

CLIENT ALERT

IRS Clarifies Qualifying Income for MLPs

May 6, 2015

This week the IRS proposed regulations in an attempt to clarify the rules on "qualifying income" for MLPs in the minerals and natural resources industries. Under the proposed regulations, only certain enumerated operational activities, as well as support services that are "intrinsic" to those activities, will give rise to qualifying income. These rules will not be effective until final regulations are published, but the proposed regulations provide a ten-year transition rule to MLPs that received favorable private letter rulings and certain MLPs that are in business before the final regulations are issued. The IRS has requested comments on the proposed regulations by August 4, 2015.

Background

A publicly traded partnership, such as an MLP, can only be treated as a partnership for federal income tax purposes if 90 percent or more of its income is "qualifying income." MLPs in the natural resources area generally rely on a particular category of qualifying income, which includes income and gain derived from exploration, development, mining or production, processing, refining, transportation, or marketing of any mineral or natural resource. The IRS has historically resolved questions about the scope of this category of income by issuing private letter rulings. Many of the rulings involve the issue of whether support services provided to businesses in this industry generate qualifying income. After a recent "break" from issuing rulings in this area, and in response to increased requests for rulings, the IRS issued these proposed regulations to provide clearer rules.

Qualifying activities

Under the proposed regulations, only "qualifying activities" can generate qualifying income. Qualifying activities include only "section 7704(d)(1)(E) activities" and a limited set of support activities (defined as "intrinsic activities").

Section 7704(d)(1)(E) activities

Section 7704(d)(1)(E) activities include only the exploration, development, mining or production, processing, refining, transportation, and marketing of a mineral or natural resource. The preamble to the proposed regulations notes that the intent is to include only those activities undertaken by an exploration and development company, mining or production company, a refiner or processor, or a transporter or marketer of a mineral or natural resource.

Support services

Support services provided to businesses conducting section 7704(d)(1)(E) activities are not qualifying activities unless they are "intrinsic" activities under three tests. Specifically, the support service must (1) be specialized to support operational section 7704(d)(1)(E) activity, involving both personnel that have training unique to the mineral and natural resources industry and of little use to others, and to the extent that the activities involve the sale, provision, or use of property, the property must be specialized to such industries, (2) be essential to completion of the activity, and (3) require provision of significant services to

support the activity. These definitions are narrowly tailored to include only support services that are very closely related to the section 7704(d)(1)(E) activities. For example, water delivery for use in fracking qualifies as an intrinsic activity only if the entity that delivers the water also collects and cleans, recycles, or otherwise disposes of the water after use. As examples of activities that are not intrinsic, the preamble notes that catering services are not "specialized," and accounting, insurance, and similar services are not "essential."

Transition rule

The proposed regulations would apply to income earned by an MLP in a taxable year beginning after the date the regulations are published as final in the Federal Register. However, there is also a proposed ten-year transition period. During the transition period, an MLP may treat income as qualifying income if it received a favorable private letter ruling from the IRS with respect to the income. An MLP may also treat income from an activity as qualified during the ten-year transition period if, prior to May 5, 2015, the MLP was publicly traded, engaged in the activity, and treated the activity as giving rise to qualifying income, based on a "reasonable" interpretation of the statute before issuance of the proposed regulations. In determining whether an interpretation was reasonable, the IRS will consider the legislative history and rulings granted by the IRS before issuance of the proposed regulations. Any other publicly traded MLP that engages in an activity after May 6, 2015, but before final regulations are published, may rely on the proposed regulations during the transition period.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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