



**BLACK STONE
MINERALS**

July 30, 2015

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

Re: Taxpayer Comments on Proposed REG-132634-14

To Whom It May Concern:

Black Stone Minerals, L.P. respectfully submits the following comments on the recently proposed regulations published by the U.S. Department of the Treasury (“*Treasury*”) and the Internal Revenue Service (“*IRS*”) on May 5, 2015, under Section 7704(d)(1)(E); dealing with the definition of natural-resource-related “qualifying income” for publicly traded partnerships (the “*Proposed Regulations*”).

We appreciate the efforts by the IRS and Treasury to clarify the types of income that qualify under Section 7704(d)(1)(E). We are concerned, however, that certain activities were overlooked in the drafting of the exclusive list of industry-specific activities that generate qualifying income that was set out in the Proposed Regulations: namely, income earned from passive, non-operating economic interests, such as landowner royalties, overriding royalties, net profits interests, and production payments in mineral or natural resource deposits (“*Passive Economic Interests*”):²

By attempting to create an exclusive list without reference to these direct, fundamental interests in mineral properties, the Proposed Regulations have created uncertainty where none existed previously and none is appropriate. Therefore, we are seeking clarification that the qualifying-income status for income of any kind derived from, or in connection with, Passive Economic Interests (including lease bonus, royalties, delay rentals, and shut-in royalties) is not affected or intended to be affected by the Proposed Regulations.

Black Stone Minerals, L.P. is a publicly traded partnership (an “*MLP*”) that owns, acquires, and manages Passive Economic Interests. We are one of the largest oil and natural gas mineral interest owners in the United States, and we generate the majority of our income from lease bonus, royalties, delay rentals, and shut-in royalties.

Mineral and royalty interest ownership is a common investment in the oil and gas industry, and in particular among MLPs and royalty trusts (some of which are treated as publicly traded partnerships for federal income tax purposes). Since the 1980s, at least six MLPs (in addition to us) and approximately twenty royalty trusts have served as public investment vehicles in Passive Economic Interests.

¹ References to a “Section” are to a section of the Internal Revenue Code of 1986, as amended (the “*Code*”), or a Section of the Treasury Regulations, unless otherwise indicated.

²As originally enacted in the Omnibus Budget Reconciliation Act of 1987 (the “*1987 Act*”), Section 7704(d)(1)(E) stated in relevant part 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” The Technical and Miscellaneous Revenue Act of 1988 (the “*1988 Act*”) added the flush language of Section 7704(d)(1), which states that the phrase “mineral or natural resource” refers to any product that is eligible for depletion under Section 611; this includes, among other things, coal, oil, gas, sand, and aggregates. The 1988 Act amendment was effective as if the provision had been included in the 1987 Act.

Qualifying income under Section 7704(d)(1)(E) from exploration, development, mining, production, or marketing is commonly derived by three types of participants in the natural resource industry: (1) owners of Passive Economic Interests that do not engage in the operations associated with mineral properties but benefit from their respective shares of production revenue, (2) working interest owners (whether or not the “operator”) that are responsible for the activities of exploring for, drilling for, and producing natural resources from the mineral properties, and (3) third-party service providers, who generally do not own an economic interest in the mineral properties but charge the working interest owners fees or service charges.

The Proposed Regulations address income generated from the activities listed for the type (2) and (3) participants described above but do not provide any guidance concerning income associated with Passive Economic Interests. We respectfully request that the regulations, when finalized, specifically state that income of any kind from a Passive Economic Interest is qualifying income under Section 7704(d)(1)(E).

Proposed Regulations

The Proposed Regulations provide guidance on whether certain activities and services relating to minerals or natural resources, referred to as “Qualifying Activities” in the Proposed Regulations, generate qualifying income within the meaning of Section 7704(d)(1)(E). Qualifying Activities include “Section 7704(d)(1)(E) Activities,” which the Proposed Regulations define to include the exploration, development, mining or production, processing, refining, transportation or marketing of minerals or natural resources. The Proposed Regulations further provide an exclusive list of operations that constitute each Section 7704(d)(1)(E) Activity.

Proposed Regulation Section 1.7704-4(c)(2) defines “exploration” for purposes of Section 7704(d)(1)(E):

Exploration. An activity constitutes exploration if it is performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit by: (i) drilling an exploratory or stratigraphic type test well; (ii) conducting drill stem and production flow tests to verify commerciality of the deposit; (iii) conducting geological or geophysical surveys; (iv) interpreting data obtained from geological or geophysical surveys; or (v) for minerals, testpitting, trenching, drilling, driving of exploration tunnels and adits, and similar types of activities described in Rev. Rul. 70-287 (1970-1 CB 146), (see §601.601(d)(2)(ii)(b) of this chapter) if conducted prior to development activities with respect to the minerals.

