

July 29, 2015

Via Federal eRulemaking Portal

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

Re: *Proposed Regulations on Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources*

Dear Sir or Madam:

Andrews Kurth LLP appreciates the opportunity to submit comments on the proposed regulations (REG-132634-14) 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”).¹ The Explanation of Provisions (the “Preamble”) to the Proposed Regulations states that no regulations have been issued under Section 7704(d)(1)(E). Instead, questions about the specific application of Section 7704(d)(1)(E), particularly with respect to the qualifying nature of income from support services provided to businesses engaged in Section 7704(d)(1)(E) activities, generally have been resolved by private letter ruling. The Proposed Regulations have been issued in response to the increased interest in the application of Section 7704(d)(1)(E).

EXECUTIVE SUMMARY

We commend the Internal Revenue Service (the “Service”) and the U.S. Department of the Treasury (“Treasury”) drafters for their efforts in this important area. This letter expresses our views regarding the meaning of (i) “mineral or natural resource,” (ii) “refining,” and (iii) “processing,” each as used in Section 7704(d)(1)(E). In addition, we have included for consideration proposed clarifications and modifications to the definitions of “mineral or natural resource,” “refining,” and “processing,” and associated modifications and additions to the

¹ Unless otherwise stated, all Section references herein refer to the Code.

Examples set forth in Prop. Reg. § 1.7704-4(e) that we believe address these matters. Although our comments do not specifically analyze refining or processing of ores and minerals and timber, we believe the definitions of refining and processing set forth herein apply to all minerals and natural resources and are consistent with and supported by the statute, legislative history, and the Service's longstanding ruling position and interpretation of Section 7704(d)(1)(E). We may submit additional comments on other topics.

In order to develop final regulations that preserve the Congressional intent behind Section 7704 while reducing uncertainty and minimizing the need for future private letter ruling requests, we believe that the Service and Treasury should modify and clarify the Proposed Regulations as follows:

A. Clarify the definition of mineral or natural resource to include "products of oil or gas, other than plastics and similar petroleum derivatives." This can be accomplished by replacing the first sentence of Prop. Reg. § 1.7704-4(b) with the following:

The term mineral or natural resource means (1) any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or other similar inexhaustible sources), (2) fertilizer, (3) geothermal energy, (4) timber, and (5) products of oil or gas, other than plastics and similar petroleum derivatives.

B. Modify the definition of refining and processing to be consistent with Congressional intent as evidenced by legislative history. This can be accomplished as follows:

1. Replace Prop. Reg. § 1.7704-4(c)(5) with the following:

Refining. An activity constitutes refining if the activity (A) is an operation or process of the type conducted in a refinery and (B) is performed with respect to a mineral or natural resource to purify, separate, remove impurities, or to effect a physical or chemical change, including through mechanical action, temperature, pressure, or a catalyst.

2. Amend Prop. Reg. § 1.7704-4(c) by adding new § 1.7704-4(c)(6):

Processing. An activity constitutes processing if the activity (A) is not a refining activity and (B) is performed with respect to a mineral or natural resource to purify, separate, remove impurities, or to effect a physical or chemical change.

3. Renumber and make conforming amendments to existing Prop. Reg. § 1.7704-4(c)(6) by replacing the first sentence thereof with the following:

(7) Transportation. Transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4), (5), or (6) of this section, including by pipeline, barge, rail, or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers.

4. Renumber and make conforming amendments to existing Prop. Reg. § 1.7704-4(c)(7) by replacing the first sentence thereof with the following:

(8) Marketing. An activity constitutes marketing if it is performed to facilitate the sale of minerals or natural resources and products produced under paragraph (c)(4), (5), or (6) of this section, including blending additives into fuels.

5. Replace Prop. Reg. § 1.7704-4(e), Example 1 with the following:

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

(ii) Z's activities give rise to qualifying income because Z is processing or refining a natural resource. Additionally, any income received from the marketing or transportation of ethylene, propylene, and other gases is qualifying income for purposes of Section 7704(d)(1)(E) because ethylene, propylene, and other gases are all products of oil or gas that are not plastics or similar petroleum derivatives.

6. Replace Prop. Reg. § 1.7704-4(e) Example 2 with the following:

Example 2. Petroleum streams chemically converted into refinery grade olefins. (i) Y, a publicly traded partnership, owns a petroleum refinery. The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic cracking unit to chemically convert the heavy gas oil into a liquid stream and a gas stream containing ethylene, propylene, and other gases. Y sells the ethylene, propylene, and other gases to a third party.

(ii) Y's activities give rise to qualifying income because Y is processing or refining a natural resource. Additionally, any income received from the marketing or transportation of ethylene, propylene, and other gases is qualifying income for purposes of Section 7704(d)(1)(E) because ethylene, propylene, and other gases are all products of oil or gas that are not plastics or similar petroleum derivatives.

