

# Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part I)

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Deborah Fields, Holly Belanger, Robert Swiech and Eric Lee examine the unique and complex set of U.S. federal income tax issues surrounding the formation and operation of a natural resources publicly traded partnership.

## I. Introduction

Publicly traded partnerships (PTPs) can be tax-efficient vehicles for developing, operating and investing in energy and natural resources properties. While PTPs can be attractive vehicles for new energy and natural resources ventures, existing businesses also may want to consider whether converting to PTP status may be the right choice for them.

Very generally, PTPs are limited partnerships or limited liability companies the interests (or “units”) in which are traded on public exchanges.<sup>1</sup> In a typical limited partnership structure, public investors hold common units,<sup>2</sup> while the “sponsor” holds the managing interest (*i.e.*, the general partnership interest or the equivalent thereof).<sup>3</sup> The common units typically are traded on the New York Stock Exchange (NYSE),

the National Association of Securities Dealers Automated Quotation exchange (NASDAQ) or a regional exchange. The market value of each unit tends to be a function, in part, of the cash distributions the PTP is expected to make to its unitholders.

The number of PTPs traded on the public markets has increased more than 10-fold in the last 15 years.<sup>4</sup> There are currently over 100 PTPs listed on public exchanges, most of which are in the energy and natural resources industries.<sup>5</sup> PTPs hold a significant percent of the energy pipelines in the United States.<sup>6</sup> PTPs also are major players in oil and gas exploration and production, oil and gas marine transportation, propane and heating oil, coal and other natural resources industries.<sup>7</sup> The PTP sector has evolved into a major part of the energy industry.

If a natural resources PTP can meet various eligibility requirements described below, it can access the public capital markets while being classified as a partnership for U.S. federal income tax purposes—

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that is, it can be classified as a partnership in a world in which most publicly traded entities are classified as corporations.<sup>8</sup> Partnership classification can be beneficial for a number of business and market related reasons. As a very general matter, the income of publicly traded corporations is taxed twice—once at the corporate level (when earned) and again at the shareholder level (when distributed).<sup>9</sup> By contrast, a PTP that is classified as a partnership is a “passthrough” entity. For U.S. federal income tax purposes, its income is not taxed at the entity level but rather flows through to its partners (on a Schedule K-1) and is taxed at the partner level.<sup>10</sup> Because such a PTP is not subject to entity-level tax, it may have more cash available (relative to a similarly situated publicly traded corporation) for acquiring assets and businesses, which can be advantageous in negotiating acquisitions and securing debt financing. It also may have more cash available (relative to a similarly situated corporation) for making distributions to public investors, which can contribute to a premium valuation for its units.<sup>11</sup>

Nonetheless, as is explained in depth in this primer, the U.S. federal income tax rules applicable to PTPs classified as partnerships are extremely complex. Many of the relevant partnership tax rules predate the explosion in the growth of PTPs and do not contemplate the unique considerations raised when partnership units are traded in the public marketplace. In the case of natural resources PTPs, this complexity is compounded by special U.S. federal income tax rules applicable to natural resources, such as the rules for depletion. Moreover, given the large number of public investors and the constant trading of PTP units, PTPs classified as partnerships must address a host of difficult compliance issues. A PTP generally must rely on sophisticated computer software programs to prepare its returns and to provide the relevant U.S. federal income tax information to its investors in a timely manner.

The purpose of this primer is to provide a practical resource for tax directors and practitioners who find themselves confronting the unique and complex set of U.S. federal income tax issues surrounding the formation and operation of a natural resources PTP. Although many of these issues are common to all PTPs (including PTPs the activities of which are financial in nature), this article primarily focuses on natural resources PTPs, such as exploration and production (“E&P” or “upstream”), pipeline (“midstream”), and refining or marketing (“downstream”) companies.

The primer is divided into several parts, each of which will be published in TAXES—THE TAX MAGAZINE. The primer generally is organized in the order of the U.S. federal income tax topics that a sponsor of a PTP may confront in organizing and operating a PTP. To that end, this first part of the primer begins by providing background information regarding the eligibility rules a PTP must meet in order to be classified as a partnership for U.S. federal income tax purposes. Then, it introduces several basic concepts that are critical to understanding the U.S. federal income tax issues PTPs confront and previews some of the issues associated with forming a PTP. Subsequent parts of this primer will address the following U.S. federal income tax issues (as well as other relevant U.S. federal income tax issues).

### ***Formation Issues***

- Issues associated with forming a PTP, including the sponsor’s options with regard to how the PTP acquires property and the impact of the initial capital infusion
- Issues raised by various kinds of “incentive interests”—including issues that have arisen in the current market environment as PTPs seek to “unwind” some of the incentive interests they previously put in place

### ***Operational Issues***

- How the PTP’s items of income, gain, loss and deduction flow through and are taxed at the partner level (including the rules for determining each partner’s distributive share of income, gain, loss and deduction with respect to property that has been contributed to the PTP and the unique allocation issues raised in the PTP context)
- Considerations associated with raising additional capital through secondary offerings and private placement transactions
- The impact of a Code Sec. 754 election on the basis of PTP property with respect to investors who purchase units and how such election can help maintain “fungibility” of the PTP’s units<sup>12</sup>
- The character of gain on sales of units in the public market, including the impact of Code Sec. 751
- Issues associated with the PTP’s assets (such as depreciation and depletion) and its debt (such as refinancings)
- Other issues that are significant to PTPs given the current market environment—as well as is-

sues that can be expected to be significant in the future, given industry trends and developments

### **Compliance Issues**

These include the significant compliance requirements associated with PTP status, including the complexities arising from providing the investors in the PTP with information regarding their distributive shares of the PTP's items of income, gain, loss and deduction and their shares of the PTP's basis in oil and gas property for purposes of computing the allowance for depletion.<sup>13</sup>

## **II. Who Can Be a PTP: History and Basic Requirements**

Not every partnership that wants to access the public capital markets can benefit from being taxed as a passthrough entity for U.S. federal income tax purposes. Instead, most entities that are publicly traded have no choice but to be classified as corporations for U.S. federal income tax purposes. Only those publicly traded partnerships that meet certain eligibility requirements relating to their activities and income can be classified as partnerships for U.S. federal income tax purposes. These eligibility requirements are set forth in Code Sec. 7704(c).

As is explained below, the natural resources and energy industries fortunately are among those for which PTP status can be an option. Nonetheless, even in those industries, careful consideration must be given to the facts of each particular situation to make sure that the eligibility requirements are met. Moreover, given the importance of partnership classification in the marketplace, PTPs must be vigilant in monitoring their activities and income on an ongoing basis to ensure that they retain their tax classifications as partnerships. For those same reasons, PTPs often model the impact contemplated future transactions may have on the nature of their activities and income.

