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Via Federal eRulemaking Portal

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

Re: Comments on Code Section 7704 Proposed Regulations (REG -- 132634 -- 14)

Dear Sir or Madam:

Vinson & Elkins LLP appreciates the opportunity to submit this letter in response to the request for comments on the proposed regulations (REG – 132634 – 14) (the "Proposed Regulations") under section 7704(d)(1)(E) of the Internal Revenue Code of 1986, as amended (the "Code"), relating to qualifying income from the 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. We represent a number of publicly traded partnerships, but these comments are intended to provide what we believe to be a supportable framework for the industry relating to the terms "processing" and "refining," and are not submitted on behalf of any client.

The terms used herein are generally intended to have the same meanings as the corresponding terms used in the Proposed Regulations and the related Explanation of Provisions (the "Preamble"), but we use the terms "qualifying activity," "qualifying process" or "qualifying refining" as shorthand for the term "section 7704(d)(1)(E) activities" that is used in the Proposed Regulations.

This letter expresses our views regarding (i) the meaning of "processing" and "refining" as used in section 7704(d)(1)(E) and (ii) certain statements in the Preamble (and provisions of the Proposed Regulations to the same effect) relating to those terms. In addition, we have included for consideration a proposed definition of "processing" and "refining" that we believe addresses these matters. We may submit additional comments on other topics.

We understand the Internal Revenue Service has been working diligently for over a year to provide guidance with regard to section 7704(d)(1)(E), particularly with respect to the matters referred to as "Intrinsic Activities" in the Proposed Regulations. We are concerned

that in light of the effort made to create a workable definition for "Intrinsic Activities," less time may have been available to develop workable definitions for the statutory terms "processing" and "refining." We appreciate the opportunity given to us through the comment process to provide additional attention to these terms.

We realize it is easier to critique the approach taken in the Proposed Regulations than to provide constructive alternatives. To propose effective definitions for "processing" and "refining" one must consider the appropriate limits of these terms, as well as their breadth. We have attempted to do that. To lay the predicate for our proposed definitions, we start our comments with a discussion of the wording and structure of section 7704(d)(1)(E). We then discuss what we believe are the issues created by the Proposed Regulations. Finally, we put forward detailed proposed definitions of "processing" and "refining" which we believe fully reflect both the scope and the limits Congress intended in adopting section 7704(d)(1)(E).

I. Executive Summary

Section 7704(d)(1)(E) is written in a straightforward manner. For a publicly traded entity to be treated as a pass-through entity for federal income tax purposes, at least 90 percent of its income must be "qualifying income" as provided in section 7704(c)(2). Section 7704(d)(1)(E) specifies the activities relating to minerals or natural resources that can generate qualifying income. The core of that subparagraph provides that qualifying income is derived from specified activities, including the exploration, development, mining or production, processing, refining, transportation or marketing of any mineral or natural resource. These terms are not defined in the statute. It is an established principle of statutory interpretation that when a term is not defined in a statute, it should be given its ordinary and accepted meaning.

The Preamble asserts that the Proposed Regulations are consistent with the limited legislative history and the existing Treasury Regulations that deal with depletion, but, upon a careful reading, we believe the opposite is actually true. The Proposed Regulations create tests that force "processing" and "refining" into narrow and awkward constructions that depart substantially from the literal meaning of the words of the statute, the legislative history, and existing Treasury Regulations, not to mention the reasonable tests applied to those terms in the Internal Revenue Service's ruling practice and by the industry during the last 27 years. For example, the Proposed Regulations provide, subject to a few exceptions, (i) that an activity is processing or refining if, and only if, it is done to purify, separate or eliminate impurities, (ii) that an activity is not processing or refining if the activity causes a substantial physical or chemical change in a mineral or natural resource and (iii) that an activity is not processing or refining if the activity transforms the mineral or natural resource into new or different mineral products or into manufactured products or if the assets used in the activity are not depreciated based on a MACRS class life "appropriate" for processing or refining assets.