7. Replace Prop. Reg. § 1.7704-4(e) Example 3 with the following:

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

(ii) Y's activities give rise to qualifying income under the definitions proposed herein because Y is processing methane, a mineral or natural resource. Additionally, any income received from the marketing of gasoline, diesel, and methanol is qualifying income from the marketing of a natural resource for purposes of Section 7704(d)(1)(E) because gasoline, diesel, and methanol are all products of oil or gas that are not plastics or similar petroleum derivatives.

8. Add new Prop. Reg. § 1.7704-4(e) Example 7:

Example 7. Processing products into plastics through chemical change. (i) X, a publicly traded partnership, manufactures polyvinyl chloride (PVC) resins. X purchases ethylene and chlorine from third parties, chemically converts ethylene and chlorine into ethylene dichloride (EDC) through direct chlorination and oxychlorination processes, then thermally cracks EDC to produce vinyl chloride monomer (VCM). PVC resins are produced from VCM through various polymerization processes. X receives income from sales of PVC resins.

(ii) X's activities do not give rise to qualifying income because the direct end product of these processes is a plastic or similar petroleum derivative.² Therefore, the income X receives from the manufacture and sale of PVC resins is not qualifying income for purposes of Section 7704(d)(1)(E).

We respectfully request that Treasury and the Service modify and clarify the Proposed Regulations in accordance with our comments.

² We believe treating income from the production of PVC resins as qualifying income is consistent with and supported by the statute and legislative history. *See* Section D.4(d)(ii). However, we would support Treasury and the Service's position that a processing activity the direct result of which is a plastic or similar petroleum derivative does not generate qualifying income.

DISCUSSION

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

Section 7704(a), enacted by the Omnibus Budget Reconciliation Act of 1987, generally treats publicly traded partnerships as corporations for federal income tax purposes. Section 7704(b) provides that the term “publicly traded partnership” means any partnership if (i) interests in that partnership are traded on an established securities market or (ii) interests in that partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) contains an exception that exempts from treatment as a corporation any publicly traded partnership for any taxable year if the partnership met the gross income requirement set forth in Section 7704(c)(2) for that taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership or any predecessor was in existence. A partnership meets the gross income requirements of Section 7704(c)(2) for any taxable year if 90 percent or more of the gross income of the partnership for that taxable year consists of “qualifying income.”

Section 7704(d)(1)(E) provides that the term “qualifying income” includes 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). For purposes of Section 7704(d)(1)(E), the phrase “mineral or natural resource” is defined to mean any product of a character with respect to which a deduction for depletion is allowable under Section 611, except that such term does not include any products described in Section 613(b)(7)(A) or (B).³

B. Brief Industry Descriptions

1. Petroleum Industry

The modern history of petroleum refining began in the 19th century, when refining was a relatively simple distillation process that separated crude oil into its component hydrocarbon compounds to produce kerosene or lamp oil. Beginning in the early 20th century, spurred by the invention of the internal combustion engine, engineers began adding pressure to the standard heating process used in distillation. Under both heat and pressure, heavier molecules “cracked” into lighter molecules such as those of gasoline. In the decades that followed, engineers improved the refining process even further, developing, among other processes, catalytic cracking. In short, the petroleum refining industry evolved significantly prior to the enactment of Section 7704 in response to changes in market demand for products and continues to evolve today. For decades before the enactment of Section 7704(d)(1)(E), petroleum refineries produced many different products through various operations, including separation, distillation, cracking, alkylation, desulfurization, desalting, dehydrogenation, solvent deasphalting, visbreaking, coking, hydrotreating and reforming, polymerization, solvent dewaxing, and blending, many of which involve substantial physical and chemical changes.

³ Section 7704(d)(1).

2. Natural Gas Industry

During most of the 19th century, natural gas was used almost exclusively as a source of light. Most of the natural gas produced in this era was manufactured from coal, rather than coming from a well. Without any way to transport it effectively, natural gas discovered pre-WWII was usually just allowed to vent into the atmosphere, or burnt, when found alongside coal and oil, or simply left in the ground when found alone. It was not until the 1920s that significant effort was put into building a pipeline infrastructure. After World War II, new welding techniques, along with advances in pipe rolling and metallurgy, further improved pipeline reliability. This post-war pipeline construction boom lasted well into the 1960s and allowed for the construction of thousands of miles of pipeline in America.