### **A. The Party's over: The Enactment of Code Sec. 7704**

The development of the eligibility rules applicable to PTPs can be traced indirectly to Congress's decision in 1986 to change the tax treatment of distributions of property by corporations to their shareholders. Prior to 1986, no corporate level tax was imposed, in general, on a dividend distribution of appreciated property to a corporation's shareholders ("*General Utilities* doctrine").<sup>14</sup> As part of the Tax Reform Act of

1986 ("1986 Act"), Congress repealed the *General Utilities* doctrine and instead required that a dividend of appreciated property to a corporation's shareholders be treated as a deemed sale of the property by the corporation immediately prior to the distribution.<sup>15</sup> In addition, the 1986 Act imposed a maximum corporate income tax rate that was higher than the maximum individual income tax rate, as well as a new corporate minimum tax provision.<sup>16</sup> Each of these changes made corporate classification a less attractive entity choice for widely held businesses.<sup>17</sup> As a result, interest increased in publicly traded entities organized as partnerships that could meet the U.S. federal income tax standards at that time for partnership classification.

Shortly after the enactment of the 1986 Act, Congress became concerned with the number of PTPs that were being formed. As the House Ways and Means Committee explained, there was concern that the 1986 Act's intent of preserving the corporate-level tax was being circumvented through the use of PTPs.<sup>18</sup> Congress was concerned that entities that very much resembled corporations were being taxed as passthrough entities. In addition to the revenue drain caused by the loss of the corporate level of tax with respect to many publicly traded companies, Congress was concerned that public companies operating in partnership form were being given an unfair competitive advantage over those operating in corporate form.<sup>19</sup> According to the House Ways and Means Committee, "[f]avoring one type of business investment over another creates new economic inefficiencies of the type that the 1986 Act was designed to reduce."<sup>20</sup> Code Sec. 7704 was enacted in 1987 in response to these concerns.

In enacting Code Sec. 7704, Congress was mindful that the possible competitive advantage afforded by the use of a PTP was less significant in certain situations. Specifically, if the partnership's income was primarily from passive-type investments, Congress felt that there was less of a need to treat the partnership as a corporation, either because the partners could have invested in the assets directly or because the income had already been subject to a corporate-level tax (*i.e.*, dividends).<sup>21</sup> In addition, Congress was aware that certain industries, such as oil and gas and real estate, had "commonly and typically" utilized the partnership form and believed that it would be inappropriate to add a layer of tax to this historic business practice.<sup>22</sup>

Therefore, although Congress generally provided, in Code Sec. 7704(a), that PTPs must be treated as corporations for U.S. federal income tax purposes,

Congress included an exception for PTPs that meet certain requirements with respect to their income and activities. Under Code Sec. 7704(c), a PTP<sup>23</sup> is not treated as a corporation if, for all tax years that the partnership is treated as a PTP, 90 percent or more of the partnership's gross income consists of certain "qualifying income." Thus, a PTP that wants to be classified as a partnership for U.S. federal income tax purposes must take steps to closely monitor whether it meets the qualifying income requirements each and every tax year.

Code Sec. 7704(d) provides the definition of qualifying income for purposes of Code Sec. 7704(c). Consistent with Congressional intent, the categories of income that are defined as qualifying income in Code Sec. 7704(d) generally are either from passive-type sources or from those industries historically organized as partnerships. Specifically, Code Sec. 7704(d) defines "qualifying income" as including income from sources such as interest, dividends, real property rents, gains from the sale or disposition of capital assets held for the production of income, and income and gains derived from certain natural resources activities.

## B. Qualifying Income in the Natural Resources Context

In the natural resources context, the rules regarding what constitutes qualifying income are complex. Further, although the Code defines what kinds of income and gain from natural resources activities constitute qualifying income, in many situations it will be important to consult the legislative history of Code Sec. 7704 for additional information regarding the kinds of activities and income Congress intended to qualify.

The determination of whether a particular kind of income constitutes qualifying income tends to be extremely fact sensitive. As a result, taxpayers have sought private letter rulings to obtain certainty with regard to their particular fact situations.<sup>24</sup> Thus, there is a substantial body of informal administrative guidance regarding discrete factual issues. This primer does not attempt to delve into the (often arcane) details of particular situations. Instead, we will provide as an appendix to a subsequent installment of this primer a table summarizing private letter rulings that have been issued regarding varying types of income in the energy and natural resources context. As such, the discussion below is intended merely to provide a high level summary of the relevant rules.

As was indicated above, Code Sec. 7704(d) defines "qualifying income" as including income from certain natural resources activities. In particular, Code Sec. 7704(d)(1)(E) provides that qualifying income includes:

[I]ncome and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel described in subsection (b), (c), (d), or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as defined in section 40A(d)(1).

In other words, qualifying income includes income and gain that is derived from either (1) certain specified activities relating to minerals, natural resources (including fertilizer, geothermal energy and timber) or industrial source carbon dioxide; or (2) a somewhat narrower set of activities (*i.e.*, transportation or storage) with respect to certain fuels. The references to industrial-source carbon dioxide and the transportation or storage of certain fuels are relatively new. Congress expanded the definition of qualifying income to include these references in legislation that was enacted as part of the Emergency Economic Stabilization Act of 2008 ("2008 Amendments").<sup>25</sup> These expanded definitions are effective for tax years ended after October 3, 2008.

The discussion below first provides an overview of what constitutes a mineral, natural resource or industrial-strength carbon dioxide and what kinds of activities with respect to such substances can generate qualifying income. Next, it addresses the rules applicable to activities with regard to certain fuels. Then, it references other kinds of "passive type" income that can be treated as qualifying income and (given the current economic environment) touches upon the current lack of clarity as to the treatment of income from the cancellation of indebtedness. It concludes with a word about the importance of monitoring hedging activities.

### ***1. Minerals, Natural Resources and Industrial-Source Carbon Dioxide***

Code Sec. 7704(d)(1)(E) indicates that the term "mineral or natural resource" generally means any product

of a character with respect to which a deduction for depletion is allowable under Code Sec. 611. Thus, for example, sulfur, gold, iron ore, gravel and products of mines and oil and gas (O&G) wells generally would be considered minerals or natural resources for this purpose.<sup>26</sup> There is no requirement that the mineral or natural resource be from deposits in the United States. The legislative history of Code Sec. 7704(d) provides some insight as to what kinds of “products” constitute mineral or natural resources:

[N]atural resources include fertilizer, geothermal energy, and timber, as well as oil, gas or products thereof. For this purpose, fertilizer includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. Oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities.<sup>27</sup>

Notwithstanding this seemingly expansive definition of “minerals or natural resources,” the legislative history and the statutory language of Code Sec. 7704 carve back the definition’s scope in certain situations. Specifically:

- The legislative history indicates that the following do not qualify as minerals or natural resources: (1) the products of farming, ranching and fishing; and (2) power generated from hydroelectric, nuclear, solar and wind sources.<sup>28</sup>
- The legislative history further indicates that “oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives.”<sup>29</sup>
- Code Sec. 7704(d) specifically excludes from the definition of “minerals and natural resources” products described in subparagraphs (A) and (B) of Code Sec. 613(b)(7). As a result, the following products are excluded from the definition of “minerals and natural resources” for purposes of the qualifying income rules: (1) soil, sod, dirt, turf, water and mosses; and (2) minerals from seawater, the air or similar inexhaustible sources.<sup>30</sup>

Naturally occurring carbon dioxide produced through a well is a product of a character with respect to which depletion is allowable to the producer

and, therefore, is a mineral or natural resource for purposes of Code Sec. 7704(d)(1).<sup>31</sup> As was indicated above, the 2008 Amendments expanded the definition of qualifying income to include “industrial-source” carbon dioxide. As a result, a PTP now can generate qualifying income from the exploration, development, mining, production, processing, refining, transportation or marketing of carbon dioxide (to the extent that all of these terms are relevant to industrial-source carbon dioxide), whether naturally occurring or from an industrial source. Thus, for example, anthropogenic carbon dioxide produced from an industrial source can be commingled with naturally occurring carbon dioxide in pipelines owned by PTPs, with the income from transporting both constituting qualifying income.

