

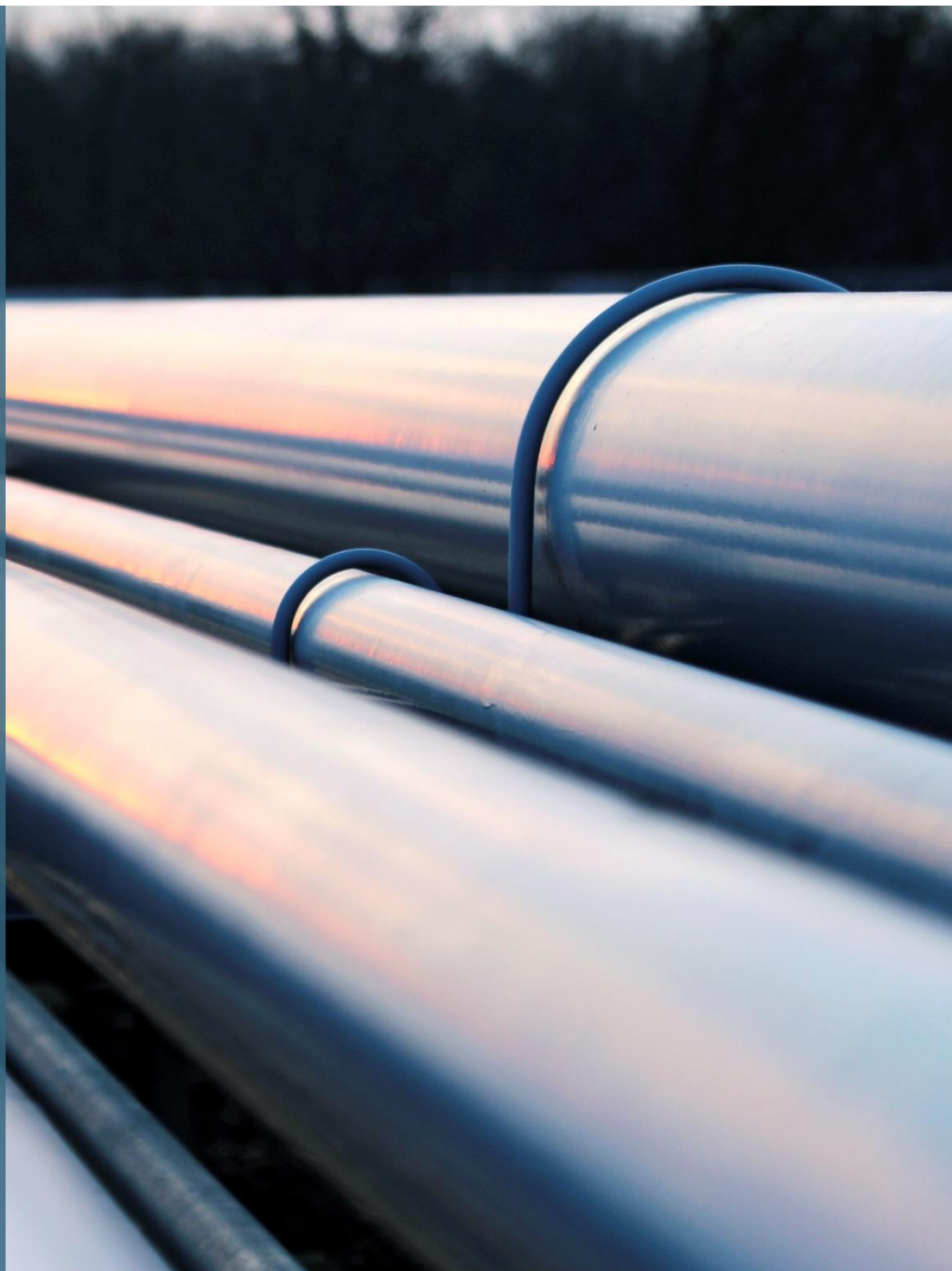
Vinson&Elkins

OCTOBER 2017

AN INTRODUCTION TO MASTER LIMITED PARTNERSHIPS (MLPS)

Energy Series

www.velaw.com



TODAY'S PANEL



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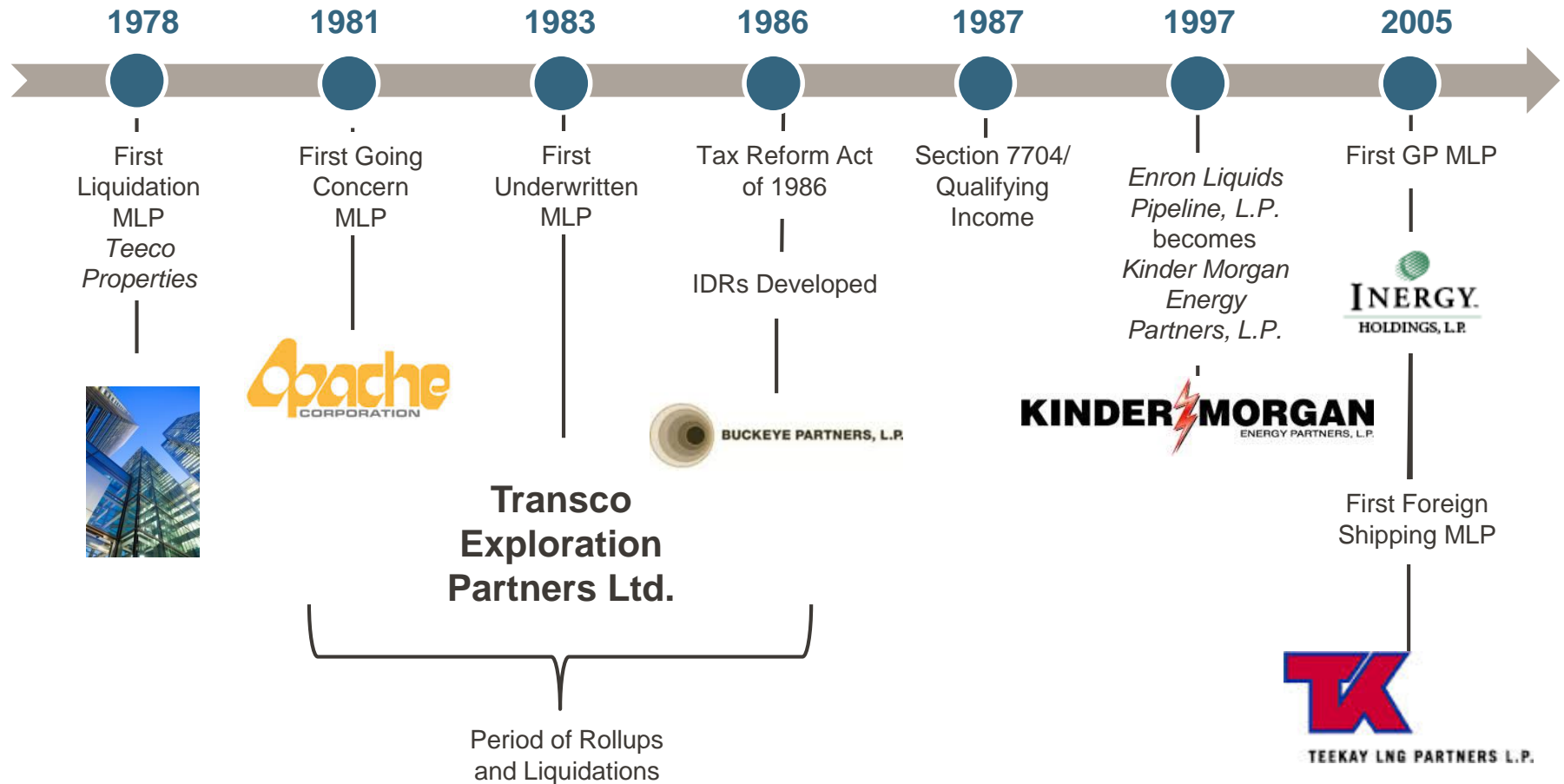
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MLP HISTORY