Once the transportation of natural gas was possible, new uses for natural gas developed including to heat homes and operate appliances such as water heaters, ovens, and cooktops. Industry began to use natural gas in manufacturing and processing plants. Also, natural gas was used to heat boilers used to generate electricity. Today, natural gas has many residential, commercial, and industrial uses. In fact, industry is the largest consumer of natural gas, accounting for 43 percent of natural gas use across all sectors. Natural gas has a multitude of industrial uses, including providing the base ingredients for such varied products as plastic, fertilizer, anti-freeze, and fabrics.⁴

There are too many uses of natural gas and products of natural gas, and too many distinct processes, many of which involve a chemical change, that can be applied to natural gas and products of natural gas, to list herein. One example of a processing activity that involves a chemical change is acknowledged by the drafters of Section 7704 in the legislative history — activities that occur beyond petroleum refineries or field facilities to produce plastics are processing activities.⁵

C. Mineral or Natural Resource - Definition

1. Statutory Construction

Section 7704(d)(1)(E) as originally enacted did not define “mineral or natural resource.” However, it was clear that “gas, oil or products thereof” were minerals or natural resources because the statute provided that qualifying income included income from the transportation (including pipelines transporting gas, oil, or products thereof)... of any mineral or natural resource.”

The Technical and Miscellaneous Revenue Act of 1988 (the “1988 Act”) further explained that the term “mineral or natural resource” means any product of a character with respect to which a deduction for depletion is allowable under Section 611, other than products described in Section 613(b)(7)(A) or (B).

⁴ See <http://naturalgas.org>.

⁵ 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. 943 (1987), 1987-3 C.B. 946-947.

2. Legislative History

The Conference Report accompanying the Omnibus Budget Reconciliation Act of 1987 (the “1987 Act”) provides:

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 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. 943 (1987), 1987-3 C.B. 946-947 (emphasis added).

The Conference Report accompanying the 1988 Act incorporates similar language, “oil and gas and products thereof,” when providing additional limitations on the transportation of minerals and natural resources:

In the case of transportation activities with respect to *oil and gas and products thereof*, the conferees intend that, in general, income from transportation of *oil and gas and products thereof* to a bulk distribution center such as a terminal or a refinery (whether by pipeline, truck, barge, or rail) be treated as qualifying income. Income from any transportation of *oil or gas or products thereof* by pipeline is treated as qualifying income.

H.R. Rep. No. 1104, 100th Cong., 2d Sess. 17-8 (1988) (emphasis added).

Additionally, the Senate Report accompanying the 1988 Act, which was followed by the Conference Report, states that oil and gas and products thereof are minerals and natural resources:

With respect to marketing of minerals and natural resources (*e.g., oil and gas and products thereof*), the Committee intends that qualifying income be income from marketing at the level of exploration, development, processing or refining the mineral or natural resource.

S. Rep. No. 445, 100th Cong., 2d Sess. 424 (1988) (emphasis added).

3. Proposed Regulations

The Proposed Regulations provide that “[t]he term mineral or natural resource (including fertilizer, geothermal energy, and timber) means any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or other similar inexhaustible sources),” but make no specific reference to oil and gas and products thereof.

The legislative history to both the 1987 Act and the 1988 Act includes products of oil and gas in the definition of natural resource. Although many products are produced by additional processing of oil or gas beyond that of petroleum refineries or field facilities, the only limitation on the types of oil and gas products that are natural resources for purposes of Section 7704 are placed on “plastics or similar petroleum derivatives.”⁶

It is useful to compare the different language used by Congress in Section 927(a) relating to foreign sales corporations (repealed) and the Section 199 deduction for qualified production activities. Prior to its repeal, Section 927(a) excluded from the definition of export property “oil or gas (or any primary product thereof).” Section 199 provides a deduction for qualified production activities income that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof, and looks to Section 927(a)(2)(C), as in effect before its repeal, to define primary product. Primary products from oil include crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil.⁷ Primary products from gas are all gas and associated hydrocarbon components from gas or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline.⁸

Where the legislature uses a term or phrase in one statute or provision, but excludes it from another, omission of the same provision from a similar section is significant to show different legislative intent for the two sections.⁹ Thus, in using the term “products thereof” as opposed to “primary product thereof,” Congress clearly intended that products of oil and gas that are not plastics or similar petroleum derivatives, such as olefins, are natural resources, despite the fact that they may be produced by additional processing of oil or gas beyond that of petroleum refineries or field facilities and may be used to produce plastics.

We believe that the Service and Treasury should clarify the Proposed Regulations to be consistent with Congressional intent as evidenced by legislative history. Clarity can be achieved

⁶ H.R. Rep. No. 495, 100th Cong., 1st Sess. 943 (1987), 1987-3 C.B. 947.

⁷ Treas. Reg. §1.927(a)-1T(g)(2)(i).

⁸ Treas. Reg. §1.927(a)-1T(g)(2)(i).

