drills wells to access deposits of mineral or natural resources; (ii) constructs and installs drilling, production, or dual purpose platforms in marine locations (or constructs and installs any similar supporting structures necessary for extraordinary non-marine terrain such as swamps or tundra); (iii) completes wells

including by installing lease and well equipment (such as pumps, flow lines, separators, and storage tanks) so that wells are capable of producing oil and gas, and the production can be removed from the premises; (iv) performs a development technique (for example, fracturing for oil and natural gas, or, with respect to minerals, stripping, benching and terracing, dredging by dragline, stoping, and caving or room-and-pillar excavation); or (v) constructs and installs gathering systems and custody transfer stations.

C. Mining or production

These proposed regulations define mining or production as an activity performed to extract minerals or other natural resources from the ground. A partnership is engaged in mining or production if the partnership: (i) operates equipment to extract natural resources from mines or wells, or (ii) operates equipment to convert raw mined products or raw well effluent to substances that can be readily transported or stored (including by passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water).

D. Processing or refining

Because processing and refining activities vary with respect to different minerals or natural resources, these proposed regulations provide industry-specific rules (described herein) for when an activity qualifies as processing or refining. In general, however, these proposed regulations provide that an activity is processing or refining if it is done to purify, separate, or eliminate impurities. These proposed regulations further

require that, for an activity to be treated as processing or refining, the partnership's position that an activity is processing or refining for purposes of section 7704 must be consistent with the partnership's designation of an appropriate Modified Accelerated Cost Recovery System (MACRS) class life for assets used in the activity in accordance with Rev. Rul. 87-56 (1987-2 CB 27) (for example, MACRS asset class 13.3 for petroleum refining facilities). In addition, except as specifically provided otherwise, processing or refining does not include activities that cause a substantial physical or chemical change in a mineral or natural resource, or that transform the extracted mineral or natural resource into new or different mineral products, including manufactured products. The Treasury Department and the IRS believe that this rule is consistent with definitions found elsewhere in the Code and regulations. See, for example, § 1.613-4(g)(5).

With respect to natural gas, an activity is processing or refining only if the activity purifies natural gas, including by removal of oil or condensate, water, and non-hydrocarbon gases (including carbon dioxide, hydrogen sulfide, nitrogen, and helium), or separates natural gas into its constituents which are normally recovered in a gaseous phase (for example, methane and ethane) and those which are normally recovered in a liquid phase (for example, propane and butane, pentane and gas condensate). It is generally anticipated that activities that create the products listed in the 2012 version (the most recent version as of the date of publication of these proposed regulations) of North American Industry Classification System (NAICS) code 211112 concerning natural gas liquid extraction will be qualifying activities. Processing will also include

converting methane in one integrated conversion into liquid fuels that are otherwise produced from the processing of crude oil, as described in the following paragraph.

With respect to crude oil, an activity is processing or refining if the activity is performed to physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes, and similar products. An activity that chemically converts the physically separated components is processing or refining of crude oil only if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost-effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline). It is generally anticipated that activities within a refinery that create the products that are listed in the 2012 version (the most recent version as of the date of publication of these proposed regulations) of NAICS code 324110 concerning petroleum refineries will be qualifying activities, if those products are refinery grade products that are obtained in the steps required to make fuels, lubricating base oils, waxes, and similar products. Additionally, physically separating any product that is itself generated by the processing or refining of crude oil is a qualifying activity for purposes of section 7704(d)(1)(E).

The production of plastics and similar petroleum derivatives does not give rise to qualifying income derived from processing or refining. See H.R. REP. NO. 100-495, at 947 (1987) (Conf. Rep.). The following products are also not qualifying products under this standard: (1) heat, steam, or electricity produced by the refining processes; (2) products that are obtained from third parties or produced onsite for use in the

refinery, such as hydrogen, if excess amounts are sold; and (3) any product that results from further chemical change of the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil (for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as to anode-grade coke) does not qualify because it is further chemically changed).

With respect to ores and minerals, an activity is processing or refining if the activity is listed in Treasury Regulation § 1.613-4(f)(1)(ii) or (g)(6)(iii). Generally, refining of ores and minerals is any activity that eliminates impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as for example, the refining of blister copper.

