State Bar of Texas Tax Section's
Annual Law Student Tax Paper Competition

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State Bar of Texas Tax Section's Annual Law Student Tax Paper Competition

The State Bar of Texas Tax Section's Annual Law Student Tax Paper Competition is designed to encourage and reward scholarly writings on legal subjects within the scope of the section. The State Bar of Texas Tax Section congratulates James Rowland from The University of Houston Law Center, the winner of its 2009 Annual Law Student Tax Paper Competition. James Rowland's winning article entitled "Tax Implications for Natural Resource Master Limited Partnerships" is published below.

Numerous entries were received which were all impressive in their own right. The judging panel reviewed each paper anonymously, without knowing the students' names or their law school affiliations. The papers were judged on the following four criteria:

- Legal analysis
- Legal research
- Organization and writing style
- Originality and relevance of topic to current tax matters

Notably, the Annual Law Student Tax Paper Competition provides a $1,000 award to its winner and additional awards for second and third places in the judges' discretion. All J.D. and L.L.M. degree candidates attending accredited Texas law schools either on a part-time or full-time basis at the time the paper is written are eligible. Students can write on any federal or state tax topic. Papers must be sponsored by a law school faculty member and only one paper per student may be submitted. All entries must be received after January 15th and before June 16th in the year of the competition and winners will be notified no sooner than July 15th in the same year. For additional information regarding the competition, please visit the section's website at http://www.texastaxsection.org/.

Tax Implications for Natural Resource Master Limited Partnerships

by James Rowland[1]

TABLE OF CONTENTS

Page

TABLE OF CONTENTS

Page

Introduction

The master limited partnership ("MLP") is an obscure, relatively unknown, and somewhat scarcely used business entity. Today, there are only about 97 MLPs that are traded on the major securities exchanges,[2] most of which are found in the energy, investment and business sectors. Some MLPs, such as the Blackstone Group and Kinder Morgan are well known, but most are not. Generally, MLPs are considered a tax advantaged way to invest in certain sectors (such as the energy sector) while retaining investment liquidity.

The first entity to use the term "master limited partnership" was Apache Petroleum Co., which was formed in 1981.[3] The concept of an MLP originated in the oil and gas industry, but soon spread to a wide variety of business ventures, "ranging from hamburger franchising (Burger King Master L.P.) to professional basketball (Boston Celtics Limited Partnership)."[4] The use of MLPs grew in popularity because an MLP offered both the tax advantages of a partnership (pass-through treatment with one level of tax) and the economic advantages of a corporation (the partnership interests could be readily sold like corporate stock). However, Congress has limited the use of the MLP entity to businesses engaged in the small number of business sectors mentioned above.[5]

Particularly in the oil and gas industry, the use of the MLP structure has followed the boom and bust cycle of the industry. Most of the oil and gas MLPs created during the 1980's failed when the price of oil fell in the latter half of that decade.[6] Then the late 1990's saw a resurgence of MLPs in the energy sector when companies created MLPs from their oil and gas pipeline businesses and similar businesses relating to the storage and shipping of oil and gas. Over half of today's MLPs concern these types of activities.[7] The use of the MLP by pipeline businesses has reduced the businesses' exposure to volatile commodities prices when compared to businesses involved in the production of oil and gas.[8]

However, with today's increased demand for the exploration and production of oil and gas, there has been a resurgence of MLPs in this sector. Linn Energy LLC marked the return of oil and gas producing MLPs when it made its initial public offering in 2006.[9] Today, there are about 11 exploration and production MLPs.[10]

Furthermore, Congress has recently passed legislation allowing businesses related to biofuels and industrial source carbon dioxide to use the MLP structure.[11] Therefore, the use of MLPs in industries related to the biofuels and industrial carbon dioxide will likely see widespread use. In addition, as the scope of MLPs is expanded to include more renewable energy activities, it is likely that the use of MLPs will increase in this sector as well.

This four-part paper provides a general understanding of MLPs, with a focus on natural resource MLPs. This paper's focus on natural resources narrows to oil and gas MLPs, biofuels MLPs and carbon sequestration MLPs. It also evaluates the potential opportunities and challenges that face natural resource MLPs resulting from current market and legislative developments. Part I of this paper defines MLPs, explaining the legal and economic structure of MLPs, and addressing legal issues with respect to formation of an MLP. Part II addresses the tax issues affecting MLPs and considers the tax advantages and disadvantages of MLPs. Part III narrows the focus to natural resource MLPs, in particular to those involved in oil and gas, biofuel, and carbon sequestration MLPs. Part IV evaluates current opportunities and challenges facing MLPs as a result of market and legislative developments.

I. General Background of MLPs

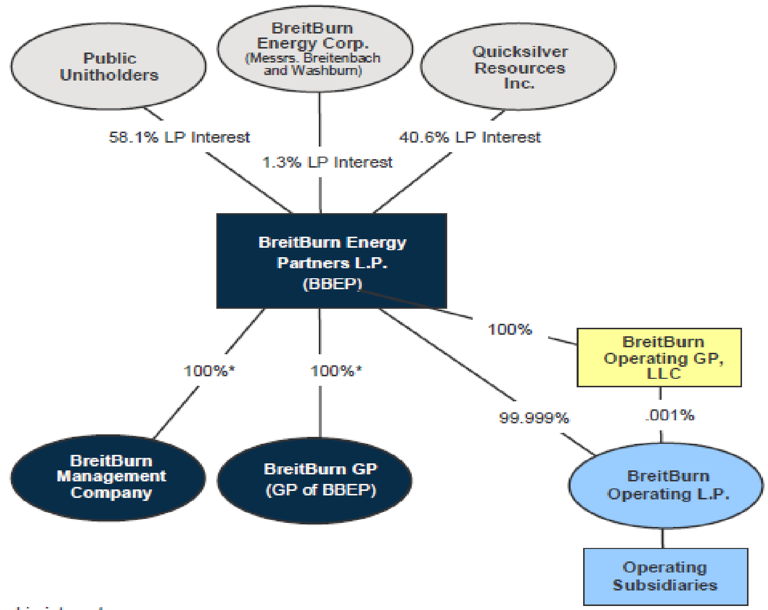
A. "Master Limited Partnership" Defined

A master limited partnership (also referred to as a "publicly traded partnership"[12]) is a foreign or domestic partnership whose partnership interests are traded on an established securities market or are readily tradable on a secondary market (or its substantial equivalent).[13] Generally, an MLP is taxed as a corporation.[14] However, certain MLPs that were grandfathered under the 1987 Revenue Reconciliation Act or that earn at least 90% of their income from certain "passive-type" qualifying income are taxed as partnerships.[15] Under state law, an MLP can be organized as any entity other than a corporation, but most often, an MLP is organized as a limited partnership.[16] When compared to other business entities, the advantages of an MLP include: "increased market valuation of underlying assets; ease in raising equity capital; and the creation of a substitute for cash in purchases or dividends through partnership units."[17]

B. Legal Structure

1. The MLP as a Limited Partnership

Typically an MLP is organized into 2 tiers. The first tier is the MLP itself, which is typically owned 2% (or less) by the general partner and 98% (or more) by the limited partners. The general partner is the promoter/original owner of the business that has been converted to an MLP. The general partner often owns many limited partner interests or "units."[18] The rest of the units are publicly owned. The second tier is an operating limited partnership ("OLP"), which owns and operates the assets of the business. The MLP will typically own a 99.999% limited partner interest and all of a limited liability company that owns the remaining interest in the OLP.[19] A look at the legal structure of Breitburn Energy Partners L.P. provides a better understanding of how MLPs are often structured.[20]



*Represents 100% membership interest.

Breitburn's organizational structure demonstrates how an MLP can be structured to protect investors from liability. At each level there is a general partner who is liable for the obligations of the partnership but has an insubstantial economic interest in the partnership. Through this structure, an MLP provides economic benefits to the limited partners while shielding them from liability. MLPs generally use the two tier structure for the same reasons that corporations use subsidiaries, to segregate the businesses "for operational accountability, liability, regulatory or state tax reason[s]."[21]

2. MLP as a Limited Liability Company

An MLP can also take the form of a limited liability company ("LLC"). LLCs are eligible entities that can elect pass-through treatment like a partnership.[22] Unlike an MLP organized as a limited partnership, the public unitholders in an MLP organized as an LLC have the right to vote on the way the business is run.[23] Additionally, an MLP organized as an LLC does not have a general partner or incentive distribution rights (explained in the section of this paper titled "Economic Structure"). However, since the public unitholders have voting rights, they can exercise those voting rights to ensure that distributions are made in a manner that is satisfactory to them.

C. Economic Structure

Investors in MLPs generally expect a consistent distribution of profits. MLP unitholders can take advantage of the MLP's deductions and credits, as well as the effective deferral of taxation on the MLP's cash distributions.[24] Since MLP units are often sought out by investors who want a higher after-tax yield on consistent distributions, MLPs are structured in a way that seeks to ensure consistent and frequent distributions. Such a structure is typically the result of the MLP's choice of industry and its partnership agreement.

To ensure a steady stream of distributions to the unitholders, an MLP requires a steady stream of income. One reason oil and gas pipeline MLPs are more common than oil and gas exploration MLPs is because pipeline businesses tend to generate a more reliable stream of cashflow than exploration businesses.[25] The relative stability enjoyed by pipeline businesses is due largely to decreased exposure to commodity price fluctuations and large capital losses such as dry holes.[26] Some MLPs seek to limit their exposure to such risks so that consistent distributions to their unitholders are possible.

An MLP generally uses its partnership agreement to incentivize the general partner to make regular distributions. Two common mechanisms used in MLP partnership agreements to incentivize the general partners to make distributions (referred to as "incentive distribution rights") are the use of "high splits" and the use of subordinated units.[27]

1. High Split Incentive Distribution Rights

A "high split" mechanism provides that the unitholders (limited partnership interest holders) get a high percentage of the distribution (e.g., 98% of the distribution to the unitholders and 2% to the general partner) until a certain fixed distribution amount is reached. After the predetermined amount is distributed, the ratio is changed so that the general partner receives a higher percentage of the distribution (e.g., 90% to the unitholders and 10% to the general partner).[28] This provides an incentive for the general partner to make a larger distribution so that it will get a larger percentage of the distributions.

As an example of a "high split" distribution agreement, assume that an MLP's partnership agreement stipulates that any required quarterly distribution of less than one dollar per unit is allocated 98% to the limited partners and 2% to the general partner. However, the partnership agreement also provides that any quarterly distribution equal to or greater than one dollar per unit is allocated 90% to the limited partners and 10% to the general partner. So, if there are 100,000 limited partnership units and the MLP makes a $0.90 per unit quarterly distribution, the total distribution is $90,000. Of that $90,000, 98% would go to the limited partners and 2% would go to the general partner. The limited partners receive $0.882 for each unit and the general partner receives $0.018 for each unit. In aggregate, the limited partners receive $88,200 and the general partner receives $1,800.