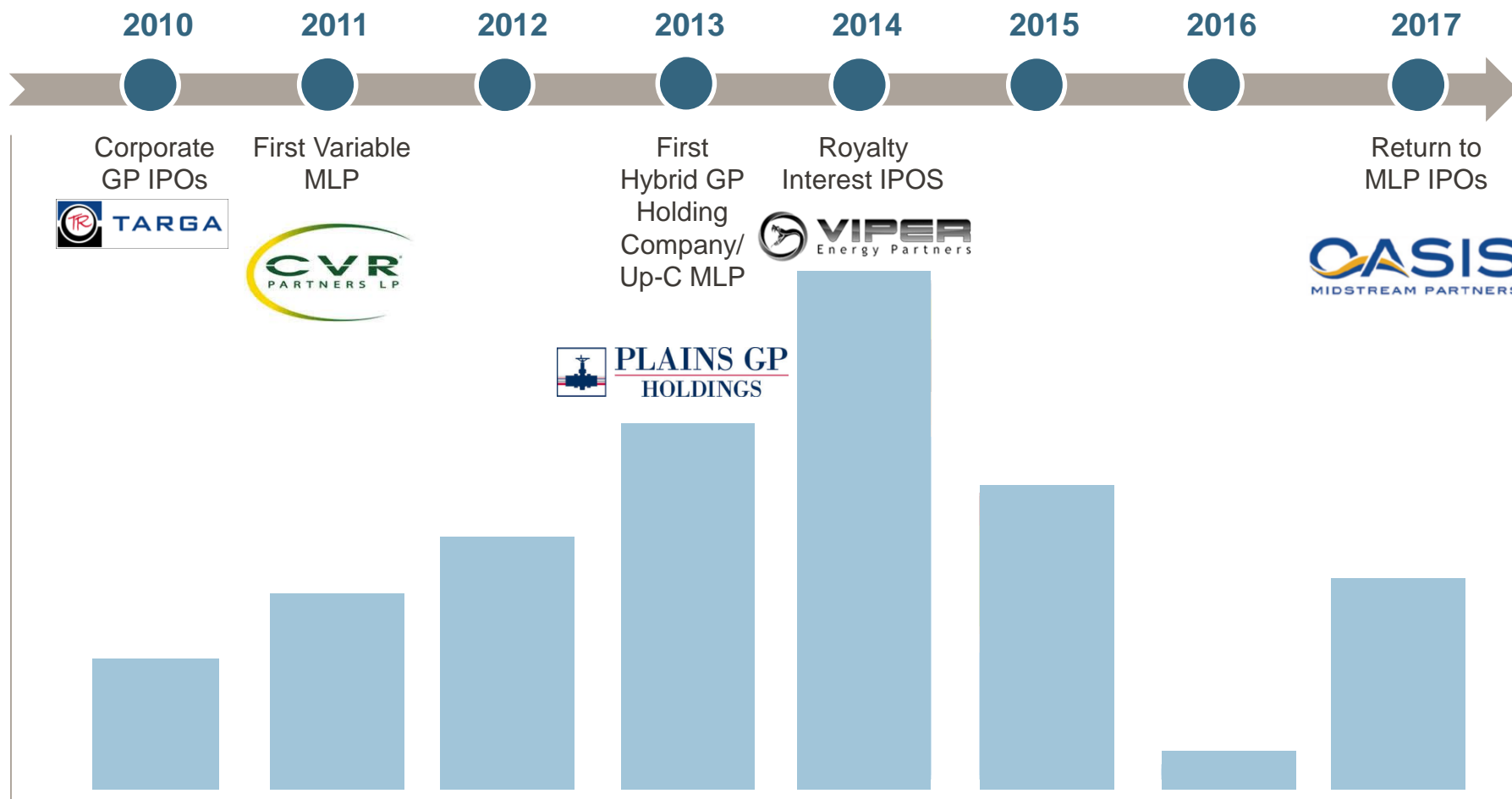


HISTORY OF MLPS



HISTORY OF MLPS

INITIAL PUBLIC OFFERING ACTIVITY (\$MM)

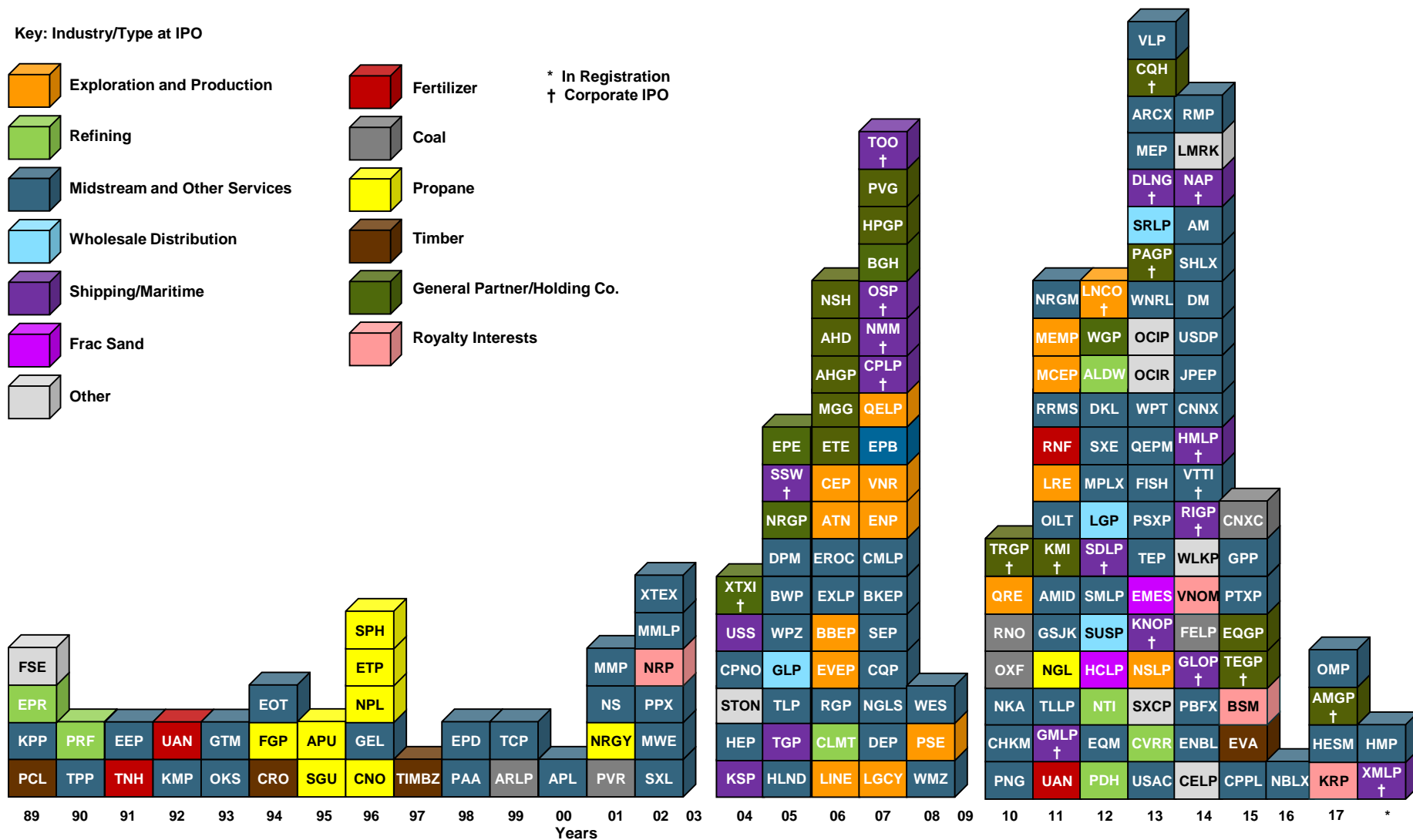
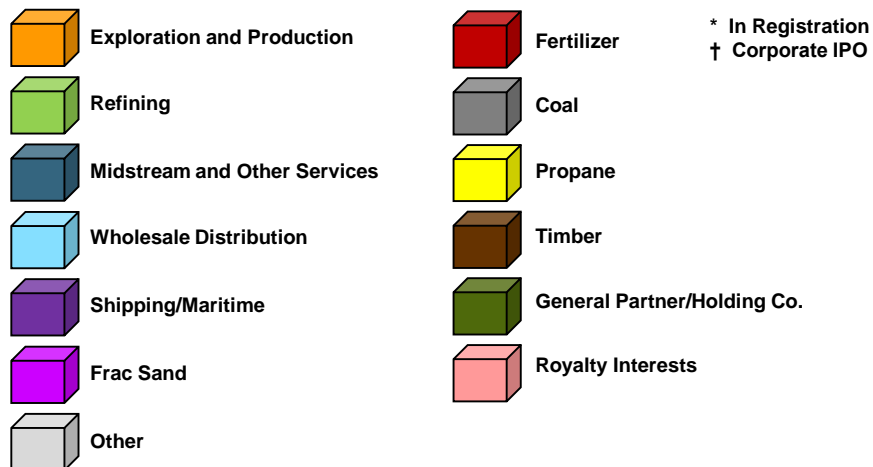


**Data Source: UBS Global Energy Group, Weekly MLP Update, Week Ended October 6, 2017

MLP INITIAL PUBLIC OFFERINGS

1989-2017

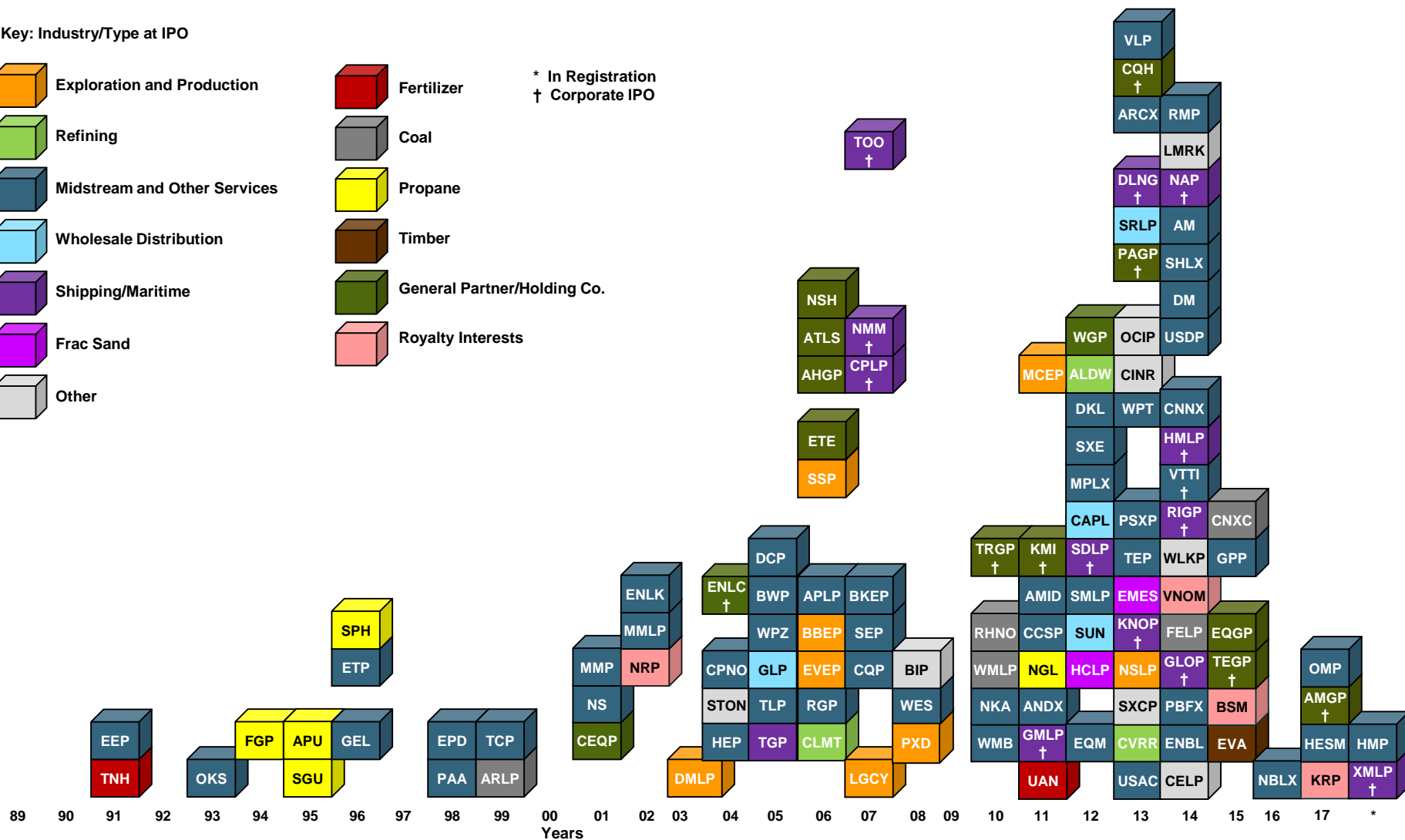
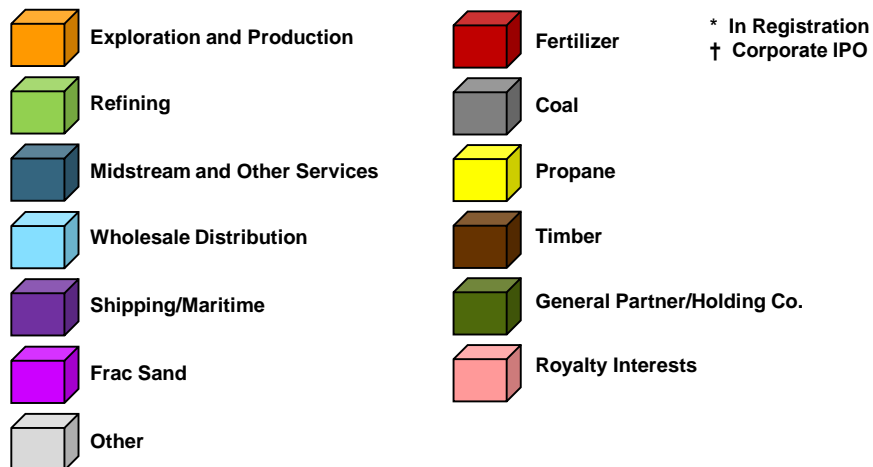
Key: Industry/Type at IPO