With respect to timber, an activity is processing if it merely modifies the physical form of timber. Processing includes the application of heat or pressure to timber without adding any foreign substances. Processing of timber does not include activities that use chemicals or other foreign substances to manipulate timber's physical or chemical properties, such as using a digester to produce pulp. Products that result from timber processing include wood chips, sawdust, untreated lumber, veneers (unless a foreign substance is added), wood pellets, wood bark, and rough poles. Products that are not the result of timber processing include pulp, paper, paper products, treated lumber, oriented strand board, plywood, and treated poles.

These proposed regulations reserve the provisions relating to fertilizer. The Treasury Department and the IRS request comments on what activities should be included.

E. Transportation

These proposed regulations define transportation as the movement of minerals or natural resources and products produced from processing and refining, including by pipeline, barge, rail, or truck. Transportation also includes terminalling, providing storage services, and operating custody transfer stations and gathering systems. Transportation includes the construction of a pipeline only to the extent that a pipe is run to connect a client to a preexisting interstate or intrastate line owned by the publicly traded partnership (interconnect agreement). Transportation (except for pipeline transportation) does not include transportation of oil or gas (or oil or gas products) to a place that sells or dispenses to retail customers. See H.R. REP. NO. 100-795, at 401 (1988). The legislative history accompanying section 7704 clarifies that “a retail customer does not include a person who acquires the oil or gas for refining or processing, or partially refined or processed products thereof for further refining or processing, ... [or a] utility providing power to customers.” See H. R. REP. NO. 100-1104, vol. 2, at 18 (1988) (Conf. Rep.). By contrast, “transporting refined petroleum products by truck to retail customers is not a qualifying activity.” *Id.* However, transportation includes bulk transportation, so long as the transportation is not to a place that sells or dispenses oil and gas (or oil and gas products) to retail customers. See S. REP. NO. 100-445, at 424 (1988).

F. Marketing

These proposed regulations define marketing as the activities undertaken to facilitate sale of minerals or natural resources, or products produced from processing and refining. Marketing may also include some additive blending into fuels provided to a

customer's specification. The legislative history of section 7704 provides that marketing does not include activities and assets involved primarily in sales "to end users at the retail level." S. REP. NO. 100-445, at 424 (1988). Therefore, marketing does not include retail sales (sales made in small quantities directly to end users). For example, gas station operations are not included in marketing for purposes of section 7704(d)(1)(E). Id. However, marketing includes bulk and wholesale sales made to end users. See, for example, H.R. REP. 100-1104, at 18 (1988) (Conf. Rep.) (with respect to fertilizer) and incorporating in footnote 1, 133 CONG. REC. 37957 (December 22, 1987) (statement of Sen. Bentsen with respect to propane).

2. Intrinsic Activities

The Treasury Department and the IRS believe that certain limited support activities intrinsic to section 7704(d)(1)(E) activities also give rise to qualifying income because the income is "derived from" the section 7704(d)(1)(E) activities. The proposed regulations set forth three requirements for a support activity to be intrinsic to section 7704(d)(1)(E) activities. An activity will qualify as an intrinsic activity only if the activity is specialized to support the 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. If each of these requirements is met, the activity is an intrinsic activity, and any income received from the activity is qualifying income. The Treasury Department and IRS intend that intrinsic activities constitute active support of section 7704(d)(1)(E) activities, and not merely the supply of goods.

A. Specialized

An activity meets the first requirement of the intrinsic test if both the personnel performing the activity and any property used in the activity or sold to the customer performing the section 7704(d)(1)(E) activity are specialized. Personnel are specialized if they have received training unique to the mineral or natural resource industries that is of limited utility other than to perform or support a section 7704(d)(1)(E) activity. An activity cannot be an intrinsic activity without specialized service personnel because all intrinsic activities require the provision of significant services (as described in part 3.C of the Explanation of Provisions section of this Preamble). For example, catering services provided to employees at a drilling site would not give rise to qualifying income because catering services do not require skills (or equipment as explained below) limited to supporting a section 7704(d)(1)(E) activity. As such, catering services are not intrinsic activities and any income from those services is not qualifying income for purposes of section 7704(c).

If an activity also involves the sale, provision, or use of property, then the property must qualify as specialized for the activity to be an intrinsic activity. The proposed regulations provide two alternative tests under which that property can qualify as specialized. Under the first test, property is specialized if it is used only in connection with section 7704(d)(1)(E) activities and has limited use outside of those activities. That property must also not be easily converted to a use other than performing or supporting a section 7704(d)(1)(E) activity. Whether property is easily converted is determined based on all facts and circumstances, including the cost to convert the property.

