

INSIGHTS

MLP Qualifying Income – Treasury and IRS Issue Proposed Regulations

May 6, 2015

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On May 5, 2015, the Department of the Treasury and the Internal Revenue Service (IRS) issued [proposed regulations](#) that provide much-anticipated guidance on the scope of qualifying income under Section 7704(d)(1)(E) of the Internal Revenue Code (Code) for master limited partnerships (MLPs) engaged in activities with respect to minerals or natural resources. The issuance of the proposed regulations is a significant development because private letter rulings (PLRs) historically have been the primary source of interpretive guidance on whether certain mineral or natural resource activities generate qualifying income.

Activities that Generate Qualifying Income

The proposed regulations provide a new term – “qualifying activities” – to define activities relating to minerals or natural resources that generate qualifying income. Qualifying activities include both the activities specifically enumerated in Code Section 7704(d)(1)(E) – exploration, development, mining or production, processing, refining, transportation and marketing of minerals and natural resources (section 7704(d)(1)(E) activities) – and certain limited support activities that are “intrinsic” to the section 7704(d)(1)(E) activities (intrinsic activities).

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

Section 7704(d)(1)(E) activities represent different stages in the extraction of minerals or natural resources and the eventual offering of products for sale. Each section 7704(d)(1)(E) activity involves various types of operations. It is intended that the final regulations will provide an exclusive list of operations that comprise each section 7704(d)(1)(E) activity. In particular, industry-specific rules and examples are provided for “processing and refining” because such activities vary with respect to different minerals or natural resources.

2. Intrinsic Activities

The preamble to the proposed regulations states that the IRS intends that section 7704(d)(1)(E) activities represent only those activities that would be undertaken by an exploration and development company, a mining or production company, a refiner or processor, or a transporter or marketer of a mineral or natural resource. Services provided to companies engaged in such activities are not section 7704(d)(1)(E) activities, but such services may generate qualifying income if they qualify as intrinsic activities. The IRS intends that intrinsic activities include active support of section 7704(d)(1)(E) activities, not merely the supply of goods for use in section 7704(d)(1)(E) activities.

An activity is an “intrinsic activity” if:

- The activity is “specialized” to support a section 7704(d)(1)(E) activity;
- The activity is “essential” to the completion of the section 7704(d)(1)(E) activity; and
- The activity requires the provision of “significant services” to support the section 7704(d)(1)(E) activity.

An activity is “specialized” if the personnel performing the activity on behalf of the MLP have received training unique to the mineral or natural resource industries that is of limited utility other than to perform or support a section 7704(d)(1)(E) activity. In addition, if an activity involves the sale, provision or use of property, then the property also must qualify as specialized. Specialized property includes water, lubricants, and sand that are used as injectants in hydraulic fracturing if the MLP also collects and cleans, recycles, or otherwise disposes of the injectant after use in accordance with federal, state or local regulations governing such waste products.

An activity is “essential” to a section 7704(d)(1)(E) activity if the activity is necessary to either physically complete the section 7704(d)(1)(E) activity or comply with laws that regulate the section 7704(d)(1)(E) activity. Included in the definition of essential activities are water delivery and disposal services when provided for use in fracturing because the water must be used to complete the drilling operation and because the water must be disposed in compliance with laws regulating the drilling and fracturing process.

Finally, an activity requires the provision of “significant services” if the MLP’s personnel have an ongoing or frequent presence at the site or sites of the section 7704(d)(1)(E) activity. Alternatively, the services may be conducted offsite if the services are performed on an ongoing or frequent basis and offered exclusively for those engaged in one or more section 7704(d)(1)(E) activities. Personnel perform significant services only if those services are necessary for the MLP to perform an activity that is essential to support the section 7704(d)(1)(E) activity.

Transitional Rules

The proposed regulations provide a 10-year transition period beginning on the date the final regulations are published. During such transition period, an MLP may continue to treat income from an activity as qualifying income if: (a) the MLP received a PLR from the IRS concluding that the income from such activity is qualifying income; (b) prior to the issuance of the proposed regulations, the MLP was engaged in the activity and treated the activity as giving rise to qualifying income under Code section 7704(d)(1)(E), provided that such income constitutes qualifying income under Code section 7704(d)(1)(E) as reasonably interpreted prior to the issuance of the proposed regulations; or (c) the MLP engages in such activity after the issuance of the proposed regulations, but prior to the date the proposed regulations are published as final, and the income from that activity is qualifying income under the proposed regulations.

Before the proposed regulations are adopted as final regulations, the IRS will give consideration to any comments that are timely submitted.

If you have questions regarding the proposed regulations and their impact or any other qualifying income questions, please contact one the following members of Bracewell & Giuliani's tax team.

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