POST-ACT MLPS TRADED OR IN REGISTRATION

1989-2017

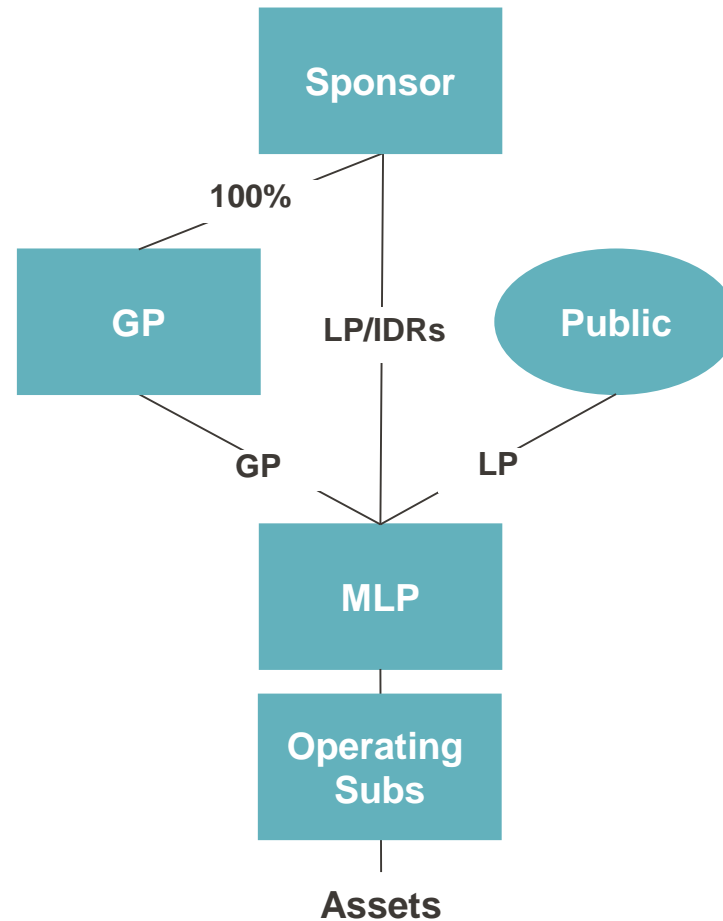
Key: Industry/Type at IPO





TRADITIONAL ORGANIZATIONAL STRUCTURE

TYPICAL ORGANIZATIONAL STRUCTURE



— = Ownership

GP = General Partner

LP = Limited Partner

IDR = Incentive Distribution Rights

ECONOMIC STRUCTURE



ECONOMIC STRUCTURE

KEY CONCEPTS

- Distribution Policy
 - Common Units and Minimum Quarterly Distribution (“MQD”)
 - Subordinated Units
 - Incentive Distribution Rights (“IDRs”)
- Capitalization
- 100 Unit Example
 - 50 common units
 - 50 subordinated units
 - \$0.25 per unit MQD

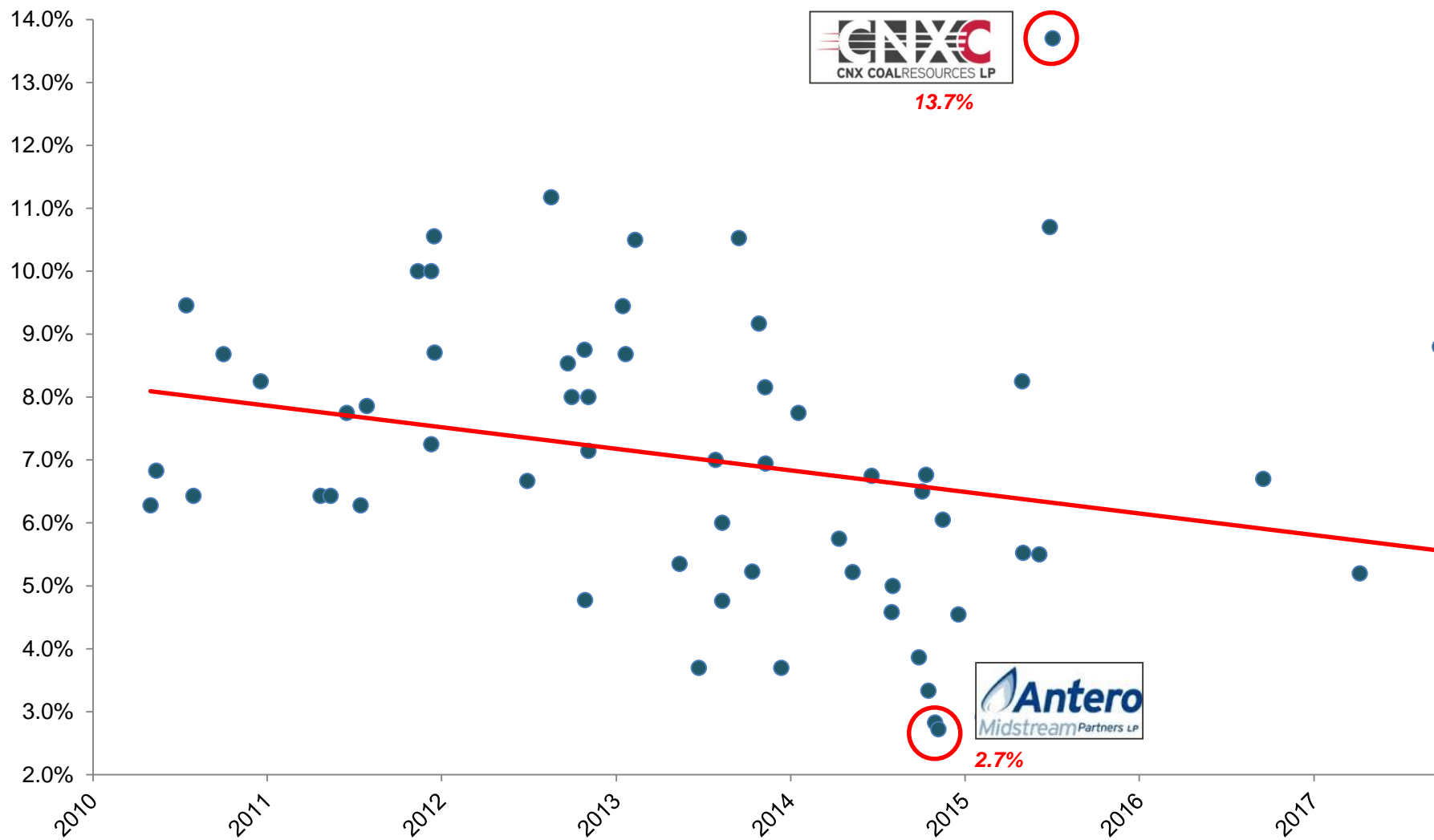
ECONOMIC STRUCTURE

DISTRIBUTION POLICY

- Generate stable (and increasing) cash distributions to unitholders
- Distributions are not a tax requirement, but the expectation of distributions (yield) is a marketing requirement
 - Since 2010, traditional MLPs have had yields at IPO ranging from 2.7% to 13.7% (average of 7.0%)
- In prospectus, the MLP makes a statement as to its intention to distribute a specified MQD per unit basis
 - Basis for yield at which the MLP is marketed
 - Sponsor subordinates a portion of its equity to payment of the MQD on the Common Units (class of equity sold to the public)
 - Sponsor receives IDRs, a special class of equity entitled to a disproportionate share of quarterly distributions in excess of targets above the MQD

