



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

April 13, 2016

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

Re: Comments on REG-132634-14, Qualifying Income from Activities of Publicly Traded Partnerships with Respect to Minerals or Natural Resources

Enviva Partners, LP ("*Enviva*") is a publicly traded partnership that processes timber feedstocks into wood pellets that are exported primarily to power plants in Europe. Enviva submitted comments on the proposed Treasury regulations (REG-132634-14) (the "*Proposed Regulations*") defining "qualifying income" under section 7704(d)(1)(E) (the "*Natural Resources Exception*") on August 4, 2015.¹ Enviva is thankful for the opportunity to submit additional comments regarding the Proposed Regulations, as recent developments in Enviva's business highlighted an additional concern with respect to the definition of "qualifying income." We appreciate the Service's efforts and the breadth of its undertaking to clarify the meaning of "qualifying income" under section 7704(d)(1)(E) and the Natural Resources Exception.

Although the Internal Revenue Service (the "*Service*") has previously concluded that hedging transactions used to manage risk in a qualifying activity generate qualifying income, nothing in the Proposed Regulations specifically addresses income arising from hedging activities.² As the Service attempted to provide an exclusive list of qualifying activities under section 7704(d)(1)(E), the lack of discussion of hedging activities introduces confusion regarding the treatment of hedging activities. Comment letters previously submitted to the Service explain that the final regulations should clarify that commodity and interest rate hedging activities generate qualifying income when used to manage risks associated with qualifying activities.³ We agree with these comments and believe that they provide useful information regarding the practical concern that the Proposed Regulations do not address common transactions whereby a taxpayer enters into a transaction to reduce or offset a risk associated with the taxpayer's

¹ Unless otherwise noted, all references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended.

² See e.g., Priv. Ltr. Rul. 96-19-011 (Jan. 30, 1996); Priv. Ltr. Rul. 93-39-014 (June 28, 1993).

³ See Comments to the Proposed Regulations by Buckeye Partners, L.P. at p. 6-8 (submitted July 31, 2015); Calumet Specialty Products Partners, L.P. at p. 11-12 (submitted Aug. 4, 2015); National Association of Publicly Traded Partnerships at p. 76-83 (submitted Aug. 4, 2015).



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

April 13, 2016

business. However, to more fully address the issue, we recommend a modification to the Proposed Regulations that will also address the ability of publicly traded partnerships to manage foreign currency risks in their qualifying activities.

I. Enviva's Business

Enviva's six wood pelleting plants have a combined production capacity of approximately 2.2 million metric tons per year. At each of these facilities, Enviva acquires multiple types of timber feedstock, including chipped wood, lumber scraps, sawdust, and pulpwood for processing into wood pellets. Because timber is a renewable resource, many governments have established policies to promote the use of wood pellets as an alternative energy source. Wood pellets enable power plants, previously fueled by coal, to reduce their carbon footprint by approximately 80 percent. As a result, there is strong and stable international demand for wood pellets, particularly in Europe.

Typically, Enviva sells wood pellets to international electric utilities, independent power producers and resellers under contracts denominated in U.S. dollars. The large majority of Enviva's expenses and financial commitments (e.g., with respect to employees, suppliers, production costs, lenders, and its unitholders) are also payable in U.S. dollars. However, from time to time, Enviva may also enter into contracts with international customers denominated in a number of different foreign currencies (the "**Foreign Contracts**"). The Foreign Contracts expose Enviva to a risk faced by many companies with export operations, that the foreign currencies in which its revenues are denominated decline in relative value to the U.S. dollar in which its expenses and other commitments are denominated. Thus, foreign currency risk creates cash flow risk for Enviva, because the revenues from the Foreign Contracts are converted to U.S. dollars to pay expenses.

