



ENTERPRISE PRODUCTS PARTNERS L.P.
ENTERPRISE PRODUCTS HOLDINGS LLC
(General Partner)

ENTERPRISE PRODUCTS OPERATING LLC

July 31, 2015

CC:PA:LPD:PR (REG-132634-14)

Room 5203

Internal Revenue Service

P.O. Box 7604

Ben Franklin Station

Washington, DC 20044

Re: Comments on REG-132634-14, Qualifying Income from Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources

As one of the nation's largest publicly-traded partnerships, Enterprise Products Partners L.P. ("*Enterprise*") is submitting this letter to express our concerns over the processing and refining portion of the qualifying income proposed regulations (REG-132634-14) (the "*Proposed Regulations*") and to propose modifications to the Proposed Regulations. The refining and processing portion of the Proposed Regulations is inconsistent in the treatment of natural gas liquids ("*NGLs*"). We believe a full understanding of oil and natural gas production, processing and refining will point to a more accurate interpretation of Section 7704(d)(1)(E).¹

This letter also proposes modifications to the transition rules included in the Proposed Regulations.

I. Enterprise

Enterprise is a leading North American provider of midstream energy services to producers and consumers of natural gas, NGLs, crude oil, refined products and primary petrochemical feedstocks.

NGLs are at the core of our business. We own an extensive network of assets for gathering, transporting, fractionating, processing, refining, and marketing NGLs and their related products, including one of the world's largest NGL complexes at Mont Belvieu, Texas.

We are not a chemical company. We produce no complex compounds or plastics. In fact, every product we produce from an NGL is also produced at a crude oil refinery and the production of those products in a crude oil refinery would produce qualifying income.

¹ Section references are to the Internal Revenue Code of 1986, as amended.

II. Overview

Section 7704(d)(1)(E) provides that qualifying income includes income derived from the following activities (each a “*Qualifying Activity*” and collectively, the “*Qualifying Activities*”):

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.²

Our comments are based on the following principles, which we believe should be reflected in revised regulations.

- The focus of Section 7704(d)(1)(E) is on the material being processed and refined (i.e., the natural resource), not on the resulting product.
- Section 7704(d)(1)(E) treats both the processing and refining of “any natural resource” as a Qualifying Activity.
- NGLs are oil and gas, unquestionably a natural resource for purposes of Section 7704(d)(1)(E). They are “of a character” with respect to which a deduction for depletion is allowable. NGLs are “crude oil” for depletion purposes under Section 613A.
- The components of oil and natural gas production (including NGLs) do not cease to be natural resources merely because they are separated from one another. Before and after separation each component continues to be of the same character as in the underground oil and gas reservoir.
- There should be a single standard for applying the processing and refining aspects of Section 7704(d)(1)(E) to oil and natural gas production. There is no basis to treat natural gas and NGLs different from crude oil.
- Both processing and refining (whether crude oil or NGLs) begin with, but do not end with, separation by distillation or fractionation. Both processing and refining involve some degree of physical or chemical change.

The standards in the Proposed Regulations should be modified to be consistent with these basic tenets.

We believe all of this can be achieved while still addressing the expressed concerns of the government regarding the inclusion of chemical manufacturing and the

² I.R.C. § 7704(d)(1)(E).

production of plastics and similar petroleum derivatives within the scope of Qualifying Activities.

We are particularly troubled by the fact that the disparate treatment of NGLs and crude oil artificially picks “winners and losers” – the Proposed Regulations provide for the disparate treatment of identical products based on whether the original input was wet natural gas or crude oil coming from the well. There is no basis for such a distinction. Moreover, we believe this disparate treatment is particularly troublesome when one considers that virtually all NGLs processed in the United States are from domestic production, while nearly half of the crude oil refined in the United States is imported.

III. Section 7704 Focuses on Input, not Output

Section 7704(d)(1)(E) provides that processing and refining are Qualifying Activities. The statute contains no narrowing based on the product that is produced from the processing and refining of a natural resource. For example, there is nothing in the statute to indicate that processing or refining of a natural resource into a fuel is any more a qualifying activity than processing or refining the natural resource into a primary petrochemical feedstock. While we concur that neither processing nor refining includes chemical manufacturing and that the final regulations should appropriately include limitations in this regard, that concurrence is based more on the fact that chemical manufacturing is not “processing” or “refining” than on some concept of good outputs and bad outputs.

All statutory interpretation must start with the language of the statute itself. Here, section 7704(d)(1)(E) is clear on its face. NGLs are, as discussed in detail below, unquestionably natural resources that may be processed and refined in a Qualifying Activity. The exclusion of even the most basic refining and processing of NGLs by the Proposed Regulations is simply inconsistent with the plain language of the statute.

Much of the confusion related to the Proposed Regulations appears to be based on one comment in the legislative history of Section 7704. The House Report provides that:

Specifically, **natural resources include** ... oil, gas or products thereof.... For this purpose, 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. 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.³