There is currently no definition of what it means for carbon dioxide to be from an “industrial source.” Although it is not completely clear, carbon dioxide presumably could be considered to be from an industrial source if it were recovered from a flue gas at a power plant, removed as a contaminant from natural gas stream at a gas processing plant or recovered from a coal gasification project. Nonetheless, the term “industrial” is somewhat vague, given the broad common meaning of the term. Hopefully, regulatory guidance will be issued to clarify the scope of the statutory amendment.<sup>32</sup>

## ***2. Specified Activities with Respect to Which Income or Gain Must Be Derived***

As was indicated above, Code Sec. 7704(d)(1)(E) indicates that income or gain from a mineral, natural resource or industrial-source carbon dioxide must be derived from one or more of the following functions in order to be qualifying income: exploration, development, mining, production, processing, refining, transportation (including pipelines transporting gas, oil or products thereof) or marketing. Note that the PTP does not need to own the mineral, natural resource or industrial-source carbon dioxide from which the income or gain is derived; it merely needs to derive income from one (or more) of the specified activities with regard to the mineral, resource or carbon dioxide.

The legislative history of Code Sec. 7704(d)(1)(E) provides important additional information and qualifications as to what kinds of transportation and marketing activities Congress intended would generate qualifying income (*i.e.*, “passive-type” income). Specifically, the legislative history provides that:

Income of certain partnerships whose exclusive activities are transportation and marketing activities is not treated as passive-type income. For example, the income of a partnership whose exclusive activity is transporting refined petroleum products by pipeline is intended to be treated as passive-type income, but the income of a partnership whose exclusive activities are transporting refined petroleum products by truck, or retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as passive-type income.<sup>33</sup>

Congress further clarified its intent regarding transportation activities in the Technical and Miscellaneous Revenue Act of 1988 (“1988 Act”). The legislative history of the 1988 Act provides:

In the case of transportation activities with respect to oil and gas and products thereof, the conferees intend that, in general, income from transportation of oil and gas and products thereof to a bulk distribution center such as a terminal or a refinery (whether by pipeline, truck, barge or rail) be treated as qualifying income. Income from any transportation of oil or gas or products thereof by pipeline is treated as qualifying income. Except in the case of pipeline transport, however, transportation of oil or gas or products thereof to a place from which it is dispensed or sold to retail customers is generally not intended to be treated as qualifying income. Solely for this purpose, a retail customer does not include a person who acquires the oil or gas for refining or processing, or partially refined or processed products thereof for further refining or processing, nor does a retail customer include a utility providing power to customers. For example, income from transporting refined petroleum products by truck to retail customers is not qualifying income.

The conference agreement also clarifies that, in the case of income from marketing of fertilizer, bulk or truckload sales to farmers in amounts of 1 ton or more are not considered retail sales giving rise to non-qualifying income.<sup>34</sup>

This passage from the legislative history includes a footnote that cites to floor statements made by the then-Chairmen of the House and Senate tax-writing

committees—Rep. Rostenkowski and Sen. Bentsen. The footnote indicates that income from transportation and marketing of liquefied petroleum gas (*i.e.*, propane) in trucks and rail cars or by pipeline may be treated as qualifying income.<sup>35</sup> Although this treatment of propane is not specified in the statute, the IRS has cited the floor statements as support for the conclusion that “income derived from the distribution and marketing of propane to end users at the retail level constitutes qualifying income” under Code Sec. 7704(d)(1)(E).<sup>36</sup>

### 3. *Transportation and Storage of Certain Fuels*

As was mentioned above, the 2008 Amendments expanded the definition of “qualifying income” to include income or gain from the transportation or storage of (1) any fuel described in subsection (b), (c), (d) or (e) of Code Sec. 6426; (2) any alcohol fuel defined in Code Sec. 6426(b)(4)(A); or (3) any biodiesel fuel defined in Code Sec. 40A(d)(1). Very generally, this expanded definition applies to the following:

- Certain mixtures of alcohol and fuel
- Certain mixtures of biodiesel and diesel fuel
- Certain alternative fuels (such as liquefied petroleum gas, “P Series Fuels,” compressed or liquefied natural gas, liquefied hydrogen, certain liquid fuels derived from coal or peat, compressed or liquefied gas derived from biomass, and liquid fuel derived from biomass)
- Certain mixtures of alternative fuels and taxable fuels
- Certain alcohol fuels (such as methanol and ethanol)<sup>37</sup>
- Certain biodiesel fuels (*i.e.*, monoalkyl esters of long-chain fatty acids derived from plant or animal matter that meet certain requirements)<sup>38</sup>

This expanded definition should be particularly helpful to pipeline operators. First, the expanded definition provides certainty that transporting qualifying fuel blends generates qualifying income, even though a component of the blend on its own might not constitute a mineral or natural resource.<sup>39</sup> Second, the amendment provides certainty that income from *storing* qualifying fuels constitutes qualifying income, regardless of whether storage is a significant function or is incidental to the transportation activity.<sup>40</sup> Third, it allows a sponsor to utilize a PTP to raise capital for building new pipelines to transport renewable synthetic fuels (such as ethanol); transporting ethanol through existing pipelines can cause damage to those pipelines.

#### **4. Other Categories of Qualifying Income— “Passive-Type Income”**

As was indicated above, there are several other sources of qualifying income under Code Sec. 7704(d) that can be relevant to PTPs. The other enumerated categories of qualifying income follow:

- Interest
- Dividends
- Real property rents
- Gain from the sale or other disposition of real property (including property described in Code Sec. 1221(a)(1))
- Any gain from the sale or disposition of a capital asset (or property described in Code Sec. 1231(b)) held for the production of income described in any of the foregoing
- In the case of a partnership a principal activity of which is the buying and selling of commodities (not described in Code Sec. 1221(a)(1)), or options, futures or forwards with respect to commodities, income and gains from such activities<sup>41</sup>

#### **5. Does Cancellation of Indebtedness Income Give Rise to Qualifying Income?**

Although PTPs historically have not recognized significant amounts of cancellation of indebtedness (COD) income, the current economic climate has greatly increased the possibility that PTPs might seek to refinance or buy back their debt securities at a discounted price. While Code Sec. 7704(d) provides a fairly broad list of income sources that are considered to be qualifying income, it appears to leave open the issue of whether COD income is qualifying income for purposes of Code Sec. 7704(c). None of the categories of income enumerated in Code Sec. 7704(d) appears to include COD income. Moreover, while there is robust legislative history on the activities Congress viewed as producing or not producing qualifying income, there is no indication in the legislative history to Code Sec. 7704 that Congress ever considered whether COD income was qualifying income. Further, the issue has never been directly addressed by the IRS or the Treasury, either formally in published guidance or informally in ruling letters or other determinations, and has not been the subject of litigation.

