CLIENT ALERT

IRS Releases Final Regulations on MLPs

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On January 19, 2017 the U.S. Internal Revenue Service released the long-awaited final regulations on the types of "qualifying income" that can be generated by master limited partnerships (MLPs). The regulations had been submitted to the Federal Register, but had not yet been published, when White House Chief of Staff Reince Priebus issued a memorandum requesting that agencies withdraw any unpublished regulations to allow for review by the new administration. Many such regulations were withdrawn, but the MLP regulations were published in the Federal Register on January 24, much to the surprise and confusion of the industry. It is likely that the regulations are in effect. It remains unclear as to what consequence, if any, violating the freeze memo will have.

Even if they were not currently in effect, the final regulations would still provide a guide to the IRS' intended interpretation of section 7704, and show the agency's willingness to broaden the criteria for qualifying activities compared to the standards in the prior, proposed regulations. Any company whose activities qualify under the more narrow proposed regulations, therefore, may be reasonably certain that it will continue to be entitled to pass-through taxation. Furthermore, both the final and proposed regulations provide a ten-year transition period, which should allow companies sufficient time to adjust to the new definitions.

The MLP Regulations

Section 7704 of the Internal Revenue Code requires taxation of a partnership traded on a public stock exchange (known as "publicly traded partnerships" or PTPs) as if it were a corporation, with the partnership's income taxed at the entity level and then again after its distribution to the partners. An MLP may preserve pass-through taxation, however, if 90 percent of its income is 'qualifying income.' Pass-through taxation generally increases the after-tax rate of return on distributions from the MLP. Qualifying MLPs generally trade at a premium value and can often outbid corporations when acquiring assets.

Subsection 7704(d)(1)(E) provides that natural resource production activities, including energy production, may produce qualifying income but does not indicate whether activities that support resource production qualify. Because approximately 80 percent of MLPs conduct energy-related activities, by 2014 the IRS was overwhelmed with requests for private letter rulings on whether activities in support of energy production produced qualifying income. After a freeze on such rulings to study the issue, the IRS issued proposed regulations in May 2015 which detailed a three part test for qualification. Support activities qualify for the 7704(d) exception if 1) the services are specialized, such that employee training has limited value other than supporting production of natural resources; 2) the services are essential to natural resource production and necessary to complete the process; and 3) support personnel have an ongoing or frequent presence at the site of the natural resources production. The proposed regulation also included an exclusive list of qualifying activities.

Many MLPs, including some that had previously received favorable private letter rulings from the IRS on the qualifying income issue, found that this exclusive list might prevent their qualification for pass-through taxation under the proposed regulations. The proposed regulations were heavily criticized. The IRS took this criticism into account and on January 19, 2017, issued final

regulations which included a non-exclusive list of qualifying activities, thereby allowing for more flexibility. The final regulations also provide separate definitions for refining and processing resources and include more types of activities in the qualified activity list. Processing of natural gas liquid into olefins is now qualifying. While more types of resource transportation activities are included, transportation of liquid natural gas and liquid petroleum gas is still non-qualifying because those liquids are not considered natural resources. Finally, baking coal to generate metallurgical coke remains non-qualifying under the final regulations, which means that PTPs such as SunCoke will no longer qualify for pass-through tax treatment.

Effectiveness of the Regulations

Under the Administrative Procedure Act, regulations are ordinarily effective 30 days after they are published in the Federal Register. The IRS states the MLP regulations are exempt from this requirement as interpretative rules, and the regulations issued on January 19, have an effective date of that same day. The IRS has suggested that this effective date makes the freeze memo inapplicable, although by its terms the memo makes no distinction based on effective date, only by date of publication. The memo provides that exceptions to the freeze can be granted by the Office of Management and Budget or others in the administration, but it is not clear whether the IRS obtained such an exception for the MLP regulations. The IRS has said only that the regulations were published "as approved by the Office of Management and Budget," and the new administration has not made a statement regarding these regulations.

Assuming the regulations are effective, they could still be repealed via the Congressional Review Act, 5 U.S.C. 801 *et seq.*, (the CRA), which allows Congress to void regulations on a case-by-case basis. The CRA was passed in 1996, with the express intention of providing an easier method for overturning regulations. It provides a 60-day window in which Congress may pass a 'resolution of disapproval' which is exempt from normal Senate process and is therefore filibuster-proof. The President may veto the resolution, which is why the CRA is rarely successful other than in the first months of a new administration. If no veto is issued, or if Congress overrides the veto with a sufficient majority, the regulation is void and has no effect. The CRA also prevents the agency from issuing substantially similar regulations in the future. The final MLP regulations are fairly popular, so Congress may shy away from using the CRA due to these extreme consequences. Outside of the CRA procedure, overturning a final regulation requires Congress to pass a law or the agency to issue new regulations – both methods requiring use of the regular, lengthy, procedures.

It seems unlikely that violation of the Priebus memo on its own is sufficient to invalidate the regulations. The memo was issued by the Chief of Staff and not by the President, and it is phrased as a request rather than a command. Companies whose activities qualify under both the proposed and final regulations may be relatively sure that they will continue to be granted pass-through taxation. MLPs whose activities qualify under the final but not under the proposed regulations may take comfort that the IRS was willing to respond to industry concerns and allow for greater flexibility in interpreting section 7704. Finally, PTPs such as SunCoke are hopeful that the uncertainty provides an additional opportunity for them to lobby for the inclusion of their activities as qualifying.

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