⁹ *Cox v. City of Dallas, Tex.*, 256 F.3d 281 (5th Cir. 2001); *Zhu v. I.N.S.*, 300 F. Supp. 2d 77 (D.D.C. 2004); *Kane v. Principi*, 17 Vet. App. 97 (2003).

by further defining the term mineral or natural resource to specifically include “products of oil or gas, other than plastics and similar petroleum derivatives.” This can be accomplished by replacing the first sentence of Prop. Reg. § 1.7704-4(b) with the following:

The term mineral or natural resource means (1) any product of a character with respect to which a deduction for depletion is allowable under section 611, except that such term does not include any product described in section 613(b)(7)(A) or (B) (soil, sod, dirt, turf, water, mosses, minerals from sea water, the air, or other similar inexhaustible sources), (2) fertilizer, (3) geothermal energy, (4) timber, and (5) products of oil or gas, other than plastics and similar petroleum derivatives.

D. Refining and Processing

1. Statutory Construction

Section 7704 as enacted includes but does not define “refining” or “processing.” The term processing was not included in the House version of the legislation when it was proposed in 1987 and was added in the Conference Report accompanying the Omnibus Budget Reconciliation Act of 1987 (the “1987 Conference Report”).¹⁰ There are no statutory limitations or qualifications on what refining or processing activities can do or accomplish, or on what the products produced by refining or processing activities can be. The only limitation in the statute is that the thing being refined or processed, i.e. the input or feedstock, be a mineral or natural resource.

2. Legislative History

a. Refining

There is no guidance in the legislative history on the definition of refining for purposes of Section 7704, other than to provide that refining is intended to include the production of fertilizer.¹¹ Certain fertilizers such as phosphate and nitrogen-based fertilizers are produced using processes which result in substantial physical and chemical changes.¹²

b. Processing

It is clear that Congress contemplated that “processing” encompassed activities that occur beyond petroleum refineries or field facilities. The 1987 Conference Report states when defining natural resources:

¹⁰ See H.R. Rep. No. 391 100th Cong., 1st Sess. 1069 (1987) and H.R. Rep. No. 495, 100th Cong., 1st Sess. 943 (1987), 1987-3 C.B. 947.

¹¹ H.R. Rep. No. 391 100th Cong., 1st Sess. 1069 (1987).

¹² See <http://www.potashcorp.com/overview/nutrients/nitrogen/overview/simplified-flow-diagram> and <http://www.potashcorp.com/overview/nutrients/phosphate/overview/simplified-flow-diagram>.

Specifically, natural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof....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. 943 (1987), 1987-3 C.B. 946-947.

The legislative history defines only what is a natural resource, and does not limit the types of processing activities that generate qualifying income from processing the natural resource. In fact, Congress clearly states that the activities that occur beyond petroleum refineries or field facilities are “processing.” Thus, the activities directed towards a natural resource that occur outside of or beyond a petroleum refinery or field facility are processing activities, despite the fact that the product produced by the processing activity is no longer a natural resource, and all income derived from those processing activities is qualifying income.

3. Ordinary Meaning

The language of Section 7704(d)(1)(E) is clear and unambiguous, and, absent a statutory definition otherwise, full effect must be giving to the ordinary, common meanings of “processing” and “refining.”¹³ The Oxford Dictionary defines the verbs “process” and “refine” as follows:

Process: perform a series of mechanical or chemical operations on (something) in order to change or preserve it.

Refine: remove impurities or unwanted elements from (a substance), typically as part of an industrial process.

4. Proposed Regulations

The Proposed Regulations generally state that processing and refining do not include activities that cause a substantial physical or chemical change in a mineral or natural resource or transform extracted minerals or natural resources into new or different mineral products, such as manufactured products. With respect to petroleum, an exception would apply to activities to make a fuel. With respect to natural gas, an activity is processing or refining only if the activity purifies the natural gas or separates the natural gas into its constituents, or if the activity involves a conversion of methane to liquid fuels that are otherwise produced from petroleum. With respect to ores and minerals, an activity is processing or refining only if it meets the definitions in Reg. §1.613-4(f)(1)(ii) or §1.613-4(g)(6)(iii). With respect to timber, an activity is processing if it modifies the physical form of the timber. The Proposed Regulations further require that for an activity to be treated as processing or refining, the partnership’s designation of the MACRS class life for any of the assets used in the activity must reflect that the activity is processing or

¹³ *Caminetti v. U.S.*, 242 U.S. 470, 485, 37 S. Ct. 192, 61 L. Ed. 442 (1917).

refining. The Proposed Regulations do not address processing or refining of products of oil or gas.

a. “Processing” and “Refining” are Separate and Distinct Activities

The Proposed Regulations incorrectly give processing and refining the same meaning — an activity “done to purify, separate or eliminate impurities.”