The Proposed Regulations also provide that processing methane (the principal component in natural gas and clearly a natural resource) into methanol is not a qualifying activity unless the methanol is used as a fuel, and they provide a much longer list of qualifying activities related to crude oil as compared to the list of qualifying activities for natural gas. As they relate to ores and minerals, the Proposed Regulations, without any clear support, appear to limit the terms "processing" and "refining" almost entirely to activities that are defined as "mining" in Treas. Reg. § 1.613-4. With respect to timber, the Proposed Regulations are very restrictive in stating that several products, including treated lumber, treated poles and pulp, are not the result of timber processing.

These treatments are not based on any words in section 7704(d)(1)(E) or its legislative history, and are inconsistent with, or are not supported by, natural resource depletion concepts and certainly do not spring from common usage of the words "processing" and "refining."

The statute and its legislative history are clear. Like the other activities to which section 7704(d)(1)(E) refers, each of the terms "processing" and "refining" were intended to be given their common sense meaning. The fact that both words appear in the statute without any qualifications indicates that Congress did not intend restrictive meanings. The principal limitation in the statute is the requirement that a mineral or natural resource, and no other material of substance, be the source material for a qualifying activity.

With regard to the need to find Congressional intent in the common usage of the words in section 7704(d)(1)(E), the Regulations ignore the diversity and complexity of the numerous activities that are commonly known as processing and refining of oil, gas and the products thereof. For example, based on common usage, there should be no issue that the production of chemical feedstocks from oil, gas or the products thereof, whether in a traditional refinery or in a standalone plant, is processing or refining.

With respect to ores, minerals and timber, the Proposed Regulations appear to completely abandon common usage of the terms "processing" and "refining." We believe there should be no issue based on common usage that traditional activities such as coking of coal should be qualifying. We also believe, for example, that the conversion of pulpwood to pulp is clearly the processing of timber.

Lastly, we do not believe it is practical to create a workable list of all activities that are "processing" and "refining" as the Proposed Regulations attempt to do. If it were practical to create some type of list, we believe that list would need a conceptual underpinning. As a result, in Part IV of our comments we propose definitions for "processing" and "refining." Because the statute and its legislative history have provided effective guidelines for the Internal Revenue Service and counsel during the last 27 years, we believe the unusual approach of incorporating an exclusive list in regulations, even if practical, is unnecessary.

II. Interpreting the Meaning of Processing and Refining

The meaning of the terms processing and refining can be best be obtained by considering the words of the statute, common and consistent usage of those words, and the impact, if any, of the relevant but limited legislative history.

A. Statutory Construction of Section 7704(d)(1)(E)

Section 7704(d)(1)(E) simply states that qualifying income consists of the following:

> "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..."

The statute describes what is in effect the life cycle of a mineral or natural resource: the mineral or natural resource is explored for, and if found, developed, produced or mined, processed, refined, transported, and ultimately marketed. At each stage, the subject of the action must be a product "of a character" that is at the time of its production or extraction subject to depletion under section 611, but need not be subject to depletion at any point thereafter. If this test is met, there is no other limitation in the statute on the character of the product at the inception or at the conclusion of any stage in its life cycle. However, as discussed below, the legislative history does identify Congressionally intended limits regarding the point at which a product loses its character as a mineral or natural resource for purposes of section 7704(d)(1)(E).

Processing and refining are what happens after a mineral or natural resource is produced or mined. The statute provides that qualifying income will be derived from the processing or the refining "of any mineral or natural resource." Looking further at the words of the statute, unlike the reference in section 7704(d)(1)(E) to mining or production, there is no "or" between processing and refining. The "or" between "mining or production" in the statute indicates some minerals and natural resources are mined and some minerals and natural resources are produced. In contrast, the lack of the word "or" between processing and refining indicates minerals and natural resources can be both processed and refined. Each of oil, gas and the products thereof can be both processed and refined. The same is true of an ore.

Although it is not uncommon to use the words "processing" and "refining" interchangeably to refer to the same activity, it follows that the two words (processing and refining) together were intended by Congress to be more inclusive than either word alone. If something is processed but not refined, or refined but not processed, it is still a qualifying activity. Therefore, as we discuss further below, because an activity relating to oil, gas or the products thereof does not occur in a refinery does not mean that the activity is not processing or refining. In addition, the fact that the word "processing" occurs before the word

"refining" does not limit the meaning of the words "processing" or "refining" to field processing. The order of the words in the statute is not controlling. After all, transportation often occurs before processing or refining, but it appears after both words in the statute.