Proposed Regulation Section 1.7704-4(c)(3) defines “development” for purposes for Section 7704(d)(1)(E):

Development. An activity constitutes development if it is performed to make accessible minerals or natural resources by: (i) drilling wells to access deposits of mineral or natural resources; (ii) constructing and installing drilling, production, or dual purpose platforms in marine locations, or any similar supporting structures necessary for extraordinary non-marine terrain (such as swamps or tundra); (iii) completing wells, including by in-

stalling lease and well equipment, such as pumps, flow lines, separators, and storage tanks, so that wells are capable of producing oil and gas, and the production can be removed from the premises; (iv) performing a development technique such as, for minerals, stripping, benching and terracing, dredging by dragline, stoping, and caving or room-and-pillar excavation, and for oil and natural gas, fracturing; or (v) constructing and installing gathering systems and custody transfer stations.

Proposed Regulation Section 1.7704-4(c)(4) defines “mining or production” for purposes for Section 7704(d)(1)(E):

Mining or production. An activity constitutes mining or production if it is performed to extract minerals or other natural resources from the ground by: (i) operating equipment to extract natural resources from mines and wells; or (ii) operating equipment to convert raw mined products or raw well effluent to substances that can be readily transported or stored (for example, passing crude oil through mechanical separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and operating heater-treaters that separate raw oil well effluent into crude oil, natural gas, and salt water).

Proposed Regulation Section 1.7704-4(c)(7) defines “marketing” for purposes for Section 7704(d)(1)(E):

Marketing. An activity constitutes marketing if it is performed to facilitate sale of minerals or natural resources and products produced under paragraph (c)(4) or (5) of this section, including blending additives into fuels. Marketing does not include activities and assets involved primarily in retail sales (sales made in small quantities directly to end users), which includes, but is not limited to, operation of gasoline service stations, home heating oil delivery services, and local gas delivery services.

The Proposed Regulations address the treatment of working interest owners and third-party service providers³ but fail to address the treatment of owners of Passive Economic Interests. Because Passive Economic Interest owners have (i) an economic interest in the minerals in place⁴ and (ii) a right to share and participate in the proceeds derived from the production of the minerals, income realized by such interests is literally “derived” from the exploration, development, mining or production, or marketing of minerals or natural resources, and therefore is qualifying income under Section 7704(d)(1)(E). Accordingly, we request that the Proposed Regulations be modified so that, when finalized, the regulations explicitly state that income of any kind from a Passive Economic Interest is qualifying income within the meaning of Section 7704(d)(1)(E).

Section 7704

Section 7704(a), enacted as part of the 1987 Act, 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) the 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 that meets the gross income requirement set forth in Section 7704(c)(2) for a given taxable year and each preceding

³This comment letter relates only to the treatment of Passive Economic Interests and does not address other aspects of the Proposed Regulations.

⁴An owner of a Passive Economic Interest is treated as an owner of oil and gas when it is in fact produced; the working interest owners merely market such production on behalf of the Passive Economic Interests owners.

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, in part, that the term “qualifying income” includes income and gains derived from the exploration, development, production, processing, refining and transportation of any mineral or natural resource.

Legislative History

The legislative history to Section 7704 provides that income earned by holders of Passive Economic Interests in mineral or natural resource deposits who are not actively involved in operations is intended to be included as qualifying income under Section 7704(d)(1)(E). In particular, House Report 100-391, the conference report relating to the 1987 Act, provided that:

[P]ublicly traded partnerships are treated as corporations for Federal income tax purposes. An exception is provided for certain partnerships, 90 percent or more of whose gross income is *passive-type income* (as defined for purposes of the provision)...

...*Passive-type income*, for purposes of the provision, is defined as certain interest, dividends, real property rents, gains from the sale or other disposition of real property, and income and gains from certain natural resources activities....

...In the case of natural resources activities, special considerations apply. Thus, *passive-type income* from such activities is considerably broader, and includes *income and gains* from exploration, development, mining or production, refining, transportation (including through pipelines transporting gas, oil, or products thereof), or marketing of, any mineral or natural resource, including geothermal energy and timber.⁵

House Report 100-391 makes it clear that Congress intended for passive income from oil and gas exploration, development, and production to generate qualifying income under Section 7704(d)(1)(E).

Analysis

Section 7704(d)(1)(E) provides, in part, that the term “qualifying income” includes income and gains derived from the exploration, development, or production of any mineral or natural resource. Section 7704(d)(1)(E) does not define the term “derived,” but the usual definition—“to take, receive or obtain from a specified source”⁶—is easily applied here. To receive qualifying income from exploration, development, mining or production, or marketing, one must be considered to take, receive, or obtain income from the exploration, development, mining or production, or marketing of any mineral or natural resource.

Passive Economic Interests are a fundamental means of investing in—and taking, receiving, or obtaining income from—exploration, development, mining or production, or marketing of a mineral or natural resource. Passive Economic Interests come in different forms (*e.g.*, landowner royalties, overriding royalties, net profits interests, and production payments) and are negotiated with varying

⁵H.R. Rep. No. 100-391 (1987) (House Ways and Means Conf. Rep.) (emphasis added).