This is contrary to Section 7704(d)(1)(E), which treats “processing” and “refining” as separate activities, separated by commas. Under the most basic principles of statutory construction, one must assume that every word, phrase, and clause in a legislative enactment is intended and has some meaning and that none was inserted accidentally.¹⁴ Thus, every word must be accorded significance and effect, and Section 7704(d)(1)(E) must be interpreted to give each term a separate meaning so that no part is superfluous.¹⁵

Although “refine” and “process” are synonyms and may be used interchangeably under their ordinary use and common meaning, by adding “processing” to the list of qualifying activities, Congress clearly intended to expand the activities that, when directed towards a mineral or natural resource, generate qualifying income. It is clear that, while there may be some overlap, processing must include activities that are not treated as refining, and refining must include activities that are not treated as processing. By giving processing and refining the same meaning, the Proposed Regulations would make part of the statute redundant, which is clearly inconsistent with legislative intent, the literal text of Section 7704(d)(1)(E), and the fundamental canons of statutory interpretation.

b. No Basis for Industry-Specific Rules

The Proposed Regulations attempt to provide industry-specific rules based only on the supposition that “processing and refining activities vary with respect to different minerals or natural resources,” yet give processing and refining the same general meaning for all industries. There is nothing in Section 7704 or the legislative history to support a different meaning of processing or refining depending on the type of mineral or natural resource being processed or refined, and it is highly inappropriate to read unwarranted meanings into an unambiguous statute.

c. MACRS

The Proposed Regulations state “[f]or an activity to be treated as processing or refining for purposes of this section, the partnership’s position that an activity is processing or refining for purposes of this section must be consistent with the partnership’s designation of an appropriate Modified Accelerated Cost Recovery System (MACRS) class life for assets used in the activity in accordance with Rev. Proc. 87-56, 1987-2 CB 674 (see § 601.601(d)(2)(ii)(b) of this chapter).”

¹⁴ *Chicksaw Nation v. U.S.*, 534 U.S. 84, 122 S. Ct. 528, 151 L. Ed. 2d 474 (2001); *United States v. Menasche*, 348 U.S. 528, 75 S. Ct. 513, 99 L.Ed. 615 (1955); *General Motors Acceptance Corp. v. Whisnant*, 387 F.2d 774 (5th Cir. 1968).

¹⁵ *Corley v. U.S.*, 556 U.S. 303, 129 S. Ct. 1558, 173 L.Ed. 2d 443 (2009).

Nothing in the statute or legislative history ties Section 7704 activities to the depreciation rules. Additionally, although there are some manufacturing class lives that incorporate certain processing activities¹⁶, there is no specific MACRS class life for “processing” thus the requirement is unworkable for processing of minerals or natural resources. To our knowledge, the Service has issued private letter rulings for the past three decades without so much as an inquiry into the MACRS depreciation life of the assets at issue. Introducing this limitation absent any explicit support in the text of the statute or legislative history would be inappropriate. Additionally, loss of partnership status under the Code is an excessive penalty for selecting an “inappropriate” MACRS recovery period.

d. Substantial Physical or Chemical Changes

The Preamble to the Proposed Regulations 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 Treasury Department and the IRS believe that this rule is consistent with definitions found elsewhere in the Code and regulations. See, for example, § 1.613-4(g)(5).” The Proposed Regulations further provide that the only qualifying processing and refining activities with respect to petroleum are those activities that involve a chemical conversion “if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline).”

There is no basis in common usage, Section 7704 or the legislative history thereunder, or any other provisions of the Code or the Treasury Regulations for the assertion that processing or refining does not include activities that cause a substantial physical or chemical change in a mineral or natural resource or to limit activities to those involving fuel production. In fact, as evidenced by the dictionary definitions and the histories of the petroleum and natural gas industries, both refining and processing include activities that cause substantial physical or chemical changes in the products being refined or processed.

i. Common Usage

As discussed previously, the common use and plain meaning of the words processing and refining include activities that cause substantial physical and chemical changes.

ii. Section 7704 and Legislative History

The Proposed Regulations set forth definitions for processing and refining of petroleum and for processing of natural gas that assume the only qualifying processing and refining activities that involve a chemical conversion are those that produce gasoline or other fuels.

¹⁶ Rev. Proc. 87-56, 1987-2 C.B. 674.

There are no limitations in the Code or the legislative history on what constitutes refining or processing for purposes of Section 7704, and no restrictions whatsoever on “changes,” physical, chemical, or otherwise. The biases towards the production of gasoline or other fuels in the Proposed Regulations and against other common products of refining or processing of petroleum, natural gas, or products thereof, such as olefins, are not supported by the statute or legislative history. One can only presume based on the language in the Proposed Regulations that there is an underlying belief that the purpose of Section 7704(d)(1)(E) was to provide tax benefits only to the gasoline industry. Where the words of a statute are clear and free from ambiguity, the letter of the statute may not be disregarded under the pretext of pursuing its (purported) purpose.¹⁷ The intent of the authors of Section 7704(d)(1)(E) is gleaned from what is said in the statute, and not from what one believes, almost three decades later, the authors may have intended to say.¹⁸ This belief is also clearly inconsistent with Congressional intent as evidenced by the statute and legislative history.