Alternatively, assume that instead of distributing $0.90 per unit, the MLP makes a $1.00 per unit distribution. In this case, the total distribution is $100,000. Of that $100,000, 90% goes to the limited partners and 10% goes to the general partner, meaning the limited partners get $0.90 for each unit and the general partner gets $0.10 for each unit. In aggregate, the limited partners receive a distribution of $90,000 and the general partner receives $10,000.

As the above examples illustrate, the high split arrangement compensates the general partner by $8,200 ($10,000 - $1,800) for meeting the distribution benchmark of $1.00 per unit rather than $.90 per unit. Even with these small numbers, it is clear that high split arrangements provide general partners significant incentives to meet distribution benchmarks. Table 1 in the Appendix summarizes the above examples.

An MLP has great flexibility in creating incentive distribution rights. Some MLPs create multiple levels of benchmarks to provide greater distribution incentives to the general partner (the general partner's share of the distribution increases for each higher distribution threshold met).[29] There is no legal limit to the number of benchmarks created by an incentive distribution rights mechanism.

2. Subordinated Units Incentive Distribution Rights

The use of subordinated units is another commonly employed incentive distribution rights mechanism. Subordinated units are limited partner units held by the general partner[30] that are subordinate to the units held by the public until a certain distribution benchmark is met. When the distribution benchmark is met, "the subordinated units convert over to ordinary limited partner units"[31] and the general partner receives a share of the distribution based on its limited partner units just like the public unitholders. If the distribution benchmark is not met, the general partner does not receive a distribution for the limited partnership units that it owns. This mechanism can provide an even greater incentive to the general partner to make distributions than the "high split" mechanism described above.

Although incentive distribution rights like those described above can result in consistent and substantial distributions to the partners, they can also jeopardize the availability of adequate capital for continued business operations and to insulate the MLP from market disruptions.[32]

D. Legal Issues Regarding Formation

1. Asset Transfers

For an MLP to be a going concern with value, assets must be transferred to it, generally from either a sole proprietorship, a partnership, or a corporation. Most asset transfers to an MLP are from a partnership or a corporation, so this discussion is limited to the law affecting transfers from those entities.

a. Assets Transferred From a Partnership

An asset transfer to an MLP from a partnership is usually accomplished through a "roll-up" transaction. A "roll-up" transaction occurs when a partnership contributes assets to an MLP in exchange for partnership interests of the MLP.[33] The contributing partnership is usually liquidated, with the partners receiving the MLP units in exchange for their partnership interest. This is generally considered a tax-free transaction.[34] The same transaction can be accomplished without the contributing partnerships liquidating.

b. Assets Transferred From a Corporation

An asset transfer to an MLP from a corporation is usually accomplished through a "roll-out" transaction. A "roll-out" transaction is a "corporate reorganization or liquidation followed by the transfer of assets to the [MLP] in exchange for partnership interests."[35] Alternatively, the corporation can transfer a portion of its assets to the MLP in exchange for a partnership interest without liquidating or merging.

The transfer of assets from a corporation to an MLP presents various potential problems. Transferring assets to the MLP in exchange for partnership interests would have the positive tax effect of transferring the assets tax-free.[36] However, practically speaking, such a transfer may be prohibited by certain debt obligations or regulatory restrictions, and may incur costs for re-obtaining certain permits, licenses and privileges.[37]

In some instances these obstacles are surmountable. Restrictions due to debt obligations, for instance, may be overcome by the MLP assuming or guaranteeing some of the debt of the corporation. However, assumption of the corporation's debt by the MLP will reduce the basis of the corporation's partnership interest and may even result in taxable gain to the corporation if the debt relieved exceeds the basis of the assets contributed.[38]

Additionally, the title transfer of oil and gas leases from one company to another can generally be accomplished with little difficulty. Generally, states treat mineral leases as real property interests[39] and simply require the transfer or "assignment" document to be filed with the county clerk of the counties where the leased property is located. Such documents can be easily produced by petroleum landmen skilled in such transactions (most companies will have databases that list all the leases it owns). Due diligence as to the title to the leases can be performed by petroleum landmen and title attorneys as well. Most likely, petroleum engineers, geologists, and appraisers will be required to value the leases, but this process is required under a corporate merger as well.

If a contributing corporation uses a merger to contribute the assets to an MLP the licensing and debt obligation issues may not arise, but it will not be a tax-free transaction.[40] Since the corporation is changing its form from a corporation to a partnership, the Internal Revenue Code's[41] tax-free reorganization provisions are inapplicable.[42] Under the tax rules, the merger of the corporation into a partnership will be treated as a deemed liquidation.[43] When a corporation is liquidated or sold in a taxable transaction, the corporation is taxed on the amount that the fair market value of its assets exceeds the basis of its assets.[44] Therefore, the tax consequences of the corporate merger might make the transaction cost prohibitive, especially if the corporation possesses appreciated assets.[45]

2. Securities Laws

When an MLP offers its limited partnership interests to the public, the units will likely be considered securities under both the Federal and state securities laws.[46] In order for the Securities and Exchange Commission ("SEC") to apply the securities regulations to transactions and individuals, the SEC must first prove that the interests at issue are "securities".[47] Both the Federal Securities Act of 1933 ("1933 Act") and the Securities Exchange Act of 1934 ("1934 Act") provide long "laundry lists" of interests that are considered "securities."[48]

Both the 1933 Act and the 1934 Act include "investment contracts" in the definition of securities. Courts generally use the definition of "investment contract" to determine whether a partnership interest is a security under the federal securities laws.[49] *Securities and Exchange Comm. v. W.J. Howey Co*[50] is the leading case that discusses whether an interest constitutes an investment contract.[51] In *Howey,* the Supreme Court used three elements to determine whether an interest was an investment contact: (1) an investment, (2) in a common enterprise, (3) with the expectation that profits will be solely derived from the efforts of others.[52] Under the *Howey* analysis, it is generally accepted that limited partnership interests are securities.[53] Therefore, when an MLP issues its limited partnership interests on a public market, the issuance will most likely be subject to the federal securities laws.

As an issuer of securities, an MLP must conform to the disclosure rules of the federal securities laws, such as filing a registration statement (Form S-1) and a prospectus. These filing requirements can be onerous because MLPs are generally more complex entities than corporations.[54] Additionally, MLPs are required to make periodic filings with the SEC such as quarterly (10-Qs), annual (10-Ks), and significant event (8-Ks) filings.[55]

Lately, some MLPs have been publicly selling general partner interests as well.[56] In 2004, Crosstex Energy, Inc., was the first company to take the general partner of its MLP public with about 11 different MLP general partners going public since then.[57] General partnership interests are attractive to the public because the general partnership can get a disproportionate amount of the distributions if the incentive distribution rights benchmarks are met.[58]

The public offering of a general partnership interest confronts the same federal securities issues discussed above. Generally, courts have considered whether general partnership interests are securities by "focusing on whether a general partner has an expectation of profits derived solely from the efforts of others."[59] In most instances, the general partner exercises managerial control over the MLP so the general partnership interest is not considered a security under the federal securities laws. But, a general partnership interest can be a "security" if it is established that:

> (1) the agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes the power as would a limited partnership, or (2) the partner or venture is so inexperienced and unknowledgeable in business affairs that he or she is incapable of exercising his or her partnership or venture powers, or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he or she cannot replace the manager of the enterprise or otherwise exercise meaningful partnership of venture powers.[60]

It is unlikely that public investors that own a general partner interest in an MLP will take direct managerial control in the general partnership, and such control might not make good business sense. In most cases, public ownership of a general partnership interest in an MLP leaves little power in the hands of the public investors and more closely resembles a limited partnership interest. Therefore, the publicly held general partnership interest is often considered a security. If the general partnership interest is a security, then the issuer must comply with all of the reporting requirements mentioned above.

The implication of any additional securities laws are beyond the scope of this paper.[61] Suffice it to say that the general partner should be aware of the federal securities laws when conducting its business. Additionally, the general partner should also be aware of any state securities laws that may apply to the MLP.

II. Tax Issues – Qualifying For Partnership Treatment

A. History

1. Corporate/Partnership Determination

Prior to 1997, the classification rules for determining whether a business entity was a partnership were confusing and had uncertain outcomes. After much argument and many cases, the Internal Revenue Service ("IRS") provided regulations outlining six characteristics of a "pure" corporation.[62] These six factors were: association, objective to carry on a business and divide the gain, continuity of life, centralization of management, limited liability, and free transferability of interests.[63] The first two factors are shared by corporations and partnerships.[64] However, if the entity possessed two of the remaining four characteristics, it was classified and taxed as a corporation rather than a partnership (the "resemblance test").[65]

2. 1987 Revenue Reconciliation Act

At the time of the 1987 Revenue Reconciliation Act, publicly traded partnerships qualified for treatment as partnerships because two of the elements defining a corporation were not satisfied. Therefore, there were publicly traded partnerships that had many of the characteristics of corporations, but were only taxed once at the partner level while corporations faced double taxation.[66] In 1987, Congress, fearing that MLPs were eroding the corporate tax base, passed Section 7704 to treat an MLP as a corporation for tax purposes.[67]

In enacting Section 7704, Congress included a grandfather clause for all businesses that had been operating as MLPs prior to 1987. The statute originally provided that existing MLPs were allowed to keep their status for 10 years[68] but was extended indefinitely in 1997. However, grandfathered MLPs are taxed 3.5% on their gross income from the active conduct of trades or businesses.[69]

3. Check the Box

In 1997, the Treasury scrapped the uncertain and contentious resemblance test and replaced it with an elective "Check the Box" system.[70] Since then, business entities (except for per se corporations incorporated under state law) have the option of whether to be treated as a corporation or a partnership. This election is accomplished by simply "checking a box" on a form. However, this elective regime did not affect Section 7704. MLPs are still treated as corporations unless they meet the grandfather exception mentioned above, or they meet the qualifying income test.

B. Section 7704

Section 7704(a) sets out the general rule that an MLP will be treated as a corporation for tax purposes.[71] As stated above, a partnership qualifies as an MLP and is subject to Section 7704 if the partnership is traded on an established securities market or readily tradable on a secondary market. The Treasury Regulations state that an "established securities market" includes:

> (1) a national securities exchange registered under the Securities and Exchange Act of 1934; (2) a national securities exchange exempt from registration because of the limited volume of transactions; (3) a foreign currency exchange; (4) a regional or local exchange; and (5) an interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.[72]

The Treasury Regulations also state that a partnership interest is readily tradable on a secondary market (or the substantial equivalent thereof) if "taking into account all the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market."[73] The main issue is whether the partners can readily trade their partnership interests. Certain transfers of partnership interests, such as transfers upon the death of a partner or transfers between family members, are disregarded in determining whether partnerships are readily tradable.[74] The IRS's safe harbors under the readily tradable rule include: "the 'private transfers' safe harbor; the 'redemption' safe harbor; the 'private placement' safe harbor; the 'qualified matching service' ('QMS') safe harbor; or the 2% *de minimis* safe harbor."[75] Also, the general rule is subject to several exceptions for an MLP with "qualifying income."[76]

1. Qualifying Income

In spite of the general rule of Section 7704, an MLP is not taxed as a corporation if 90% or more of the gross income of the MLP comes from certain "passive-type income."[77] The passive-type income exception suggests that Congress thought there was "no reason to impose a second-tier of tax on passive income that one can generate directly, without investing in an MLP."[78] However, as discussed below, "passive type income," as defined in Section 7704, can include business activities that are very active in nature.