Under the second test, property that can be used for purposes other than to perform or support a section 7704(d)(1)(E) activity will qualify as specialized to the extent that the property is used as an injectant to perform a section 7704(d)(1)(E) activity, 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. Injectants under this definition include, for example, water, lubricants, and sand used in connection with section 7704(d)(1)(E) activities.

B. Essential

An activity meets the second requirement of the intrinsic test if the activity is essential to a section 7704(d)(1)(E) activity. An activity is essential if it is necessary to (a) physically complete the section 7704(d)(1)(E) activity (including in a cost effective manner in order to make the activity economically viable), or (b) comply with federal, state or local law regulating the section 7704(d)(1)(E) activity. For example, water delivery and disposal services are essential when provided for use in fracturing because the water must be used to complete the drilling operations (a development activity under section 7704(d)(1)(E)) and because the water disposal services must be performed to comply with federal, state, or local law regulating drilling and fracturing. Legal, financial, consulting, accounting, insurance, and other similar services are not essential to a section 7704(d)(1)(E) activity because the connection to completion of the section 7704(d)(1)(E) activity is too attenuated.

C. Significant Services

An activity meets the third requirement of the intrinsic test if the activity includes the provision of significant services. A partnership provides significant services if its personnel have an ongoing or frequent presence at the site 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. A partnership that provides the same services to multiple clients may satisfy this test by performing the activity through a rotating presence at multiple sites. For this purpose, determining whether services are ongoing or frequent is determined under all facts and circumstances, including recognized best practices in the relevant industry. The Treasury Department and the IRS request comments on whether and how this requirement could be set forth as an objective standard.

In addition, the proposed regulations acknowledge that a qualifying activity in which the partnership engages could require extensive offsite services. Therefore, these proposed regulations provide that the services may be conducted offsite if the services are performed on an ongoing or frequent basis and offered exclusively for those engaged in one or more section 7704(d)(1)(E) activities. For example, monitoring services will satisfy the significant services requirement if the monitoring is done on an ongoing or frequent basis only to support persons engaged in one or more section 7704(d)(1)(E) activities.

The proposed regulations also identify certain activities that do not qualify as significant services because they involve the manufacture and sale or temporary provision of a good. Thus, the design, construction, manufacturing, repair,

maintenance, lease, rent, or temporary provision of assets is not taken into account when determining whether a partnership has provided significant services.

Proposed Effective/Applicability Date and Transition Rules

Except for rules concerning the Transition Period, these regulations are proposed to apply to income earned by a partnership in a taxable year beginning on or after the date these regulations are published as final regulations in the Federal Register. These regulations also provide for a Transition Period, which ends on the last day of the partnership's taxable year that includes the date that is ten years after the date that these regulations are published as final regulations in the **Federal Register**.

The proposed regulations provide that a partnership may treat income from an activity as qualifying income during the Transition Period if the partnership received a private letter ruling from the IRS holding that income from the activity is qualifying income. In addition, a partnership may treat income from an activity as qualifying income during the Transition Period if, prior to May 5, 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. In determining whether an interpretation was reasonable, the legislative history and interpretations applied by the IRS prior to the issuance of these proposed regulations are taken into account. An interpretation was not reasonable merely because a partnership had a reasonable basis for that position. With respect to an activity undertaken prior to May 6, 2015, , no inference is intended that an activity

that is not described in these proposed regulations as a qualifying activity did or did not produce qualifying income under the statute and legislative history.

A partnership that is publicly traded and engages in an activity after May 6, 2015, but before the date these regulations are published as final regulations in the **Federal Register** may treat income from that activity as qualifying income during the Transition Period if the income from that activity is qualifying income under these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these proposed regulations. Because these proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The IRS and the Treasury Department request comments on all aspects of the proposed rules. All comments will be available at www.regulations.gov or upon request. A public hearing will be

scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Caroline E. Hay, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.7704-4 is added to read as follows:

§1.7704-4 Qualifying income – mineral and natural resources.

(a) In general. For purposes of section 7704(d)(1)(E), qualifying income includes only income and gains from qualifying activities with respect to minerals or natural resources as defined in paragraph (b) of this section. For purposes of section 7704(d)(1)(E), qualifying activities include section 7704(d)(1)(E) activities (as described

in paragraph (c) of this section) and intrinsic activities (as described in paragraph (d) of this section).

(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).