While there are several good arguments in favor of treating COD income as qualifying income in some cases, this issue continues to be source of uncertainty.<sup>42</sup> The authors are hopeful that the IRS and the Treasury will address this issue favorably in published guidance in the near future.

#### **A Word About Hedging**

It is common for natural resources PTPs to engage in product price hedges to reduce the volatility of cash flow, particularly given the need to make regular cash distributions to investors. Depending upon how significant the hedging activity and hedging income, the PTP may need to evaluate carefully the extent to which the hedging gives rise to qualifying income.

In the natural resources context, the IRS generally has employed a “look-through” approach to analyzing whether certain derivatives give rise to qualifying income. For example, the determination of whether income derived from a notional principal contract is qualifying income involves determining whether the property, income or cash flow upon which the contract is based would have given rise to qualifying income if held or received directly by the partnership.<sup>43</sup> Further, in a private letter ruling, the IRS concluded that derivatives bought and sold by marketers of oil and gas to hedge commodity price risk produced qualifying income to the extent that the hedging was integral to a qualifying activity.<sup>44</sup> The ruling proceeded to provide that, where the marketer buys or sells derivatives on commodities that it does not own, it is not reducing the risk of price or interest rate changes for its own qualifying activities, and, therefore, the income from such derivatives would not be qualifying income.<sup>45</sup>

The IRS applied a similar analysis to an E&P PTP that had entered into interest rate swaps and treasury locks to manage the interest rate risk associated with the debt securities it issued for purposes of obtaining funds for use in its trade or business.<sup>46</sup> Because the underlying income source upon which the notional principal contracts were based would have given rise to qualifying interest income if held directly by the PTP, the private letter ruling concluded that the income from the swaps and locks also produced qualifying income for purposes of Code Sec. 7704(c).<sup>47</sup>

### **III. Some Basic Concepts**

Before delving into a discussion of the technical tax issues surrounding the formation and operation of a PTP, it is important to understand some basic facts and concepts regarding PTPs. Some of the concepts described below relate to critical marketplace factors that affect—and sometimes drive—decisions made with respect to certain U.S. federal income tax issues. We will refer back to these facts and concepts at various points in the primer.

## A. The Typical “Players”

The “sponsor” typically is the person or entity behind the formation and operation of the PTP. The sponsor typically structures the PTP with a goal of raising capital through the public markets to fund the acquisition, development and/or operation of property. As is explained in more detail in other parts of this primer, the sponsor typically will contribute property to the PTP (or lower-tier entity) or will otherwise arrange for the PTP (or lower-tier entity) to acquire property. The sponsor often acts as the general partner (or managing member) of the PTP. In some situations, the sponsor itself will be a publicly traded entity.

In the case of a newly formed PTP, the sponsor typically will seek to raise capital through an initial public offering (IPO). The public investors in a PTP typically acquire limited partnership units—or common units—in exchange for cash in an IPO.<sup>48</sup> As part of the IPO transaction, a PTP may offer to its underwriter an option to acquire a percentage of the units of the partnership at the original offering price. This option is referred to as an “overallotment option,” or colloquially as “the green shoe” or simply “the shoe.” From a business perspective, the overallotment is intended to allow the underwriter to manage some of the risk associated with the IPO.

In some cases, part of the cash raised in the IPO will be paid (or distributed) to the sponsor. (As is explained in the next part of this primer, such payments or distributions can give rise to U.S. federal income tax issues, such as the application of the “disguised sale” rules.) The sponsor often will use this cash to pay back debt or to acquire and develop property outside of the partnership. In this latter case, after the property has been developed and its value has been enhanced, the sponsor may contribute it to the PTP in conjunction with a secondary public offering. Under the typical PTP business model, especially for an exploration and production PTP, this cycle may repeat itself again and again.

Recently, PTPs have raised an increasing share of capital through private placement transactions known as PIPEs—*i.e.*, Private Investment in Public Entities.<sup>49</sup> In a PIPEs transaction, large investors, such as institutional investors and investment funds, typically negotiate directly with the PTP to purchase a large volume of the same common units that are issued to public investors, but at a discounted rate. The units issued in the PIPEs transaction often can-

not be registered for sale on the public market for a certain period of time.

## B. Economic Rights Associated with the Sponsor’s (and Management’s) Interests

As was indicated above, the public investors in a PTP typically hold common units. In some situations, the sponsor also may hold common units that are identical to those held by the public investors. In addition, the sponsor may hold “incentive units” with different economic rights. In fact, until recently, it was common for natural resources PTPs to provide incentive interests to the sponsor or key personnel at the time of the formation. These interests sometimes are characterized as special limited partnership units in the PTP. Some of the common types of incentive interests are listed below:

- **Incentive Distribution Rights (IDRs).** IDRs are typically granted to the general partner (*i.e.*, the sponsor) as an additional return for the general partner’s management of the PTP. Depending on the value of the IDRs, the sponsor may look to take the general partner entity itself public or to sell an interest in the general partner entity to a large investor.
- **Management Incentive Units and Management Incentive Interests (MIUs and MIIs).** As the names imply, these units generally are issued to the key management personnel of the PTP for their efforts in managing and growing the PTP’s business.
- **Subordinated Units.** Subordinated units are another form of incentive interest that may be issued to either the sponsor or key management personnel of the PTP.

These incentive interests tend to have some roughly equivalent economic features. Generally, they are issued to their holders in exchange for the performance of future services, rather than for a contribution of money or other property. IDRs, MIUs and MIIs typically have a right to increasing distributions out of the net cash flow from the current year’s operations. The right to receive a greater share of distributable cash typically is subject to “hurdles” based on the distributions made to the public unitholders. As the public shareholders receive greater amounts of per-share quarterly distributions, the incentive interests typically become entitled to a greater percentage of the cash available for distribution.<sup>50</sup> For example, the terms of an incentive interest may provide that, if a PTP has surpassed the higher hurdle distribution rates, commonly referred to as being in the “high splits,” the



holder of such interest may be entitled to distributions of up to 48 percent of the available cash.

Subordinated units typically track the economic returns of the public's units, often on a one-to-one unit ratio. However, as the name implies, the right to this economic return typically is either partially or fully deferred until the expiration of a specified subordination period. After the subordination period has lapsed, it is common for subordinated units to be entitled to be "caught up" to the economic position they would have been in had they not been subordinated.

Incentive units typically will be entitled to share in the upside of the PTP's business. This usually takes the form of a right to receive an increasing share of the proceeds in the event that the assets of the partnership are sold at a gain on liquidation of the PTP. As with the rights to net cash from operations, the right to receive a share of the "net termination gains" of the PTP typically is subject to several hurdles based on the intended return to the public investors. Conversely, the incentive interests typically will share disproportionately in any losses in the event that the liquidation value of the PTP decreases. The disproportionate allocation of "net termination losses" to the incentive interests helps ensure that the public unitholders will not lose their invested capital until after the incentive interests have lost all of their entitlement to money on a liquidation of the PTP.