2. Qualifying Income Defined

Section 7704 defines qualifying income as income from: interest, dividends, real property rents, gain from the sale of real property, natural resources, gain from the sale of capital assets, and gain from commodities.[79] The discussion below is limited to dividend income and income from natural resources.

a. Dividends

Dividends generally constitute qualifying income to an MLP.[80] The Code defines a dividend as a distribution from a corporation to its shareholder out of the corporate earnings and profits.[81] An MLP is permitted to hold ownership interests in corporations and an MLP can have corporate subsidiaries.[82]

This is an important strategic advantage for an MLP that engages in activities that generate both qualifying and non-qualifying income. The MLP can drop the assets that generate non-qualifying income into a wholly-owned subsidiary, which will then make distributions up to the parent MLP. So long as the subsidiary corporation engages in business activities and the "drop down" of assets to the corporate subsidiary serves a business purpose, the business activities of the subsidiary will not be attributed to the parent MLP.[83] If the distribution from the corporate subsidiary to the parent MLP constitutes a dividend, then the income to the MLP is qualifying income and the MLP has avoided taxation as a corporation. However, if the MLP is taxed as a partnership, then it will not be able to take advantage of the dividends received deduction available to most corporate parents.[84]

b. Natural Resources

Income generated from natural resources is also qualifying income to an MLP. The natural resource exception, which is evaluated under a two step analysis, is the broadest form of qualifying income. The first step of the analysis determines what qualifies as mineral or natural resources.[85] If the first step is satisfied, the second step considers whether the MLP's activities in connection with those mineral or natural resources are qualifying activities.[86]

i. Step One: What Are Mineral or Natural Resources?

Congress initially did not provide a definition for "mineral or natural resource" in Section 7704. But a year after Section 7704 became law Congress defined a mineral or natural resource asset as "any product of a character with respect to which a deduction for depletion is allowable under [S]ection 611,"[87] including fertilizer, geothermal energy, and timber.[88]

The term "mineral or natural resource" has recently been expanded by the Emergency Economic Stabilization Act of 2008 to include, "industrial source carbon dioxide, or the transportation of any fuel described in subsection (b), (c), (d), or (e) of [S]ection 6426, or any alcohol fuel defined in [S]ection 6426(b)(4)(A) or any biodiesel fuel as defined in [S]ection 40A(d)(1)."[89] The Joint Committee on Taxation explained that the new alternative fuel provision means:

> [T]hat qualifying income of a publicly traded partnership includes income or gains from the transportation or storage of certain fuels. Specifically, the fuels are: (1) any fuel described in subsection (b), (c), (d), or (e) of [S]ection 6424, namely alcohol fuel mixtures, biodiesel mixtures, alternative fuels (which include liquefied petroleum gas, P Series Fuels, compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process, and liquid fuel derived from biomass), and alternative fuel mixtures; (2) neat alcohol other than alcohol derived from petroleum, natural gas, or coal, or having a proof of less than 190 (as defined in [S]ection 6426(b)(4)(A)), and (3) neat biodiesel (as defined in section 40A(d)(1)).[90]

Carbon sequestration means the "capture and storage or disposal of $CO_{2,}$ or other carbon compounds produced by industrial processes, in order to prevent its release into the atmosphere."[91]

ii. Step Two: Are the MLP's Activities In Connection With Mineral or Natural Resources?

Section 7704 gives a laundry list of activities undertaken in connection with minerals or natural resources. These activities include "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."[92] The Code and Treasury Regulations do not define or explain these activities but the apparent purpose of this list is to cover essentially all activities that are materially connected with the production and sale of natural resources.

Included on the list of approved activities, the IRS included many activities that are not normally associated with the production and sale of natural resources. For example, the IRS has ruled that the smelting of alumina qualifies as an activity related to the processing of a natural resource.[93] It has also ruled that a fertilizer company's sale of nitric acid, carbon dioxide and its purchase and sale of natural gas futures constituted qualifying activities.[94] The IRS stated that the activities qualified because nitric acid and carbon dioxide are natural by-products of the production of fertilizer and the purchase and sale of natural gas futures contracts secured the cost of the natural gas needed for the fertilizing process.[95]

The IRS has issued several Private Letter Rulings ("PLR") with respect to the transportation and storage of oil and natural gas. For example, income from "terminaling operations" related to the storage of oil fed to terminals by pipelines and barges has been determined to constitute qualifying income.[96] The IRS has also ruled that income from shuttling butane from refineries to salt domes in the warmer months and back to refineries in colder months was qualifying income.[97] The income gained from the storage of natural gas has also been deemed to be qualifying income.[98] The IRS has additionally ruled that income paid from pipeline transportation customers as reimbursement for the construction of pipeline extensions for oil and gas pipelines was qualifying income.[99]

The IRS has issued additional PLRs regarding the processing of oil and natural gas. In one such PLR, the income earned by a partnership under an agreement with a corporation to process that corporation's natural gas was ruled to be qualifying income.[100] In another PLR, the IRS ruled that income from the refinement of crude oil and from the processing of petroleum based oils into lubricating oils was qualifying income.[101]

The IRS has also issued rulings with respect to oil and gas well drilling activities. In a recent PLR, the IRS ruled that drilling services and other related well services constituted qualifying income.[102] Fracturing, a process used by oil and gas service companies to create fractures in the rock to aid retrieval of oil and natural gas, has also been held to generate qualifying income.[103] As a final example, the IRS has held that income earned from acquiring and licensing land and marine seismic data to oil and gas producers constituted qualifying income.[104]

However, the IRS does not say "yes" to every activity related to natural resources. For example, the IRS has held that income from derivative pricing activities related to natural resources did not constitute qualifying income.[105] Furthermore, the IRS has held that "income earned from marketing minerals and natural resources to the end users at the retail level" does not constitute qualifying income.[106] The sale of electricity generated by power plants that are fueled by natural resources also does not constitute qualifying income.[107] As a general rule of thumb, the IRS appears to be reluctant to classify as a qualifying activity those natural resources activities that are related to the retail level.

C. Loss of Qualifying Status

An MLP can lose its partnership status if it fails to meet the 90% qualifying income exception.[108] If an MLP is taxed as a partnership, but later loses that status, it will be taxed as a corporation. In such a case, the reclassified MLP is deemed to have traded its assets and liabilities to a newly formed corporation in exchange for that corporation's stock, which stock is then distributed to the partners in complete liquidation of the MLP.[109] This deemed transaction will normally be treated as a non-recognition event for tax purposes.

However, under Section 7704(e), if the IRS determines that the failure to qualify was inadvertent, and the failure is corrected reasonably quickly after the failure is discovered, the MLP may be permitted to keep its partnership status as long as it complies with any adjustments required by the IRS.[110] But, if an MLP inadvertently fails to meet the 90% qualifying income standard on a consistent basis, the IRS may withhold this remedy.[111] Therefore, as a practical tip, to avoid a loss of qualifying status, the general partners of an MLP that is taxed as a partnership should remain cognizant of any effect a business transaction will have on the MLP's income status.

D. Tax Implications of an MLP Taxed as a Partnership

1. Tax Advantages

Generally, MLPs that are taxed as partnerships are attractive to investors because there is no entity level tax. This can make an MLP's units desirable to certain investors, who are in turn willing to pay a premium for the MLP's units.

a. One Level of Tax

A corporation is taxed at two levels, once at the corporate level and again at the shareholder level when dividends are paid. The income generated by a partnership, on the other hand, is only taxed at the partner level. The result is that, all other things being equal, the partner will end up having more post-tax dollars in his pocket than his corporate shareholder counterpart.

Here is an example to illustrate the point. Assume that there is a shareholder of a corporation and a partner of a partnership, both of whom are taxed in the highest income bracket of 35%. Assume that the corporate tax rate is 35% and that corporate dividends are taxed at 15%. Additionally, assume that the partnership and the corporation both have a before tax net income of $100 and both plan to distribute their entire after tax income to their respective interest holders. For the partnership, the income is not taxed at the partnership level, so the entire $100 is distributed to the partner, who will pay $35 in tax and have a net amount of $65. The corporation, on the other hand, pays a tax of $35 for the $100 it earned. The corporation then distributes the $65 to the shareholder, who will pay $9.75 in tax (65*15%) and have a net amount of $55.25. Basically, the general net effective tax rate for corporations is 44.75%, while the net effective tax rate for partnerships is 35%.[112] Table 2 in the Appendix summarizes the above examples. There are certain other considerations, not considered here, such as deferral at the shareholder level, which can affect these calculations. Generally speaking, however, the one level of tax for partnerships is advantageous to investors, given the current corporate and individual tax rates.[113]

b. Basis Shield

Another tax advantage of owning units in an MLP that is taxed as a partnership is that an MLP can provide a "basis shield" for distributions to the unitholders. Unlike the shareholder of a corporation, the partner of an MLP that is taxed as a partnership will generally not be taxed on distributions. Rather, a distribution from an MLP to a partner decreases the partner's basis in his partnership interest.[114] Partners will be taxed on the distribution only if the distribution exceeds the partner's basis in his partnership interest. In this way, the partner is "shielded" from taxes on distributions, to the extent of his basis. A corporate shareholder, on the other hand, is generally taxed on her distribution to the extent that the corporation has earning and profits.

As an example, assume that a shareholder purchases a share of stock in a public corporation for $20.00 and partner buys a unit in an MLP that is taxed as a partnership for $20.00. They both start out with the same amount of basis in their respective share/unit, $20.00.[115] Now assume that the corporation makes a dividend of $1.00 to the shareholder out of its earning and profits and the MLP makes a distribution of $1.00 to the unitholder. The corporate shareholder will be taxed for the full amount of the dividend at a rate of 15%. Thus the corporate shareholder will end up with $0.85 in her pocket but will still have a basis in her stock of $20.00. So if she sold the stock for $20.00 at the end of year 1, she would recognize no gain on the sale.

