Tax Alert

February 3, 2017

Final Regulations on MLP Qualifying Income Provide Clarification

Final regulations issued by the Treasury and the Internal Revenue Service (IRS) on January 19, 2017, revealed a set of new rules interpreting "qualifying income" under Section 7704(d) of the Internal Revenue Code, affecting activities conducted by natural resources publicly traded partnerships (or "MLPs"). These final regulations were published as initially scheduled on January 24, 2017, despite the "regulatory freeze" mandated by the memorandum issued by White House Chief of Staff Reince Priebus on January 20, 2017, requesting all agency heads to immediately withdraw then-unpublished regulations (including the final regulations on qualifying income). The impact the Priebus memorandum has on the final regulations is unclear, as well as whether they will be subject to challenge. Nevertheless, as published, the final regulations are viewed as a big improvement from the proposed regulations.

The following discussion highlights significant changes made in the final regulations in response to some of the more controversial approaches adopted in the prior proposed regulations.

Exclusive List of Qualifying Activities Abandoned

The proposed regulations originally contained a very limited "exclusive list" of operations that can qualify as Section 7704(d)(1)(E) core activities, which did not address many operations on which the IRS had previously issued favorable rulings. The final regulations abandon this narrow approach and instead provide a general definition for each of the core activities. In addition, the final regulations address many areas that were left out by the proposed regulations, including compression services to a pipeline; liquefying and regasifying natural gas; sales of renewable identification numbers; retail sale of propane; cost reimbursement in connection with a qualifying activity; income from passive interests in oil and gas properties, such as royalties, net profits interests and lease bonus payments; and blending and additization of qualifying products. The IRS expects this to tremendously decrease the number of private letter rulings requests that it receives in this area.

Processing and Refining Separately Defined

The proposed regulations combined the definition of processing and refining, and required a taxpayer to use a consistent MACRS class life for the assets used in the activity. The proposed regulations also prohibited any substantial physical or chemical change during the processing or refining stage. These requirements were perceived by the industry as arbitrary, and the IRS retracted from those positions. The final regulations separately define processing and refining in order to better clarify which activities generate qualifying income. Importantly, for purposes of the "refining" definition, the final regulations considered the information provided by the U.S. Energy Information Administration in adopting 35 qualifying products that are typically produced in a refinery or natural gas processing plant. Lastly, the final regulations dropped the physical/chemical change limitation and dispensed with the MACRS requirement.

Propylene and Ethylene Qualify

The proposed regulations treated olefins, such as propylene, ethylene and butylene, produced from natural gas processing as nonqualifying while the same products produced from the processing of crude oil and related fuels were treated as qualifying. This approach was sharply criticized for lack of judicial and legislative support, especially given the fact that the IRS had previously issued a favorable ruling to the contrary. The final regulations abandon this approach and treat olefins produced, whether from natural gas or crude oil, as qualifying products.

Water Services Rule Relaxed

The proposed regulations allowed noncore Section 7704(d)(1)(E) activities to nonetheless be treated as qualifying activities if the activities themselves are intrinsic activities. Under the requirements of the proposed regulations, a provider of water or other injectant used in oil and gas exploration would also have to collect, clean, recycle, or otherwise treat the water or injectants on a strict “well-by-well” basis. The final regulations relax this standard by requiring only that the provider be in the business of collecting, cleaning, recycling or otherwise disposing of injectants within the same geographic area.

Transition Period

The final regulations apply to income earned by a partnership in a taxable year that begins on or after January 19, 2017, but also include a 10-year transition for partnerships that do not meet the requirements under the final regulation. A partnership is eligible for the transition period if it (i) has received a private letter ruling from the IRS holding that an activity is qualifying income; (ii) has been engaged in an activity prior to May 6, 2015, and has reasonably treated the activity as giving rise to qualifying income under the statute as interpreted prior to May 6, 2015; (iii) has entered into a binding agreement for construction of assets to be used in an activity that would give rise to qualifying income under the statute as reasonably interpreted prior to May 6, 2015; or (iv) engaged in an activity after May 6, 2015, but before January 19, 2017, and the income from that activity was qualifying income under the proposed regulations. A technical termination under Section 708(b)(1)(B) will not terminate the 10-year transition period.

Action Items

We expect any uncertainty surrounding the effectiveness of the final regulations to be resolved soon by the new administration. Meanwhile, MLPs and other investors considering the MLP tax structure should carefully review their existing operations and activities to ensure that they meet the standards promulgated by the final regulations.

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