HISTORICAL INITIAL PUBLIC OFFERINGS

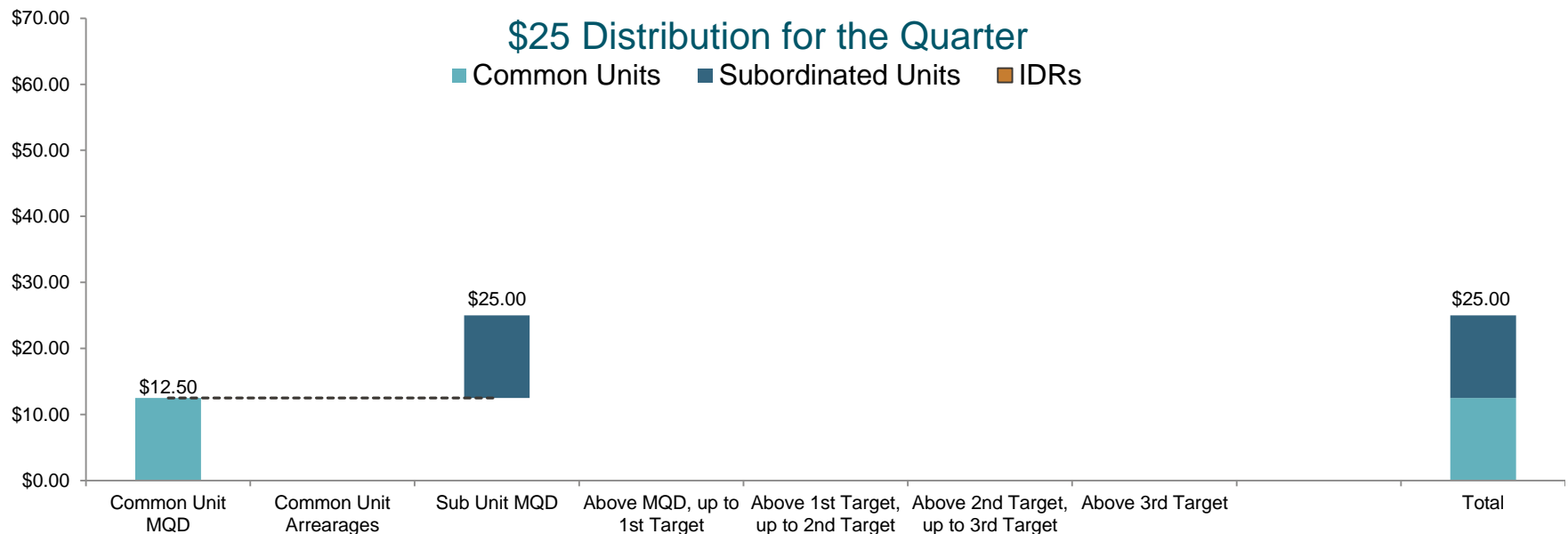
YIELD AT INITIAL PUBLIC OFFERING; TRADITIONAL MLPS



ECONOMIC STRUCTURE

SUBORDINATED UNITS: FORM OF CASH DISTRIBUTION SUPPORT

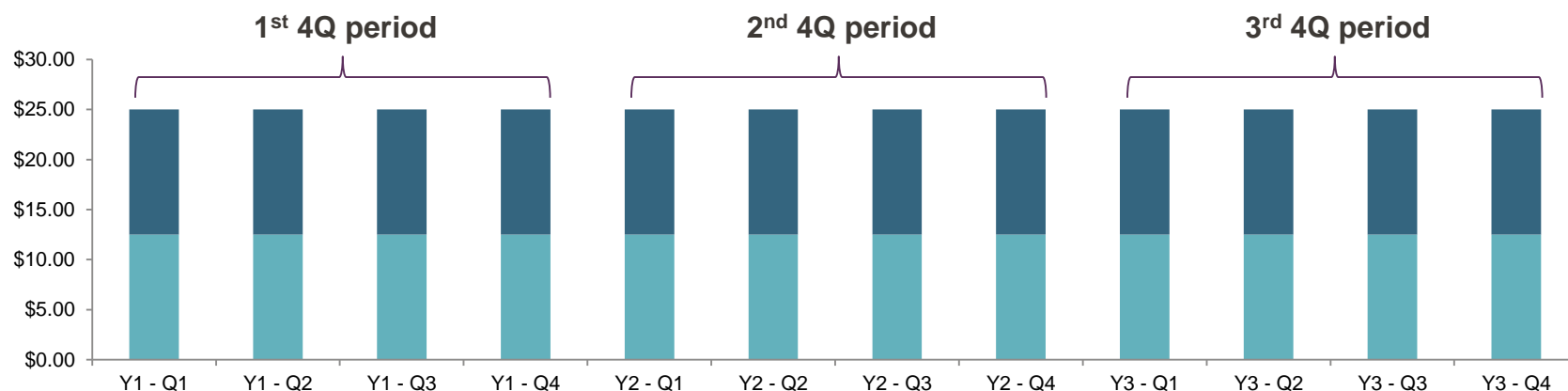
- Sponsor retains Subordinated Units
 - Often 50% of total units
 - Form of cash distribution support - subordinated to Common Units in payment of the MQD
 - Common Units entitled to arrearages in MQD if not paid
- 100 Unit Example



ECONOMIC STRUCTURE

SUBORDINATED UNITS: CONVERSION

- Subordinated Units convert to common at the end of Subordination Period
 - After three four-quarter periods of “earning” and “paying” the MQD on all outstanding units, and there being no existing arrearages on the Common Units
 - First tested approximately three years after IPO, rolls from quarter to quarter thereafter



- Early conversion (bullet test) of the Subordinated Units
 - After one four-quarter period where the MLP has “earned” and “paid” 150% of the MQD on all outstanding units and the corresponding payment on the IDRs

ECONOMIC STRUCTURE

IDRS AND DISTRIBUTION WATERFALL

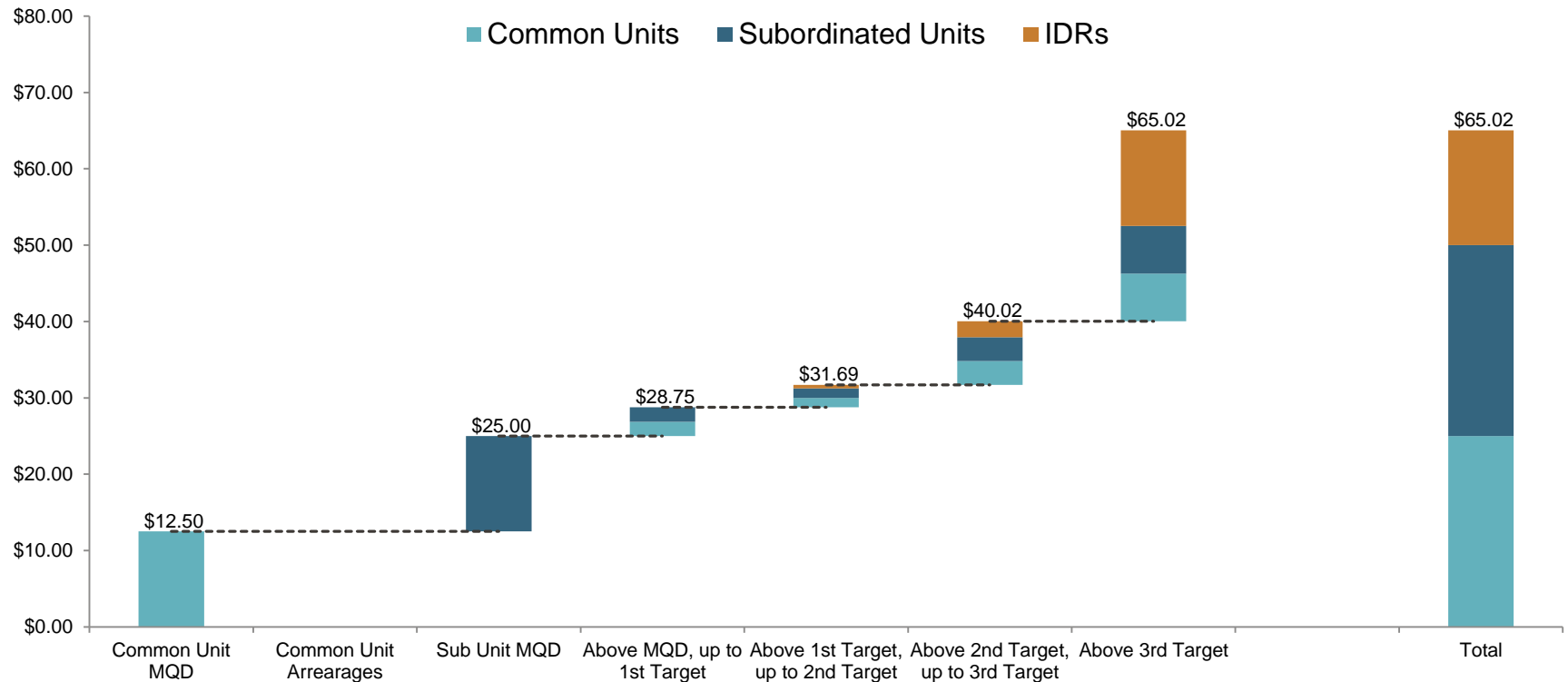
- After 115% of the MQD is paid on the Common and Subordinated Units each quarter, the IDR holders have a right to an increasing share of marginal cash distributions as target cash distributions to unitholders are exceeded
- 100 Unit Example

Distribution Tier	Distribution Range (per unit)	% Common Units	% Subordinated Units	% IDRs
Common Unit MQD	\$0.0 - \$0.2500	100.0%	--	--
Common Unit Arrearages	X	100.0%	--	--
Sub Unit MQD	\$0.0 - \$0.2500	--	100.0%	--
Above MQD, up to 1st Target (1.15 X MQD)	\$0.2500 - \$0.2875	50.0%	50.0%	--
Above 1st Target, up to 2nd Target (1.25 X MQD)	\$0.2875 - \$0.3125	42.5%	42.5%	15.0%
Above 2nd Target, up to 3rd Target (1.5 X MQD)	\$0.3125 - \$0.3750	37.5%	37.5%	25.0%
Above 3rd Target	> \$0.3750	25.0%	25.0%	50.0%