Now, consider the partner in the MLP. Unlike the shareholder of a corporation, the unitholder in an MLP that is taxed as a partnership is allocated a portion of the MLP's income or losses.[116] The partner is taxed on the allocation of gain or loss rather than on the amount of a distribution.[117] This means that the unitholder is responsible for his share of the MLP taxable income whether the MLP makes a distribution or not.[118] In our example, assume that the partner's share of income is $0.20 (which is in the range the average income to distribution ratio for MLPs[119]) and the partner receives a $1.00 distribution from the MLP. The unitholder will be taxed on his allocation of partnership income ($0.20) at a rate of 35%, or $0.07. The $0.20 of income will act to increase the partner's basis in his unit[120] while the amount of the distribution ($1.00) will act to decrease the partner's basis in his partnership unit.[121] Thus the partner will end up with $0.93 in his pocket ($1.00 - $0.20*35%) and have a basis in his unit of $19.20. If the MLP unitholder sold his unit at the end of year 1 for $20.00, he would recognize a gain of $0.80. A portion of this gain would be capital gain and a portion of it would be ordinary gain depending on the deductions previously allocated to the unitholder.[122] Thus, the distribution from the MLP to the unitholder is "shielded" by basis or deferred until such time that the unitholder sells his interest in the MLP. Table 3 in the Appendix summarizes the above examples.

c. Section 754

A new partner buying a partnership interest in an existing MLP has the opportunity to adjust his basis in the partnership interest upward under a Section 754 election.[123] This is a great benefit to new partners, especially if the MLP's assets are highly depreciable or subject to depletion. The Section 754 election allows the new partner to raise the basis in his share of the partnership assets up their fair market value.[124] Since depreciation and deductions are only allowed to the extent there is basis, this is an extremely important election for MLPs.

2. Tax Disadvantages

Although the tax advantages of an MLP discussed above can be significant, certain taxpayers should be aware of possible adverse tax consequences of owning an interest in an MLP.

a. Accounting

By its nature as a publicly traded entity, it can be very difficult for an MLP to account for the partners' basis adjustments required under the Code. An MLP has to file a federal income tax return and deliver Form K-1s (partnership tax return documents) to every partner. Monitoring what is potentially a huge number of public partners and their constantly shifting interests has led many MLPs to impose limitations on what types of interests a partner may own, thereby eliminating some of the tax advantages partners generally enjoy.

Generally, a partnership is more flexible than a corporation in terms of tax law because a partnership can make certain "special allocations" of income and loss to their partners (provided that those allocations have "substantial economic effect").[125][126] However, because of the financial and tax accounting requirements associated with special allocations, the partnership interests some MLPs issue to the public limit or eliminate the use of special allocations.[127] For instance, the initial public offering of limited partnership units for Breitburn Energy Partners L.P. involved 6.9 million units.[128] If an MLP were to make special allocations to certain limited partners for certain tax items, those allocations would have to be reflected on every partner's K-1 (tax return) to ensure that the allocations had "substantial economic effect." Since units in the MLP are bought and sold on public exchanges, for Breitburn Energy Partners to keep track of the special allocations for each partner would be unwieldy to say the least.

b. Limitation on Mutual Fund Investors

Mutual funds are limited on their ownership in MLPs.[129] Before the American Jobs Creation Act of 2004, mutual funds were not able to invest in MLPs at all.[130] Now, mutual funds are permitted to invest in MLPs, subject to two restrictions: (1) the mutual fund cannot have more than 25% of its asset value invested in MLPs, and (2) the mutual fund cannot own more than 10% of any one MLP.[131] Nonetheless, MLPs are an attractive investment for many mutual funds. Investors also see advantages to using mutual funds to invest in MLPs. For example, if an investor uses a mutual fund to invest in an MLP, he will receive a 1099 from the mutual fund instead of a K-1 from the MLP.[132]

c. Disadvantages for Tax Exempt Organizations

Investment in MLPs can often be disadvantageous for tax exempt organizations because the MLP income often constitutes Unrelated Business Taxable Income ("UBTI"). A tax equal to the corporate tax rate is imposed by the Code on all UBTI earned by tax exempt organizations.[133] Unrelated income means any income that is not related to the organization's charitable, educational, or other related functions.[134] As a general rule, income generated by an interest in most partnerships is treated as UBTI because the partnership's business is unrelated to the organization's charitable functions. However, as discussed below, certain types of income, such as royalties, are not considered UBTI.[135]

d. Disadvantages for Foreign Investors

Foreign investors may also lose some of the tax advantages of investing in an MLP. Under Section 871(b), nonresident alien individuals who are engaged in a trade or business within the U.S. are taxed at the normal graduated tax rates.[136] Section 875 establishes that a foreign individual or entity is considered to be engaged in a U.S. trade or business if a partnership in which that individual or entity is a partner is engaged in a U.S. trade or business.[137] Under Section 1446, a withholding obligation is imposed on a foreign partner's share of the partnership net income that is effectively connected with a U.S. trade or business.[138][139] A foreign partner is "any partner that is a nonresident alien individual, foreign corporation, foreign partnership, foreign trust, or foreign estate."[140] Under the current regulations, a partnership must determine whether a partner is a foreign partner by obtaining a withholding certificate form from the foreign partner (such as Forms W-8BEN, W-8IMY, W-8ECI, W-8EXP, and W-9).[141] These general rules also apply to MLPs.[142]

Under the withholding rules, an MLP "that has effectively connected income, gain, or loss generally must pay a tax under Section 1446 by withholding from distributions to a foreign partner."[143] However, under Revenue Procedure 89-31, an MLP can elect to pay a withholding tax based on its effectively connected taxable income allocable to foreign partners, which is 31% of any distribution made to a foreign partner.[144]

Since the withholding amount of 31% of the distribution is most likely in excess of the tax ultimately owed by the foreign partner, the foreign partner will have to file a tax return to recover the excess taxes withheld. For various reasons, a foreign partner might not want to receive a K-1 or file a U.S. tax return.

e. Passive Loss Rules

Perhaps the most onerous tax consequence of investing in an MLP, is the application of the passive loss limitations. A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not "materially participate."[145] Generally speaking, limited partners of an MLP do not materially participate in the MLP unless they are also the general partners or are active in management. Under Section 469, passive losses are usually deductible only to the extent that the taxpayer also has passive gains.[146] If a taxpayer has a business that generates passive income for the tax year and has another business that generated a passive loss, the taxpayer can use the passive loss from one business against the passive activity gain from the other. However, the rules are much more restrictive on the passive losses recognized by a partner in an MLP, which can only be deducted against gains attributable to the same MLP.[147][148] Therefore, if a partner recognizes a loss from their interest in an MLP during one year, that partner will be unable to realize the loss until the partner recognizes a gain from his interest in the MLP in a subsequent year or until that partner disposes of his interest in the MLP. This can present a substantial tax disadvantage for the investor of an MLP that is expected to generate losses (e.g., during the start-up years) compared with an investment in a corporation or even a traditional limited partnership.

III. Natural Resource MLPs

A. Oil and Gas MLPs

1. History

Oil and gas exploration and production MLPs became popular during the 1980's but fizzled out when the price of oil dropped and they could no longer make consistent distributions.[149] These MLPs were also established with a fixed amount of assets so they did not have an income stream that could grow.[150] MLPs were absent from the oil and gas scene for many years but have made a small resurgence in recent years. Currently, there are about 97 MLPs in the US.[151] Only about 11 of these are exploration and production, or "upstream," MLPs.[152]

2. Upstream v. Midstream

Upstream companies conduct exploration and production operations, basically finding oil and gas and getting it out of the ground.[153] Midstream companies conduct operations that get the oil and gas from the wellhead (where the oil or gas comes out of the well) to locations for refinement and distribution to consumers. Midstream MLPs conduct activities such as the gathering and processing of oil and natural gas, and the transportation and storage of oil, natural gas, natural gas liquids, and refined petroleum products.[154] A good example of a midstream company is a natural gas pipeline company. The current majority of oil and gas related MLPs are involved in midstream activities because such activities can provide a consistent and reliable level of income. As noted above, consistent income levels are an important consideration for an MLP, which is often required to make disbursements to cover a partner's taxable income.

It appears that today's upstream oil and gas MLPs have learned their lessons from the failures of their predecessors.[155] The MLPs of the early 1980s over-leveraged their balance sheets, used risky drilling methods or drilled in unproven areas, and used inadequate hedging mechanisms to insulate against commodity price fluctuation.[156] Today, MLPs account for these risks by focusing on exploiting reserves that are proven and have known risk, and by using aggressive hedging strategies to lock in prices on most of its production (70-90%).[157] Today's upstream MLPs also have strong management teams and conservative balance sheets (with modest debt) to diligently guard against cash-flow shortfalls.[158]

3. Addressing Net-Profits Interests

In discussing upstream oil and gas MLPs, is it important to have an understanding of the different types of oil and gas interests. Once a basic understanding of oil and gas interests is established, the concept of net-profits interests will be discussed to explore possible planning opportunities for upstream MLPs.

a. Types of Oil and Gas Interests[159]

There are four basic types of oil and gas interests: a working interest, a royalty interest, a production payment, and a net-profits interest. The costs of production are generally born by the owner of a "working interest," or "operating interest."[160] A working interest is generally acquired through a lease of the mineral rights to a piece of property. In exchange for a working interest, the owner of the mineral rights (the lessor) usually receives a royalty right, a production payment, a net-profits interest, or some combination of the three.

A royalty interest entitles its owner to a share of the "gross" production of the well. A royalty interest holder is not responsible for any of the costs of production.[161] Another type of interest created from the operating interest is called the overriding royalty interest. Like the royalty, the overriding royalty interest is a right to share in the gross production from a mineral property.[162] The overriding royalty does not bear the costs of producing the minerals.[163] Consequently, overriding royalty interests usually pay out a relatively small percentage of the production.

Another type of interest that can be created from the operating interest is a net-profits interest or "non-operating economic interest." The holder of a net-profits interest is not responsible for drilling or operating the well, but he does bear some of the "costs to the extent of its share of the income."[164] Net-operating interests are used frequently and with great success in financing oil and gas operations.[165]

A comparison of two scenarios will help distinguish between an overriding royalty interest and a net-profits interest. In the first scenario, assume that there is an oil well that is burdened by a 25% royalty owner (the lessor), a 25% overriding royalty owner, and an operator/working interest owner. Assume that each barrel of oil is sold for $100, with a cost of $60 to produce. The royalty owner is entitled to 25% of the gross ($100), or $25. Likewise, the overriding royalty owner is entitled to 25% of the gross ($100), also $25. Now the operator is in the red for $10 (meaning the operator has lost money on the activity).

The following is a scenario which uses a net-profits interest. Assuming the same facts as the above example, except replace the overriding royalty with a net-profits interest for 25% of production. The royalty owner still receives $25. The net-profits owner is entitled to 25% of the net-profits. In this scenario, the net-profit is $40 ($100 gross-$60 cost). Therefore, the net-profits owner is entitled to $10. After covering the rest of the costs, the operator receives a profit of $5. Since a net-profits interest shares the expenses of production, operators generally prefer issuing net-profits interest to overriding royalty interests.

