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On August 3, 2015, the Treasury Department and the IRS issued final and proposed regulations under §706(d). The final regulations were first proposed on April 14, 2009 and provide rules for allocating partnership items, such as income, gains, deductions, and losses among partners when partners’ interests change during a taxable year. Prior to the issuance of these regulations, partnerships did not have precise rules for allocating partnership items amongst partners in years in which partners’ interests changed. Accordingly, many partnerships will now have less freedom to determine how partnership items will be allocated under the final regulations.

Overview
Under the final regulations, the partnership must divide its taxable year into segments based on the period of time during which the partners’ interests remain unchanged. The partnership must then allocate its partnership items to each segment under either the interim closing method or the proration method. Unless all partners agree to use the proration method, the partnership is required to use the interim closing method.

In accordance with interim closing method, the partnership must calculate partnership items for each segment as if the segment was its own taxable period, and then allocate the partnership items of each segment among the partners in accordance with their ownership interests for that segment. Under the proration method, the partnership simply allocates all partnership items for the tax year to the segments on a pro rata basis, based on the number of days in between each ownership variation. The interim closing method can allocate partnership items on a monthly, semimonthly or calendar day basis, but the proration method must utilize the calendar day convention. This was a new requirement with the proposed regulations in 2009. Under the final regulations, the partnership is not restricted to one method of allocation for a taxable year with multiple ownership variations. Rather, a partnership can choose to use either the interim method or proration method for each variation, even if multiple variations occur within the same taxable year.

Unlike most partnership items, extraordinary items, as defined under §1.706-4(e)(2), must be specially allocated to the partners based on the interests of the partners at the time of day that the extraordinary item occurs, regardless of whether the partnership is using the interim method or the proration method. This distinction prevents partnerships using the interim method from shifting extraordinary items between a transferor and transferee based on the allocation convention they select.

Publicly Traded Partnership Rules
The final regulations contain rules that are specific to publicly traded partnerships (“PTPs”). For instance, a PTP must use the same convention for all variations during a taxable year that relate to its publicly traded units. As a simplifying assumption, a PTP is allowed to treat all transfers of its publicly traded units during a calendar month as occurring on the first day of the following month for purposes of determining ownership interests under both the interim method and proration method. This simplifying assumption was explicitly laid out in a safe harbor under proposed §1.706-4(b)(3) in 2009. However, the IRS did away with the need for this safe harbor by incorporating this rule into other sections of the final regulations that discuss methods and conventions.

Proposed Regulations
In concurrence with issuing the final regulations under §706(d), the IRS issued proposed regulations under the same code section. The proposed regulations provide for two additional extraordinary items under §1.706-4(e)(2). The first would treat deductions for the transfer of an interest in a partnership in connection with the performance of services as extraordinary items. Second, items of fixed or determinable annual or periodic income paid by PTPs to nonresident aliens or foreign corporations and subject to withholding may be treated as extraordinary items if the partners agree to consistently treat similar items as extraordinary for that taxable year. This proposed change is intended to allow PTPs to link each partners’ distributive share to related cash distributions.

Next, the proposed regulations attempt to clarify the scope and definition of “allocable cash basis item” under §706(d)(2)(B) by expanding the language in the statute and providing examples of deductions, losses, income, or gains that should be treated as allocable cash basis items. The proposed regulations provide that the term “allocable cash basis item” includes items of deduction, loss, income or gain specifically listed in the statute, as well as items that accrue over time and that would, if not allocated as an allocable cash basis item, result in the significant misstatement of a partners’ income. Specifically, the Treasury Department and IRS believe that items such as rebate payments, refund payments, insurance premiums, prepayments, and cash advances are examples of items that could result in significant misstatements of partners’ income if not allocated as an allocable cash basis item in accordance with §706(d)(2). Under §706(d)(2)(A), anytime a partnership experiences a change in ownership interest during a period, a cash basis item must be appropriately assigned to each day in the period to which it is attributable and then allocated amongst the partners’ based on their ownership at the close of each day.

Lastly, the proposed regulations provide rules on allocating partnership items to tiered partnerships. The proposed regulations provide that the daily allocation method used for cash basis items apply to all items of a lower-tier partnership if there is a change in any partners’ interest in the upper-tier. However, there is a de minimis exception if the upper-tier partnership directly owns less than 10 percent interest in the lower-tier partnership and all de minimis partners own, in aggregate, less than 30 percent of the lower-tier partnership. If the de minimis upper-tier exception applies, the upper-tier partnership may apply the general rules of §1.706-4 in allocating items attributable to the lower-tier partnership.
Effective Date

For most partnerships, the final regulations are effective for taxable years beginning on or after August 3, 2015. However, existing PTPs that were formed prior to April 14, 2009 will not be subject to the rules under Reg. §1.706-4 and may allocate partnership items across varying partner interests using a method and convention of proration that is proscribed under the final regulations.