(c) Section 7704(d)(1)(E) activities--(1) Definition. Section 7704(d)(1)(E) activities include the exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource as limited to those activities described in this paragraph (c) or as provided by the Commissioner by notice or in other forms of published guidance. No other activities qualify as section 7704(d)(1)(E) activities.

(2) Exploration. An activity constitutes exploration if it is 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 by:

- (i) Drilling an exploratory or stratigraphic type test well;
- (ii) Conducting drill stem and production flow tests to verify commerciality of the deposit;

(iii) Conducting geological or geophysical surveys;

(iv) Interpreting data obtained from geological or geophysical surveys; or

(v) For minerals, testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146), (see § 601.601(d)(2)(ii)(b) of this chapter) if conducted prior to development activities with respect to the minerals.

(3) Development. An activity constitutes development if it is performed to make accessible minerals or natural resources by:

- (i) Drilling wells to access deposits of mineral or natural resources;
- (ii) Constructing and installing drilling, production, or dual purpose platforms in marine locations, or any similar supporting structures necessary for extraordinary non-marine terrain (such as swamps or tundra);
- (iii) Completing wells, including by installing lease and well equipment, such as pumps, flow lines, separators, and storage tanks, so that wells are capable of producing oil and gas, and the production can be removed from the premises;
- (iv) Performing a development technique such as, for minerals, stripping, benching and terracing, dredging by dragline, stoping, and caving or room-and-pillar excavation, and for oil and natural gas, fracturing; or
- (vi) Constructing and installing gathering systems and custody transfer stations.

(4) Mining or production. An activity constitutes mining or production if it is performed to extract minerals or other natural resources from the ground by:

- (i) Operating equipment to extract natural resources from mines and wells; or
- (ii) Operating equipment to convert raw mined products or raw well effluent to

substances that can be readily transported or stored (for example, passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water).

(5) Processing or refining--(i) In general. Except as otherwise provided in paragraph (c)(5) of this section, an activity is processing or refining if it is done to purify, separate, or eliminate impurities. For an activity to be treated as processing or refining for purposes of this section, the partnership's position that an activity is processing or refining for purposes of this section must be consistent with the partnership's designation of an appropriate Modified Accelerated Cost Recovery System (MACRS) class life for assets used in the activity in accordance with Rev. Rul. 87-56, 1987-2 CB 27 (see § 601.601(d)(2)(ii)(b) of this chapter). For example, for an activity to be processing or refining of crude oil under paragraph (c)(5)(iii) of this section, the assets used in that process must also have a MACRS class life of 13.3, Petroleum Refining. Unless otherwise provided in this paragraph (c)(5), an activity will not qualify as processing or refining if the activity 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.

(ii) Natural Gas. An activity constitutes processing of natural gas if it is performed to:

(A) Purify natural gas, including by removal of oil or condensate, water, or non-hydrocarbon gases (including carbon dioxide, hydrogen sulfide, nitrogen, and helium);

(B) Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and gas condensate); or

(C) Convert methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.

(iii) Petroleum--(A) Qualifying activities. An activity constitutes processing or refining of petroleum if the end products of these processes are not plastics or similar petroleum derivatives and the activity is performed to:

(1) Physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes and similar products;

(2) Chemically convert the physically separated components if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline); or

(3) Physically separate products created through activities described in paragraph (c)(5)(iii)(A)(1) or (2) of this section.

(B) Non-qualifying activities. For purposes of this section, the following products are not obtained through processing of petroleum:

(1) Heat, steam, or electricity produced by the refining processes;

(2) Products that are obtained from third parties or produced onsite for use in the refinery, such as hydrogen, if excess amounts are sold; and

(3) Any product that results from further chemical change of the product produced from the separation of the crude oil if it is not combined with other products separated from the crude oil (for example, production of petroleum coke from heavy (refinery) residuum qualifies, but any upgrading of petroleum coke (such as to anode-grade coke) does not qualify because it is further chemically changed).

(iv) Ores and minerals. An activity constitutes processing or refining of ores and minerals if it meets the definition of mining processes under § 1.613-4(f)(1)(ii) or refining under § 1.613-4(g)(6)(iii). Generally, refining of ores and minerals is any activity that eliminates impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as for example the refining of blister copper.