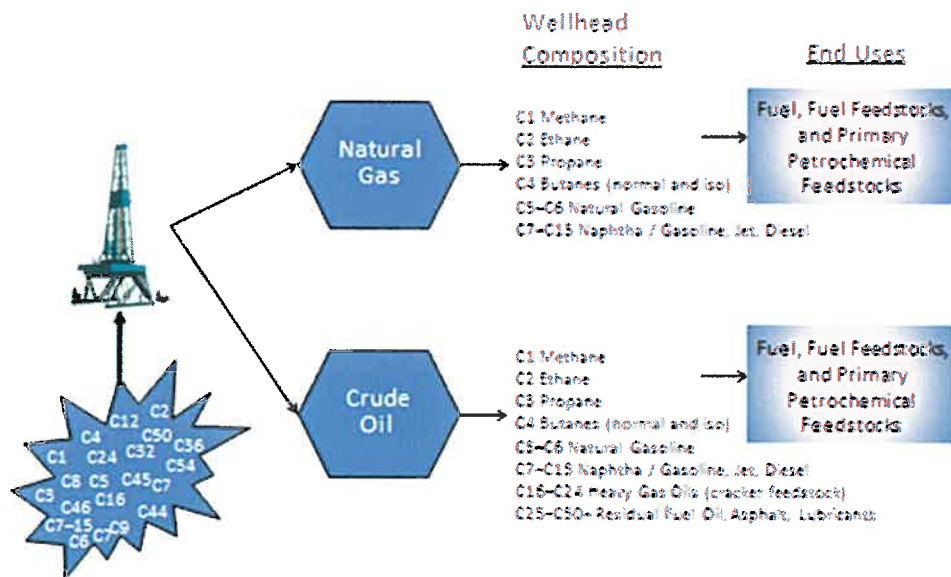
³ H.R. REP. NO. 100-495, at 30 (1987) (emphasis added).

There is nothing that suggests Congress intended the above list to be exclusive. Yet this excerpt seems to be the source of the view adopted by the Proposed Regulations that there is a limited universe of acceptable products that may be produced from the processing and refining of oil and gas and that because most of the substances listed are crude oil based fuels, those fuels must have favored status.

A closer reading, however, reveals this interpretation is incorrect. The House Report is not describing a limited list of acceptable products that may be derived from processing and refining. Instead it is describing substances that are included in the universe of “natural resources” – substances that may still be subjected to processing and refining as a Qualifying Activity.

IV. Production of Natural Gas Liquids and the Depletion Rules

The disparate treatment of different types of oil and natural gas production under the Proposed Regulations reflects a misunderstanding of the composition of oil and natural gas prior to production. Oil and natural gas in the ground is a complex collection of hydrocarbons under high pressure embedded in rock formations. In the underground oil and gas reservoir, all of the hydrocarbon components of oil and gas are mixed together. As part of the process of production, they are separated into two basic streams: natural gas (including NGLs) and crude oil (including NGLs).



The natural gas stream, which includes NGLs, and the crude oil stream (which also includes NGLs) are both equally “oil and gas.” In fact, every component of the natural gas stream is included in the crude oil stream. The U.S. Energy Information

Administration (“*EIA*”) defines NGLs as “hydrocarbons—in the same family of molecules as natural gas and crude oil, composed exclusively of carbon and hydrogen.”⁴

V. NGLs Are Clearly a “Natural Resource” under Section 7704(d)(1)(E)

Section 7704(d)(1)(E) further provides that “mineral or natural resource” means any product “of a character” with respect to which a deduction for depletion is allowable under Section 611 of the Code. NGLs, as part of the production stream of an oil and natural gas well, are a product of a character with respect to which a deduction for depletion is allowable under Section 611 of the Code. Both Section 613A(e)(1) and Treasury Regulations Section 1.613-7(g) define “crude oil” to include NGLs.

Moreover, it is clear from the legislative history that NGLs do not lose their status as “natural resources” merely as a result of being separated. The House Report (quoted above) explicitly references separated NGLs as “natural resources.” The separation process (whether crude oil distillation or NGL fractionation) does not alter the character of the underlying hydrocarbons at all. Following separation, the underlying components are in exactly the same state as they were in the ground. These separated components may then be further processed or refined, and such activity is a Qualifying Activity. This concept seems to be embraced in the Proposed Regulations’ treatment of crude oil, which permits continued refining beyond separation by distillation, but is rejected in the context of components of the natural gas stream. There is no justification for this difference.

VI. Processing and Refining of NGLs is a Qualifying Activity under Section 7704(d)(1)(E)

Section 7704(d)(1)(E) provides that both the processing and refining of any natural resource is a Qualifying Activity. Since NGLs are natural resources under Section 7704(d)(1)(E), the processing and refining of NGLs should be a Qualifying Activity.

A. Processing and Refining as Defined under the Proposed Regulations

The Proposed Regulations provide that an activity constitutes “processing or refining” of a natural resource (including crude oil or natural gas) for purposes of Section 7704 only if (i) the activity is done to purify, separate or eliminate impurities, (ii) the activity does not (a) cause a substantial physical or chemical change in a mineral or natural resource or (b) transform the mineral or natural resource into new or different mineral products or into manufactured products, and (iii) the assets used in the activity are depreciated in accordance with the MACRS class life prescribed for assets used in the

⁴ *What are natural gas liquids and how are they used?*, U.S. ENERGY INFO. ADMIN. (Apr. 20, 2012), <http://www.eia.gov/todayinenergy/detail.cfm?id=5930>.

activity for which processing or refining characterization is sought. We refer to this three-pronged test as the “*Processing or Refining Test*.”