Legislative history tells us that Section 7704 was enacted due to concerns about the long-term erosion of the corporate tax base.¹⁹ The exception for certain natural resources was carved out because the legislators considered the disruption of the industry to be inadvisable due to the economic conditions at the time and considered it inappropriate to subject net income from such activities to the corporate tax regime.²⁰ The exception provided for natural resources activities initially included refining of any mineral or natural resource, and later added processing to the list of qualifying activities. There is no restriction on refining or processing in the statute or legislative history regarding a “chemical change” or a “physical change” or limiting activities to those directed towards fuel production and it is inappropriate to in effect rewrite the statute to introduce such limitations.

In fact, the only mention of processing in the legislative history indicates that processing includes activities that involve substantial physical and chemical changes.

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. 943 (1987), 1987-3 C.B. 946-947.

Thus, legislative history tells us that, although plastics and similar petroleum derivatives are not natural resources for purposes of Section 7704, the activities conducted with respect to oil, gas or products thereof to produce plastics and similar petroleum derivatives are processing activities. Plastics are produced from the processing of oil, natural gas, or coal. All of the

¹⁷ *Com. v. Firman*, 571 Pa. 610, 813 A.2d 643 (2002).

¹⁸ *Com. v. Young*, 453 Mass. 707, 905 N.E. 2d 90 (2009); *Clark v. Clark*, 601 S.W.2d 614 (Ky. Ct. App. 1980).

¹⁹ H.R. Rep. No. 391, 100th Cong., 1st Sess. 1065 (1987).

²⁰ H.R. Rep. No. 391, 100th Cong., 1st Sess. 1066 (1987).

intermediate activities to produce hydrocarbon compounds called monomers, such as ethylene, propylene, butane, benzene and xylenes, from oil, natural gas, or coal, involve substantial physical and chemical changes. The polymerization process used to ultimately produce a plastic product involves chemically reacting monomers to form polymer chains.²¹ The activities to produce monomers from oil, natural gas, or coal, and ultimately plastics are refining or processing activities and a significant portion of such activities involve substantial physical and chemical changes.

iii. Other Treasury Regulations

Treas. Reg. § 1.613-4(g)(5) only treats processes that effect a substantial physical or chemical change in a crude mineral product as nonmining processes and not as processes that are not “refining” or “processing.” There are no definitions of processing found elsewhere in the Code and Treasury Regulations, and therefore no support for the definition of processing set forth in the Proposed Regulations.

The Proposed Regulations ignore the definition of refining in Treas. Reg. § 1.613A-7. Treas. Reg. § 1.613A-7 defines refining, with respect to crude oil, as “any operation by which the physical or chemical characteristics of crude oil are changed, exclusive of such operations as passing crude oil through separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and blending of crude oil products.” For purposes of Treas. Reg. § 1.613A-7, crude oil includes natural gas liquids (“NGLs”) recovered from a gas well.²²

The definition set forth in the Proposed Regulations for processing and refining of petroleum is clearly inconsistent with the definition of refining in Treas. Reg. § 1.613A-7. While the Proposed Regulations allow substantial physical and chemical changes to occur during the processing or refining of petroleum, there is no support in Treas. Reg. § 1.613A-7 for the very detailed requirements set forth under the Proposed Regulations that require products of a chemical conversion to be “recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels” for such conversion to constitute processing or refining of petroleum or for the disallowance of further processing or refining of NGLs that involve substantial physical or chemical changes. This is a marked contrast from the treatment of any operation that changes the physical or chemical characteristics of crude oil (including NGLs) as refining under Treas. Reg. § 1.613A-7.

Treas. Reg. § 1.613-4(g)(6)(iii) defines refining of ores and minerals as “processes (other than mining processes designated in section 613(c)(4) or this section) used to eliminate impurities or foreign matter from smelted or partially processed metallic and nonmetallic ores and minerals, as, for example, the refining of blister copper. In general, a refining process is designed to achieve a high degree of purity by removing relatively small amounts of impurities or foreign matter from smelted or partially processed ores or minerals.” While this definition of refining is consistent with the general definition of processing or refining set forth in the

²¹ See <http://plastics.americanchemistry.com/Education-Resources/Plastics-101/How-Plastics-Are-Made.html>.

²² Treas. Reg. § 1.613A-7(s)(3).