In the case of ores and minerals, non-mining processes are defined in Treas. Reg. §§ 1.613-4(g)(1) though (6). Subsection 1.613-4(g)(5) expressly defines refining as it applies to ores and minerals. Thus, Treas. Reg. § 1.613-4(g) clearly indicates that ores and minerals can be subject to both processing and refining activities.

Both processing and refining are transitive verbs whose object is the input, not the output. For example, one processes or refines crude oil or natural gas to get various outputs. Thus, we believe it is clear that the definition of "mineral or natural resource" identifies the intended inputs of processing or refining under section 7704(d)(1)(E). In other words, what is critical to a qualifying process or refining activity under the statute is what goes **into** that activity (a mineral or natural resource). What is not critical is what goes **on in** that activity (physical or chemical change, transformation, etc.) or what is produced thereby (whether a chemical feedstock or fuel). The words of the statute clearly say that processing or refining a mineral or natural resource generates qualifying income. If we have a mineral or natural resource and it undergoes an operation or activity that is commonly considered to be processing or refining and there is no other significant non-natural resource input into the operation or activity, then income derived from that process or refining should be qualifying income.

B. Common Usage and Consistency

There is nothing in the statute that indicates that the terms "processing" and "refining" should be applied differently depending on the type of mineral or natural resource being processed or refined, nor is there anything in the statute that indicates that its terms should not be given their common sense and independent meanings. A key principle of statutory construction is that, when writing statutes, the legislature intends to use words in their ordinary senses and that the statute means what it says. According to Oxford Dictionaries, the verb forms of the two words have the following definitions:

> Process: To perform a series of mechanical or chemical operations on (something) in order to change or preserve it.
>
> Refine: To remove impurities or unwanted elements from (a substance), typically as part of an industrial process.

Both words have broad meanings, are used commonly and have applications that span a wide range of activities. Nothing in the statute or the legislative history suggests that either word was meant to have (i) any meaning other than its common usage, (ii) a meaning that varies based on the type of mineral or natural resource being processed or refined or (iii) a meaning that overlaps with the other. There is no basis for a Treasury Regulation to suggest

otherwise or to deviate from the plain meaning of the words in the statute. The limiting concept in the statute is that substantially all the input of a qualifying activity (processing or refining) must be a mineral or natural resource of a single type.

If a substantial part of the input of an activity is something other than a mineral or natural resource of a single type, then the activity is not qualifying processing or refining within the meaning of section 7704(d)(1)(E). Whether such activity is called manufacturing or something else is irrelevant; the important point is that it is not processing or refining of a mineral or natural resource within the meaning of section 7704(d)(1)(E). The words "processing" and "refining" are not, and, based on the legislative history, were not intended to be, key restrictive words in the statute.

C. Legislative History

The legislative history includes the following statements which generally expand what might otherwise be considered a mineral or natural resource, but do not attempt to define what is processing or refining:

> "Income and gains from certain activities with respect to minerals or natural resources are treated as passive-type income. Specifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer, includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives."
>
> (H.R. Rep. No. 495, 100th Cong., 1st Sess. At 946-7 (1987))

The important point is that the relevant language in the legislative history defines only the terms "mineral or natural resource." Neither the statute nor the legislative history defines what is a qualifying process or a qualifying refining activity. Section 7704(d)(1)(E) addresses only the input of a qualifying process, not the output. The legislative history defines what is a mineral or natural resource; in other words, it identifies and limits inputs for those activities which are qualifying processing or refining activities.