B. The Treatment of Processing and Refining of NGLs in the Proposed Regulations is Inconsistent and Incorrect

1. The definition in the Proposed Regulations of processing or refining is overly restrictive

With respect to natural gas (including NGLs), the Proposed Regulations provide that an activity constitutes processing of natural gas only

if it is performed to: (A) Purify natural gas, including by removal of oil or condensate, water, or nonhydrocarbon gases (including carbon dioxide, hydrogen sulfide, nitrogen, and helium); (B) Separate natural gas into its constituents which are normally recovered in a gaseous phase (methane and ethane) and those which are normally recovered in a liquid phase (propane, butane, pentane, and gas condensate); or (C) Convert methane in one integrated conversion into liquid fuels that are otherwise produced from petroleum.⁵

The Proposed Regulations include no concept of refining for NGLs. Qualifying income as it relates to NGLs includes only income from a limited category of processing - fractionating (separating) the NGL stream into its component parts (ethane, propane, normal butane, isobutane and natural gasoline). No further processing (or any refining) of these natural resources is a Qualifying Activity under the Proposed Regulations, despite the fact that the Proposed Regulations *do* expand the Processing or Refining Test for crude oil, allowing for physical and chemical changes to occur in a Qualifying Activity.⁶

⁵ Prop. Treas. Reg. § 1.7704-4(c)(5)(ii).

⁶ The relevant section of the Proposed Regulations states:

An activity constitutes processing or refining of petroleum if the end products of these processes are not plastics or similar petroleum derivatives and the activity is performed to: (1) Physically separate crude oil into its component parts, including, but not limited to, naphtha, gasoline, kerosene, fuel oil, lubricating base oils, waxes and similar products; (2) Chemically convert the physically separated components if one or more of the products of the conversion are recombined with other physically separated components of crude oil in a manner that is necessary to the cost effective production of gasoline or other fuels (for example, gas oil converted to naphtha through a cracking process that is hydrotreated and combined into gasoline)....

Prop. Treas. Reg. § 1.7704-4(c)(5)(iii)(A).

These rules ignore the plain meaning of the terms used in the statute. Both processing and refining often include more than merely purifying and separating and frequently cause a substantial physical or chemical change in a mineral or natural resource.

Definitions of “processing” include “the act or process of treating or preparing something by a special method”⁷ and “[p]erform[ing] a series of mechanical or chemical operations on (something) in order to change or preserve it.”⁸ Nothing in Section 7704 or its legislative history suggests that the word “processing” was intended to have a specific meaning or serve as a limitation on the types of activities that generate qualifying income.

Regardless of whether referred to as processing or refining, activities that are similar to those applied in crude oil refineries constitute Qualifying Activities. Time and again, the Service has confirmed this parallel treatment in issuing private letter rulings.⁹

The preamble to the Proposed Regulations suggests that the exclusion of activities that cause a substantial physical or chemical change in a mineral or natural resource from processing and refining is consistent with definitions found elsewhere in the Code and Treasury regulations, citing Treasury Regulations Section 1.613-4(g)(5) as an example. However, the purpose of that regulation is to list “transformation processes” which are non-mining processes, and therefore cannot add value to a mineral or ore for purposes of computing percentage depletion. That such “transformation processes” are not mining processes *does not* mean that they are not processing or refining activities for purposes of Section 7704(d)(1)(E). To the contrary, mining processes are considered part of mining. To the extent transformation processes are not mining processes, the use of such processes, as the name implies, is clearly “processing” and should be a Qualifying Activity under Section 7704(d)(1)(E).¹⁰

In order to be consistent with the legislative intent underlying Section 7704, the term “processing” must, like refining, mean processes applied to depletable natural resources after production or mining processes (activities treated as a component part of production or mining under Section 613).

⁷ *Processing Definition*, COLLINS ENGLISH DICTIONARY, <http://www.collinsdictionary.com/dictionary/english/processing?showCookiePolicy=true> (last visited July 27, 2015).

⁸ *Process Definition*, OXFORD ENGLISH DICTIONARY, http://www.oxforddictionaries.com/us/definition/american_english/process?q=processing#process__13 (last visited July 27, 2015).

⁹ See, e.g., I.R.S. Priv. Ltr. Rul. 96-39-011 (May 20, 1996) (natural gas processing); I.R.S. Priv. Ltr. Rul. 2013-37-014 (May 30, 2013) (NGL processing or refining); I.R.S. Priv. Ltr. Rul. 2012-41-004 (July 2, 2012) (NGL processing); I.R.S. Priv. Ltr. Rul. 2012-36-005 (June 5, 2012) (NGL processing via hydrogenation and catalytic cracking); I.R.S. Priv. Ltr. Rul. 2007-18-005 (May 4, 2007) (processing of highly refined lubricating oils).

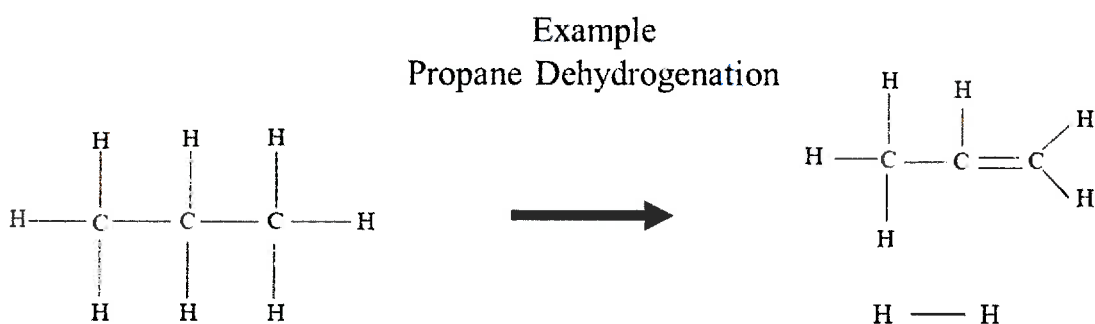
¹⁰ See I.R.C. §§ 613(c)(2), (4).

i. *NGL Processing and Crude Oil Refining include Similar Basic Processes and Produce Overlapping Products*

NGL processing activities at our Mont Belvieu complex are in substance the same as activities at a crude oil refinery. Every product produced at our Mont Belvieu complex is also produced at a crude oil refinery.