(v) Timber. An activity constitutes processing of timber if it is performed to modify the physical form of timber, including by the application of heat or pressure to timber, without adding any foreign substances. Processing of 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. Products that result from timber processing include wood chips, sawdust, rough lumber, kiln-dried lumber, veneers, wood pellets, wood bark, and rough poles. Products that are not the result of timber processing include pulp, paper, paper products, treated lumber, oriented strand board/plywood, and treated poles.

(vi) Fertilizer. [Reserved]

(6) Transportation. Transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section, including by pipeline, barge, rail, or truck, except for transportation (not including pipeline

transportation) to a place that sells or dispenses to retail customers. Retail customers do not include a person who acquires oil or gas for refining or processing, or a utility.

The following activities qualify as transportation--

- (i) Providing storage services;
- (ii) Terminalling;
- (iii) Operating gathering systems and custody transfer stations;
- (iv) Operating pipelines, barges, rail, or trucks; and
- (v) Construction of a pipeline 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).

(7) Marketing. An activity constitutes marketing if it is performed to facilitate sale of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section, including blending additives into fuels. Marketing does not include activities and assets involved primarily in retail sales (sales made in small quantities directly to end users), which includes, but is not limited to, operation of gasoline service stations, home heating oil delivery services, and local gas delivery services.

(d) Intrinsic activities--(1) General requirements. An activity is 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.

(2) Specialization. An activity is a specialized activity if:

(i) The partnership provides personnel to perform or support a section 7704(d)(1)(E) activity and those personnel have received training unique to the mineral or natural resource industry that is of limited utility other than to perform or support a section 7704(d)(1)(E) activity; and

(ii) To the extent that the activity includes the sale, provision, or use of property, either:

(A) The property is primarily tangible property that is dedicated to, and has 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; or

(B) The 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.

(3) Essential--(i) An activity is essential to the section 7704(d)(1)(E) activity if it is required to--

(A) Physically complete a section 7704(d)(1)(E) activity (including in a cost effective manner, such as by making the activity economically viable), or

(B) Comply with federal, state, or local law regulating the section 7704(d)(1)(E) activity.

(ii) Legal, financial, consulting, accounting, insurance, and other similar services do not qualify as essential to a section 7704(d)(1)(E) activity.

(4) Significant services--(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.

(e) Examples. The following examples illustrate the provisions of this section:

Example 1. Petrochemical products sourced from an oil and gas well. (i) Z, a publicly traded partnership, chemically converts a mixture of ethane and propane (obtained from physical separation of natural gas) into ethylene, propylene, and other gases through use of a steam cracker.

(ii) Z's activities chemically convert physically separated components of natural gas. The chemical conversion of physically separated components of natural gas (ethane and propane) is not an activity that gives rise to qualifying income under paragraph (c)(5)(ii) of this section. Therefore, the income Z receives from the sale of ethylene and propylene is not qualifying income for purposes of section 7704(d)(1)(E).

Example 2. Petroleum streams chemically converted into refinery grade olefins byproducts. (i) Y, a publicly traded partnership, owns a petroleum refinery. Y classifies Y's assets used in the activity described in this paragraph under MACRS class 13.3 (Petroleum Refining). The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic cracking unit to chemically convert the heavy gas oil into a liquid stream suitable for gasoline blending and a gas stream containing ethane, ethylene, and other gases. The refinery also further physically separates the gas stream without additional chemical change, resulting in refinery grade ethylene. Y sells the ethylene to a third party.

(ii) Y's activities are performed to physically separate crude oil into its component parts and to chemically convert the separated heavy gas oil into a liquid stream for recombining with other physically separated components of crude oil. Y has classified its assets used in that activity under an appropriate MACRS code pursuant to paragraph (c)(5)(i) of this section. Income Y receives from the liquid stream is qualifying income pursuant to paragraph (c)(5)(iii)(A)(2) of this section. Y's further physical separation of the gas stream produces ethane, ethylene, and other gases. Pursuant to paragraph (c)(5)(iii)(A)(3), income Y receives from the physically separated gases is qualifying income because the heavy gas oil was chemically converted as part of a processing activity pursuant to paragraph (c)(5)(iii)(A)(2) of this section.

Example 3. Processing methane gas into synthetic fuels through chemical change. (i) Y, a publicly traded partnership, chemically converts methane into methanol and synthesis gas, and further chemically converts those products into gasoline and diesel fuel. Y receives income from sales of gasoline and diesel created during the conversion processes, as well as from sales of methanol.