ECONOMIC STRUCTURE

DISTRIBUTION WATERFALL

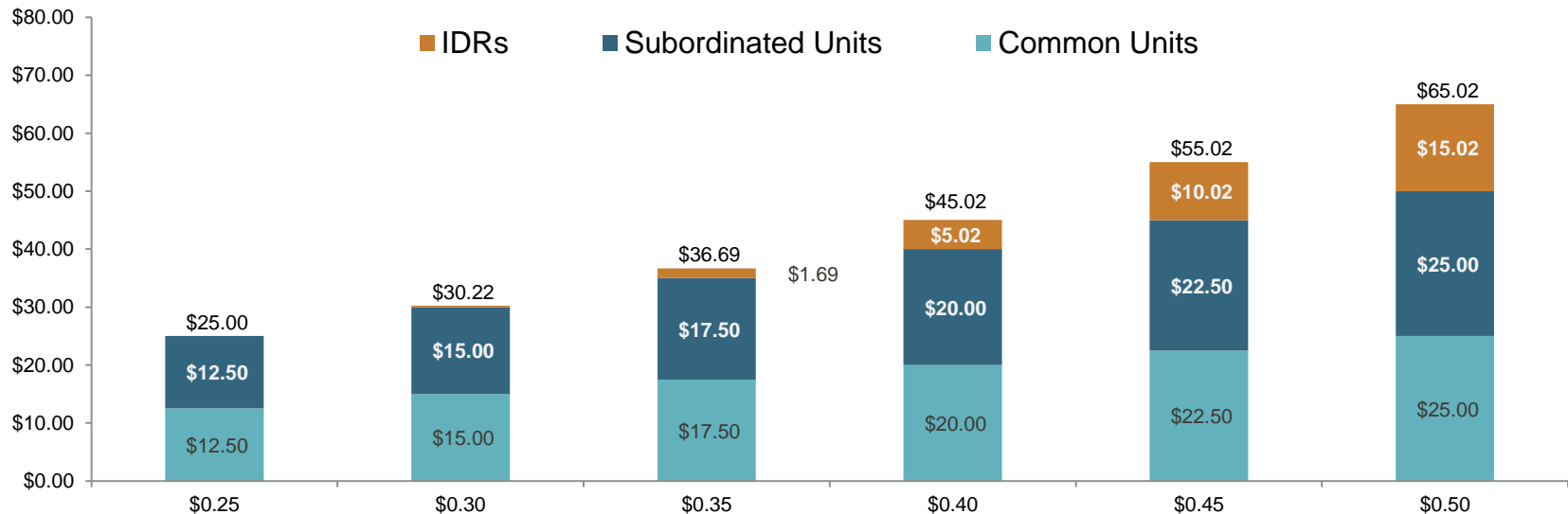
- 100 Unit Example
 - 1 quarter distribution
 - \$0.50 per unit



ECONOMIC STRUCTURE

IDR THEORY

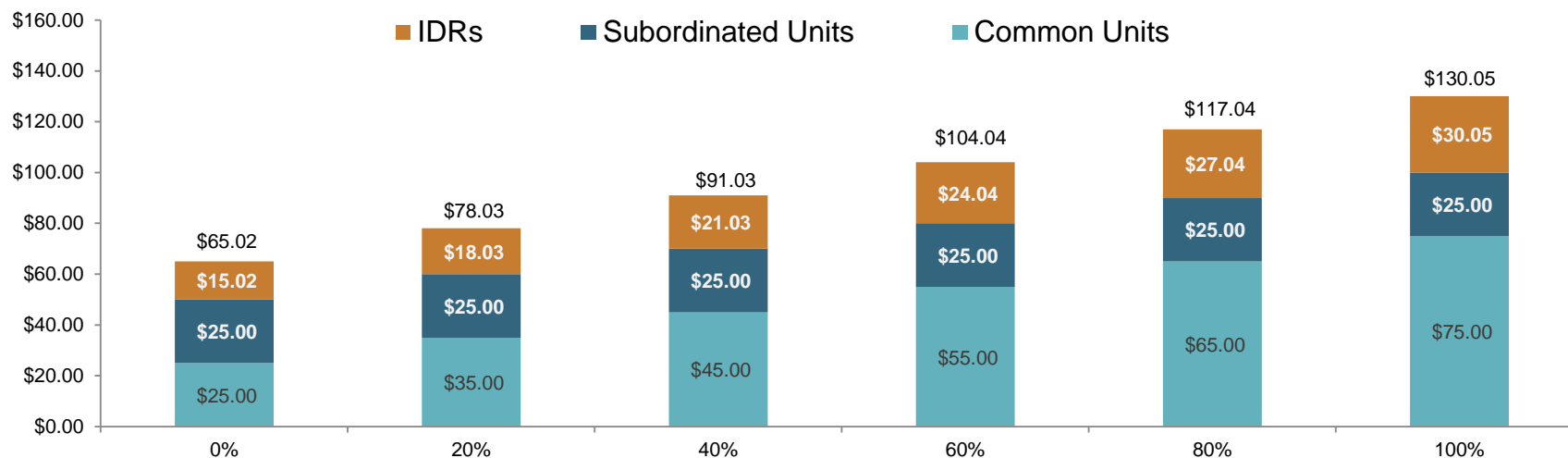
- Provides incentive for the Sponsor to grow distributions and compensation for subordination
- 100 Unit Example
 - \$0.05 per unit distribution increase






ECONOMIC STRUCTURE

IDR GROWTH THROUGH EQUITY ISSUANCES

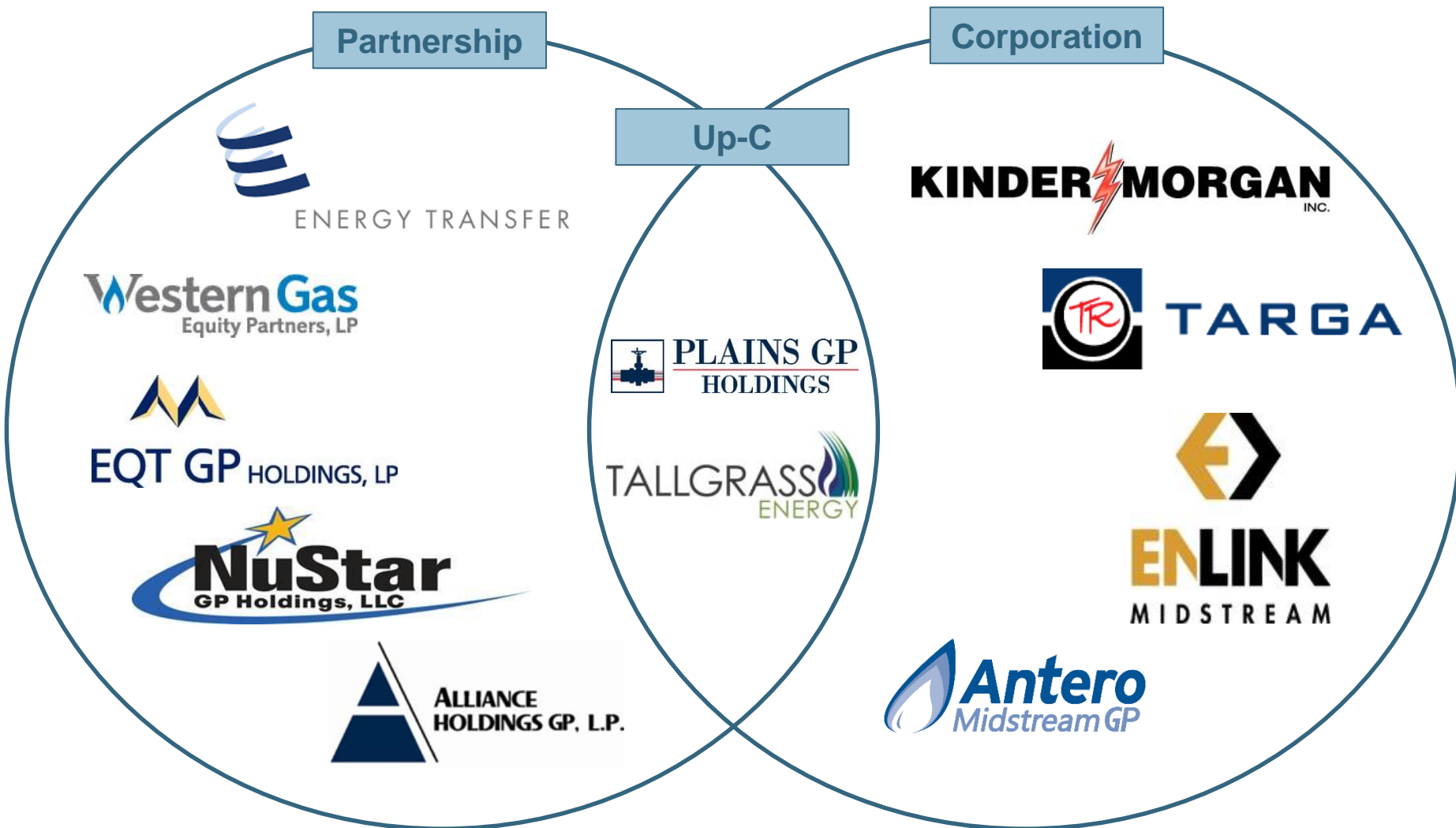
- Once in the money, IDRs also benefit from increases in unit counts (assuming per unit distribution level is sustainable)
- IDRs are effectively a free carried interest as the MLP grows
- Absent modification, increases cost of MLP equity capital
- 100 Unit Example
 - 20% increases in unit count



RECENT ROYALTY MLPS

			
IPO Date	June 2014	May 2015	February 2017
Capital Structure	Common units only	Common units Subordinated units Preferred units	Common units only
Subordination Structure	None	50% subordination Escalating MQD: \$0.10/yr for 3 years “Fish or cut bait” conversion	None
Distribution Policy	Variable	Steady	Variable
Distribution Pattern	12 distributions paid 7 increases 3 decreases 1 flat	9 distributions paid 3 increases No decreases 5 flat	2 distributions paid 1 increase
Governance	GP controlled by Diamondback Energy	Elected board	GP controlled by 4 individuals
Asset Composition	Concentrated Mineral interests - 12,687 net acres in the Permian Basin, operated by Diamondback or RSP Permian	Diversified Mineral interests in 14.5mm gross acres Royalty interests in 1.2mm acres Overriding royalties in 1.4mm acres 41 states and 62 basis	Diversified Mineral interests in 3.7mm gross acres Overriding royalties in 0.9 gross acres 22 states, 44% of acreage in the Permian Basin