The use of net-profits interests in an upstream MLP is a successful tool in attracting institutional investors to the project. However, a full understanding of the advantages of a net profits interest depends on a basic understanding of the taxation of energy resources.

b. Taxation of Energy Resources -- Economic Interest[166]

The taxation of energy resources is based on the concept of "economic interest."[167] If one has an economic interest in a mineral property then that person will be taxed on the income that the property produces and will be entitled to certain deductions for that property's expenses or losses.[168] Though used many times in the Code and Regulations, the term "economic interest" is not expressly defined.[169] An interest in a mineral property is an economic interest if it is "(1) acquired by an investment in the minerals in place, (2) entitling the owner to income derived from the extraction of the minerals, and (3) to which the owner must look for a return of its capital."[170]

The courts and the IRS have established that a net-profits interest is an economic interest for tax purposes. For example, in *Burton-Sutton Oil Co., Inc. v. Commissioner,*[171] the Supreme Court held that a lessee who assigned the lease to another operator but retained a net-profits interest had an economic interest and was entitled to depletion. Likewise, in *Southwest Exploration Co. v. Commissioner*,[172] the Supreme Court held that upland landowners from a mineral interest who made no capital investment, but were granted a net-profits interest in exchange for use of their land for a drill-site, held an economic interest and were entitled to depletion. Today, the Treasury Regulations stipulate that "economic interest" includes "working or operating interests, royalties, overriding royalties, *net profits interests* and, to the extent not treated as loans under 26 U.S.C. § 636, production payments."[173] In *Kirby Petroleum v. Commissioner*, [174] the Supreme Court held that the term "economic interest" did not mean legal title to the minerals in place, but rather the possibility of profit from the extraction of those minerals. This holding is important in the context of an MLP because it means that limited partners can have an "economic interest" in the MLP without having to hold legal title to the MLP's oil and gas assets. This means that the limited partners of an MLP are able to use the deductions and depletion related to their MLP interest to reduce their taxable income.

c. Interests in MLPs Not Treated as Unrelated Business Taxable Income Per Se

As discussed above (see Tax Disadvantages) tax exempt organizations ("TEOs") that invest in MLPs often realize UBTI on the income from an MLP. While most qualifying income of an MLP will be treated as UBTI, it is not the case that all qualifying income will be treated as UBTI.

Income from an MLP is treated the same as income from privately held partnerships.[175] Section 512(c) establishes that if the business or trade of the partnership of which the TEO is a member is an unrelated trade or business, then the income from the partnership is UBTI. UBTI generally does not include passive investment income.[176] In fact, Section 512(b)(2) specifically excludes from UBTI "all royalties (including overriding royalties) whether measured by production or by gross taxable income from the property, and all deductions connected with such income."

Although a net-profits interest is not specifically mentioned in Section 512(b)(2), in 1964 the Fifth Circuit in *U.S. v. Robert A. Welch Foundation*[177] concluded that a net-profits interest is also excluded from UBTI. In that case, a decedent's estate conveyed working interests to two companies, reserving a 100% net-profits interest. Then, the decedent's estate conveyed the net-profits interest to a charity (TEO).[178] The court rejected the government's argument that the net-profits interests were actually working interests (and therefore that the income from the interest was UBTI), stating that to hold otherwise "would call for a departure of the concepts of the terms."[179]

Initially, the IRS announced that it would not follow the holding in *Robert A. Welch Foundation*.[180] Congress even responded by adding Section 512(b)(13), which states that income from controlled entities will be treated as UBTI.[181] For partnerships affected by this statute, control means "ownership of more than 50% of the profits interests or capital interests in such a partnership."[182] Section 512(b)(13) was designed so that a TEO could not use corporate controlled subsidiaries to re-characterize income into a royalty or dividend. However, in 1979, the IRS issued a General Counsel Memorandum stating that net-profits interests are properly treated as royalties under Section 512. Additionally, it stated that a TEO which conveyed working interests in wells to third parties but reserved a 100% net-profits interest still qualified for the UBTI exclusion.[183] Therefore, an MLP's income from a net-profits interests will not be UBTI to a TEO unitholder.

d. Possible Plan for Attracting TEOs

An MLP can benefit from investment by TEOs. For example, TEO investment – often from large pension funds and charities – can provide an MLP with a broader scope of possible investors from which the MLP can obtain capital. But for the potential for realizing UBTI, TEOs would most likely find MLPs to be an attractive investment. As noted above, MLPs, on average, provide higher yields and more steady cash distributions than the broader market, which is a perfect match for TEOs that seek steady cash flows to meet their obligations and objectives.[184]

Generally, TEOs invest their endowments through either corporate stock purchases or corporate loans, both of which have significant disadvantages when compared to an investment in a profitable MLP. When a TEO purchases corporate stock, the TEO gets to share in the success of the corporate venture but its return on investment is taxed at the corporate level, 35%. Therefore, the TEO stock holder only gets 65% of its share of the net income of the corporation (TEOs are not taxed on dividends).[185] For loans made to business ventures, the interest income from the loans is tax-free to TEOs.[186] However, a TEO lender does not get to share in the business venture's upside. If the business venture is highly successful, the TEO will still receive the same amount in interest payments (this assumes a normal loan arrangement without an "equity kicker").

But, if a TEO were able to invest in an MLP without paying UBTI, the TEO would be able to share in the success of the MLP without paying a corporate tax (this is not counting distribution shifts due to incentive distribution rights). As noted above, if a TEO holds a net-profits interest in an MLP, the income generated by the investment is not UBTI.

The mechanism by which a TEO is granted a net-profits interest in an MLP is that the sponsor transfers its leasehold interest to the MLP and the MLP then conveys out that interest to an unrelated third party, but reserves to itself a 100% (or maybe 90%) net-profits interest. Under this framework a TEO is able to buy units in the MLP without worrying about UBTI (but see the discussion on unrelated debt financed income, below). The net-profits MLP might have a competitive advantage over MLPs structured differently because of the large institutional TEO investors that it might attract. Such an MLP can continue to acquire assets by acquiring new leases and then conveying out the working interests and reserving the net-profits interest. Getting the net-profits interests into the hands of the MLP in this way can be advantageous because such a structure is generally able to withstand substance arguments from the IRS, although giving up some of the net profits to the third parties may be required.

An MLP can also obtain net-profits interests by creating a corporate subsidiary into which it transfers the working interest while reserving the net-profits interest. The IRS may object to the substance of the transaction, but the MLP may be able to overcome such a substance argument by showing that the corporate subsidiary significantly reduces the liability to the MLP.

A third mechanism by which an MLP can obtain net-profits interests is accomplished where the sponsor "carves out" and transfers the net-profits interests directly to the MLP with the sponsor retaining the lease. One major problem with this transaction is that the corporate sponsor may have used the working interests in its leases as collateral to finance its operations and the creditors may prevent the sponsor from conveying its net-profits interest in the lease to an MLP. However, the MLP may be able to solve this problem by assuming the liens on the leases (however, this may cause problems of its own which are described in the next section). Alternatively, if the sponsor receives some cash from the MLP when it contributes the net-profits interests to the MLP, the sponsor can use the cash to eliminate its debt and quiet the creditors. However, the receipt of cash in this transaction may constitute boot, which can cause the corporate sponsor to recognize gain. However, this gain may be offset by a deduction the sponsor may claim when it pays down its debt.[187]

A TEO might be attracted to this type of structure even though Section 512(b)(13) disallows a TEO from owning more than 50% of the equity in an MLP because MLPs generally do not require as much investor control as a corporation does. For various reasons, large institutional investors, including TEOs, generally want to control the corporations in which they are invested. In this way, a TEO can ensure that the corporation acts in the TEO's best interest, including the consistent payment of dividends. As discussed above, the incentive mechanisms in place in many MLPs provide accountability and ensure that regular distributions are made without the need for investor control.[188]

Lastly, under Section 512(b)(13), there are no adverse tax consequences for various TEOs owning a more than 50% interest in a company in the aggregate. The adverse consequences are triggered only if a single TEO owns more than 50%. Therefore, an MLP could theoretically be 90% owned by three TEOs (30% each) and no adverse tax consequences would be triggered as to each TEO.

e. Additional Obstacle to TEO Investment: Unrelated Debt Financed Income

Under Section 514, if a TEO acquires income producing assets by means of debt financing, then the percentage of the TEO's gross income attributed to the income producing assets is treated as UBTI.[189] Section 514 defines debt financed property as "any property which is held to produce income and with respect to which there is an acquisition indebtedness." [190] Basically, if the TEO receives income from property for which there is "acquisition indebtedness," then that income will be considered UBTI unless the TEO can prove that the acquisition of the debt-financed property is substantially related to the TEO's tax exempt purpose.[191]

"Acquisition indebtedness" means any debt incurred by the organization before, during, or after the acquisition or improvement of the property, which would not have been incurred otherwise.[192] Also, when the property acquired by the organization is subject to a lien or mortgage, then the lien or mortgage is treated as acquisition indebtedness of the organization even though the organization did not assume or agree to pay such indebtedness.[193] However, interest and dividends from stock securities of debt financed property is not considered unrelated debt-financed income.[194]

This presents some problems for TEOs that invest in an upstream oil and gas MLP. As discussed above, an MLP may have to take some of the net-profits interest or leases subject to liens of the sponsor's creditors. If this occurs, it is likely that these assets will be debt-financed property. Once a TEO buys an interests in the MLP, the debt-financed property assets of the MLP will be imputed to the TEO's partnership interest. This will make the income from the TEO's partnership interest UBTI.

Also, upstream oil and gas MLPs generally rely on debt financing for their acquisitions.[195] Even if an MLP starts out with no debt, if the MLP uses debt financing to renew its depleting asset base, those newly acquired assets will be unrelated debt-financed income to a TEO limited partner.

i. Possible Solutions

An upstream MLP that holds net-profits interests may be able to avoid the unrelated debt-financed property obstacle of Section 514 if it receives the net-profits interests upon formation. This can be accomplished by the sponsor or the MLP paying off the existing creditors so that the assets (net-profits interests or leases) are not encumbered by creditor's liens. In the event that either the corporation or the MLP is not able to pay off the debt with cash, the sponsor can attempt to convert the creditor's security interests into equity interests. If the creditors accept this proposal, they will generally want to ensure that they are paid before the regular unitholders and the general partner are paid on distributions and will therefore require a three-tiered subordination incentive distribution mechanism (see section title "Economic Structure" for a review). Such a three-tiered distribution mechanism would have three types of limited partnership interests: the former creditor limited partnership interests, the limited partnership interests held by the public, and the limited partnership interests held by the general partner. In the first tier, only the former creditor limited partnership interests will receive distributions. In the second tier, once a certain distribution benchmark is met, the former creditor limited partnership interests and the public limited partnerships interests will receive the distributions. In the third tier, once a higher distribution threshold is met, all three limited partnership interests will receive distributions. Such a structure ensures that the former creditors are paid before the other partners.