NGL processing and crude oil refining both begin with separation (fractionation or distillation) where the production stream (mixed NGLs or crude oil) is separated into its component parts using heat. Following the initial separation, certain components are sold to customers while others are retained for processing or refining.

In the case of our Mont Belvieu facility, some propane will be retained and subjected to a dehydrogenation process, which converts propane into propylene using heat, pressure and a metal catalyst.¹¹ Propane dehydrogenation separates hydrogen (H₂) from the propane molecular structure — propane (C₃H₈) becomes propylene (C₃H₆) and hydrogen (H₂). Similarly, some isobutane is retained and subjected to dehydrogenation, separating hydrogen (H₂) from the isobutane molecular structure — isobutane (C₄H₁₀) becomes isobutylene (C₄H₈) and hydrogen (H₂). Our dehydrogenation process is the same as the dehydrogenation process which commonly occurs in a crude oil refinery.



In addition, our Mont Belvieu facility includes an isomerization facility, which converts normal butane into isobutane, itself a natural resource used in the production of octane enhancers that are components of motor gasoline. The production of propylene, isobutylene and isobutane are all common in crude oil refinery processes that were in use in 1987 when Section 7704 was enacted.

ii. *Definitions of “Refining” in other Treasury Regulations include NGLs*

¹¹ Our propane dehydrogenation facility is currently under construction with start-up expected in late 2016.

The Proposed Regulations ignore decades-old authorities regarding the definition of refining. Treasury regulations regarding the depletion of crude oil define “refining” as “...any operation by which the physical or chemical characteristics of crude oil are changed, exclusive of such operations as passing crude oil through separators to remove gas, placing crude oil in settling tanks to recover basic sediment and water, dehydrating crude oil, and blending crude oil products.”¹²

The Treasury Regulations regarding the depletion of crude oil define “crude oil” to include a “[n]atural gas liquid recovered from gas well effluent in lease separators or field facilities before any conversion process has been applied to such production.”¹³ In sum, existing Treasury Regulations define “refining” of NGLs broadly to include any transformative process, including chemical and physical changes, with certain limited exceptions to recognize activities treated as part of production of oil or gas. This is consistent with the plain meaning of “refining” discussed in the prior paragraph.

The Proposed Regulations rely to some extent on the existing depletion regulations to define “processing or refining” of ores and minerals,¹⁴ but ignore the definition of “refining” of crude oil and NGLs in the oil and gas depletion regulations. The Proposed Regulations should eliminate this inconsistency by incorporating the meaning of “refining” of crude oil, which includes NGLs, from the existing depletion regulations as well.

iii. *“Refining” under the Internal Revenue Manual includes NGLs*

Section 4.41.1.6 of the IRM’s Oil & Gas Handbook contains a general description of refining.¹⁵ The IRM describes modern refining processes as involving the “breaking down, restructuring and recombining of hydrocarbon molecules.”¹⁶ The IRM also states that a “refinery process” includes converting petroleum into petrochemical feedstocks through a cracking process that converts paraffins into olefins.¹⁷ More specifically, the description of “refinery process” includes “the removal of hydrogen to produce highly reactive hydrocarbons with double or triple bonds.”¹⁸ The use of advanced fractionation processes that produce finely defined cuts of petroleum byproducts are also a “refinery process.”¹⁹ Moreover, while discussing the various processes that constitute petroleum

¹² Treas. Reg. § 1.613A-7(s).

¹³ Treas. Reg. § 1.613A-7(g)(3).

¹⁴ See Prop. Reg. § 1.7704-4(c)(5)(iv).

¹⁵ The most recent version of the description of a “refinery process” in the IRM was published December 3, 2013.

¹⁶ IRM 4.41.1.6.1(2).

¹⁷ IRM 4.41.1.6.1.1(2).

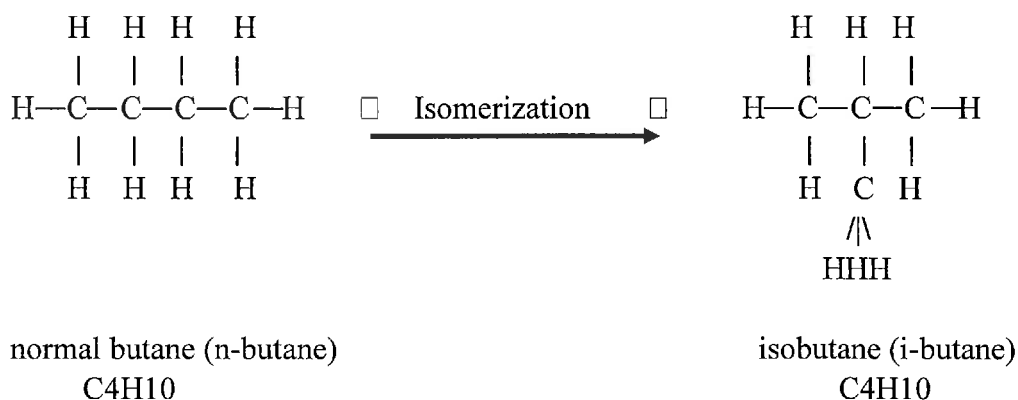
¹⁸ IRM 4.41.1.6.1.1(5).