GENERAL PARTNER IPO OPTIONS



QUALIFYING INCOME



QUALIFYING INCOME – REQUIREMENT

PARTNERSHIP TREATMENT

- Treatment as a partnership for U.S. federal income tax purposes is a fundamental aspect of PTP MLPs
 - PTP MLPs do not pay U.S. federal income tax
 - Unitholders receive cash distributions and pay tax on their share of the MLP's taxable income
- Pre-1987 any business could qualify
- Post-1987 most publicly traded partnerships are treated as corporations
- Marketing efforts/underwriters require certainty – “will” level opinions

QUALIFYING INCOME – REQUIREMENT

STATUTORY REQUIREMENT FOR PARTNERSHIP TREATMENT

- Qualifying Income Test: 90% or More of Gross Income
 - Services (e.g., pipeline transportation): Gross revenue
 - No reduction for cost of services
 - Products (e.g., E&P): Gross margin
 - Gross revenue less costs of goods sold
- Measured each tax year
- Failure results in corporate tax treatment for that tax year and all tax years going forward
- Mechanisms to handle Non-Qualifying Income
 - Keep below 5% of gross income
 - Put operations in a corporate subsidiary

QUALIFYING INCOME – TYPES

NATURAL RESOURCE QUALIFYING INCOME

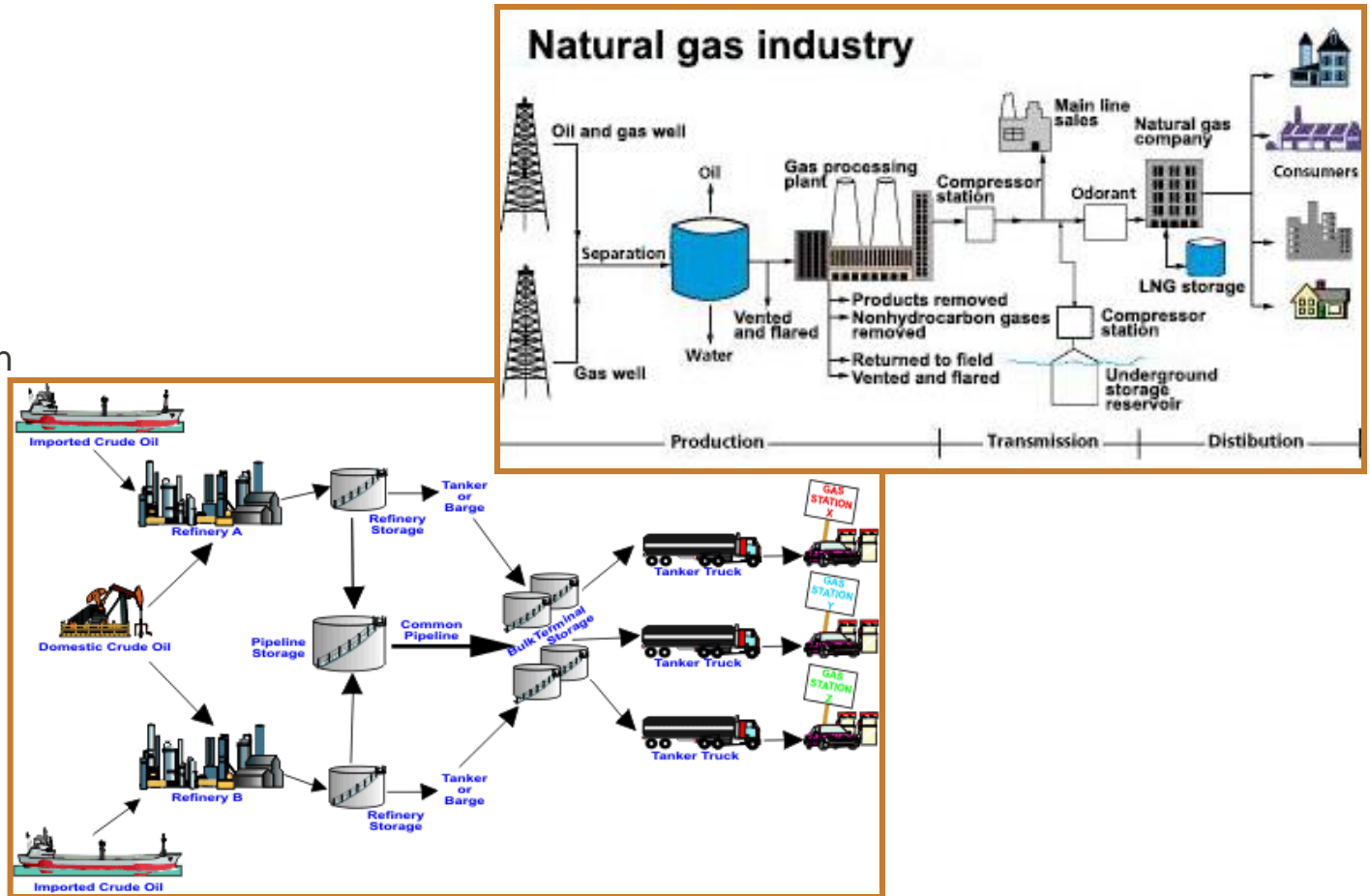
- Qualifying **Products**: Natural Resources and “Green” Fuels
 - Naturally occurring deposits (gas, oil, depletable minerals)
 - Oil and gas products (refinery tailgate or gas processing tailgate) – includes gasoline, kerosene, number 2 fuel oil, refined lubricating oils and diesel fuel
 - Fertilizer
 - Geothermal energy
 - Timber
 - Industrial source CO₂
 - Biodiesel/ethanol (transport and storage only)

QUALIFYING INCOME – TYPES

NATURAL RESOURCE QUALIFYING INCOME

- Qualifying **Activities**: Natural Resources

- Exploration
- Development
- Mining
- Production
- Processing
- Refining
- Transportation
- Storage
- Marketing



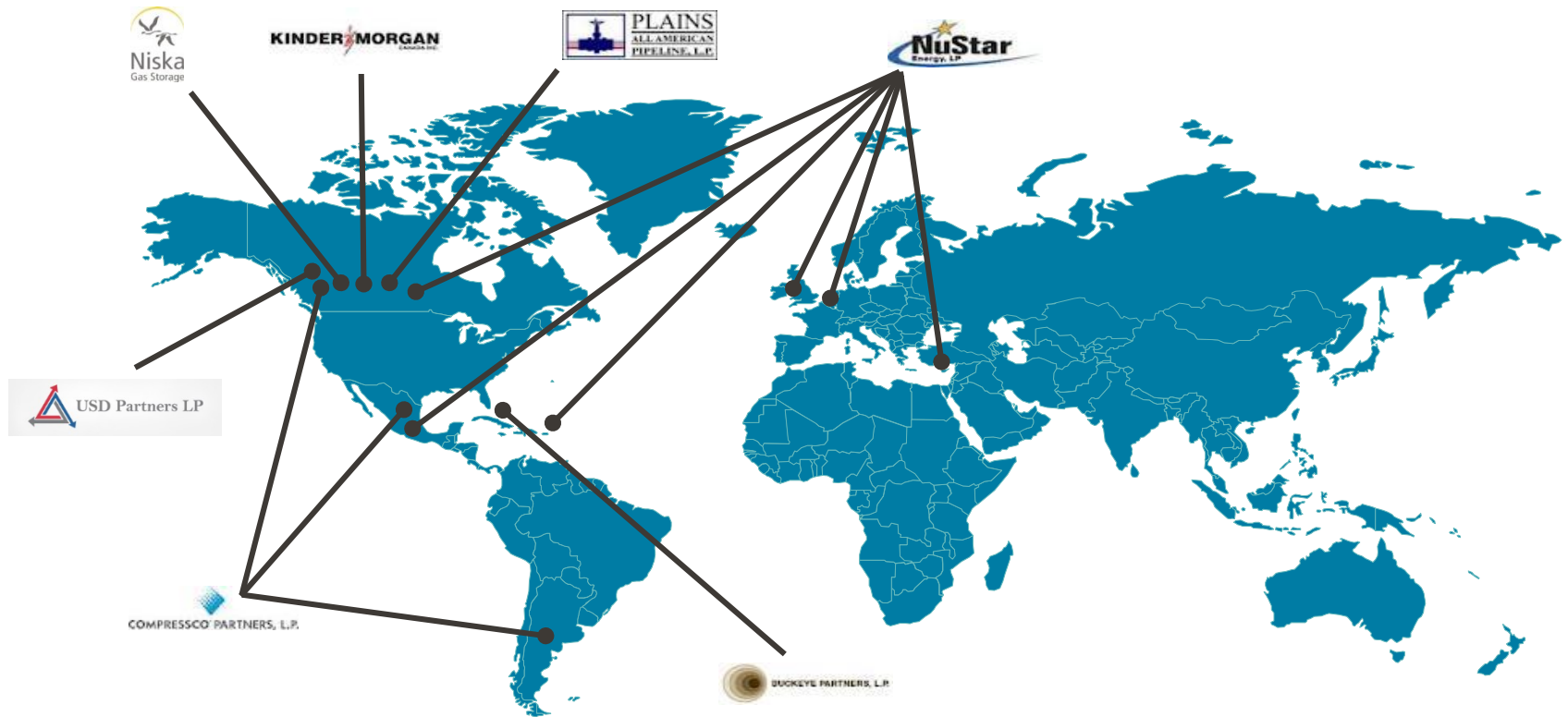
QUALIFYING INCOME – TYPES

NON-NATURAL RESOURCE QUALIFYING INCOME

- Real property income
 - Rents from real property (excluding (i) rents for personal property in excess of 15% associated real property and (ii) related party rents)
 - Income from sale of real property (including inventory)
- Gain from sale of assets generating qualifying income
- Interest (not from financial/insurance business)
- Dividends (from qualifying or non-qualifying activities)
- Gain from sale of stock
- Gain from commodities, futures, forwards and options with respect to commodities

FOREIGN ACTIVITIES

- Qualifying income knows no geographic bounds. A number of MLPs own significant assets outside the United States.