A common, but not universal, feature of PTP incentive interests is that they may be convertible into common units. In such cases, the trigger for the conversion usually is the PTP having made certain minimum quarterly distribution targets over a specified period of time. Upon reaching this milestone, the holder of the incentive units typically has the option of trading in its incentive interests for a certain number of common units at a pre-established ratio. In some situations, the conversion of the incentive units into common units will be subject to several escalating distribution hurdles. In the event that the PTP meets a higher minimum quarterly distribution threshold, the ratio of the common units received for every incentive unit in the conversion typically increases. In these PTPs, the holders of incentive units may have the option of choosing to convert their incentive units into common units sooner, or deferring the conversion until a future time in the hopes of receiving a greater number of common units.

While incentive interests are still present in the vast majority of PTPs, they have become less popular in

newly formed PTPs in recent years, with the majority of E&P PTPs being formed without incentive interests.<sup>51</sup> This is at least partially because of the strain that the incentive interests place on the public's yield and the negative impact on the PTP's cost of capital. As incentive interests reach higher distribution tiers, and eventually get into the high splits, the PTP must be able to produce a correspondingly higher amount of net cash in order to maintain its distributions to the public unitholders. Many sponsors have decided that they would prefer to part with the additional return in favor of additional security with respect to the ability to make distributions to investors. For these same reasons, some sponsors currently are considering restructuring existing incentive interest arrangements or waiving their entitlement to distributions.

Incentive interests raise a number of U.S. federal income tax issues that will be discussed in other parts of this primer. For example, the sponsor not only must consider the basic tax consequences of issuing and making distributions with respect to such interests, but also must consider the impact of such interests on capital accounts, allocations and the drafting of the partnership agreement. Further, recapitalizing incentive interests or changing their economic entitlements raises U.S. federal income tax considerations of which the sponsor should be aware, which will be discussed in future installments of the primer.

### C. Minimum Cash Distributions

Most PTPs make regular quarterly cash distributions to the holders of their common units. In the prospectus for a public offering, the PTP typically will state its intent to distribute a specified minimum level of "available cash" to its limited partnership unit holders on a quarterly basis. This amount is referred to as the minimum quarterly distribution (MQD) or initial quarterly distribution (IQD). In this context, available cash typically means, for each fiscal quarter, all cash on hand as of the end of the quarter *less* the amount of cash reserves ("hold back") established by the general partner (or managing member) to:

- provide for the proper conduct of the PTP's business;
- comply with applicable law, any of the PTP's debt instruments, or other agreements; or
- provide funds for distributions to the PTP's unitholders and to the general partner for any one or more of the next four quarters.

Many PTPs will agree to distribute a substantial amount (e.g., between 70 and 100 percent) of their

net operating cash flow each year. This agreement is market driven; it is not a tax requirement. Thus, from the sponsor's perspective, it often will be important for operating income, cash flow, maintenance expenses, and capital expenditures to be predictable. The need to maximize and to predict cash flow can drive sponsors to contribute property with respect to which minimal development is required. In addition, some PTPs may utilize product price hedges to reduce the volatility of cash flow. As was indicated above, a PTP that uses such hedges needs to be sensitive to whether such hedges generate qualifying income for purposes of testing its status as a partnership for U.S. federal tax purposes.

## D. Fungibility

In order for a PTP to be a viable vehicle for public investors, its common units must be fungible—that is, a prospective purchaser of PTP units in the public marketplace must be indifferent as to which particular common unit or units he or she purchases. Each publicly traded unit must carry with it the same economic entitlements to PTP assets and the same U.S. federal income tax consequences for a purchaser of such unit in the public marketplace. Fungibility of the PTP's units is absolutely vital in the marketplace.

As will be discussed in other parts of this primer, the need for fungibility does not intersect well with some of the partnership tax rules. Many of these rules were drafted well before the growth of PTPs and are focused on a world in which buyers and sellers of partnership interests know who each other are. Under some of those rules, the tax characteristics of a purchased interest in the hands of the buyer can be dependent, in part, on the tax characteristics of such unit in the hands of the seller. A PTP must take steps to ensure that, even taking into account these partnership tax rules, a buyer of common units on the public market is indifferent to the identity of the current unitholder from whom he or she acquires units. As will be discussed throughout this article, various measures are employed by PTPs to make sure that their common units are fungible at all times.

## E. The “Tax Shield”

From a market perspective, investors typically view a PTP unit as a yield-based security. To this end, the amount of “tax shield” associated with a PTP can be relevant to potential buyers of a PTP's units. The tax shield is based upon the expected amount of annual distributions per unit and the expected share of income

allocable to each unit (and subject to tax at the investor level). Specifically, the investor's tax shield generally is computed as the excess of one over the ratio of (1) the partner's expected taxable income from the PTP, to (2) such partner's expected cash distribution.

**Example.** Assume that an investor acquires a PTP unit and expects distributions of around \$100 per unit annually. The investor expects its share of the PTP's taxable income to be around \$15—*i.e.*, the individual expects to have to include an amount that is equal to 15 percent of the expected \$100 distribution in its income. Thus, the tax shield would be 0.85 (*i.e.*, one minus 0.15).

From the investor's perspective, it likely will be the case that the bigger the tax shield, the better; a bigger tax shield reflects a smaller ratio of taxable income to distributions. Deductions for depreciation, depletion and amortization (DD&A) can reduce the share of taxable income allocable to each unit. As such, as a general rule, the greater the amount of DD&A deductions allocable to a unit, the higher the tax shield.

If an investor does not view the tax shield of the units of a particular PTP as adequate, he or she may choose to sell such units and to buy another investment, such as units in a different PTP that delivers a higher tax shield. In fact, it appears that some investors may accord the tax shield more weight than the type of assets held by the PTP. Thus, it is not unusual for an investor to sell a unit in an E&P PTP and to buy a unit in a midstream PTP, or *vice versa*.

The PTP's projections as to its tax shield also may drive its property acquisition behavior. For example, assume a PTP projects that public investors will be 90-percent shielded in year 1, 75-percent shielded in year 2, and only 60-percent shielded in year 3. The PTP may begin planning the acquisition of new property in year 1, with an eye to avoiding the expected drop in its tax shield by year 3. Towards that end, many sponsors of PTPs plan regular and ongoing asset acquisitions by the PTP.<sup>52</sup> Moreover, the PTP may be willing to pay more to acquire property in year 2 than in year 1, and even more in year 3 than in year 2, because of its projections regarding its declining tax shield. That is, the price the PTP may be willing to pay to acquire property may be directly correlated to its perception as to how a public investor values its units.

Given the importance of the tax shield, most sponsors create and maintain models showing annual historical computations, and expected future projec-

tions, of the tax shield. This model can serve a number of purposes. For example, it can allow the sponsor to monitor the tax shield for its partners, it can assist the sponsor in making property acquisition decisions, and it can provide the sponsor with information about how the public market might perceive the attractiveness of its units relative to other potential investments.

## IV. Formation Issues— Basic Considerations and Preview of Significant Issues

Assuming the benefits of classification as a partnership for U.S. federal income tax purposes are available, the sponsor of a new energy or natural resources venture must determine the appropriate organizational structure for the PTP, how to get property into the PTP and how to raise capital for the venture. The remainder of this part of the primer highlights certain of the structural issues the sponsor may want to consider—*i.e.*, whether to legally organize the PTP as a limited partnership or a limited liability company; the potential impact of the choice of legal entity on allocations of liabilities; and whether to have the PTP hold property directly or through a lower-tier entity. The next installment of the primer will delve into the U.S. federal income tax considerations the sponsor may want to consider with respect to acquiring property and raising capital.