¹⁹ IRM 4.41.1.6.1.1(4).

refining, the IRM makes multiple mentions of the fact that such processes may produce products that can be sold as primary petrochemical feedstocks and suggests that producing such feedstocks may even be a valid reason for performing a particular “refining process.”²⁰ Finally, the IRM specifically discusses in the context of refining the separation of hydrogen, ethylene, propylene and butylene for the purpose of either alkylation or sale to the petrochemical industry.²¹

NGL dehydrogenation, which is analogous to the processes used in a catalytic cracker and coker in a crude oil refinery, is entirely consistent with this definition. The process does not change the number of carbon atoms in the molecule (as does a polymerization reaction), but simply removes hydrogen (see diagram on p. 8). As discussed above, the IRM specifically discusses dehydrogenation as a “refinery process.”

Isomerization is also a defined “refinery process” that occurs in exactly the same manner in a crude oil refinery and an NGL processing facility. For example, our Mont Belvieu facility isomerizes butane, a straight-chain hydrocarbon, by separating two carbon-hydrogen bonds that are then rearranged to form isobutane, a branched hydrocarbon.



The isobutane can be fed into an octane enhancement facility to produce isobutylene, isooctane, and other octane enhancers blended into finished gasoline. The isomerization process is simply a matter of molecular rearrangement; no atoms in the compound are lost or changed. Both materials remain NGLs.

Processes such as isomerization and dehydrogenation change the molecular structure of an NGL, but do not affect its character as a natural resource. Further, the conversion of NGLs into olefins via dehydrogenation occurs very early in the progression of NGLs relative to components of finished petrochemical products. Moreover, isobutane and its derivatives, such as isobutylene, are more similar to butane than gasoline is to

²⁰ IRM 4.41.1.6.1.1.

²¹ IRM 4.41.1.6.1.1(9).

crude oil. The same is true of propylene and propane. Olefins are certainly not a plastic or similar remote petroleum derivative. Far from a plastic, these products continue to have the form of a gas. Consequently, any concern that NGL processing or refining involves a petroleum derivative similar to plastics is unwarranted.

2. The Proposed Regulations' definitions impose an inappropriate emphasis on crude-oil based fuel production.

The Proposed Regulations inexplicably provide that “refining,” as applied to hydrocarbon natural resources, should be limited to those activities the primary purpose of which is to produce fuel. The Proposed Regulations contain two primary exceptions (the “***Fuel Exceptions***”) to the application of the Processing or Refining Test to petroleum and natural gas: that (i) processing will include converting methane in one integrated conversion into liquid fuels, provided that such liquid fuels are otherwise produced from the processing (or presumably refining) of crude oil, and (ii) the production of ethylene, propylene and similar primary petrochemical feedstocks in a crude oil refinery will be qualifying activities, provided such products are refinery grade products that are obtained in the steps required to make fuels.

The statute does not include any indication that refining and processing is limited to the production of fuel. Rather, the term “refining,” as used in Section 7704(d)(1)(E), applies to all natural resources, without any implication that the production of fuel is required.

The statute and legislative history are clear that NGLs can be processed and refined in a manner directly and mechanically analogous to activities taking place in a crude oil refinery, and that such activities are Qualifying Activities that produce qualifying income. Any emphasis on fuel production that occurs in a petroleum refinery inappropriately favors fuel derived from crude oil over fuel derived from NGLs. For example, income from alkylates, isooctane and other octane enhancers produced in a refinery qualifies under the Proposed Regulations, while income from such fuel products generated from NGLs would not qualify.

With respect to methane, while any activity that results in a physical or chemical change to an NGL would not be a Qualifying Activity, the Fuel Exceptions would permit the conversion of methane to fuels to be a Qualifying Activity. While many types of fuel and fuel components are derived from NGLs (e.g., isooctane, alkylates and other octane enhancers), no similar exception would apply even though the methane and the NGLs could have come from the same well.

Similarly, under the Fuel Exceptions, the production of products that result from a physical or chemical change of crude oil feedstock (e.g., ethylene, propylene and similar

primary petrochemical feedstocks) in connection with the production of fuel in a refinery is a Qualifying Activity. Remarkably, the production of identical products from NGLs, which could have come from the same well, would not be a Qualifying Activity.

The treatment of identical products of natural gas and those of crude oil is illustrated by the examples provided by the Proposed Regulations. Example 1²² of the Proposed Regulations provides that income derived from the conversion of a mixture of ethane and propane obtained from the physical separation of a natural gas stream into ethylene via steam cracking is not qualifying income.²³ Yet, Example 2 of the Proposed Regulations comes to the opposite conclusion where the taxpayer is a crude oil refiner.²⁴ The taxpayer in Example 2 physically separates the components of crude oil, derives a liquid stream suitable for gasoline blending and a gas stream containing ethane, ethylene and other gases from the catalytic cracking of a crude oil stream, then physically separates the components of the resulting gas stream.²⁵ The separation of the components of that stream to produce refinery grade ethylene and the subsequent sale of such ethylene produces qualifying income under Example 2.²⁶

In addition, the different treatment of identical products under the Proposed Regulations will lead to confusion in the application of Section 7704(d)(1)(E) to storage and transportation. These identical products, whether derived from crude oil or NGLs, are stored and transported using common facilities. Because it will be impossible to determine the source of any particular molecule of product, there will be no way to determine whether which marketing, storage or transportation services should be treated as a Qualifying Activity under the Proposed Regulations.

3. The Confusion over Plastics and Similar Petroleum Derivatives.

The Proposed Regulations suggest that any activity that results in a significant physical or chemical change will only be a Qualifying Activity if it is undertaken to produce fuel and it is directed at crude oil or methane. Any such activity that is aimed at an NGL will not be a Qualifying Activity.