⁶Webster’s Third New International Dictionary.

economics, but in each case, the Passive Economic Interest entitles the owner to share in the underlying mineral or natural resource or the proceeds from disposing of such mineral or natural resource. The IRS explicitly stated in Rev. Rul. 85-16 that a mineral royalty is generally “payable only from the minerals produced or the proceeds derived from the disposition of those minerals.”⁷ The Oil and Gas Industry Handbook section of the Internal Revenue Manual (the “*Oil and Gas Handbook*”) and case law specifically define other Passive Economic Interests and the payments associated with them:

- A net profits interest is a non-operating, non-expense bearing interest that represents a share of gross production that is determined by the net profits received in connection with mineral development and production.⁸
- A production payment is a share of gross mineral production, free of the costs of production, which terminates when a specified sum of money has been realized.⁹
- A lease bonus payment is a payment in advance for minerals or natural resources to be eventually produced under a lease.¹⁰
- Delay rentals are amounts paid to the mineral interest owner for the privilege of deferring the commencement of drilling a well on a mineral property.¹¹
- Shut-in royalties are payments to the mineral interest owner when a well is capable of producing in commercial quantities but is “shut in” because of lack of market or marketing facilities.¹²

As such, any income received by a holder of a Passive Economic Interest is clearly “received or obtained” from the exploration, development, or mining or production of a mineral or natural resource, and any income derived from those payments or interests is clearly passive in nature. As stated in the Oil and Gas Handbook, “income from oil and gas royalties is *passive-type income* derived from a landowner’s royalty, overriding royalty, or a net profits interest.”¹³ Therefore, treating income derived from Passive Economic Interests as qualifying income under Section 7704(d)(1)(E) is consistent with the statute, legislative history, and other IRS guidance regarding such interests.

Additionally, because a Passive Economic Interest encompasses the right to a share of the produced mineral or natural resource or a share of the proceeds derived from the sale and disposition of the produced mineral or natural resource, income with respect to such interests should also be viewed as derived from the marketing of such minerals or natural resources under Section 7704(d)(1)(E). In some cases, a Passive Economic Interest owner elects to receive its share of the mineral or natural resource in kind (actually taking possession of the mineral or natural resource).

The Passive Economic Interest owner must then sell the mineral or natural resource to realize value. The sale would clearly constitute income from the marketing of a mineral or natural resource. More commonly, however, the owner

⁷ Rev. Rul. 85-16, 1985-1 CB 180 (emphasis added).

⁸ Oil and Gas Handbook, Drilling Site Location as Consideration for a Net Profits Interest, I.R.M. 4.41.I.2.3.4 (07-31-2002).

⁹ Oil and Gas Handbook, Acquisition of Property by a Production Payment, I.R.M. 4.41.I.2.3.5 (12-03-2013).

¹⁰ *Herring v. Comm’r*, 293 U.S. 322 (1934).

¹¹ Oil and Gas Handbook, Delay Rentals, I.R.M. 4.41.I.2.2.2 (10-01-2005).

¹² Delay rentals and shut-in royalties may also be considered rents from real properties, which is considered qualifying income for purposes of Section 7704(d)(1)(C). See *Johnson v. Phinney*, 387 F.2d 544 (5th Cir. 1961); *Houston Farms Dev. Co. v. U.S.*, 131 F.2d 577, 579 (5th Cir. 1942); Priv. Ltr. Rul. 2012-50-008 (Dec. 14, 2012). However, such income is related to the business of owning a mineral interest and therefore is derived from this activity.

¹³ Oil and Gas Handbook, Income to Royalty Owner, I.R.M. 4.41.I.3.I.1 (12-03-2013) (emphasis added).

of a Passive Economic Interest chooses to take a share of the revenue derived from the sale of the produced mineral or natural resource (instead of its share of the actual production). In this situation, the working interest owner sells the mineral or natural resource on behalf of the Passive Economic Interest owner, but the income to the Passive Economic Interest owner is still “received or obtained” from the marketing of a mineral or natural resource under Section 7704(d)(1)(E).

Conclusion

The plain meaning of 7704(d)(1)(E) and the legislative history to Section 7704 clearly indicate that “income and gains derived from the exploration, development, mining or production, processing, refining, transportation, and marketing of any mineral or natural resource” includes any income earned by a publicly traded partnership that directly or indirectly holds a Passive Economic Interest in a mineral or natural resource deposit. Accordingly, we respectfully request that final regulations explicitly state that income of any kind from a Passive Economic Interest is qualifying income under Section 7704(d)(1)(E).

Regards,

A handwritten signature in dark ink, appearing to read 'S. Putman', written in a cursive style.

Steve Putman
Senior Vice President, General Counsel, and Secretary