The last two sentences of the legislative history quoted above have been the source of some confusion regarding the interpretation of processing and refining for purposes of section 7704(d)(1)(E). We believe the confusion disappears when you look carefully at the words of the legislative history, which only address what is a natural resource. They do not

address at all what is processing or refining. The second sentence above provides that natural resources include oil, gas or products thereof. The fourth sentence defines "oil, gas, or products thereof" by way of a list of examples. This list confirms that products of oil and gas processing or refining retain their status as a natural resource. In other words, the list is a recitation of oil and gas products that are natural resources and, therefore, can generate qualifying income when they are further processed, refined, transported or marketed downstream. It does not seek to define processing or refining. The last sentence in the legislative history above makes it clear that, despite the wording in the second sentence, not all oil and gas products are natural resources. Furthermore, it specifies those products that are not natural resources – specifically, plastics or similar petroleum derivatives – meaning they will not generate qualifying income if they are further processed, transported or marketed downstream. The last sentence does not address what is processing or refining, only what is not a natural resource.

III. Comment on Certain Concepts in the Preamble

With Part II as a predicate, the following is a discussion of certain concepts included in the Preamble (and the Proposed Regulations) that we do not believe are supported by the common usage of the words "processing" or "refining," section 7704(d)(1)(E) or the related legislative history.

A. Exclusive List

The Preamble states that "the proposed regulations provide an exclusive list of operations that comprise the section 7704(d)(1)(E) activities for purposes of section 7704." We question whether it is possible to have a workable, exclusive (restrictive) list because of the hundreds of existing processes applied to minerals and natural resources and the fact that technological and economic changes result in the continuous development of new and different processes and refining techniques. As discussed, we believe section 7704(d)(1)(E) is focused on what feedstock is processed or refined, just like it is focused on what is transported or marketed. The articulation of a standard that (i) is consistent with the requirements of section 7704(d)(1)(E), (ii) is based on the plain meanings of the words in that section and (iii) gives effect to the relevant legislative history would be more practical and useful than an exclusive (restrictive) list and would be more consistent with the concepts that have guided the Internal Revenue Service and tax counsel during nearly three decades in determining what processes and refining activities generate qualifying income. Therefore, even if it were possible to now identify all qualifying processes, we believe it is not necessary to do so. In addition, we question how a list could be prepared without overarching and consistently-applied definitions to provide a basis for what is included on the list as processing or refining.

A non-exclusive list of examples of operations that would be processing and/or refining, and a similar list of operations that would not be processing and/or refining, would

certainly be helpful. These types of non-exclusive lists would assist in explaining the operative intent of any definitions of processing and refining.

B. Industry-Specific Rules

The Preamble states: "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."

To the extent this statement is intended to mean that different definitions of processing and refining are needed for each industry, the concept is not supported by section 7704(d)(1)(E) or its legislative history. All that section 7704(d)(1)(E) requires is that a mineral or natural resource be processed or refined. It says nothing about different definitions of processing and refining applied to different types of minerals or natural resources. Also, the relevant language in the legislative history addresses only what materials are minerals or natural resources. As a result, any definition should, like the legislative history, focus on what goes into the process. Congress made no attempt to limit qualifying activities based on what happens in the process or what is produced as an output. The fact that different minerals and natural resources are subjected to different processes should not matter in formulating an overarching definition of processing and refining. Further, we point out the fact that the non-mining processes relating to ores and minerals set forth in Treas. Reg. §§ 1.613-4(g)(1) through (6) do not vary substantially, in any general sense, from the types of activities which are involved in processing or refining oil, gas or products thereof.

C. Physical and Chemical Change

The Preamble states: "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 sole basis for this "no substantial physical or chemical change" rule is its asserted consistency with definitions found elsewhere in the Code and Treasury Regulations, and Treas. Reg. § 1.613-4(g)(5) is cited as an example of that consistency. The language of that regulation is reproduced almost verbatim in the Proposed Regulations as a disqualifying litmus test for processing or refining. However, Treas. Reg. § 1.613-4(g)(5) is directed to identifying processes that are not mining processes, and therefore not a part of "mining" as used in the Treasury Regulation. The fact that such processes are not mining not only fails to cast them as something other than processing or refining for purposes of section 7704(d)(1)(E), but rather strongly suggests the opposite – that they are common processing or refining activities beyond mining.