We believe this disparate treatment of products produced from NGLs is rooted in the statement in the legislative history 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

²² We note that the title of that example, “petrochemical products sourced from an oil and gas well” incorrectly suggests that ethylene, propylene and other direct NGL derivatives are petrochemicals. These items are, at most, products that serve, among other uses, as a primary petrochemical feedstock.

²³ Prop. Treas. Reg. § 1.7704-4(e), Example 1.

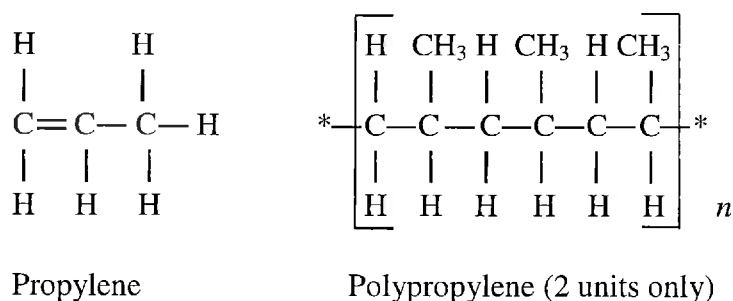
²⁴ Prop. Treas. Reg. § 1.7704-4(e), Example 2.

²⁵ *Id.*

²⁶ *Id.*

derivatives.”²⁷ As discussed above on page 3, however, this language was describing the scope of the term “natural resources” and was not attempting to set out a list of permissible end products.

Moreover, the use of the phrase “similar petroleum derivatives” logically would disqualify only those products with characteristics so far removed from oil and gas products as to be similar to plastics, such as polyethylene, polyvinyl chloride (also known as PVC), polypropylene, nylon, styrofoam, fiberglass and other chemical products that differ substantially from, and have more complex molecular structures (such as products with multiple double carbon bonds, products of polymerization reactions that change the carbon number of a molecule, or products which are chemically reacted with a nonhydrocarbon) than, the primary petrochemical feedstocks and hydrocarbon sources from which they are produced. For example, it is easy to see how substantially different propylene and polypropylene (which can create such long chains that only two units are shown herein, with its potential length represented by n) are when their molecular structures are compared:



Much attention appears to have been given to the production of olefins during the Proposed Regulation project. Olefins, such as propylene (dehydrogenated propane) or ethylene (dehydrogenated ethane), are all derived from the first-stage processing of NGLs. That is to say, the feedstock for the process is an NGL; not a feedstock derived from NGLs. Propane and propylene are gases - neither the propane nor propylene is equivalent to plastic or any similar petroleum derivative. They are simply hydrocarbon “building blocks” for further processing; and may be used for further refinery operations or they may be used as primary petrochemical feedstocks, but they are not finished products nor are finished products produced from them. In fact, these products are similar to, and actually have a simpler molecular structure (typically, having one less hydrogen atom) than, their corresponding NGL or refined product hydrocarbon sources. Plastic, however, is a final product that results from many processes and combinations of products that are neither produced in petroleum refineries nor common in petroleum refineries.

²⁷ H.R. REP. NO. 100-495, at 30 (1987).

Olefins are fungible with one another. The molecular structure of propylene produced in a crude oil refinery is identical to that of propylene produced from NGLs. There is certainly no indication in the statute or its legislative history that fungible products should be treated differently based on where they were produced. Rather, making such a distinction would cause identically situated taxpayers and identical products to be treated differently. Moreover, if under the Proposed Regulations these products, when produced in a refinery that also produces fuel, are not “plastics or similar petroleum derivatives,” it cannot logically be maintained that they somehow become “plastics or similar petroleum derivatives” simply because they are not being produced incidentally to fuel production.

4. There is no basis for the inclusion of MACRS class lives as part of the Qualifying Activities test.

The third component of the Processing or Refining Test would deny qualifying income status to income derived from an otherwise Qualifying Activity if the taxpayer fails to use “an appropriate” MACRS class life for purposes of depreciation of the assets used in that activity. This rule would apparently apply even if the taxpayer’s failure were reasonable, inadvertent, isolated, or the result of the Service’s refusal to grant consent to change to a different appropriate depreciation method.²⁸

There is no basis in the statute or its legislative history for the inclusion of MACRS class lives as part of the test. Regardless of the precise interpretation of the statutory terms “processing” and “refining,” a processing or refining activity cannot become something else merely because a taxpayer chooses to use a specific depreciation method. That determination should be based solely on the facts regarding a particular activity. Under the Proposed Regulations, two taxpayers who do exactly the same things for exactly the same reasons in exactly the same manner could be treated as performing different activities based on the depreciation method they elect. The inconsistency of this result is compounded by the widely accepted belief that the MACRS categorization system is significantly outdated.²⁹

²⁸ See Treas. Reg. § 1.446-1(e)(2)(iii), Example 14 (requiring Service consent to change the MACRS class life for an asset).

²⁹ In a report to Congress in 2000, the Department of the Treasury reported:

The current depreciation system is dated. The asset class lives that serve as the primary basis for the assignment of recovery periods have remained largely unchanged since 1981, and most class lives date back at least to 1962. Entirely new industries have developed in the interim, and manufacturing processes in traditional industries have changed. These developments are not reflected in the current cost recovery system, which does not provide for updating depreciation rules to reflect new assets, new activities, and new production technologies.