### A. LP or LLC?

As was indicated above, some PTPs are legally organized as limited partnerships (LPs) while others are legally organized as limited liability companies (LLCs). The decision as to whether to form a PTP as an LP or an LLC typically will be primarily a legal matter. That is, the key drivers in a sponsor's decision as to the whether to organize a PTP as an LLC or an LP often relate to state law and corporate governance differences between the organizational forms.

Regardless of whether a PTP is organized as an LP or an LLC, it can be treated as a partnership for U.S. federal income tax purposes if it meets the eligibility requirements described above. As such, U.S. federal income tax issues often will not be a major factor in the decision to organize a PTP as an LP or an LLC. Nonetheless, the sponsor should be aware that there are some areas of tax law in which members of LLCs can be treated differently than limited partners of LPs.<sup>53</sup> These areas include the application of the “at-risk” rules and “passive activity rules” with respect to the passthrough of losses; the

employment tax treatment of service provider partners; the treatment of payments made in liquidation of a partner's interest; and the characterization of whether a partner bears the economic risk of loss for purposes of allocating partnership liabilities and determining the consequences of sales, exchanges and modifications of debt. Some of these issues may be relevant to investors in particular fact situations. The potential impact of the choice of legal entity on how the partnership allocates liabilities is discussed below.

### B. Impact of Choice of Legal Entity on Allocation of Debt

The choice as to whether to organize the PTP as an LLC or an LP may, in certain circumstances, affect how liabilities are allocated. A partner typically will prefer to have a higher basis (as opposed to a lower basis) in its interest. The partnership tax rules generally take into account a partner's share of the partnership's liabilities in determining such partner's basis in his or her partnership interest. While the Code Sec. 752 liability allocation rules are extremely complex, as a very general matter, a partner is allocated the portion of any liability for which he or she (or a related person) bears the economic risk of loss.<sup>54</sup> Other rules apply for allocating liabilities if no partner bears the economic risk of loss with respect to a liability. The determination of whether a partner bears the economic risk of loss with respect to a liability turns on whether the partner would be required by the partnership agreement or state law to pay money to fund the payoff of the liability.<sup>55</sup>

In most cases, no member of an LLC has any liability as a matter of state law with respect to the creditors of the LLC if the LLC's business fails. By contrast, the general partner in an LP typically would be responsible under state law for paying off the LP's recourse liabilities. Thus, in some situations, the choice of an LP over an LLC could have a significant impact on how the liabilities of the PTP would be shared.

Nonetheless, it is common for the sponsor of a PTP organized as a state law LP to hold its general partnership interest through an LLC that is wholly owned by the sponsor and that is disregarded for U.S. federal income tax purposes.<sup>56</sup> In such a situation, the sponsor may only be at risk with regard to the creditors of the PTP under state law to the extent of the assets of the LLC—and the LLC may not hold significant assets. The Code Sec. 752 liability allocation rules contain a special rule for situations where a partner that otherwise bears the risk of loss with regard to the liabilities of the partnership holds its interest

through an entity that is disregarded for U.S. federal income tax purposes.<sup>57</sup> This rule generally provides that the partner will only be considered to bear the economic risk of loss to the extent of the net value of the disregarded entity.<sup>58</sup> Thus, depending upon the particular facts, the sponsor may be treated as bearing little if any of the risk of loss and any liability allocation distinction between a PTP organized as an LP and an LLC may not be significant.

### **C. Whether to Hold Operating Assets Directly or Indirectly**

It is very common for PTPs not to hold their operating assets directly as a legal matter. In fact, many PTPs hold operating assets indirectly either (1) through an LLC that is wholly owned by the PTP, or (2) by a state law LP in which the PTP is a limited partner and in which an LLC that is wholly owned by the PTP is the general partner. In both such cases, the lowest-tier entity typically serves as the operating company for the PTP and the state law owner of all of the PTP's property. Sponsors often employ this structure in order to limit the PTP's liability under state law for the business operations conducted by the lower tier entity. Moreover, where the operating company is a pre-existing entity owned by the sponsor, contributing the entity to the partnership can serve the added benefit of avoiding the need to re-title the assets and may avoid the need to pay state transfer taxes.

While the operating company may serve an important role for state law purposes, the sponsor can structure the arrangement such that the operating company is treated as disregarded as an entity separate from the PTP for U.S. federal income tax purposes.<sup>59</sup> Importantly, however, this disregarded entity status does not extend to all U.S. federal tax purposes. For example, the operating company will be regarded for certain excise tax purposes.<sup>60</sup> Additionally, in the event that the operating company houses the employees that work in the operations of the PTP's business, the operating company may be regarded for purposes of U.S. federal employment tax purposes.<sup>61</sup> Treating the otherwise disregarded operating company as a separate entity for excise tax and employment tax purposes will require the operating company to file under its own employer identification number (EIN).<sup>62</sup> If the operating company is a pre-existing "regarded" entity, uncertainty can arise regarding which entity must use the historic EIN of the operating company.<sup>63</sup>

There also are situations in which a sponsor of a PTP may want the PTP to hold operating assets indi-

rectly through a lower-tier entity that is classified as a separate—regarded—entity for U.S. federal income tax purposes. This may be the case when some of the operations of the PTP may produce nonqualifying income. For example, when a PTP is engaged in several trade or business activities, it is not uncommon for some of the ancillary activities to produce nonqualifying income. Rather than worry about whether the PTP meets the qualifying income requirements each year (such that it can remain a passthrough entity for U.S. federal income tax purposes), the sponsor may choose to place the nonqualifying activities in a wholly owned corporation, or "blocker." The corporation pays dividends to the PTP, which are qualifying income for purposes of Code Sec. 7704(c). The obvious downside of such a structure is that the corporation pays corporate-level tax on the income earned from the nonqualifying activity. However, given the critical importance of meeting the qualifying income requirements, the security of knowing that such requirements can be met may make the tax charge worthwhile.

In this regard, it is worth noting that it is common for a PTP that holds a portion of its operations through a wholly owned corporation to fund the operations of the corporation by lending funds to the corporation, rather than by making capital contributions. The deduction for the interest paid by the corporation can help reduce the tax charge associated with the corporation's payment of corporate-level tax, while the interest received by the PTP constitutes qualifying income. While this may be an attractive way in some situations to reduce the negative tax consequences of including a corporation in the PTP structure, care should be taken to avoid over-leveraging the corporation such that it becomes thinly capitalized. This can raise both business and tax issues (e.g., potential for less attractive financing terms, recharacterization of the loans as "equity" for U.S. federal income tax purposes, etc.)

## **VI. Conclusion**

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As was indicated above, the next installment of the primer will begin by delving into formation issues in more detail, focusing both on planning considerations and potential "traps for the unwary." For example, the next installment will explore various tax-free and taxable structures the sponsor may use for the PTP's acquisition of property, why a sponsor might find different structures desirable, and the key U.S. federal income tax issues the sponsor may confront with respect to such structuring.

