

BLOG POST

## Master Limited Partnership (MLP) Private Letter Rulings Issued in 2013 – A Busy Start to the Year!

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So far this year, the Internal Revenue Service (IRS) has released 8 private letter rulings related to MLP qualifying income. In addition to affirming conclusions reached in prior rulings, these rulings provide meaningful clarity with respect to certain MLP activities and income streams, including compression services, natural gas processing, customer-funded facility improvements, operation of assets owned by third parties, and bulk sales to industrial users.

Pursuant to the Internal Revenue Code, a publicly traded partnership (commonly referred to as a “master limited partnership” or “MLP”) is generally treated as a corporation for federal income tax purposes. However, if at least 90% of an MLP’s gross income for each taxable year consists of “qualifying income,” the MLP will be treated as a partnership for federal income tax purposes.

The Internal Revenue Code defines “qualifying income” to include income and gains derived from the exploration, development, mining, production, processing, refining, transportation or marketing of any mineral, natural resource or industrial source carbon dioxide, as well as the transportation or storage of certain renewable and alternative fuels. Qualifying income also includes interest (other than interest derived from a financial or insurance business), dividends, real property rents, gain from the sale of real property, gain from the sale of assets held for the production of qualifying income, and certain income that would be qualifying to a regulated investment company (RIC) or a real estate investment trust (REIT).

In order to obtain certainty as to whether a specific activity generates qualifying income, an existing MLP or a “to-be-formed” MLP may request a private letter ruling (PLR) from the IRS. PLRs are taxpayer-specific rulings furnished by the IRS and can only be relied upon by the taxpayer to whom it is issued. Although private letter rulings generally cannot be used or cited as precedent, such rulings can provide useful information about how the IRS may view certain issues. The qualifying income private letter rulings released by the IRS this year are summarized below.

### **Processing Natural Gas into Gasoline and Liquefied Petroleum Gas (LPG) and Marketing of Gasoline and LPG – PLR 201315015**

In PLR 201315015, the MLP will own a facility that will process natural gas into gasoline and LPG through a three-step integrated process. First, the natural gas enters a steam methane reformer where under high heat the natural gas is combined with steam to produce synthesis

gas. Second, the synthesis gas is converted into methanol, hydrogen and water in the presence of a copper-based catalyst. Finally, the methanol is converted into a mixture of methanol, dimethyl ether and water, which is then passed over a catalyst to produce gasoline, LPG and water. The MLP will then sell the gasoline and LPG to third-party distributors who will further distribute the gasoline and LPG to end-user customers. The IRS concluded that the income derived by the MLP from processing natural gas into gasoline and LPG and marketing the gasoline and LPG constitutes qualifying income.

#### **Treasury Lock, Interest Rate Swap, Forward-Start Interest Rate Swap and Interest Rate Cap – PLR 201315008**

In PLR 201315008, the MLP engages in a variety of activities, including terminalling and storage services for petroleum products and by-products and natural gas services. In order to manage the risk of interest rate movement with respect to its debt securities, the MLP enters into certain interest rate derivatives, including treasury locks, interest rate swaps, forward-start interest rate swaps and interest rate caps. The IRS concluded that the income derived by the MLP from treasury locks, interest rate swaps, forward-start interest rate swaps and interest rate caps is qualifying income.

#### **Processing Natural Gas into Dimethyl Ether (DME) and Marketing of DME – PLR 201314038**

In PLR 201314038, a “to-be-formed” MLP will build a facility that will process natural gas into DME (a premium diesel fuel) through a three-step integrated process. First, the natural gas will enter a steam methane reformer where under high heat the natural gas is combined with steam to produce synthesis gas. Second, the synthesis gas will be converted into methanol in the presence of a catalyst. Finally, the methanol will be converted into DME in a reactive distillation column through methanol dehydration in the presence of a second catalyst. The MLP will sell the DME to third-party distributors who will further distribute the DME to end-user customers. The IRS concluded that the income to be derived by the MLP from processing natural gas into DME and marketing the DME will constitute qualifying income.