The appropriate approach is to determine whether a taxpayer's activity is processing or refining for purposes of Section 7704(d)(1)(E), and then, if deemed necessary and legally permissible, impose on the taxpayer's assets a MACRS class life that is consistent with that conclusion. The Service already enforces its interpretation of the MACRS rules in this manner. It is not necessary to interject regulation of MACRS issues into the qualifying income regulations.³⁰

5. It is inappropriate to rely on the NAICS Codes to determine whether an activity is processing or refining.

The Preamble to the Proposed Regulations provides that the Service expects that Qualifying Activities include activities that produce the (i) “the products listed in [the most recent version] of North American Industry Classification System (“NAICS”) code 211112 concerning natural gas liquid extraction” and (ii) refinery grade products that are listed in NAICS code 324110 and obtained in the steps required to make fuels, lubricating base oils, waxes, and similar products. However, the Preamble does *not* provide any express guidance regarding the treatment of any other NAICS codes, such as NAICS code 325110 concerning petrochemical manufacturing.

We believe that the use of the NAICS codes to define Qualifying Activities is inappropriate. As discussed above, taxpayers' activities should be characterized by reference to the common understanding of the terms “processing” and “refining.” Accordingly, we support the use of the NAICS codes only to the extent that they are used as a safe harbor.

NAICS is a system of classifying U.S. industries, designed and developed for statistical purposes, with no centralized system in place for assigning NAICS codes for various purposes.³¹ Unsurprisingly given their purpose, the NAICS codes do not match up with the statutory language of Section 7704(d)(1)(E). For example, there is no NAICS code labeled “processing,” and certainly no separate NAICS codes for processing and/or refining NGLs. Considering that the two NAICS codes mentioned in the Preamble, by their terms, cover only “extraction” of NGLs and “refin[ing]” crude petroleum, these two NAICS codes clearly cannot comprise the full range of qualifying processing and refining activities.

In addition, the official descriptions of the NAICS codes reveal that the NAICS codes are not sophisticated or clear enough to serve as adequate regulatory guidance in

U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON DEPRECIATION RECOVERY PERIODS AND METHODS, at 2 (July 28, 2000).

³⁰ See, e.g., I.R.S. Tech. Adv. Mem. 2006-29-031 (July 21, 2006); I.R.S. Field Serv. Adv. 1999-49-016 (Sept. 9, 1999) (discussing when taxpayers should be required to use MACRS asset class 13.3).

³¹ See *North American Industry Classification System: Frequently Asked Questions*, U.S. CENSUS BUREAU, <http://www.census.gov/eos/www/naics/faqs/faqs.html> (last visited July 27, 2015).

this area. For example, the NAICS codes at various times equate “manufacturing” with “smelting/refining”³² or with “processing (i.e., beyond basic preparation),”³³ and include “petroleum refineries” under the “manufacturing” umbrella.³⁴ The NAICS codes explain that the “Chemical Manufacturing” subsector (which includes NAICS code 325110) includes “the production of basic chemicals” and “the production of intermediate and end products produced by further processing of basic chemicals” while acknowledging that some other “chemical processing” occurs “during mining operations.”³⁵ Particularly given how the NAICS codes intermix the terms refining, processing, manufacturing, and even mining, the NAICS codes do not provide suitable guidance regarding the meaning of the distinct statutory terms in Section 7704(d)(1)(E).

To further highlight the difficulties in using the NAICS codes, processes that generate the products listed in NAICS codes 211112 and 324110 may also fit within other NAICS codes — such as 325110 — potentially creating a situation in which a taxpayer has a legitimate choice between alternative NAICS codes for the same activity. Nothing in section 7704 or its legislative history suggests the use of NAICS codes to determine qualifying income. As such, we recommend clarification that the language in the preamble was not meant to limit qualifying income based on a taxpayer’s NAICS codes.

VII. A Case Study: Mont Belvieu

Enterprise operates one of the world's largest NGL complex at Mont Belvieu, Texas. It is a highly complex, integrated facility dedicated to the storage, processing and refining of NGLs. It has all the attributes of a traditional refinery except that it processes and refines NGLs rather than crude oil. The scale and complexity of the facility are truly unique. With access to a vast network of NGL pipelines, the facility receives mixed NGLs streams from several major oil and gas basins in North America, including the Eagle Ford Shale, Rocky Mountains, Mid-Continent, Permian Basin, San Juan Basin and Marcellus Shale. The facility includes more than 100 million barrels of salt dome storage

³² See *2012 NAICS Definition of Sector 21*, U.S. CENSUS BUREAU, <http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=21&search=2012%20NAICS%20Search> (last visited July 27, 2015).

³³ See *2012 NAICS Definition of Sector 21 – Mining, Quarrying, and Oil and Gas Extraction: 21232 Sand, Gravel, Clay, and Ceramic and Refractory Minerals Mining and Quarrying*, U.S. CENSUS BUREAU, <http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=21232&search=2012%20NAICS%20Search> (last visited July 27, 2015); see also *2012 NAICS Definition of Sector 31-33 -- Manufacturing*, U.S. CENSUS BUREAU, <http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=31&search=2012%20NAICS%20Search> (last visited July 27, 2015) (“Manufacturing establishments may process materials or may contract with other establishments to process their materials for them. Both types of establishments are included in manufacturing.”).

³⁴ See *2012 NAICS Definition of Sector 31-33 – Manufacturing: 32411 Petroleum Refining*, U.S. CENSUS BUREAU, <http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=32411&search=2012%20NAICS%20Search> (last visited July 27, 2015).

³⁵ See *2012 NAICS Definition of Sector 31-33 Manufacturing: 325 Chemical Manufacturing*, U.S. CENSUS BUREAU, <http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=325&search=2012%20NAICS%20Search> (last visited July 27, 2015) (emphasis added).

capacity, and access to international markets through its export facilities. The facility includes eight NGL fractionators with the capacity to fractionate more than 700,000 barrels of NGLs per day.

