

# IRS Letter Rulings and TAMs (1954-1997), UIL No. 7704.03-00, Letter Ruling 9639011, (May 20, 1996), Internal Revenue Service, (May 20, 1996)

Letter Ruling 9639011, May 20, 1996

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## Uniform Issue List Information:

UIL No. 7704.03-00

[Code Sec. 7704 ]

This is in reply to your request for a ruling on behalf of the Partnership and its operating limited partnerships, Pipeline Operating Partnership and Transportation Operating Partnership, (collectively, the Operating Partnerships) on the proper treatment of certain income under §7704 of the Internal Revenue Code.

Partnership is a State X limited partnership formed to acquire and operate the assets and continue the businesses of various wholly owned subsidiaries of Parent. The Partnership, through the Operating Partnerships, engages in the processing of natural gas among other activities.

GP, a State X corporation and an indirect, wholly owned subsidiary of Parent serves as the sole general partner of the Partnership. In addition to its 2% general partner interest in the Partnership, GP owns a 12.9% limited partner interest. An 85.1% limited partnership interest in the Partnership is owned by various investors who have purchased interests in the Partnership pursuant to a public offering. The units representing this limited partner interest are publicly traded and listed on the New York Stock Exchange.

The Partnership's activities are conducted through the Operating Partnerships of which the Partnership is the 99% limited partner and GP is the 1% general partner. Specifically, the Partnership is the 99% limited partner in: (i) Pipeline Operating Partnership, which owns various interests and conducts various activities in the oil and gas area; and (ii) Transportation Operating Partnership, which owns a natural gas processing plant and related facilities among other interests. Each of the Operating Partnerships is a State X limited partnership. On a, Partnership acquired a natural gas processing plant and related facilities from an affiliate of Parent, along with other related businesses and assets.

## Facts

On b, an Indirect Subsidiary of Parent assigned to Pipeline Operating Partnership its rights and duties under a gas processing contract with Corporation (Agreement). Under this contract, Pipeline Operating Partnership is obligated to process dedicated volumes of natural gas produced by Corporation. Also on b, Pipeline Operating Partnership subleased from Indirect Subsidiary of Parent, a portion of the capacity at a NGL extraction facility (Facility). The leased capacity at Facility enables Pipeline Operating Partnership to fulfill the processing obligations it assumed in Agreement. As a result of these transactions, Pipeline Operating Partnership receives processing fees from Corporation and makes sublease payments to Indirect Subsidiary of Parent. It is anticipated that the fees generated under the Agreement will be greater than the sublease payments.

Pipeline Operating Partnership's duties under the Agreement require only the processing of natural gas delivered by Corporation and not the storage or transportation of any NGLs generated as a result of such processing. Corporation retains legal title to the natural gas delivered to the plant, and to the contractually

specified volumes of extracted NGLs and the resulting residue gas at the outlet of the plant. Furthermore, Corporation is solely responsible for the fuel necessary to provide power for the processing of its gas at Facility. Facility also bears the loss for the shrinkage of the natural gas stream experienced during such processing.

Pursuant to the Agreement, the processing fee received by Pipeline Operating Partnership consists of two elements. The first element is a monetary payment based upon the gallons of NGLs produced. The second part is a variable, in-kind transfer of NGLs based upon the processing efficiency of Facility and the BTU content of the residue gas. Contractually, Corporation is entitled to receive specified volumes of NGLs based upon the NGLs contained in one thousand cubic feet of natural gas processed; Pipeline Operating Partnership is allowed to retain any NGLs produced in excess of the contractually specified volumes. However, for any NGLs that are retained, Pipeline Operating Partnership is obligated to reimburse Corporation with a quantity of natural gas containing an equivalent BTU content. Additionally, Pipeline Operating Partnership must bear the cost of the plant fuel for the retained NGLs. Typically, this exchange of natural gas for NGLs is profitable for Operating L.P. because hydrocarbons have a higher fair market value in a liquid than in a gaseous state.

Natural gas processing plants recover salable liquids from gaseous streams produced directly from gas wells or from normal oil and gas separation equipment on oil wells. The use of conventional oil and gas separators and emulsion treaters is not usually considered gas processing, nor are treatments to remove such contaminants as dirt, water, vapor, hydrogen sulfide, and carbon dioxide from the gas. Treatments of this latter type are normally referred to as gas conditioning. With these two exceptions, gas processing may be defined as including any operation the primary purpose of which is the recovery of NGLs from gas.

#### Law

Section 7704(a) of the Code, enacted by the Revenue Act of 1987 (the 1987 Act), generally treats publicly traded partnerships as corporations for federal tax purposes. Section 7704(b) provides that the term publicly traded partnership means any partnership if:

(1) interests in such partnership are traded on an established securities market; or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) exempts from treatment as a corporation any publicly traded partnership for any taxable year if the partnership meets the gross income requirements of §7704(c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. Section 7704(c)(2) provides that a partnership meets the gross income requirements of §7704 for any taxable year if 90% or more of the gross income of such partnership for such taxable year consists of qualifying income.

Section 7704(d)(1)(E) defines qualifying income to include income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber).

Qualifying income under §7704(d)(1)(E) is broadly defined to include income and gains derived from processing, transporting or marketing any mineral or natural resource, including fertilizer and timber.

The Conference Report accompanying the 1987 Act, in discussing the type of qualifying income described in §7704(d)(1)(E), states as follows:

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, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane, and similar products that 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. 947 (1987).

Under the terms of the Agreement, Pipeline Operating Partnership is paid a fee for separating the "wet" gas received from Corporation into its constituent components. Corporation retains legal title to the natural gas delivered to the plant and to the contractually specified volumes of extracted NGLs and the resulting residue gas at the outlet of the plant. Furthermore, Corporation provides the fuel to power the processing of its gas at Facility and bears the loss for product shrinkage during such processing.

The negotiation and consummation of the sale of Corporation's products are solely the responsibility of Corporation.

Additionally, any profits or losses resulting from the sale of Corporation's "dry" gas and NGLs accrue solely to Corporation. Pipeline Operating Partnership's only financial benefit from the Agreement results from the monetary and in-kind fees paid by Corporation for the processing of its wet gas.

Qualifying income for purposes of §7704(d)(1)(E) includes income from the processing of any mineral or natural resource. The legislative history quoted above, provides that oil, gas and the products thereof constitute natural resources for this purpose. The income earned by Pipeline Operating Partnership from the Agreement is from the processing of natural gas into NGLs. Such activity constitutes the processing of a natural resource, and accordingly all of the income earned by Pipeline Operating Partnership therefrom constitutes qualifying income under §7704(d)(1)(E) .

Except as specifically ruled upon above, we express no opinion on the federal tax consequences of the transactions described above under any other provisions of the Code.

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See section 11.04 of Rev. Proc. 96-1 , 1996-1 I.R.B. 8, 39. However, when the criteria in section 11.05 of Rev. Proc. 96-1 are satisfied, a ruling is not or modified retroactively, except in rare or unusual circumstances.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to Taxpayer's representative.

Sincerely yours, William P. O'Shea, Chief, Branch 3, Office of Assistant Chief Counsel (Passthroughs and Special Industries)