Proposed Regulations, Treas. Reg. § 1.613-4 clearly does not define processing. Additionally, in light of the definition of crude oil refining in Treas. Reg. § 1.613A-7, the seemingly arbitrary choice of the definition of refining of ores and minerals as the general definition of refining of all minerals and natural resources under Section 7704 is unsupportable.

iv. Internal Revenue Manual

In addition, Section 4.41.1.6.1 of the Internal Revenue Manual (the “IRM”) Oil and Gas Handbook (the “Oil and Gas Handbook”) states that modern refining operations may involve the “separation of components plus the breaking down, restructuring, and recombining of hydrocarbon molecules.” The Oil and Gas Handbook further provides that a “refinery process” includes the conversion of petroleum into more valuable products (gasoline or feedstocks) in part through a cracking process where the large saturated hydrocarbons are broken down to yield a mixture of smaller saturated hydrocarbons, unsaturated hydrocarbons such as olefins, and other products. Other refining processes are used for recombining the resulting hydrocarbons to produce finished refinery products or for separating individual products as specialty feedstocks. Separation of component streams is accomplished by additional fractionation, absorption, or solvent extraction.²³

The purpose of the IRM is to serve as “the primary, official source of ‘instructions to staff’ that relate to the administration and operation of the IRS. It details the policies, delegations of authorities, procedures, instructions and guidelines for daily operations for all IRS organizations. The IRM ensures that employees have the approved policy and guidance they need to carry out their responsibilities in administering the tax laws or other agency obligations.”²⁴ The Oil and Gas Handbook introduces examiners to and assists them in the examination of income tax returns of taxpayers in the oil and gas industry, including publicly traded partnerships.²⁵ The Oil and Gas Handbook does not limit what constitutes a refining process to those that purify, separate or eliminate impurities, nor does it state that the only processes involving a chemical conversion that will be treated as refining processes are those that produce gasoline or other fuels. Instead, the Oil and Gas Handbook clearly indicates that any conversion to create more valuable products such as gasoline or feedstocks is a refinery process.

e. Evisceration of Transportation and Marketing

The Proposed Regulations render the transportation and marketing provisions of Section 7704 utterly inoperative for certain products of natural resource processing, such as olefins. Under the Proposed Regulations, transportation and marketing of olefins produced by certain petroleum refining activities is qualifying. However, the transportation and marketing of olefins produced from certain other natural resource feedstocks (e.g. products of natural gas) is nonqualifying. A transporter or marketer cannot determine with any level of certainty the origin of products that are otherwise fungible, and in effect, the Proposed Regulations void the

²³ IRM 4.41.1.6.1.1(2) and IRM 4.41.1.6.1.1(4).

²⁴ IRM 1.11.2.2.

²⁵ IRM 4.41.1.5.3.

transportation and marketing provisions of Section 7704 for certain products of natural resource processing and refining.

5. Clarify Definitions of “Processing” and “Refining”

We believe that the Service and Treasury should modify the Proposed Regulations to be consistent with Congressional intent as evidenced by legislative history. The basic rules of statutory construction favor according statutes with their plain and obvious meaning and provide that one cannot look beyond plain language unless there is obvious or clear evidence of contrary legislative intent.²⁶ As stated herein, there is no clearly expressed legislative intent to give processing and refining the same general meaning, introduce industry specific rules that limit what a refining or processing activity does or accomplishes, or to incorporate into Section 7704 additional limitations under Section 168 of the Code. Thus, to give effect to the meaning of the statute and legislative intent, we suggest the following modifications to the Proposed Regulations:

Replace Prop. Reg. § 1.7704-4(c)(5) with the following:

Refining. An activity constitutes refining if the activity (A) is an operation or process of the type conducted in a refinery and (B) is performed with respect to a mineral or natural resource to purify, separate, remove impurities, or to effect a physical or chemical change, including through mechanical action, temperature, pressure, or a catalyst.

Amend Prop. Reg. § 1.7704-4(c) by adding new § 1.7704-4(c)(6):

Processing. An activity constitutes processing if the activity (A) is not a refining activity and (B) is performed with respect to a mineral or natural resource to purify, separate, remove impurities, or to effect a physical or chemical change.

Re-number and make conforming amendments to existing Prop. Reg. § 1.7704-4(c)(6) by replacing the first sentence thereof with the following:

(7) **Transportation.** Transportation is the movement of minerals or natural resources and products produced under paragraph (c)(4), (5), or (6) of this section, including by pipeline, barge, rail, or truck, except for transportation (not including pipeline transportation) to a place that sells or dispenses to retail customers.

Re-number and make conforming amendments to existing Prop. Reg. § 1.7704-4(c)(7) by replacing the first sentence thereof with the following:

²⁶ *Barber v. Gonzales*, 347 U.S. 637, 74 S. Ct. 822, 98 L.Ed. 1009 (1954).

(8) Marketing. An activity constitutes marketing if it is performed to facilitate the sale of minerals or natural resources and products produced under paragraph (c)(4), (5), or (6) of this section, including blending additives into fuels.

6. Effect on Examples in the Proposed Regulations

The following examples are derived from Prop. Reg. § 1.7704-4(e) and analyzed under the revised definitions of refining and processing set forth herein. We respectfully request that the Service and Treasury modify the Examples in accordance with our comments.

a. Example 1. Petrochemical products sourced from an oil and gas well.

(i) Z, a publicly traded partnership, chemically converts a mixture of ethane and propane (obtained from the physical separation of natural gas) into ethylene, propylene, and other gases through the use of a steam cracker.