PLR PROCESS

- Administrative Process with IRS
 - PLRs are taxpayer-specific and granted at the discretion of the IRS
 - For novel issues, taxpayers often seek a pre-submission conference or call
- PLR Requests
 - Apprx. 25 page written legal brief with summary of relevant facts, law and analysis
- Timing
 - Drafting typically takes several weeks
 - IRS Response
 - Historically 4-9 months
 - Notable exceptions (several in less than 1 month and one took 27 months)
 - Current timing?
- Costs
 - IRS user fee of \$28,300

QUALIFYING INCOME PLRS

111 PLRS SINCE 2007

2014

Terminal Additization
and Blending Activities
PLR 2014-03-004

Grease Blending and
Wholesale Distribution of Grease
PLR 2014-03-008

Redacted Oilfield Services
with Customer Contracts
PLR 2014-05-011

Operating an Air Separation Unit
Within a Refinery
PLR 2014-08-008

Processing Feedstock into
Redacted Products
PLR 2014-08-025

Oilfield Fluids Handling and
Disposal Services
PLR 2014-10-017

Sale of EPA Credits (RINS) and
Fuel Delivery Services
PLR 2014-11-004

Redacted Oilfield Services
with Customer Contracts
PLR 2014-12-007

Energy Infrastructure Services and
Managing Coal JV
PLR 2014-18-021

Time Charters for Natural Resource
Product Tankers
PLR 2014-17-005

Supply and Transportation of
Frac Fluids
PLR 2014-16-003

Marketing and Transportation of
Frac Sand
PLR 2014-14-004

Supply and Transportation of
Frac Fluids
PLR 2014-14-002

Well-site Oilfield Services
and Supervision
PLR 2014-20-012

Processing Iron Ore into
Direct Reduced Iron
PLR 2014-48-019

Midstream Services
Including Rail
PLR 2014-51-002

2015

Interest Rate Hedging
PLR 2015-23-018

Water Delivery, Recycling and
Disposal
PLR 2015-37-014

Liquefaction of Natural Gas and
Regasification of LNG
PLR 2015-37-007

Transportation, Storage and
Marketing of Redacted Product
PLR 2015-38-012

Wholesale Fuel Distribution
PLR 2015-41-008

Leasing of Cell Towers and
Billboards
PLR 2015-49-013

Water Handling, Treatment
and Processing
PLR 2015-49-004

Fluid Handling, Treatment,
Processing and Disposal
PLR 2015-45-002

Fluid Handling, Treatment,
Processing and Disposal
PLR 2015-48-013

2016

Water and Fluid Handling, Treatment,
Recycling and Disposal
PLR 2016-02-004

Fluid Hauling, Storage and Disposal
PLR 2016-08-011

Water Transportation and
Disposal and Pressure Pumping
PLR 2016-11-017

Oil and Gas Transportation,
Gathering and Storage Activities
PLR 2016-14-004

Fertilizer Production, Storage,
Transportation and Marketing
PLR 2016-19-002

Fluid Management and Disposal
Services; Filtered Hydrocarbon Sales
PLR 2016-33-020

Regasification of LNG
PLR 2016-36-025

Interest Rate Swaps and Caps,
Forward Locks and Treasury Locks
PLR 2016-36-039

Fluid Management, Transportation,
Disposal, Washout and Storage
PLR 2016-37-007

2017

Reimbursement Payments,
Accelerated Tolling and Tariff Fees
PLR 2017-21-007

Timber Processing, Transportation,
Storage and Marketing Services
PLR 2017-22-023

Fluid Management, Inter-Well
Transfer and Disposal Services
PLR 2017-23-004

Construction and Operation of
Transportation and Processing Assets
PLR 2017-24-024

Natural Gas Processing
PLR 2017-28-021

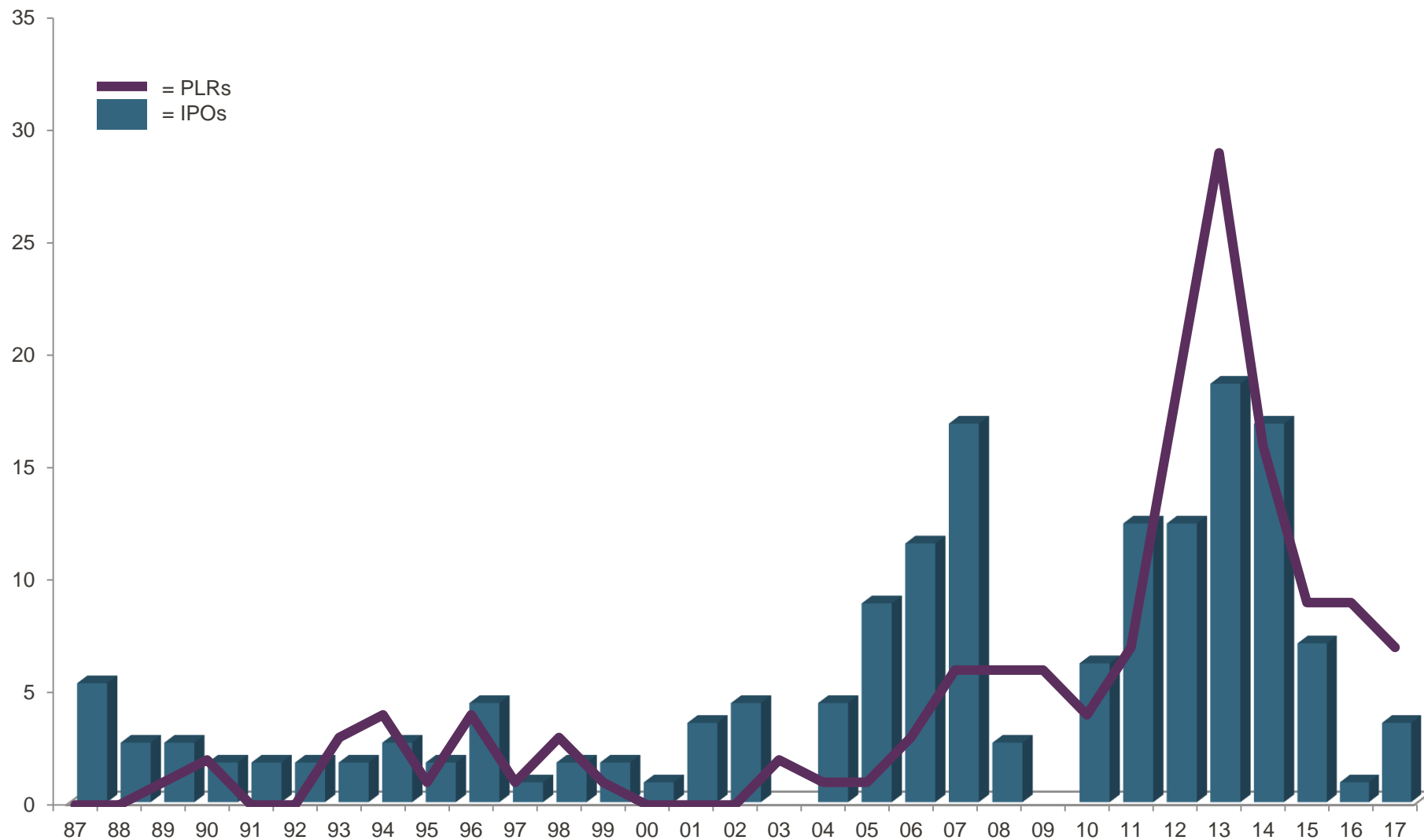
Water and Fluid Handling, Treatment,
Recycling and Disposal
PLR 2017-32-006

Crude Oil Transportation
PLR 2017-36-020

A list of, and links to, all qualifying income PLRs are available at www.velaw.com/MLPQualifyingIncome

MLP IPOS V. PLRS: 1987-2017

OVER 140 PLRS SINCE 1987





THE FINAL REGULATIONS ON QUALIFYING INCOME

HIGHLIGHTS OF NEW REGULATIONS

- The final regulations are largely viewed as an improvement over the proposed regulations. They address favorably many, but not all, of the comments to the proposed regulations, but do so largely within the framework of the proposed regulations.
- The most significant changes are as follows:
 - Not an “exclusive list”
 - Greater clarity on qualifying nature of some activities:
 - LNG liquefaction and regasification
 - Transportation and sale of propane to retail customers
 - Pipeline compression services
 - Many blending and additization activities
 - Reimbursement of costs
 - Hedging activities subject to further guidance

HIGHLIGHTS

- The most significant changes are as follows (con't):
 - Simplified analysis of oil and gas products:
 - “Good list” approach to processing and refining of oil and gas
 - Olefins generate qualifying income
 - Methanol does not generate qualifying income
 - Narrow interpretation of hard mineral processing depending on the type of ore
 - Excludes coking of coal, steelmaking, and aluminum smelting
 - Oilfield services still qualify
 - Basin-by-basin approach for oil field service providers; and clarification that an MLP’s subcontractors are treated as partnership personnel

INTRINSIC ACTIVITIES

- The Treasury Department and the IRS agreed with commenters that the injections exception should be revised to account for industry practice in which a producer may not hire the same company to provide both water delivery and disposal services.
- Accordingly, the regulations relax the “well-by-well” matching requirement for the provision of water and other injectants for use in oil and gas exploration.
- Instead, the final regulations allow for the provision of water or injectant if the MLP is also in the trade or business of collecting, cleaning, recycling, or otherwise disposing of injectants within the same “geographic area.”

INTRINSIC ACTIVITIES

- Under the final regulations, qualifying income includes income from intrinsic activities. An activity is an intrinsic activity only if it:
 - is **specialized** to support a qualifying activity,
 - Requires that the partnership provide personnel to support a qualifying activity and that those personnel have received training “that is unique to the mineral or natural resource industry.”
 - Requires that to the extent the activity involves the use of specific property, that the property is dedicated to performing qualifying activities and is not easily converted to another use.
 - is **essential** to the completion of the qualifying activity, and
 - An activity is essential if it is required to physically complete a qualifying activity (including in a cost-effective manner, such as by making the activity economically viable).
 - requires **significant services** to support the qualifying activity.
 - Requires that services provided are conducted on an ongoing or frequent basis by the partnership’s personnel at the site or sites of the qualifying activity.
 - Services are not significant with respect to a qualifying activity if the services principally involve the design, construction, manufacturing, repair, maintenance, lease, rent or temporary provision of property.