If an MLP incurs debt to acquire new assets, as discussed above, these new assets will be unrelated debt-financed property to the MLP's TEO limited partners. To avoid this result, an upstream MLP can attempt to acquire additional net-profits interests solely through cash acquisitions. Because, it is unlikely that most MLPs will be able to operate competitively while using its cash to purchase assets, an MLP with TEO investors might be forced make a secondary offering to raise the cash it needs to acquire additional assets.[196]

Nevertheless, even if an MLP has debt-financed property that would cause a TEO to have UBTI, investment in an MLP may still be tax advantaged over investing in corporations. For instance, assume that an upstream oil and gas MLP generates 10% of its income from debt-financed property. Imagine that the MLP earns a net income (income minus expenses) of $1 per unit all of which is distributed to its unitholders, which includes a TEO. For the TEO unitholder, $0.10 per unit is unrelated taxable income. Assuming that the tax rate for the unrelated business taxable income is 35%, the TEO would pay $0.035 and be left with $0.965 after taxes.

Conversely, consider the consequences to the same TEO if it purchased stock in an upstream oil and gas corporation instead of units in the MLP. Like the MLP, the corporation generates 10% of its income from debt-financed property. The corporation earns a net income of $1 per share which it distributes to it's shareholders, including the TEO. Assuming that the corporation's tax at the entity level is 35%, it pays $0.35 in taxes and pays $0.65 to each shareholder. The TEO is not taxed on the dividend it received and it does not owe additional taxes on the income from the debt-financed property. Although the TEO has no unrelated business taxable income,[197] the TEO shareholder ends up with only $0.65 per share.

As demonstrated by the above examples, even though a TEO may recognize UBTI if it invests in an upstream oil and gas MLP that uses debt financing, the TEO may still end up better off than had it invested in a corporation. Nonetheless, a TEO investor might seek assurances, for example through provisions in the MLP partnership agreement, that the amount of debt financing will be kept below certain levels to ensure an acceptable levels of UBTI.

B. "Green" Resource MLPs

1. Biofuels

While no biofuel MLPs have yet emerged since the Emergency Economic Stabilization Act of 2008 added the biofuel provisions to Section 7704(d)(1)(E), there has been significant investment in biofuel technologies over the last several years. Much of the investment has come from big oil companies.[198] For example, British Petroleum has committed $1.5 billion over the last two years and Shell has quadrupled its biofuel research spending since 2007.[199]

The recent investment in alternative fuels, such as biofuels, is partly due to legislation, which has encouraged such investments. For example, in the Energy Independence and Security Act of 2007 (the "Act"),[200] Congress appropriated $500 million in grants for the development of advanced biofuels, including $50 million for the research and development of cellulosic ethanol, [201] and $75 million for additional biofuels research.[202] Additionally, the Act provided $1.4 billion in grants for programs directed toward renewable fuel infrastructure such as "renewable fuel blend stations."[203] Congress followed these measures by expanding the accelerated 50% bonus depreciation, which had been limited to cellulosic biomass ethanol operations, to include all "cellulosic biofuel" operations.[204] The Act also provided a grant to advanced energy facilities related to renewable energy (including biofuels) in the amount of $2 billion.[205]

These grants and accelerated depreciation provisions are direct attempts to create a biofuels market and has increased large oil companies' interest in biofuels.[206] The changes in Section 7704(d)(1)(E) will likely have the same encouraging effect. The expansion of the natural resources exemption to include biofuels and other alternative fuels will provide tax advantaged structures for refining, processing, transporting, and storing these alternative fuels just as it has with oil and natural gas. Existing midstream MLPs that store, transport and refine oil and natural gas are now able to expand into the alternative fuels market.

2. Carbon Dioxide Storage

The Emergency Economic Stabilization Act of 2008 also opened the door for the use of MLPs for carbon sequestration businesses. Both BP and Shell have increased their investments in the carbon sequestration and storage area.[207]

Like the investments in biofuel, the investments in carbon sequestration have been spurred by recent legislation. For example, the Act appropriated $1.2 billion in grants for the research and development of carbon sequestration technology.[208] Additionally, the Act provided $1 billion for projects that attempt to capture and remove carbon from industrial sources like power plants.[209] The Act supplemented these measures with expenditures for several studies and programs with respect to carbon sequestration.[210]

Congress followed up on these actions by increasing the carbon sequestration tax credits to $20 per metric ton of industrial carbon dioxide that is captured and stored in a geological storage and $10 per metric ton of industrial carbon dioxide that capture and used as an injectant in an enhanced oil or natural gas recovery project.[211] Congress has recently stipulated the geological storage must be secure so that the carbon dioxide does not escape into the atmosphere in order to qualify for the credit.[212]

Carbon sequestration is the logical future business of an upstream oil and gas MLP. As upstream oil and gas MLPs deplete their well reserves as time goes by they can use carbon dioxide in a process called "enhanced oil recovery" to force more oil out of their wells and get paid for keeping the carbon dioxide underground.[213] In fact, carbon dioxide has been used in enhanced oil recovery projects for many years.[214] There are several companies and organizations in Oklahoma, for instance, which are eager to employ carbon dioxide sequestration in oil and gas operations.[215] Some speculate that the use of carbon dioxide could "more than double Oklahoma's oil production."[216]

It appears that the government will continue to provide incentives for carbon sequestration while reducing incentives for oil and gas production.[217] Oil and gas companies are uniquely situated to go into the carbon sequestration business because they have access to the depleted underground reserves and they have the technology to implement the sequestration. However, most oil and gas leases continue only while there is production of oil and gas in paying quantities. Therefore, the upstream companies will have to amend their leases so that they can continue to operate on the mineral owner's land that has the underground storage.

IV. Current Opportunities and Developments

A. Market Opportunities and Challenges

Some might wonder, "Why doesn't Exxon become a MLP, it would save a bunch of money on taxes, right?" Wrong. Exxon doesn't want to become an MLP because, for Exxon, becoming an MLP would most likely be a taxable transaction. Exxon would have to liquidate for tax purposes and recognize all of the built-in gain on its assets.[218] For Exxon, converting to an MLP would be prohibitively expensive, but that might not be the case for all oil and gas companies. Given current economic conditions, the fair market value of many assets are depressed. Some companies might have built-in losses in their assets. For instance, on April 6, 2009, Chesapeake Energy had a price/book ratio of 0.78.[219] This means that its stock value (which can be viewed as a fair market value indicator) had the company valued at less than its book value. Although, accounting book value and tax book value do not necessarily reflect the same figures, the ratio gives an indicator as to the fair market value of a company's assets compared to the basis in those assets. Therefore, if a company that is carrying built-in losses was thinking about becoming an MLP, it might be able to take advantage of any built-in losses.

Even if the business's assets do not have built-in losses, it is unlikely that that the assets will be valued lower in the near future than they are now, possibly making now a good time for some oil and gas businesses to convert to MLPs.

However, the current market conditions have also decreased the demand for new oil and gas companies, meaning a newly formed MLP might not have a successful initial public offering. Thus the dilemma: the oil and gas business might get a break on the taxes when it converts to an MLP, but it is not able to obtain the asking price in the IPO. Financial analysts can sort out the specifics, but, if the business thinks that the MLP is being undersold at the initial public offering, it can acquire a larger limited partnership interests than it had originally planned and wait until the market improves.

B. Important Legislative Developments

There are several proposed legislative developments that might impact the MLP market in general and the natural resources MLP market in particular. Proposals from the Obama administration and Congress include: lowering the nominal corporate rate and raising the tax rate for the highest individual income bracket,[220] allowing the expiration of the taxation of dividends to individuals at the capital gains rates,[221] repealing tax incentives for the oil and gas industry such as intangible drilling cost deductions and percentage depletion,[222] and treating carried interest used by financial MLPs as ordinary non-qualifying income.[223]

The proposed changes in the relative corporate and individual rates call into question whether the partnership "one level of tax" remains advantageous. President Obama has hinted that the corporate rate will be reduced to 30% and the highest individual rate will be increased to 39.4%.[224] If implemented, this change in rates might make an MLP investment slightly less attractive than it is with the current tax rates.

The Obama administration has also suggested that the corporate level tax rate can be lowered if some of the corporate tax "loopholes" are eliminated.[225] The tax incentives for the oil and gas industry have been identified by the Obama Administration as such "loopholes." For example, the Administration has proposed repealing the intangible drilling costs deduction and the percentage depletion deduction for oil and gas companies.[226] Additionally, in April, Senator Charles Schumer introduced a bill titled the Oil Industry Tax Break Repeal Act of 2009 that seeks to repeal additional tax incentives for the oil and gas industry.[227] If these changes are enacted, MLP unitholders will not be able to use these deductions to reduce the amount of taxable income allocated to them, reducing the cash-flow needed for distributions.

Additionally, due to some particularly bad press about MLPs such as Blackstone, Congress has proposed treating carried interests that resemble fees for financial services to be treated as non-qualifying income.[228]

However, there is currently a bill in the Senate that would expand qualifying income under Section 7704(d)(1)(E) to include wind energy,[229] which indicates that Congress may be content with the MLP structure and change only the industries and activities that the MLP structure currently favors.

Recently, the green energy industry has conducted a great amount of lobbying in Washington, D.C., to procure the estimated $100 billion in loan guarantees, grants and other funding allocated in the American Recovery and Reinvestment Act of 2009.[230] These lobbying efforts are so intense that Mitch Tyson, chief executive officer of Advanced Electron Beams, remarked that, "'[e]merging technology companies in the energy space are landing in Washington like locusts.'"[231] Lobbying efforts will likely make the business prospects of these "green technologies" (such as biofuels, carbon sequestration, wind and solar energy) more attractive for investors. These lobbying efforts and the legislative trend indicate that "green technologies" will be the beneficiaries of the MLP structure in the future.

Conclusion

Investors in MLPs with qualifying income have certain tax advantages over investors in corporations because MLP qualifying income is taxed only at one level and tax recognition on some distributions can be deferred to future years. Businesses and investors that are considering an MLP should carefully consider the legal, economic and tax aspects of an MLP.

With careful planning, upstream oil and gas MLPs can use net-profits interests to overcome obstacles that might otherwise prevent some investors, like TEOs from investing in an MLP. Additionally, there have been several economic and legislative developments that may increase the attractiveness of the MLP structure for certain businesses and investors. However, recently proposed legislation suggests that the government might repeal certain tax incentives for oil and gas companies while providing additional tax incentives for “green energy” companies. Current legislative trends also indicate that the natural resources exception of Section 7704 will continue to be expanded to provide tax advantaged vehicles for these “green energy” enterprises.