Under the depletion regulations dealing with oil and natural gas, (i) "crude oil" includes natural gas liquids ("NGLs") recovered from gas well effluent in lease separators or field facilities before any conversion process has been applied (Treas. Reg. § 1.613A-7(g)), and (ii) "refining" means "any operation by which the physical or chemical characteristics of crude oil are changed" (Treas. Reg. § 1.613A-7). If consistency with the depletion rules is an objective, we submit that the Proposed Regulations miss the mark by treating NGLs from a gas stream and NGLs in petroleum differently, and by defining refining in such a way as to exclude the very essence of that process.

There is nothing in section 7704(d)(1)(E) that distinguishes between processing and refining activities that involve physical changes and those that involve chemical changes. All that the statute requires is that a mineral or natural resource be processed or refined, and as discussed elsewhere, the relevant legislative history defines what is a mineral and natural resource.

We believe the words "transform" and "manufactured products" included in the Preamble have no applicability in defining a qualifying activity. Indeed, the standard dictionary definition of "process" includes activities that "change" the input, which is synonymous with "transform." And, again, the specific output of a process has no bearing on whether the process itself is processing or refining. Neither the statute nor the legislative history states or implies that the processing or refining of a mineral or natural resource must not transform the natural resource or manufacture a product. Significantly, neither the statute nor the legislative history even mention these words or concepts. Moreover, one could easily argue that even the processing and refining permitted by the Proposed Regulations transforms minerals and natural resources, and manufactures specific products. Oil and gas refining clearly transforms oil, gas and the products thereof, and manufactures specific products. Even the NAICS codes (discussed further below) recognize that the refining of crude petroleum is a type of manufacturing.

In addition, the Proposed Regulations' application of the "no physical or chemical change" concept, and their misplaced focus on the "product of a process" in determining what is "processing and refining of oil and natural gas," seem not only to disregard the clear meaning of the words in the statute as previously discussed, but also to ignore the processes that have historically been recognized as parts of petroleum refineries. For decades before section 7704(d)(1)(E) was adopted, petroleum refineries produced many different products through various operations, including distillation, cracking, alkylation, desulfurization, desalting and dehydrogenation, among others. A number of these processes involve a chemical change. The number and types of operations in which a particular refinery might engage can vary widely depending on the intended input and output of the refinery. The Preamble itself acknowledges that petroleum refineries produce (or "manufacture") many products, including nonfuels like lubricating oils and waxes, and that substantial physical and chemical changes occur in a refinery cracker and other units. The Preamble seems to overlook that petroleum refineries currently produce, and have for many decades produced,

important nonfuel products like propylene and ethylene, which are key feedstocks for chemical plants. These products, and many other products of a petroleum refinery, are often the result of a chemical change occurring in the refinery.

The Preamble does not take into account the fact that (i) there are many different types of petroleum refineries, (ii) refineries use many different types of petroleum and NGLs as feedstocks and (iii) petroleum can contain methane and NGLs in varying quantities. In fact, some refineries use coal as a feedstock. Others use the bitumin produced from oil sands. Some use naphtha, natural gasoline and/or NGLs as primary feedstocks. There are multipurpose refineries producing many different products. Many refineries, however, specialize in particular products, such as asphalt refineries or refineries that specialize in producing lubricating oil.

Simply because a plant's or refinery's principal purpose is to take propane or ethane (both NGLs) and process (or refine) them, through a chemical process, into propylene or ethylene, does not make those operations something other than processing or refining. Propylene and ethylene have been products of traditional refineries for decades. Further, the fact that a plant (refinery) specializes in producing (either by refining or processing) propylene from propane or other olefins from oil and gas products should not change the qualifying nature of the income derived from the activity.

The confusion and uncertainty created by the Proposed Regulations regarding the processing and refining of ores and minerals is particularly perplexing. Certainly, Congress and, we have to believe, the Internal Revenue Service intend that centuries old activities viewed as processing, such as the conversion of coal to coke, would be treated as qualifying activities. Yet the approach to ores and minerals in the Proposed Regulations certainly raises issues. Common usage of the words processing and refining when applied to ores and minerals, as well as a need to treat ores and minerals on a consistent basis with other types of natural resources, requires changes in the approach taken in the Proposed Regulations.