(ii) With respect to the production of gasoline or diesel, Y is engaged in the processing of natural gas as provided in paragraph (c)(5)(ii)(C) of this section. The production and sale of methanol, an intermediate product in the conversion process, is not a section 7704(d)(1)(E) activity because methanol is not a liquid fuel otherwise produced from the processing of crude oil.

Example 4. Delivery of refined products. (i) X, a publicly traded partnership, sells diesel and lubricating oils to a government entity at wholesale prices and delivers those goods in bulk.

(ii) X's sale of refined products to the government entity is a section 7704(d)(1)(E) activity because it is a bulk transportation and sale as described in paragraphs (c)(6) and (7) of this section and is not a retail sale.

Example 5. Delivery of water. (i) X, a publicly traded partnership, owns interstate and intrastate natural gas pipelines. X built a water delivery pipeline along the existing right of way for its natural gas pipeline to deliver water to A for use in A's fracturing activity. A uses the delivered water in fracturing to develop A's natural gas

reserve in a cost-efficient manner. X earns income for transporting natural gas in the pipelines and for delivery of water.

(ii) X's income from transporting natural gas in its interstate and intrastate pipelines is qualifying income for purposes of section 7704(c) because transportation of natural gas is a section 7704(d)(1)(E) activity as provided in paragraph (c)(6) of this section.

(iii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph (c) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section. An activity is an intrinsic activity if the activity is specialized to narrowly support the 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. Under paragraph (d)(2)(ii)(B) of this section, the provision of water used in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership also collects and cleans, recycles, or otherwise disposes of the water after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities. Because X does not collect and clean, recycle, or otherwise dispose of the delivered water after use, X's water delivery activities are not specialized to narrowly support the section 7704(d)(1)(E) activity. Thus, X's water delivery is not an intrinsic activity. Accordingly, X's income from the delivery of water is not qualifying income for purposes of section 7704(c).

Example 6. Delivery of water and recovery and recycling of flowback.

(i) Assume the same facts as in Example 5, except that X also collects and treats flowback at the drilling site in accordance with state regulations as part of its water delivery services and transports the treated flowback away from the site. In connection with these services, X provides personnel to perform these services on an ongoing or frequent basis that is consistent with best industry practices. X has provided these personnel with specialized training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas.

(ii) The income X obtains from its water delivery services is not a section 7704(d)(1)(E) activity as provided in paragraph (d) of this section. However, because X's water delivery supports A's development of natural gas, a section 7704(d)(1)(E) activity, X's income from water delivery services may be qualifying income for purposes of section 7704(c) if the water delivery service is an intrinsic activity as provided in paragraph (d) of this section.

(iii) An activity is an intrinsic activity if the activity is specialized to narrowly support the 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. Under paragraph (d)(2)(ii)(B) of this section, the provision of water used in a section 7704(d)(1)(E) activity is specialized to that activity only if the partnership also collects and cleans, recycles, or otherwise disposes of the water after use in accordance with federal, state, or local regulations concerning waste products from mining or production activities. X's provision of personnel is specialized because those personnel received training regarding the recovery and recycling of flowback produced during the development of natural gas, and this training is of limited utility other than to perform or support the development of natural gas. The provision of water is also specialized because water is an injectant used to perform a section 7704(d)(1)(E) activity, and X also collects and treats flowback in accordance with state regulations as part of its water delivery services. Therefore, X meets the specialized requirement. The delivery of water is essential to support A's development activity because the water is needed for use in fracturing to develop A's natural gas reserve in a cost-efficient manner. Finally, 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. Because X's delivery of water and X's collection, transport, and treatment of flowback is a specialized activity, is essential to the completion of a section 7704(d)(1)(E) activity, and requires significant services, the delivery of water and the transport and treatment of flowback is an intrinsic activity. X's income from the delivery of water and the collection, treatment, and transport of flowback is qualifying income for purposes of section 7704(c).

(f) Proposed Effective/Applicability Date and Transition Rule--(i) Except as provided in paragraph (f)(ii) of this section, this section is proposed to apply to income earned by a partnership in a taxable year beginning on or after the date these regulations are published as final regulations in the Federal Register. Paragraph (f)(ii) of this section applies during the Transition Period, which ends on the last day of the partnership's taxable year that includes the date that is ten years after the date that these regulations are published as final regulations in the **Federal Register**.

(ii) A partnership may treat income from an activity as qualifying income during the Transition Period if:

(A) The partnership received a private letter ruling 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, 2016, 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.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

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