Appendix

Table 1		
Distribution Examples[232]	Distribution 1	Distribution 2
Distribution Per Unit	$0.90	$1.00
Distribution split: Limited Partners vs. General Partners	98% vs. 2%	90% vs. 10%
Limited Partners' Distribution Per Unit	$0.882	$0.90
Limited Partners' Distribution in the Aggregate	$88,200	$90,000
General Partner's Distribution Per Unit	$0.018	$0.10
General Partner's Distribution in Total	$1,800	$10,000

Table 2		
Entity	Corporation	Partnership
Pre-Tax Income	$100.00	$100.00
Entity Level Tax	35%	0%
Distribution to Shareholder/Partner	$65.00	$100.00
Shareholder/Partner Level Tax	15%	35%
Net Income to shareholder/partner	$55.25	$65.00

Table 3		
Entity	Corporation	Partnership
Pre- Distribution Basis in Stock/Unit	$20.00	$20.00
Dividend/Distribution	$1.00	$1.00
Return of Capital /"Basis Shield"	0%[233]	80%
Taxable Income	$1.00	$0.20
Shareholder/Partner Level Tax	15%	35%
Tax Paid	$0.15	$0.07
Net Income	$0.85	$0.93

[1] James Rowland earned his LL.M. at the University of Houston Law Center in May 2009. He can be contacted via email at jameskeenerowland@yahoo.com.

[2] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 21 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf (the major exchanges referred to are the NYSE, AmEx, and NASDAQ).

[3] ARTHUR B. WILLIS & PHILLIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 3.04[1] (2009).

[4] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:1 (2009).
[5] This will be discussed in further detail in the "History" section of PART III of this paper.
[6] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 16 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf.
[7] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 61 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 116, 208, 122 Stat. 3765, 3831, 3865(2008); I.R.C. § 7704(d)(1)(E) (West 2009).
[12] For purposes of this paper, "master limited partnerships" refer to what are called "publicly traded partnerships" in the Code because this is the term commonly used in the industry, though some have pointed out that there can be differences between the two (See MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 8 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf).
[13] Treas. Reg. § 1.7704-1(a)(1) (West 2009).
[14] I.R.C. § 7704(a) (West 2009).
[15] I.R.C. §§ 7704(c), (g) (West 2009).
[16] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 2 (September 9, 2005) (unpublished manuscript, on file with author).
[17] 541-3d T.M. IV-G-2., *Publicly Traded Partnerships.*
[18] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 2-3 (September 9, 2005) (unpublished manuscript, on file with author).
[19] *Id*.
[20] RANDALL H. BREITENBACH, WACHOVIA PIPELINE AND ENERGY MLP CONFERENCE, at 6 (2008), http://files.shareholder.com/downloads/BBEP/612932535x0x257532/32fd119b-59f1-4c2c-8de4-362cc718fb14/Dec%202008%20Wach%20Pipeline%20Presentation%20NY_vFINAL.ppt.pdf.

[21] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 3 (September 9, 2005) (unpublished manuscript) (on file with author).
[22] Treas. Reg. 301.7701-3(a) (West 2009).
[23] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 33 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf.
[24] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:22 (2009). This will be discussed in further detail below in the section titled "Tax Issues."
[25] *Id*.
[26] A "dry hole" is a term describing an oil or gas well that is drilled but does not produce oil or gas in paying quantities (meaning that the well makes no profit over its operating expenses).
[27] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 39 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[28] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:3 (2009).
[29] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 40 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf (providing an example of a four-tier distribution table).
[30] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 5 (September 9, 2005) (unpublished manuscript, on file with author).
[31] *Id*. JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:3 (2009).

[32] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 41 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf (providing an example of a four-tier distribution table).
[33] 541-3d T.M. IV-G-2., *Publicly Traded Partnerships*; 700-3d T.M. II-H., *PubliclyTraded Partnership*.
[34] 541-3d T.M. IV-G-2., *Publicly Traded Partnerships.*
[35] 700-3d T.M. II-H., *PubliclyTraded Partnership.*
[36] I.R.C. § 721(West 2009).
[37] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 9 (September 9, 2005) (unpublished manuscript, on file with author).
[38] I.R.C. §§ 752(b), 722 (West 2009).
[39] MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 9 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (noting that some states, such as Kansas, treat leasehold interests as personal property, and suggesting that one contact local counsel to determine the treatment of leases in unfamiliar states) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925.
[40] I.R.C. § 368 (West 2009).
[41] Unless otherwise noted, all subsequent uses of "Code" refer to the Internal Revenue Code of 1986, as amended (the "Code"). All uses of "Section" refer to sections of the Code.
[42] I.R.C § 368(a)(1) (West 2009)(although, a corporation may avail itself of the reorganization provisions if the new MLP is treated as a corporation under §7704, but this would defeat the purpose of the MLP).
[43] *Id.* at ¶ 10.5[2][c].
[44] I.R.C. §§ 311(b), 336(a) (West 2009).
[45] BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 10.5[1] (7th ed. 2000).
[46] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:29 (2009).
[47] George K. Chamberlain, Annotation, *Partnership and Joint Venture Interests as Securities Within the Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934*, 58 A.L.R. 408 (1982).
[48] Federal Securities Act of 1933 §2(1), 15 U.S.C. § 77b(1) (West 2009); Securities and Exchange Act of 1934 §(3)(a)(10), 15 U.S.C. §78c(a)(10) (West. 2009).
[49] George K. Chamberlain, Annotation, *Partnership and Joint Venture Interests as Securities Within the Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934,* 58 A.L.R. 408 (1982).
[50] 328 US 293 (1946).
[51] George K. Chamberlain, Annotation, *Partnership and Joint Venture Interests as Securities Within the Meaning of Federal Securities Act of 1933 and Securities Exchange Act of 1934,* 58 A.L.R. 408 (1982)(citing *Securities and Exchange Comm. v. W.J. Howey Co*., 328 US 293 (1946)).
[52] *Id.*
[53] 69A AM. JUR. 2D *Securities Regulations- State* §32 (2008); J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 31:3 (2008).
[54] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 13 (September 9, 2005) (unpublished manuscript, on file with author).
[55] *Id.*
[56] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 58 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[57] *Id.*
[58] *Id.*
[59] J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 31:2 (2008).

[60] 69A AM. JUR. 2D SECURITIES REGULATION- FEDERAL § 46.
[61] See J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 31 (2008), for more information about partnerships and securities laws.
[62] ARTHUR B. WILLIS & PHILLIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 3.04[3] (2009).
[63] *Id*.
[64] *Id.*
[65] *Id.*
[66] BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 85.6.1 (2009).
[67] *Id.*
[68] *Id*. at ¶ 85.6.4.
[69] *Id.*
[70] Treas. Reg. § 301.7701-3 (West 2009).
[71] I.R.C. § 7704(a) (West 2009).
[72] Treas. Reg. §1.7704-1(b) (West 2009).
[73] Treas. Reg. § 1.7704-1(c). (West 2009) (there are other notable exceptions in this regulation).
[74] Treas. Reg. § 1.7704-1(e) (West 2009).
[75] 736-1st T.M. IV-C, *Publicly Traded Partnership Limitations*
[76] I.R.C. § 7704(b) (West 2009).
[77] *Id.*
[78] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 15 (September 9, 2005) (unpublished manuscript, on file with author).
[79] I.R.C. § 7704(d)(1)(A-G) (West 2009).
[80] Cite
[81] I.R.C. § 316 (West 2009).
[82] Cite
[83] Barry R. Miller & Tim Fenn, *The Tax Treatment of Publicly Traded Partnerships ("MLPs")* 13 (January 11, 2008)(unpublished memo, on file with author).
[84] I.R.C. § 243 (West 2009).
[85] Cite.
[86] Barry R. Miller and Tim Fenn, *MLP's (Master Limited Partnerships)* 17 (September 9, 2005) (unpublished manuscript, on file with author).
[87] *Id*. at 18.
[88] I.R.C. § 7704(d)(1)(E) (West 2009).
[89] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 116, 208, 122 Stat. 3765, 3831, 3865(2008); I.R.C. § 7704(d)(1)(E) (West 2009).
[90] Joint Comm. Tax Rep. JXC-75-08 ¶ 5026 (2008).
[91] Tom Skilling, *Ask Tom Why*, Chicago Tribune, April 9, 2009, at Live!, Zone C, Weather Report, pg. 8.
[92] I.R.C. § 7704(d)(1)(E) (West 2009).
[93] I.R.S. Priv. Ltr. Rul. 95-38-016 (Jun. 21, 1995).
[94] I.R.S. Priv. Ltr. Rul. 93-39-014 (Jun. 28, 1993).
[95] *Id.*
[96] I.R.S. Priv. Ltr. Rul. 93-40-031 (Jul. 6. 1993).
[97] I.R.S. Priv. Ltr. Rul. 94-16-033 (Jan. 24, 1994).
[98] I.R.S. Priv. Ltr. Rul. 94-52-013 (Sept. 26, 1994).
[99] I.R.S. Priv. Ltr. Rul. 2008-45-035 (Nov. 7, 2008).
[100] I.R.S. Priv. Ltr. Rul. 96-39-011 (Sept. 27, 1996).
[101] I.R.S. Priv. Ltr. Rul. 2008-48-018 (Nov. 28, 2008); I.R.S. Priv. Ltr. Rul. 2007-18-010 (May 4, 2007).