Like many companies faced with foreign currency risk, Enviva is considering transactions to mitigate its risk, including financial arrangements with parties seeking the opposite exposure (e.g., currency swaps, cross-currency interest rate swaps, currency options, spot contracts, bi-lateral hedges or other transactions that mitigate the risk of currency fluctuations) (the "**Hedging Transactions**"). Given the long-term nature of some of the Foreign Contracts and the other commercial terms of the Foreign Contracts, Enviva may not be able to enter into a single Hedging Transaction that fully hedges the currency risk with respect to a particular Foreign Contract. However, Enviva anticipates that a combination of different Hedging Transactions, entered into on a rolling basis over the various terms of the Foreign Contracts, will allow it to mitigate its aggregate exposure to foreign currency fluctuations with respect to its qualifying activities.



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

April 13, 2016

II. Analysis

The ability to hedge risks associated with currency fluctuations to ensure predictable cash flows is essential to publicly traded partnerships that have suppliers or customers outside the U.S. and enter into transactions in a foreign currency. Previously, the Service (along with the entire tax bar that focuses on the Natural Resources Exception, as shown in the comment letters to the Proposed Regulations) has properly looked to the principles articulated in Treasury Regulation § 1.1221-2, which addresses when hedging gains and losses are ordinary in character, to determine if income from hedging transactions should be considered qualifying income.⁴ Based on the framework of Treasury Regulation § 1.1221-2, the Service concluded that hedging transactions that were integral to reducing the partnership's risks in qualifying activities generated qualifying income.⁵

A. "Normal Course" Framework of Treasury Regulation § 1.1221-2

Treasury Regulation § 1.1221-2 provides that a hedge produces ordinary income or loss when it manages risk in the *normal course* of the taxpayer's trade or business.⁶ Hedging transactions are transactions that manage (1) the risk of price changes or currency fluctuations with respect to ordinary property that is held (or to be held) by the taxpayer, (2) the risk of interest rate or price changes or currency fluctuations with respect to borrowings made (or to be made) or ordinary obligations incurred (or to be incurred), by the taxpayer, or (3) such other risks as the Service may prescribe in regulations.⁷ "Hedging transaction" is also defined to include a transaction that "manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations."⁸ A transaction entered into in furtherance of a taxpayer's trade or business is considered to be in the "normal course" of business.⁹ However, if a transaction is

⁴ See Priv. Ltr. Rul. 96-19-011 (Jan. 30, 1996).

⁵ See *id* ("[The Treas. Reg. § 1.1221-2] hedging definition and the section 7704(d)(1)(E) legislative history suggest that if owners of oil and gas directly purchase derivative products of oil and gas for the [purposes described in Treas. Reg. 1.1221-2], income from these products is integral to a qualifying activity and may be qualifying income under section 7704(d)(1)(E).")

⁶ See *id* ("Section 1.1221-2 of the Income Tax Regulations provides rules for determining when buying a hedge is part of a taxpayer's normal course of business, and, therefore, ordinary income.").

⁷ See section 1221(b)(2); Treas. Reg. § 1.1221-2(b).

⁸ Treas. Reg. § 1.1221-2(c)(3).

⁹ Treas. Reg. § 1.1221-2(c)(1).



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

April 13, 2016

undertaken for speculative purposes, it is not treated as a hedging transaction.¹⁰ The Service's prior reliance upon the "normal course" framework set forth in Treasury Regulations § 1.1221-2 to apply the Natural Resources Exception ensured consistency with other areas of the Internal Revenue Code by focusing the analysis on whether there is a sufficient link between a publicly traded partnership's hedging activities and the normal course of its qualifying trade or business activities.¹¹

B. Role of Section 988

Although the rules found in Treasury Regulation § 1.1221-2 generally apply to international as well as domestic transactions, they do not apply to determine the character of gain or loss on "section 988 transactions".¹² However, like Treasury Regulation § 1.1221-2, section 988 generally would treat the income from "section 988 transactions" as ordinary income. The primary exception to this general rule does not explicitly focus on the link between the hedging transaction and the taxpayer's trade or business, although it would require that the foreign currency or hedging contract be a capital asset in the hands of the taxpayer under section 1221.¹³ For purposes of the Natural Resources Exception, we believe that a consistent standard should be applied to all foreign currency transactions, regardless of whether section 988 applies to those transactions. Although the rules of Treasury Regulations § 1.1221-2 do not directly apply to a section 988 transaction, the "normal course" framework of Treasury Regulations § 1.1221-2 provides a logical standard for evaluating all hedging transactions under the Natural Resources Exception.