Just like the distillation towers of a crude oil refinery, NGL processing at Mont Belvieu begins with separation. Mont Belvieu's fractionation towers merely separate the NGLs included in the production stream received. Fractionation does not change the NGLs. Each fractionator (which is interchangeable with the term "distillation tower") includes:

- A Deethanizer - separates the ethane.
- A Depropanizer - separates the propane.
- A Debutanizer – separates a mix of normal butane and isobutane, leaving the pentanes and heavier hydrocarbons in the NGL stream.
- A Butane Splitter or Deisobutanizer - this step separates the isobutane and normal butane.

Following fractionation, the separated NGLs are either delivered to customers or subjected to processing and refining.

For example, as discussed above, our Mont Belvieu facility includes propane and isobutane dehydrogenation facilities which convert propane and isobutane (both natural resources) into propylene and isobutylene by separating hydrogen. In addition, our Mont Belvieu facility includes an isomerization facility, which converts normal butane into isobutane, itself a natural resource used in the production of octane enhancers that are components of motor gasoline. Each isomerization unit includes two reactors that convert normal butane feedstock into mixed butane, which is a stream of isobutane and normal butane, using a proprietary isomerization process. Isomerization causes a rearrangement of butane's molecular structure, though it neither adds to nor takes away from its atomic structure.

Our Mont Belvieu operations also include an octane enhancement production facility that is designed to produce isobutylene, which in turn is used to produce isooctane and other octane enhancers for gasoline. The facility uses high-purity isobutane feedstocks supplied by the isomerization units described above. Isobutylene is produced via the catalytic dehydrogenation of isobutane. The isobutylene is then used to produce alkylates, isooctane and other octane enhancers blended into finished gasoline. All of the products produced by this facility are created via common refinery processes for use in reformulated motor gasoline blends to increase octane values.

Within a fifteen minutes' drive from our Mont Belvieu facility are several of the nation's largest crude oil refineries. Like our facility, they receive production from

various basins. Like our facility, they begin with an initial separation phase, then further process the resulting streams. Like our facility, these facilities employ separation, fractionation, cracking, and dehydrogenation processes to maximize value of their feedstock. Like our facility they produce purity NGLs, propylene and octane enhancing fuel components. In fact, every product we produce at our Mont Belvieu facility is also produced at crude oil refineries.

Under the Proposed Regulations, there is a major difference in the treatment of our Mont Belvieu facility and its neighbors, and the Proposed Regulations would deny Qualifying Activity treatment for many of our activities. There is no statutory or legislative basis for discriminating against taxpayers who refine NGLs rather than crude oil.

VIII. Recommended Changes

The Proposed Regulations as they relate to the processing and refining of oil and gas should be revised to include a single, unified standard applicable to the processing or refining of all oil and gas production (crude oil, natural gas and NGLs). The new standard should primarily focus on whether the input is a natural resource and should recognize that both processing and refining often includes both separation and physical and chemical changes. The new standard should abandon the MACRS requirement.

To the extent a “bright-line” standard is desired, we propose that an activity relating to oil and gas be treated as a qualifying processing or refining activity if:

1. the input is a natural resource, and
2. it is undertaken to purify or eliminate impurities from the natural resource,
3. it is undertaken to separate (but not alter) the component hydrocarbons (e.g., distillation or fractionation), or
4. to the extent the activity involves a physical or chemical change, the resulting product is either a fuel (including fuel components produced from NGLs, such as octane enhancers blended into gasoline) or a product of a type produced by a crude oil refinery.

IX. Transition Relief

The Proposed Regulations provide a ten-year transition rule for income from an activity if “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 the issuance of these proposed regulations.” In the event that final

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regulations, contrary to the foregoing recommendations, adopt positions that are similar to the Proposed Regulations, the transition rule should be modified to provide (i) permanent relief for covered activities, and (ii) relief for activities related to assets that were under construction pursuant to binding agreements on May 6, 2015.

Because the Proposed Regulations represent a material departure from the current treatment of qualifying income under Section 7704(d)(1)(E), we believe it is appropriate to permanently “grandfather” activities covered by the transition rule. Such activities were entered into with a reasonable expectation of being qualified and any change in treatment that jeopardizes partnership classification seems excessive.

Moreover, in determining the scope of activities to which the transition rule applies, the Proposed Regulations fail to take into account that publicly traded partnerships may be subject to binding commitments with respect to new assets. In June 2012, we announced plans to build a propane dehydrogenation (“*PDH*”) facility, with capacity to produce up to 1.65 billion pounds per year (or approximately 750 thousand metric tons per year or 25 MBPD) of polymer grade propylene. The new facility was under construction on May 6, 2015, but was not yet completed. The new facility will be integrated with our existing propylene fractionation facilities, which will provide operational reliability and flexibility for both the PDH facility and the fractionation facilities. The PDH facility, which is supported by long-term, fee-based contracts, is expected to begin commercial operations during the fourth quarter of 2016.

The current proposal ignores the commercial reality that publicly traded partnerships have invested significant amounts of capital with respect to facilities that take years to construct and place in service. Accordingly, any transition rule should allow income from projects undertaken prior to May 6, 2015 to be eligible for transition relief.

X. Conclusion

We appreciate the opportunity to provide these comments and would be pleased to provide any additional information at the IRS or Treasury’s request.

Sincerely,



Michael A. Creel
Chief Executive Officer
Enterprise Products Partners L.P.