## ENDNOTES

- \* The authors wish to express appreciation to Carol Kulish Harvey, also with the WNT Passthroughs Group, for her substantial contribution to this article. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax advisor. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.
- <sup>1</sup> Some people refer to PTPs as master limited partnerships, or MLPs. Nonetheless, as a technical matter, a PTP is not necessarily the same as an MLP. MLPs are organized as limited partnerships and have a particular tiered structure. Although most MLPs are publicly traded, not all MLPs are publicly traded. Further, while many PTPs are MLPs, other PTPs legally are organized as limited liability companies. Thus, not all PTPs are MLPs. See National Association of Publicly Traded Partnerships, *Publicly Traded Partnerships 101: Understanding MLPs*, at 8 (May 23, 2009), [www.naptp.org/documentlinks/PTP101\\_Presentation.pdf](http://www.naptp.org/documentlinks/PTP101_Presentation.pdf) (“NAPTP Presentation”). The NAPTP is the trade association for PTPs.
- <sup>2</sup> As indicated in note 4, *infra*, in some PTPs, public investors also may hold preferred units.
- <sup>3</sup> In a limited partnership structure, the public investors and the sponsor, as a legal matter, are “partners.” The investors typically hold limited partnership interests, while the sponsor typically holds a general partnership interest. In a limited liability company structure, the public investors and the sponsor, as a legal matter, are “members.” The investors typically hold common (and, possibly, preferred) membership interests, while the sponsor holds the managing member’s interest. As is explained in text *infra*, in both limited partnership and limited liability company structures, the sponsor also may hold “incentive interests.” Given that a PTP may be legally organized as either a limited liability company or a limited partnership, this primer may use terminology associated with the limited partnership legal form at some points and with the limited liability company legal form at others. Note also that, if the PTP is classified as a partnership for U.S. federal income tax purposes, the public investors and the sponsor typically are referred to as “partners” for U.S. federal income tax purposes, regardless of whether the PTP is legally organized as a limited partnership or a limited liability company.
- <sup>4</sup> See Wachovia Capital Markets, LLC, *MLP Primer—Third Edition: Everything You Wanted to Know about MLPs, But were Afraid to Ask*, at 48 (July 14, 2008), [www.naptp.org/documentlinks/071508wacoviaprimer.pdf](http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf) (“Wachovia Report”). The Wachovia Report provides a large amount of data regarding PTPs, including information about performance, growth, sector trends and certain investor issues.
- <sup>5</sup> See NAPTP Presentation, *supra* note 1, at 21.
- <sup>6</sup> According to the Wachovia Report, PTPs held approximately 37 percent of energy pipelines as of the date of such report. Wachovia Report, *supra* note 4, at 13.
- <sup>7</sup> According to *The Research Magazine Guide to Master Limited Partnerships 2009*, 32 RESEARCH: MAGAZINE, Supplement, July 2009 (“*Research Magazine Guide*”), approximately 42 percent of MLPs are in the pipeline (or “midstream”) sector; 11 percent are in the oil and gas exploration and production sector; eight percent are in the marine transport sector; nine percent are in the propane and heating oil sector; five percent are in the coal sector; two percent are in other minerals or timber sector; and the remaining MLPs are in other industries (such as investment, financial, commodities or real estate). *The Research Magazine Guide*, at 14.
- <sup>8</sup> In the “tax world,” many practitioners depict partnerships on organizational charts as triangles and corporations as squares. Hence, as indicated in the title of this article, PTPs are triangles in a world of squares.
- <sup>9</sup> Certain kinds of corporations (“S corporations”) are subject to only one level of tax (at the shareholder level), subject to certain limited exceptions. Nonetheless, a publicly traded corporation cannot be an S corporation because of the limits on the numbers and kinds of shareholders that an S corporation can have. See generally Code Sec. 1361(b). Instead, a publicly traded corporation typically is taxed under the rules of Subchapter C of Chapter 1 of the Code—*i.e.*, it is a “C corporation.”
- <sup>10</sup> Note that, although a PTP can access the public markets, certain kinds of investors may have concerns about investing in PTP units. For example, as will be explained in another part of this primer, although mutual funds can own PTP units, they are restricted as to how much of their asset value can be invested in PTPs and how much they can own in any individual PTP. As another example, tax-exempt investors often are reluctant to own PTP units because the PTP may generate unrelated business taxable income (UBTI). The primer is not intended to provide advice to investors as to the tax consequences of investing in a PTP. The tax consequences to each investor may vary depending upon such investor’s particular facts and circumstances. A potential investor should seek advice from his or her own tax counsel regarding the tax consequences of investing in a particular PTP.
- <sup>11</sup> See Wachovia Report, *supra* note 4, at 33. The Wachovia Report indicates that MLPs with C corporation sponsors typically traded at an estimated median 2008 enterprise value-to-adjusted EBIDTA multiple of 11.1x, versus 6.5x for the associated C corporation. *Id.*
- <sup>12</sup> Except to the extent provided otherwise, all “Code Sec.” references are to the Code or to the Treasury regulations promulgated thereunder.
- <sup>13</sup> Natural resources PTPs also confront other issues, such as accounting issues and regulatory considerations. A discussion of these topics is beyond the scope of this primer.
- <sup>14</sup> *General Utilities & Operating Co. v. Helvering*, 296 US 200 (1935).
- <sup>15</sup> Act Sec. 631 of the Tax Reform Act of 1986 (P.L. 99-514). The rules for imposing a corporate-level tax on distributions of appreciated property are set forth in Code Sec. 311.
- <sup>16</sup> P.L. 99-514. The individual and corporate rates, and the alternative minimum tax provisions, were (and are) reflected in Code Secs. 1, 11 and 55. The rate schedules have changed, however, since 1986. Currently, the maximum corporate income tax rate is lower than the maximum individual income tax rate.
- <sup>17</sup> As indicated in note 9, *supra*, certain closely held S corporations generally are treated as passthrough entities (although subject to a different set of tax rules than partnerships). Nonetheless, publicly traded corporations cannot qualify for S corporation status due to restrictions regarding the number and kinds of shareholders that an S corporation can have.
- <sup>18</sup> See H.R. REP. NO. 100-391, at 1787 (1987).
- <sup>19</sup> *Id.*, at 1788.
- <sup>20</sup> *Id.*
- <sup>21</sup> See H.R. CONF. REP. NO. 100-495, at 949–50 (1987).
- <sup>22</sup> *Id.*
- <sup>23</sup> Code Sec. 7704(b) generally defines a PTP for this purpose as any partnership if interests in such partnership either (1) are traded on an established securities market, or (2) are readily tradable on a secondary market (or the substantial equivalent thereof). For this purpose, an “established securities market” includes the NYSE, NASDAQ, certain foreign securities exchanges, regional or local exchanges and certain “interdealer” quotation systems that regularly disseminate firm “buy” or “sell” quotations by identified brokers and dealers. See Reg. §1.7704-1 for more detail regarding what constitutes an “established securities market” or a “secondary market or the substantial equivalent thereof.” Under paragraph (d) of that regulation, interests in a partnership are not considered to be traded on an established securities market or to be readily tradable on a secondary market or the substantial equivalent thereof unless (1) the partnership participates in the establishment of the market or the inclusion of its interests thereon; or (2) the partnership recognizes transfers made on the market by redeeming transferor partners (in the case of a redemption or repurchase by the partnership) or admitting transferees as partners or otherwise recognizing rights of the transferee. References in this primer to PTPs are to partnerships that meet the definition of a PTP set forth in Code Sec. 7704(b).