#### **Customer-Funded Facility Improvements – PLR 201314029**

In PLR 201314029, the MLP earns income by terminalling, storing and transporting crude oil, refined petroleum products and LPG on behalf of its customers (which include refineries, chemical and petrochemical companies, common carriers and other pipeline transporters). If no transportation pipeline exists between the MLP’s current terminalling, storage and transportation assets and a potential customer’s facilities, or it is otherwise necessary to expand the MLP’s assets to satisfy a customer request, the MLP and the customer may enter into a separate contract pursuant to which the terminalling, storage and transportation facility improvements will be constructed (an “expansion agreement”). Pursuant to the expansion agreement, the customer will ultimately bear some or all of the construction costs. In some cases, the customer is responsible for constructing the facility improvements and then transferring ownership of the completed improvements to the MLP. In other cases, the customer will either reimburse the MLP to cover the MLP’s construction costs, or will pay a premium to the MLP for future terminalling, storage and transportation services. In all cases, the MLP will own the facility improvements constructed pursuant to the expansion agreements. The IRS concluded that since the expansion agreements are integral to the MLP’s otherwise qualifying activities, the amounts received by the MLP from its customers for

construction of facility improvements (or the receipt of the facility improvements from customers) will constitute qualifying income.

#### **Operating Service Fees and Related Cost Reimbursements – PLR 201313015**

In PLR 201313015, the MLP is principally engaged in the transportation and storage of “products” and performs operating services relating to the transportation and storage of “products.” The MLP owns an interest in a joint venture that earns operating service fee income and related cost reimbursements pursuant to agreements with service recipients. Under the terms of those agreements, the joint venture agrees to provide service recipients the services necessary to manage the day-to-day operations of certain assets owned by the service recipients, including general and administrative services and direct operating and maintenance services with respect to such assets. These services specifically include (i) contracting with customers for the use of the assets, (ii) taking delivery from customers, (iii) performing tasks necessary to physically move products through the assets, (iv) metering the quantity of products, (v) monitoring the specification of products, (vi) offloading products to customers, (vii) staffing the operations of the assets, (viii) conducting routine maintenance, (ix) identifying and purchasing supplies, and (x) handling all commercial transactions (including billing, accounting and financial reporting) for the assets. In addition to the fee income received by the joint venture under the terms of the agreements, the joint venture also receives cost reimbursements for employee costs for activities performed under the agreements. The IRS concluded that the operating service fee income and related cost reimbursements derived from the agreements is qualifying income.

#### **Natural Gas Compression – PLR 201313014**

In PLR 201313014, the MLP is engaged in the gathering, processing, treating and transportation of natural gas and the transportation, processing and storage of natural gas liquids. Additionally, the MLP owns and operates a fleet of compressors used to provide turn-key natural gas compression services for customer-specific systems. Because of the MLP’s expertise in compressing natural gas, the MLP entered into an agreement to provide operating services with respect to natural gas compressors owned by a third-party gas gathering and processing entity. The agreement requires the MLP to perform the tasks necessary to physically compress the natural gas and to move such natural gas through the processing facility. The MLP maintains a large body of service employees to compress natural gas pursuant to the agreement (including engineers, service technicians and field personnel). In exchange for operating the natural gas compressors owned by the third-party, the MLP is paid a services fee pursuant to the agreement. The IRS concluded the income derived by the MLP for providing operating services with respect to the natural gas compressors is qualifying income.

#### **Fertilizer Products Sold to Non-Agricultural Customers – PLR 201308004**

In PLR 201308004, the MLP is engaged in the production and marketing of nitrogen fertilizer products. The MLP proposes to sell its nitrogen fertilizer products, including ammonia, urea and UAN fertilizer, to customers operating in non-agricultural industries. Additionally, the MLP intends to sell nitric acid, produced as an intermediary step in the production of its direct-application fertilizer products, to customers operating in non-agricultural industries. Finally, the MLP proposes a facility expansion to produce urea in solution (a compound of urea and water or condensed steam), which is used to reduce nitrogen oxide emissions in diesel engines.

The MLP customers will not include end users of the various products. The IRS concluded that the income derived by the MLP from the production and marketing of ammonia, urea, UAN fertilizer, nitric acid and urea in solution for non-retail sale to customers operating in non-agricultural industries will constitute qualifying income to the extent that the various products would otherwise be marketable as fertilizer for agricultural purposes.

**Sale of Refined Products and Lubricants – PLR 201301010**

In PLR 201301010, the MLP is engaged in the business of refining, blending, processing, packaging, marketing and distribution of crude oil and other natural resource based products (“refined products”). The MLP is also engaged in the business of blending, processing, packaging, marketing and distribution of lubricants. The MLP sells its products to customers who are not end-users, including wholesalers and other fuel distributors and marketers. The MLP also sells certain products in bulk to government, commercial and industrial users in quantities and at prices that are not consistent with retail sales transactions. The IRS concluded that the income derived by the MLP from the refining, blending, processing, packaging, marketing and distribution of the refined products and lubricants is qualifying income.

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For more information on these rulings, please contact Gregory Bopp (Partner), Elizabeth Behncke (Associate) or Vivian Ouyang (Associate).

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