C. Treatment of Foreign Currency Transactions Not Related to a Separate Trade or Business

Section 7704(d)(4) provides that qualifying income includes income which would qualify under section 851(b)(2)(A). Section 851(b)(2)(A) provides, in part, that gross income derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of

¹⁰ Treas. Reg. § 1.1221-2(c)(4)(ii).

¹¹ See Ltr. Rul. 96-19-011.

¹² See Treas. Reg. § 1.1221-2(a)(4). Generally, transactions within the purview of section 988 are those where a taxpayer is entitled to receive, or is required to pay, amounts denominated in a nonfunctional currency, or determined by reference to the value of one or more nonfunctional currencies. See section 988(c)(1). The disposition of a nonfunctional currency is also a transaction covered by section 988. See section 988(c)(1)(C).

¹³ See Treas. Reg. § 1.988-3(b).



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

April 13, 2016

investing in such stock, securities, or currencies is qualifying income. Thus, a publicly traded partnership could produce qualifying income by holding foreign currencies and entering into foreign currency hedges if such activities were a separate line of activity of the partnership. Given the foregoing, the Service need not be concerned that promulgating rules under the Natural Resources Exception will improperly cause income from investments or trading in foreign currencies to be qualifying income. Those activities could independently produce qualifying income. Moreover, it would be an illogical outcome if those activities could independently generate qualifying income but would not generate qualifying income if they relate to qualifying trade or business activities covered by the Natural Resources Exception. To avoid this outcome, explicit rules need to be included in the final version of regulations addressing the scope of qualifying income under section 7704(d)(1)(E) with respect to foreign currency transactions.

III. Recommendations

The Proposed Regulations should follow the longstanding position of the Service (and Natural Resources Exception tax bar) that the “normal course” framework provided in Treasury Regulation § 1.1221-2 should be used to analyze whether transactions entered into to manage risks (including risks related to interest rates, commodity prices, and foreign currencies) generate qualifying income. For the reasons stated above, we recommend revising the Proposed Regulations to include the language below in paragraph (e) and move the examples to a new paragraph (f):

(e) Hedging and Foreign Currency Transactions.

(1) *In general.* Income and gains from hedging transactions used to manage risk with respect to qualifying activities and transactions in foreign currencies relating to qualifying activities shall be considered income from such qualifying activities. A hedge of an aggregate risk with respect to both qualifying activities and non-qualifying activities shall be considered income from the qualifying activities if substantially all of the risk hedged relates to the qualifying activities.

(2) *Hedging transaction defined.* The term hedging transaction means any transaction that a taxpayer enters into in the normal course of one or more of the taxpayer’s trades or businesses to manage a specific or aggregate risk of interest rate changes, price changes and/or currency fluctuations or to manage similar risks.



7200 Wisconsin Avenue
Suite 1000
Bethesda, MD 20814 USA

+1 (301) 657 5560
fax (301) 657 5567

www.envivabiomass.com

April 13, 2016

(3) *Normal course.* If a transaction is entered into in furtherance of a taxpayer's trade or business, the transaction is entered into in the normal course of the taxpayer's trade or business. This rule includes managing risks relating to the expansion of an existing trade or business or the engagement in or acquisition of a new trade or business. Except to the extent that income from a foreign currency transaction or hedging transaction is described in section 851(b)(2)(A), a foreign currency transaction or hedging transaction entered into by a taxpayer shall be considered entered into in the normal course of one or more of the taxpayer's trades or businesses.

Sincerely,

A handwritten signature in blue ink that reads "Carlisle Sewell".

Carlisle Sewell

Director, Tax Planning and Compliance
Enviva Partners, LP