The Proposed Regulations state, "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 1.613-4(g)(6)(iii)." Treasury Regulation § 1.613-4(f)(1)(ii) defines what are "mining processes" that are included as "mining" for purposes of computing percentage depletion. This reference is therefore appropriate for defining "mining" as used in section 7704(d)(1)(E) but not appropriate for defining "processing" and "refining," which are separate and distinct concepts from mining as used in section 7704(d)(1)(E). "Processing" and "refining" are what happens to an ore or mineral after it is mined. "Nonmining processes" of an ore or mineral are described in Treas. Reg. §§ 1.613-4(g)(1) through (6), not solely subsection (g)(6)(iii) thereof.

Subsection (g)(6)(iii) is the subsection to which the Proposed Regulations refer to define "refining" of an ore or mineral. But even subsection (g)(6)(iii) refers to smelting,

which involves a chemical change when dealing with an ore like iron ore that naturally oxidizes. By referring to subsection (g)(6)(iii), the Proposed Regulations provide that further purifying of a smelted metal is a qualifying activity. It logically follows then that smelting and similar activities referred to in subsection (g)(1) must also be qualifying activities, even though such activities involve a chemical change.

Any definitions of "processing" and "refining" of an ore or mineral should, and can be, completely consistent with the processes described in Treas. Reg. § 1.613-4(g). The common thread is that what goes into each of the processing and refining activities described in Treas. Reg. § 1.613(4)(g) is an ore or mineral and nothing else of substance. Those specified activities are clearly processing or refining a mineral or natural resource within the meaning of section 7704(d)(1)(E).

D. Processing or Refining Natural Gas and its Products; Use of NAICS Codes

The Preamble states: "With respect to natural gas, an activity is processing or refining only if the activity purifies natural gas...It is generally anticipated that activities that create the products listed in the 2012 version...of [NAICS] code 211112 concerning natural gas liquids 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...."

In the context of the Preamble, this quoted language distinguishes and narrows the processing of natural gas and differentiates it from the processing or refining of crude oil. There is nothing in the language of section 7704(d)(1)(E) or the relevant legislative history that provides a basis to distinguish between oil and natural gas. In fact, the references in the legislative history are to "oil, gas, or the products thereof" as a single type of natural resource. Moreover, NGLs recovered from a wet natural gas stream are treated for depletion purposes as crude oil, but the Proposed Regulations fail to recognize this.

The statement in the quoted language that activities that produce only certain products are qualifying is not consistent with section 7704(d)(1)(E) and its legislative history, which require a natural resource to be processed or refined but do not impose any requirement regarding the processing or refining activity itself or the product of the processing or refining activity. The reference in the quoted language to the type of products resulting from the processing of methane is also without basis because it incorrectly focuses on the product of the process being a fuel or having been produced as an incident to the production of a fuel.

In addition to the use of the NAICS codes to provide a list of products that may be derived from natural gas in qualifying activities, the Preamble states: "It is generally anticipated that activities within a refinery that create the products that are listed in ...NAICS code 324110 concerning petroleum refineries, will be qualifying activities...."

To the extent this list, in the context of either of its uses, is meant to be restrictive, we believe that there is no statutory support for such restriction. Again, there is no mention in section 7704(d)(1)(E) of a resulting product affecting the qualification of a process. Rather, that section stipulates only that what is processed or refined must be a mineral or natural resource to produce qualifying income. Similarly, there is nothing in the legislative history that indicates that the product of a process impacts the qualification of the processing or refining activity utilized. Moreover, the NAICS codes were developed after section 7704(d)(1)(E) was enacted, are maintained for statistical purposes only, and nowhere even attempt to list "processing" activities; consequently, the NAICS codes cannot be determinative in interpreting the statutory language.

In summary, we do not believe that the statute or the legislative history provide any support for the disparate treatment of natural gas and crude oil or the reference to NAICS product codes.

E. Timber

The Preamble states: "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...Processing of timber does not include activities that use chemicals or other foreign substances to manipulate timber's physical or chemical properties.... Products that are not the result of timber processing include pulp, paper, paper products, treated lumber oriented hardboard, plywood and treated poles."