TRANSITION RULE

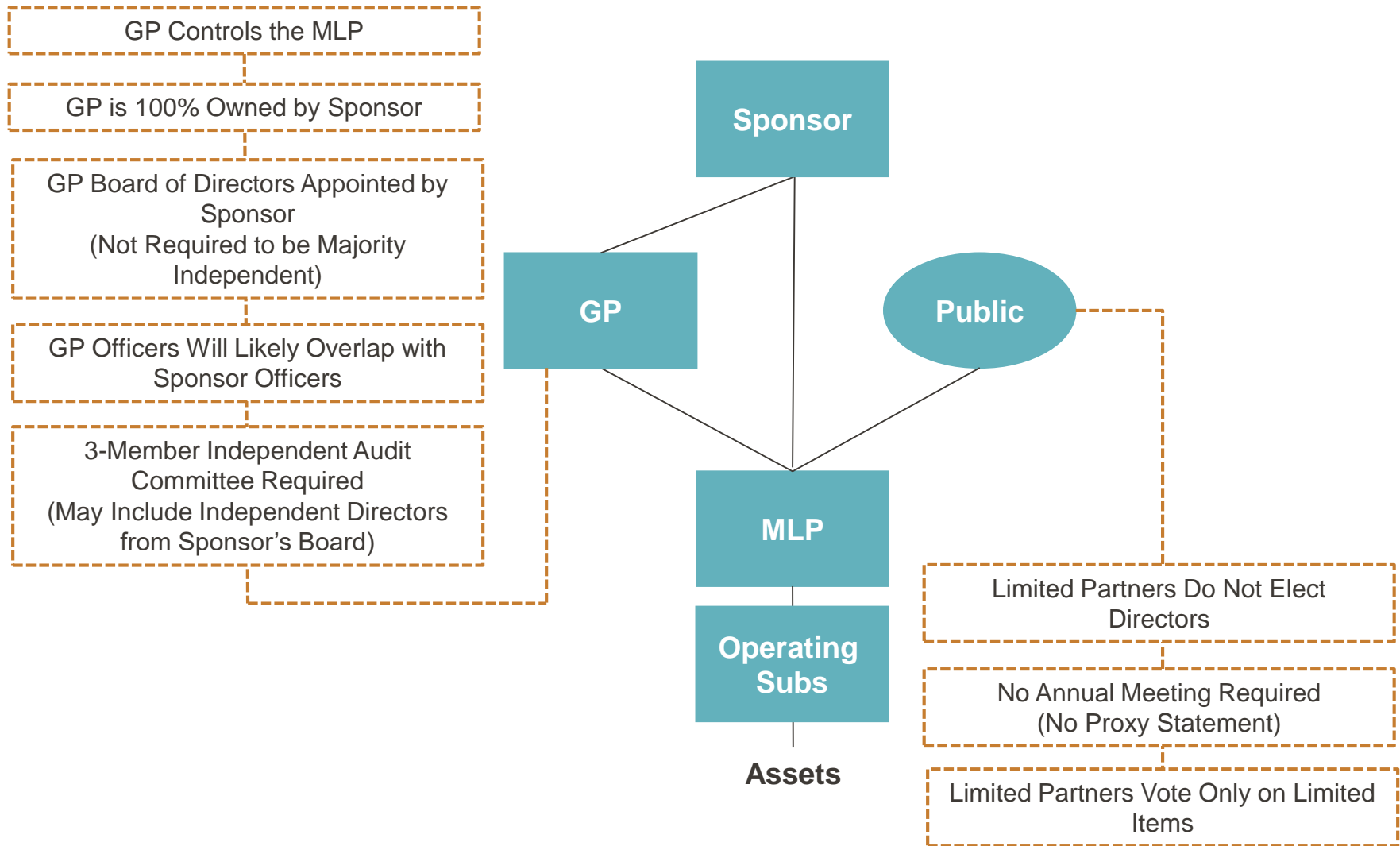
10-YEAR TRANSITION PERIOD

- A partnership may treat income from an activity as qualifying income during the 10-year transition period if:
 - 1) The partnership has a PLR.
 - 2) The partnership is publicly traded and engaged in the activity after May 6, 2015, but before January 19, 2017, and the income from that activity is qualifying income under the proposed regulations.
 - 3) Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as generating qualifying income under a reasonable interpretation.
 - 4) Prior to May 6, 2015, the partnership had entered into a binding agreement for the construction of assets to be used in an activity that generated qualifying income under a reasonable interpretation.

MLP GOVERNANCE AND REPORTING



SUMMARY OF GOVERNANCE STRUCTURE



GOVERNANCE

GENERAL PARTNER CONTROLS THE MLP

- DRULPA permits elimination of fiduciary duties
- LPA sets out duties akin to fiduciary duties
- General Partner is typically 100% owned by the Sponsor
- Executive officers of the Sponsor are typically designated to serve as executive officers of the General Partner
 - Executive officers of the General Partner may devote 100% of their time to the MLP or may continue to be involved with other businesses of the Sponsor
- Often, the MLP and the General Partner have no employees
 - Employees can be retained by the Sponsor and the allocable share of salaries and benefits of these employees reimbursed to the Sponsor (typically for cost) by the MLP
 - The General Partner typically establishes new equity incentive plans to incentivize employees who devote a substantial portion of their time to the MLP's affairs

GOVERNANCE

BOARD AND COMMITTEE REQUIREMENTS

- Board of Directors
 - Sit at GP level, delegated authority by member of GP to manage MLP, with member often retaining control of “sole discretion” items
 - Limited partnerships and “controlled companies” NOT required to have majority of independent directors
- Audit Committee
 - Minimum of three directors, composed of entirely independent directors
- Corporate Governance and Compensation Committee
 - Limited partnerships and “controlled companies” NOT required to have these committees
- Conflicts Committee
 - Provided for in the Limited Partnership Agreement
 - Composed entirely of independent directors

GOVERNANCE

VOTING RIGHTS OF LIMITED PARTNERS

- Limited Partners do not elect directors of the General Partner
 - As a result, most MLPs do not have annual meetings of unitholders
 - *BreitBurn, Buckeye, Linn, Magellan, MarkWest, Suburban* and certain maritime MLPs are among the exceptions
- Limited partners vote only on specified events
 - Sale of all or substantially all assets
 - Removal of the General Partner
 - Certain material amendments to partnership agreement

GOVERNANCE

“FIDUCIARY-LIKE” DUTIES

- Duty is set forth in the limited partnership agreement – a “good faith” standard.
 - When the GP is acting in its capacity as the GP of the MLP, it shall act in good faith and shall not be subject to any higher standard
 - Any action taken (or failure to act) by the GP will be deemed to have been taken in good faith unless the Board believed the action (or failure to act) was adverse to the interests of the MLP
 - Any action taken (or failure to act) by the GP in reliance upon the advice or opinion of a professional expert (lawyer, consultant, investment banker, etc.) is presumed to have been done in good faith and in accordance with such advice or opinion
- Case law states that it is “subjective”, but indicates that the process is the key.

GOVERNANCE

CONFLICTS OF INTEREST

- After the completion of the IPO, conflicts of interest will develop between the MLP and the Sponsor
 - Business opportunities, such as potential acquisitions, that either the MLP or the Sponsor could pursue individually, or when they decide to pursue them jointly
 - Direct dealings between the MLP and the Sponsor, such as in the case of the Sponsor desiring to sell additional assets to or buy assets from the MLP or the MLP and the Sponsor entering into a contractual arrangement
 - Allocations of general and administrative expenses to the MLP
 - Enforcement of indemnification or other agreements between the Sponsor and the MLP
 - The decision to borrow money or sell equity

GOVERNANCE

CONFLICTS RESOLUTION

- The partnership agreement will contain other conflict of interest resolution procedures, which typically provide that the General Partner will not be in breach of its fiduciary duty to the MLP or its unitholders if the resolution of the conflict is:
 - Approved by the Conflicts Committee of the GP (a committee comprised entirely of directors who are independent from the Sponsor); or
 - Approved by the vote of a majority of the outstanding common units, excluding any common units owned by the GP or any of its affiliates.

ACCOUNTING

FINANCIAL STATEMENT REQUIREMENTS

- The timing of an IPO is often driven by the timing of the auditor's annual and interim reviews of the company's financial statements and the staleness dates for the financial statements.
- Generally required for all IPOs:
 - Unaudited financial statements for any stub period
 - Three years of audited financial statements (two of audited balance sheets)
 - Two for Emerging Growth Companies (<\$1bln revenue)
 - Five years of selected financial data
 - Two for Emerging Growth Companies
- Special requirements for MLP IPOs:
 - Cash Distribution Forecast (ability to pay first year's MQD)
 - Cash Distribution Backcast (pro forma ability to have paid MQD during the most recent FY and LTM)
 - Shortfall requires disclosure, but is not a problem

OTHER TAX CONSIDERATIONS



SPONSOR TAX CONSIDERATIONS

DISGUISED SALE AND GAIN DEFERRAL

- Potential deferral of gain upon contribution of assets to an MLP, even where Sponsor receives a distribution or is relieved of debt
- General Rule: Assets In + Cash Out = Sale
- Exceptions to Sale Treatment:
 - Working capital retention
 - Cap-ex reimbursement (prior 24 months)
 - Distributions of operating cash flow
 - Assumption of qualified liabilities
 - Leveraged distributions
- Basis limitation may also cause gain
- Tax Deferral
 - Sponsor recognizes the built-in-gain on public's portion under Section 704(c) over the tax life of the assets or upon disposition

INVESTOR TAX SHIELD

- Unitholders are taxed on their share of the taxable income as if they were engaged in the activity directly
- Distributions are non-taxable (return of capital) unless they exceed a partner's basis
- Disclosure is for marketing purposes
 - Reciprocal of “Ratio of Taxable Income to Distributions”
 - Taxable income may differ across asset classes
- Unitholder vs. Sponsor Considerations
 - Tax rules allow, and unitholders anticipate, deductions based on full FMV tax basis
 - Sponsor pays for this by agreeing to offsetting income allocations to the extent there is not actually enough basis
 - Refreshing of Shield
 - 754 Election / 743(b) Adjustment for Subsequent Purchasers



THANK YOU

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