[102] I.R.C. § 7704(d)(1)(E) (West 2009); I.R.S. Priv. Ltr. Rul. 2008-27-022 (Jul. 4, 2008).
[103] I.R.C. § 7704(d)(1)(E) (West 2009); I.R.S. Priv. Ltr. Rul. 2008-27-014 (Jul. 4, 2008).
[104] I.R.S. Priv. Ltr. Rul. 2009-09-006 (Feb. 27, 2009).
[105] I.R.S. Priv. Ltr. Rul. 96-19-011 (Jan. 30, 1996).
[106] I.R.S. Priv. Ltr. Rul. 2008-48-018 (Nov. 28, 2008).
[107] I.R.S. Priv. Ltr. Rul. 2008-21-021 (May 23, 2008).
[108] I.R.C. § 7704(c)(2) (West 2009); BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 85.6.3 (2009).
[109] I.R.C. § 7704(f) (West 2009).
[110] *Id*; BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 85.6.3 (2009).
[111] *Id*.
[112] Note that this assumes that the highest level tax under the tax rates established by the 2004 Jobs Act. These rates have a sunset provision which is set to expire in 2011 (See "Legislative Developments" below).
[113] See the "Legislative Developments" section below.
[114] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:22 (2009); I.R.C. §§ 702, 731(a) (West 2009).
[115] I.R.C. § 1012 (West 2009).
[116] Cite.
[117] Cite.
[118] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 43 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[119] *Id*.
[120] I.R.C. § 705(a)(1)(A).
[121] I.R.C. § 705(a)(2); *see also*, JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:22 (2009).
[122] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 44 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[122] *Id*.
[123] I.R.C. § 754 (West 2009).
[124] *See* JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:20 (2009).
[125] I.R.C. § 704(b)(2) (West 2009).
[126] See WILLIAM S. MCKEE ET AL, FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 11.02 (4th ed. 2007), for a comprehensive explanation of "substantial economic effect."
[127] JOHN C. ALE, PARTNERSHIP LAW FOR SECURITIES PRACTITIONERS § 6:19 (2009); Anthony P. Polito, *Advancing to Corporate Tax Integration: A Laissez-Faire Approach*, 55 S.C. L. REV. 1, 87-88 (2003).
[128] RANDALL H. BREITENBACH, WACHOVIA PIPELINE AND ENERGY MLP CONFERENCE, at 4 (2008), http://files.shareholder.com/downloads/BBEP/612932535x0x257532/32fd119b-59f1-4c2c-8de4-362cc718fb14/Dec%202008%20Wach%20Pipeline%20Presentation%20NY_vFINAL.ppt.pdf.
[129] I.R.C. § 851(b)(3) (West 2009).
[130] American Jobs Creation Act of 2004 Pub. L. No. 108-548 §331, 118 Stat. 1418, 1476-77; H.R. Rep. No. 108-548 at 151 (2004).
[131] I.R.C. §§ 851(b)(3)(A)(ii), (b)(3)(B)(iii) (West 2009).
[132] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 58 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[133] I.R.C. § 511 (West 2009).
[134] I.R.C. § 513 (West 2009).
[135] I.R.C. § 512(b)(2) (West 2009).
[136] I.R.C. § 871(b)(1) (West 2009).

[137] I.R.C. § 875 (West 2009).
[138] I.R.C. § 1446 (West 2009).
[139] I.R.C. 1446(c) (West 2009); Joel D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C.205[3] (2009).
[140] Joel D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C.205[2][a] (2009).
[141] Treas. Reg. § 1.1446-1(c)(2) (West 2009).
[142] Treas. Reg. § 1.1446-4(e) (West 2009).
[143] Joel D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ C.205[8] (2009).
[144] *Id.* (citing Rev. Proc. 89-31, 89-1 CB 895).
[145] I.R.C. § 469(c)(1) (West 2009).
[146] I.R.C. § 469 (West 2009).
[147] AMY SUTTON & LAURA HOWELL-SMITH, FEDERAL INCOME TAXATION OF PASSIVE ACTIVITIES ¶ 13.02[1] (2009).
[148] It is unclear why this limitation exists. Most likely, this measure was borne from Congress's concern during the 1980's that partnerships were being used as tax shelters for investors to trade in losses. Though other laws have been enacted to prevent such shelters, it likely that this provision was aimed at preventing the use of MLPs from being used as such a shelter.
[149] Greg Barr, *IPOs Swim Back Upstream*, HOUS. BUS. J., Nov. 9, 2007, at 1.
[150] *Id.*
[151] MARY LYMAN, PUBLICLY TRADED PARTNERSHIPS 101, at 21 (2008), http://www.naptp.org/documentlinks/PTP101_Nov_08.pdf
[152] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 39 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[153] *Id.*
[154] *Id*. at 20.
[155] *Id*.
[156] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 61 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[157] *Id*.
[158] *Id.*
[159] See 605-2d T.M. II., *Acquisition of Interest*, for a full discussion of the different types of oil and gas interests,
[160] 605-2d T.M. II-C-2-b., *Working and Operating Interests*.
[161] 605-2d T.M. II-C-1-c., *Royalty*.
[162] 605-2d T.M. II-D-1., *Overriding Royalty*.
[163] *Id.*
[164] 605-2d T.M. II-D-2-c-3., *Net Profits Interest*.
[165] *See* MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 1 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925.
[166] See MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 1 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925, for a concise, substantive treatment of the judicial development of the "economic interest" concept.
[167] 605-2d T.M. II-B., *Economic Interest.*
[168] PATRICK A. HENNESSEE & SEAN P. HENNESEE, OIL AND GAS FEDERAL INCOME TAXATION ¶201 (2d ed. 2008).
[169] PATRICK A. HENNESSEE & SEAN P. HENNESEE, OIL AND GAS FEDERAL INCOME TAXATION ¶201-02 (2d ed. 2008).
[170] 605-2d T.M. II-B., *Economic Interest*. (citing Treas. Reg. 1.611-1(b)(1)).
[171] 328 U.S. 25, 34-37 (1946).

[172] 350 U.S. 308 (1956).
[173] Treas. Regs. § 1.614-1(a)(2) (West 2009) (emphasis added).
[174] 326 U.S. 599, 604 (1946).
[175] H.R. REP. NO. 103-213 at 617 (1993).
[176] MICHAEL P. PEARSON, USE OF NET PROFITS INTEREST IN FINANCING OIL AND GAS TRANSACTIONS 14 (Apr. 4, 2008)(unpublished article, 34th Annual Ernest E. Smith Oil, Gas & Mineral Law Institute) (on file with author) *available at* http://www.jw.com/site/jsp/publicationinfo.jsp?id=925.
[177] 334 F.2d 774 (5th Cir. 1964).
[178] *Id*.
[179] *U.S. v. Robert A. Welch Foundation*, 334 F.2d at 775.
[180] Rev. Rul. 69-162 1969-1 C.B. 158.
[181] I.R.C. § 512(b)(13) (West 2009).
[182] *Id.*
[183] I.R.S. Gen. Couns. Mem. 38,216 (Dec. 28, 1979)(the memo did mention that net-profits interest could still be treated like a working interest if it closely resembled one).
[184] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 5 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[185] I.R.C. § 512(b)(1) (West 2009).
[186] *Id.*
[187] I.R.C. §§ 731 (a), 162 (West 2009).
[188] Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1477-79 (2006).
[189] I.R.C. § 514 (a) (West 2009); PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009).
[190] I.R.C. § 514(b)(1) (West 2009).
[191] PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009).
[192] I.R.C. § 514(c)(1) (West 2009).
[193] I.R.C. § 514(c)(2) (West 2009).
[194] PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009) (citing Rev. Rul. 79-122, 1979-1 CB 204).
[195] WACHOVIA CAPITAL MARKETS, LLC, MASTER LIMITED PARTNERSHIPS: A PRIMER 61 (3d. ed. 2008), *available at* http://www.naptp.org/documentlinks/071508wacoviaprimer.pdf.
[196] Here is another example of how MLPs are better than royalty trusts. MLPs can make subsequent offerings to raise more cash and finance their activities while royalty trusts are limited to the number of interests in their original offering. Telephone Interview with Tim Fenn, Partner, Vinson and Elkins (May 29, 2009).
[197] PAMELA D. PERDUE, QUALIFIED PENSION AND PROFIT SHARING PLANS ¶ 20.03[1] (2d ed. 2009) (citing Rev. Rul. 79-122, 1979-1 CB 204).
[198] Clifford Krauss, *Once Antagonists, Big Oil and Biofuels Mix*, INT'L. HERALD TRIB., May 27, 2009, at 13.
[199] *Id*.
[200] Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492.
[201] Energy Independence and Security Act of 2007 § 230.
[202] Energy Independence and Security Act of 2007 §§ 207, 223.
[203] Energy Independence and Security Act of 2007 § 244.
[204] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 201, 122 Stat. 3765, 3832; I.R.C. § 168(l) (West 2009).
[205] American Recovery and Reinvestment Act of 2009, Pub. L. No 111-5, § 1302, 123 Stat. 115, 345.
[206] Clifford Krauss, *Once Antagonists, Big Oil and Biofuels Mix*, INT'L. HERALD TRIB., May 27, 2009, at 13.

[207] *Terry Macalister, Financial: BP Sheds 620 Jobs at Solar Power Business: Oil Group Accused of Undermining Green Energy: Campaigners Say Move is a Great Leap Backwards*, THE GUARDIAN, Nov. 5, 2008, at 26(these moves have been to the detriment of some of their other green projects such as solar).
[208] Energy Independence and Security Act of 2007, Pub. L. No. 110-140, § 702, 121 Stat. 1492, 1704-08.
[209] Energy Independence and Security Act of 2007 § 703.
[210] Energy Independence and Security Act of §§ 705, 711-14.
[211] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 115, 122 Stat. 3765, 3807.
[212] American Recovery and Reinvestment Act of 2009, Pub. L. No 111-5, § 1131, 123 Stat. 115, 325.
[213] See Phillip M. Marston & Patricia A. Moore, *From EOR to CCS: The Evolving Legal and Regulatory Framework for Carbon Capture and Storage,* 29 ENERGY L.J. 421 (2008), for a substantive discussion of the current and future uses of carbon dioxide in the oil and gas industry.
[214] Phillip M. Marston & Patricia A. Moore, *From EOR to CCS: The Evolving Legal and Regulatory Framework for Carbon Capture and Storage*, 29 ENERGY L.J. 421, 428-29 (2008).
[215] Janice Francis-Smith, *New Energy Technology Spawns Regulatory Jurisdiction Questions in Oklahoma*, J. REC. (OKLAHOMA CITY, OK), Nov. 5, 2008.
[216] *Id.*
[217] See the discussion in "Legislative Developments."
[218] I.R.C. §§ 311(b), 336(a) (West 2009).
[219] Yahoo! Finance, http://finance.yahoo.com/q/ks?s=CHK (last visited May 26, 2009) (at the date last visited, Chesapeake's price/book value was 1.13).
[220] Jonathan Weisman, *Obama Makes Overtures for Cooperation of CEOs*, WALL ST. J., Mar. 13, 2009, at A3.
[221] Jim Kunhenn, *Obama's Tax Policy is a Matter of Interpretation Critics Blast the President's Claims, but Devil is in the Details,* HOUS. CHRON., Mar. 6, 2009, at A3.
[222] Ben Geman, *Obama's Budget Plan Seeks Repeal of Oil and Gas Industry Tax Breaks*, GREENWIRE, Feb. 26, 2009.
[223] H.R. 1935, 110th Cong. (2009).
[224] Weisman, *supra* note 254, at A3.
[225] *Id*.
[226] Geman, *supra* note 257.
[227] S. 888 111th Cong. (2009).
[228] H.R. 1935 111th Cong. (2009).
[229] S. 826 111th Cong. § 5 (2009).
[230] Scott Kirsner, *Green Energy Sets Up Shop in Washington, Green Energy Firms Ramp Up Lobbying*, BOSTON GLOBE, May 17, 2009, at Business Section, 1.
[231] *Id*.
[232] This table reflects the examples' assumption that there were 100,000 units.
[233] This example assumes that the corporation's earnings and profits are greater than the distribution, so that the entire distribution would be characterized as a dividend.