As in the case of natural gas discussed above, this quoted language narrows the processing of timber and differentiates it from other types of minerals and natural resources without any basis for doing so. The appropriate focus of the regulations should be what goes into an activity, not what happens in the activity or what comes out of the activity, provided the activity meets the common sense meaning of processing or refining. Processing and refining when used in connection with timber should be used in the same or similar manner as those terms are used in connection with other minerals and natural resources.

For example, pulp is made from wood chips. Wood chips contain two main components (apart from water): cellulose fibers (what is desired in paper making) and lignin (what holds the cellulose fibers together in the wood and is, in effect, an impurity). The aim of all pulping processes is to separate the desired cellulose fibers from the lignin. Some pulping processes use physical operations, some use chemical operations and some use both. This is the same kind of activity that happens to oil and gas and the products thereof in a refinery or processing facility and what happens to many minerals or ores after they are mined. We believe the commonly-accepted concept that timber is often harvested specifically to make pulp is strong evidence that Congress viewed timber processing as including pulping. Indeed, the term "pulpwood" is used to refer to timber to be used to make pulp. We believe there is no basis in the words of section 7704 or its legislative history to

say that pulping is not a qualifying processing or refining of timber. Further, we believe it is unreasonable to assume Congress intended that an activity which converts pulpwood to pulp would not be considered processing timber within the meaning of section 7704(d)(1)(E).

Another example where the Proposed Regulations apply an inappropriate restriction is in the case of treated lumber and treated poles. The process of adding treatment to lumber and poles is virtually the same as adding additives to other minerals and natural resources (for example, fuel additives). The sole purpose of treating is to enhance (lengthen the useful life) of the lumber and poles. It is not to change the inherent use of the lumber or poles. This activity should be viewed as processing timber.

F. The MACRS-Based Qualification Test

The Preamble states: "These proposed regulations further require that, for an activity to be treated as processing or refining, the partnership's position ...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..."

It appears this requirement is rooted in a concern about petroleum refineries using Class 28.0 (Modification of Chemicals and Allied Products) instead of Class 13.3 (Petroleum Refining). The former has a shorter recovery period. We believe that addressing this concern by including a blanket requirement in the qualifying income regulations is inappropriate. There is nothing in the statute or legislative history that ties qualifying income to the depreciation rules. The Internal Revenue Service is capable of enforcing the selection of the proper class life for an asset without resorting to regulations under a completely different Code section. Further, if this requirement is retained in the final regulations, we believe there are a number of serious issues in its application to the variety of refineries, processes and assets that should generate qualifying income, creating in many cases an unworkable situation. This requirement would unnecessarily increase uncertainty, not decrease it. Further, loss of partnership status under the Code is an excessive penalty for selecting an "inappropriate" MACRS recovery period.

IV. Proposed Definition

We respectfully submit that the following definition or a definition similar to it would be appropriate in any final Treasury Regulations relating to processing and refining under section 7704(d)(1)(E).

Qualifying activities:

A. *Processing, as used in section 7704(d)(1)(E), means one or a series of mechanical or chemical operations on 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 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 adds additives to 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, or*

   f. *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) through (6), 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 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.*

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, sulfuric acid and petroleum coke,*

    b. *Smelted 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), wood pellets, 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, 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 chips and sawdust, and*

   d. *Products from coal that are generally fungible with the products of oil and gas included in this subsection 9.*

V. Conclusion

As stated at the outset, our recommendations and comments are based on our view of the common meaning of the words in section 7704(d)(1)(E) and the legislative history. We recognize there may be different views regarding how to develop a workable set of rules based on those words, but we believe that consideration of our views can be helpful in formulating the final regulations.

The proposed definition of "processing" and "refining" set forth above takes a reasonably conservative and restrictive approach to interpreting these terms. For example, the statute and its legislative history can be read to support the position that the production of basic plastics and paper are qualifying activities, but any further processing or refining of such resources are not. The proposed definition specifically treats such activities as non-qualifying, in recognition of the long-standing ruling position of the Internal Revenue Service.

We would be pleased to provide any clarification of these comments if that would be helpful.

Respectfully submitted,

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