

AN ALERT FROM THE BDO NATIONAL TAX PRACTICE

# BDO KNOWS:

## PARTNERSHIP TAXATION



### SUBJECT

## FINAL REGULATIONS BRING CLARITY TO QUALIFYING INCOME FOR PUBLICLY TRADED PARTNERSHIPS

### SUMMARY

On January 19, 2017, Treasury and the IRS issued final regulations (TD 9817) under Section 7704(d)(1)(E) of the Internal Revenue Code. The regulations provide guidance on the types of activities that generate Qualifying Income for publicly traded partnerships (“PTPs”), define the term “mineral or natural resource,” provide rules for determining whether activities that are not Section 7704(d)(1)(E) activities are nonetheless qualifying “Intrinsic Activities,” and establish a transition period for certain PTPs. The final regulations follow the basic approach of the proposed regulations while incorporating changes based on feedback received from public comments.

### DETAILS

#### *Background*

Section 7704(a) provides that, as a general rule, PTPs will be treated as corporations for federal income tax purposes. Section 7704(c) provides an exception to this rule if 90 percent or more of a PTP’s gross income is Qualifying Income. Qualifying Income is generally passive-type income such as interest, dividends, and rent. However, Section 7704(d)(1)(E) provides that income and gains derived from the exploration, development, mining or production, processing, refining, transportation, or the marketing of any mineral or natural resource (a “Qualifying Activity”) also constitutes Qualifying Income.

Prior to the issuance of proposed regulations on May 6, 2015, little guidance was available that defined the specific activities that generate Qualifying Income in the mineral and natural resource industries. As a result, PTPs often sought opinion letters from law firms and private letter rulings (“PLRs”) from the IRS to obtain comfort that the income generated by a particular activity

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was Qualifying Income. Treasury issued the proposed, and now these final regulations due to the increased demand for PLRs, the responsibility to treat all taxpayers equally, and the desire to apply Section 7704(d)(1)(E) consistent with congressional intent.

## OVERVIEW

Treas. Reg. Section 1.7704-4 creates a framework for determining whether an activity is a Qualifying Activity. Pursuant to the new regulations, Qualifying Activities include Section 7704(d)(1)(E) activities and Intrinsic Activities.

### *Section 7704(d)(1)(E) Activities*

Section 7704(d)(1)(E) activities are those activities specifically enumerated in the statute. One of the fundamental differences between the proposed regulations and the final regulations is the removal of an exclusive list of operations that comprised Section 7704(d)(1)(E) activities. Instead, the final regulations provide general definitions of each of the eight component activities described in Section 7704(d)(1)(E), followed by a non-exclusive list of examples of each. Despite the lists provided being non-exclusive, Treasury and the IRS do not intend that the final regulations be interpreted and applied expansively.

### *Intrinsic Activities*

Intrinsic Activities are support activities essential to Section 7704(d)(1)(E) activities. According to the preamble of the proposed regulations, it is the belief of Treasury and the IRS that these activities also give rise to Qualifying Income because the income is "derived from" the Section 7704(d)(1)(E) activity. Consistent with the proposed regulations, the final regulations adopt the following three requirements for a support activity to be considered intrinsic to a Section 7704(d)(1)(E) activity:

1. The activity is specialized to support a Section 7704(d)(1)(E) activity;
2. The activity is essential to the completion of the Section 7704(d)(1)(E) activity; and
3. The activity requires the provision of significant services to support the Section 7704(d)(1)(E) activity.

Support activities must be analyzed on an activity-by-activity basis for these three requirements to determine if the activity is an intrinsic activity.

## EFFECTIVE DATE AND TRANSITION PERIOD

The final regulations apply to income earned by a partnership in a taxable year beginning on or after January 19, 2017. However, an exception applies for certain income earned during a transition period. The transition period ends on the last day of the partnership's taxable year that includes January 19, 2027. The exception provides that a partnership may treat income from an activity as Qualifying Income during the transition period if one of the following conditions are met:

1. The partnership received a PLR from the IRS holding that the income from that activity is Qualifying Income;
2. Prior to May 6, 2015, the partnership was publicly traded, engaged in the activity, and treated the activity as giving rise to Qualifying Income under Section 7704(d)(1)(E), and that income was Qualifying Income under the statute as reasonably interpreted prior to May 6, 2015;
3. Prior to May 6, 2015, the partnership was publicly traded and had entered into a binding agreement for construction of assets to be used in such activity that would give rise to income that was Qualifying Income under the statute as reasonably interpreted prior to May 6, 2015; or
4. The partnership is publicly traded and engages in the activity after May 6, 2015, but before January 19, 2017, and the income from that activity is Qualifying Income under the proposed regulations (REG-132634-14) contained in the Internal Revenue Bulletin 2015-21.

## BDO INSIGHTS

The final PTP regulations bring much needed clarity in determining which activities give rise to Qualifying Income. Existing and prospective PTPs should analyze their activities to determine if they fall within the newly defined guidelines for Qualifying Activities, and if not, whether they qualify under the transition rules. While the new regulations are intended to reduce the need for case-by-case guidance, companies developing new technologies and companies with activities not defined by the new regulations may still need to consider requesting a PLR.

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