<sup>24</sup> A private letter ruling is based on the specific facts presented and can only be relied upon by the taxpayer to whom issued. See Code Sec. 6110(k)(3). Nonetheless, such rulings can provide useful information about how the IRS may view certain issues.

<sup>25</sup> P.L. 110-343 (2008).

<sup>26</sup> Code Sec. 611 generally applies in the case of mines, oil and gas wells, other natural deposits and timber. For this purpose, the term “mines” includes certain deposits of waste or residue, the extraction of ores or mineral from which is considered “mining” under Code Sec. 631(c). See Code Sec. 611(a).

<sup>27</sup> H.R. CONF. REP. NO. 100-495, at 947.

<sup>28</sup> S. REP. NO. 100-445, at 424 (1988).

<sup>29</sup> H.R. CONF. REP. NO. 100-495, at 947.

<sup>30</sup> For purposes of the second part of the statutory exclusion described above, note that minerals, other than sodium chloride, extracted from brines pumped from a saline perennial lake within the United States are not considered to be minerals from an inexhaustible source and, therefore, are not excluded from the definition of “minerals and natural resources.” Code Sec. 613(b). Note also that the statutory language indicates that the treatment of sodium chloride (*i.e.*, salt) can be different depending upon whether it is extracted from a mine or salt dome as opposed to from seawater or the Great Salt Lake. Moreover, water extracted and sold from a depleting ground water reservoir could be depletable under Code Sec. 611, while not generating qualifying income under Code Sec. 7704(d).

<sup>31</sup> Rev. Rul. 82-17, 1982-1 CB 95.

<sup>32</sup> The legislative history of the 2008 legislation does not include an explanation of the amendment to the qualifying income rules. Further, given the recent enactment of the amendment, regulatory guidance has not yet been provided.

<sup>33</sup> S. REP. NO. 100-445, at 424; H.R. CONF. REP. NO. 100-495, at 947.

<sup>34</sup> H.R. REP. NO. 100-1104, at 18 (1988).

<sup>35</sup> See Statement of Mr. Rostenkowski, 133 Cong. Rec. H 11968 (Dec. 21, 1987); Statement of Sen. Bentsen, 133 Cong. Rec. S 18651 (Dec. 22, 1987) (substantially similar language).

<sup>36</sup> CCA 200749012 (Aug. 15, 2007).

<sup>37</sup> For this purpose, the term “alcohol” does not include (1) alcohol produced from petroleum, natural gas or coal (including peat); or (2) alcohol with a proof of

less than 190 (determined without regard to any added denaturants). The term, however, does include an alcohol gallon equivalent of ethyl tertiary butyl ether or other ethers produced from such alcohol. See Code Sec. 6426(b)(4)(A).

<sup>38</sup> Note that the definition of “biodiesel” in Code Sec. 40A(d)(1) excludes any liquid with respect to which a credit may be determined under Code Sec. 40 (relating to the alcohol mixture credit, the alcohol credit, the small ethanol producer credit and the cellulosic biofuel producer credit).

<sup>39</sup> Prior to the law change, the IRS had issued letter rulings in which it treated the transportation of fuels that contained small amounts of other substances as generating qualifying income. Nonetheless, there was uncertainty as to what extent fuels that contained larger amounts of other substances constituted minerals or natural resources for purposes of Code Sec. 7704.

<sup>40</sup> As was indicated above, a couple of private letter rulings have been issued that concluded that the transportation, storage and distribution of fuel generated qualifying income. However, these rulings were based upon the particular facts provided and may have involved situations in which the storage function was incidental to the transportation and distribution functions.

<sup>41</sup> Code Sec. 7704(d)(1).

<sup>42</sup> For a discussion of the arguments in favor of treating COD income as qualifying income in certain circumstances, see the letter from KPMG LLP (“KPMG”) to Michael Mundaca at the U.S. Department of Treasury, dated March 13, 2009, 2009 TNT 60-26 (Apr. 1, 2009), in which KPMG suggested that the IRS and the Treasury issue guidance that adopts a “look-through” or tracing rule for purposes of determining when COD income can be considered qualifying income within the meaning of Code Sec. 7704(d).

<sup>43</sup> Reg. §1.7704-3(a)(1).

<sup>44</sup> LTR 9619011 (Jan. 30, 1996), available at 1996 WL 241468.

<sup>45</sup> *Id.*

<sup>46</sup> LTR 200841017 (June 16, 2008), available at 2008 WL 4533237. See also LTR 200919019 (Jan. 23, 2009), available at 2009 WL 1262908.

<sup>47</sup> LTR 200841017, *supra*.

<sup>48</sup> In some cases, both common units and preferred units will be sold to the public, with

the preferred units having rights similar to preferred stock.

<sup>49</sup> The Wachovia Report, *supra* note 4, at 56.

<sup>50</sup> There are primarily two ways in which the incentive share of the distributable cash is determined. In some PTP partnership agreements, the incentive interests are given a varying percentage of the total distributable cash. Other PTP partnership agreements assign the incentive interests a common unit equivalence, which provides the incentive interest holder with a distribution determined based on the per-unit quarterly distribution made to the public unitholders multiplied by the common unit equivalence.

<sup>51</sup> The Wachovia Report, *supra* note 4, at 15.

<sup>52</sup> As will be discussed in a subsequent part of this primer, many sponsors enter into a series of like-kind exchange transactions in which the PTP acquires the sponsor’s “relinquished” property.

<sup>53</sup> See note 3, *supra*, for the distinction between “members” and “limited partners.”

<sup>54</sup> See generally Reg. §1.752-2. A detailed discussion of the Code Sec. 752 rules is beyond the scope of this primer.

<sup>55</sup> Reg. §1.752-2(b).

<sup>56</sup> The “check-the-box” regulations issued under Code Sec. 7701 allow certain entities that only have one owner for U.S. federal income tax purposes to elect to be classified as entities that are disregarded as separate from their owners for U.S. federal income tax purposes. See generally Reg. §301.7701-2 *et. seq.*

<sup>57</sup> Reg. §1.752-2(k).

<sup>58</sup> Reg. §1.752-2(k)(1) and (2).

<sup>59</sup> An operating company LLC that is wholly owned by a PTP can be structured so as to be a disregarded entity for U.S. federal income tax purposes. Further, if the operating company is an LP owned by the PTP and an intermediary LLC, the arrangement can be structured such that both the intermediary LLC and the LP are disregarded as separate from the PTP for U.S. federal income tax purposes.

<sup>60</sup> Reg. §301.7701-2(c)(2)(v).

<sup>61</sup> Reg. §301.7701-2(c)(2)(iv).

<sup>62</sup> Reg. §301.7701-2(c)(2)(iv)(C)(ii) and (v)(B)(ii).

<sup>63</sup> For a discussion of many of the key technical issues, see KPMG’s comment letter to the IRS and the Treasury on the final regulations on the employment tax rules relating to disregarded entities, dated May 19, 2009, 2009 TNT 105-15 (June 4, 2009).

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