(ii) Z's activities give rise to qualifying income because Z is processing or refining a natural resource. Additionally, any income received from the marketing or transportation of ethylene, propylene, and other gases is qualifying income for purposes of Section 7704(d)(1)(E) because ethylene, propylene, and other gases are all products of oil or gas that are not plastics or similar petroleum derivatives.

b. Example 2. Petroleum streams chemically converted into refinery grade olefins.

(i) Y, a publicly traded partnership, owns a petroleum refinery. The refinery physically separates crude oil, obtaining heavy gas oil. The refinery then uses a catalytic cracking unit to chemically convert the heavy gas oil into a liquid stream and a gas stream containing ethylene, propylene, and other gases. Y sells the ethylene, propylene, and other gases to a third party.

(ii) Y's activities give rise to qualifying income because Y is processing or refining a natural resource. Additionally, any income received from the marketing or transportation of ethylene, propylene, and other gases is qualifying income for purposes of Section 7704(d)(1)(E) because ethylene, propylene, and other gases are all products of oil or gas that are not plastics or similar petroleum derivatives.

c. Example 3. Processing methane gas into synthetic fuels through chemical change.

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

(ii) Y's activities give rise to qualifying income under the definitions proposed herein because Y is processing methane, a mineral or natural resource. Additionally, any income received from the marketing of gasoline, diesel, and methanol is qualifying income from the

marketing of a natural resource for purposes of Section 7704(d)(1)(E) because gasoline, diesel, and methanol are all products of oil or gas that are not plastics or similar petroleum derivatives.

7. Add New Example 7 in the Proposed Regulations

Although we believe treating income from the production of plastics or similar petroleum derivatives as qualifying income is consistent with and supported by the legislative history to Section 7704, we support Treasury and the Service's position that a processing activity the direct result of which is a plastic or similar petroleum derivative does not generate qualifying income. The following new Example 7 provides that a processing activity to manufacture a plastic or similar petroleum derivative does not generate qualifying income. We respectfully request that the Service and Treasury modify the Examples to add new Example 7.

Example 7. Processing products into plastics through chemical changes. (i) X, a publicly traded partnership, manufactures polyvinyl chloride (PVC) resins. X purchases ethylene and chlorine from third parties, chemically converts ethylene and chlorine into ethylene dichloride (EDC) through direct chlorination and oxychlorination processes, then thermally cracks EDC to produce vinyl chloride monomer (VCM). PVC resins are produced from VCM through various polymerization processes. X receives income from sales of PVC resins.

(ii) X's activities do not give rise to qualifying income because the direct end product of these processes is a plastic or similar petroleum derivative. Therefore, the income X receives from the manufacture and sale of PVC resins is not qualifying income for purposes of Section 7704(d)(1)(E).

8. Prior Ruling Positions

Taxpayers require a high level of certainty regarding qualifying income to operate and do business in publicly traded partnership form. The Service has historically responded to the need for taxpayer certainty in this area, in the absence of any qualifying income regulatory guidance, through the issuance of private letter rulings. While these private letter rulings are not binding authority and cannot be used by persons other than the taxpayer who requested it or cited as precedent, they are instrumental in business planning and structuring in that they do provide a contemporary indication of the Services' position.

We understand the desire to issue regulatory guidance to provide some level of taxpayer certainty without the need to go through the time-consuming private letter ruling process. However, the Proposed Regulations present an extreme and unwarranted departure from the Service's longstanding interpretation of and ruling position on processing and refining, as expressed in more than forty private letter rulings over the span of twenty five years. The effects of the Proposed Regulations range, for example, from the very first Section 7704(d)(1)(E) private letter ruling issued by the Service shortly after the enactment thereof that held that pulping of cut timber constitutes the processing of a natural resource within the meaning of Section 7704(d)(1)(E), to more recently, when the Service ruled that the processing of NGLs into

olefins would generate qualifying income for purposes of Section 7704.²⁷ The Proposed Regulations inexplicably and without support reverse the positions of these private letter rulings.

We believe that the Service's prior rulings and the definitions and examples proposed herein are consistent with and supported by the statute and legislative history. In the absence of any Congressional action or change in law, the use of regulatory guidance to make such a sudden, unexpected and arbitrary change in policy that has the effect of revoking prior rulings, even after a transition period, is unprecedented and would be inequitable to taxpayers and investors. This unwarranted about-face from the Service will erode confidence in the tax system and call into question the integrity of the private letter ruling process.

We appreciate your consideration of these comments. If you have any questions regarding these comments, or would like to discuss them further, please contact Tom Ford, Allison Mantor, Robert McNamara, or Angela Richards at 713-220-4200.

Respectfully submitted,



Andrews Kurth LLP

²⁷ PLR 9008035 (November 24, 1989); PLR 201340011 (June 26, 2013).