The proposed regulations are recommended to be effective for partnership taxable years beginning on or after the date of publication of the proposed regulations in final form.

Links

T.D. 9728: Published in the Federal Register on August 3, 2015

Determination of Distributive Share When Partner’s Interest Changes

https://www.federalregister.gov/articles/2015/08/03/2015-18816/determination-of-distributive-share-when-partners-interest-changes

REG-109370-10: Published in the Federal Register on August 3, 2015

Allocable Cash Basis and Tiered Partnership Items


Update: State Filing Tax Year 2015

New eFile Mandates

We are working closely with the States to verify their TY2015 updates as they pertain to publicly traded partnerships. Thus far, Maryland is the only State that we presently have plans to add to our eFile roster. Strictly speaking, eFile is still optional for PTPs in the State of Maryland, however they have made it increasingly more difficult to convey the partner information by any other method. As of 1/1/2016, the only form of media that they will accept is the XML file generated by the MeF system. Furthermore, starting in TY2014, they began to push back on any media delivered via USB, CD or DVD. By process of elimination, they have effectively restricted tax payers to either submit their returns via eFile or paper. The latter would include paper copies of all partner-level detail.

Vermont’s e-File offering is new for the TY2015 partnership/composite type return filed during 2016 and is at paid preparer level, per CCH. We’re currently in the very early stages of working with the state trying to determine if the size of PTP returns are an issue for their new MeF system. Should it prove viable, we will support Vermont eFile.

The addition of Maryland makes a total of 16 States and 1 city (NYC) that have adopted the modernized eFile format since it’s advent in 2009.

For those partnerships without nexus, neither Maryland nor Vermont have a resident partner filing requirement. Based on TY2014 filings, we anticipate approximately 30 partnerships to file with Maryland and less than 15 to file in Vermont. We are presently working through the approval process with each of the 16 mandatory eFile states and will be prepared to suit all of your TY2015 filing needs.

State Filing and Resident Filing Requirements

Of the 26 states we support, here are eight states that require a return be filed if the partnership has partners who reside in the state. We believe the filing dates to remain consistent with the 2014 tax year.

<table>
<thead>
<tr>
<th>State</th>
<th>eFile Required</th>
<th>Resident Filing Requirement</th>
<th>Calendar Year Filing Date</th>
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* Deadline is 10/15/2016 with state extensions

** If the partnership paid >$10,000 in TY2014, eFile is mandatory

The states listed above represent those states with whom we are either approved to eFile or have approved media formats for delivery of your partner-level information.

As always, if you have any questions, please don’t hesitate to contact any member of your client team.
The following summarizes the 12 Private Letter Rulings (PLRs) that were published by the Internal Revenue Service following the issuance of the recent proposed regulations on qualifying income. It should be emphasized that PLR rulings can only be relied upon by the taxpayer who requested them, and that the rulings were based upon information and representations submitted by the taxpayer and therefore directed only to the requesting taxpayer. Moreover, except as expressly provided in each PLR, no opinion is expressed or implied concerning the federal or state tax consequences of any aspect of any transaction or item discussed or referenced. In addition, no opinion is expressed by either PwC or the IRS concerning whether the taxpayer meets the 90 percent gross income requirement of §7704(c)(1) in any taxable year for which these rulings may apply.

**UPSTREAM**

PLR-108992-14 / No. 201548013 11/27/2015

**Summary:** Yes, is qualifying income (with qualifications)

In this case, the IRS concludes that gross income derived by “Y” from the delivery of fluids, provision of inter-well water transfer services, and the processing, treatment, and disposal of waste solids and waste fluids will constitute qualifying income for purposes of §7704(d)(1)(E). It also concludes that gross income derived from the provision of hot oiler and superheater services, slurry injection activities, drilling pipe decontamination, washout services and condensate and battery vapor control services during the exploration and production of oil and natural gas constitutes qualifying income within the meaning of §7704(D)(1)(E). Also, gross income from the recovery and marketing of hydrocarbons other than to end users at the retail level constitutes qualifying income within the meaning of §7704(d)(1)(E). However, the ruling is not applicable to any income derived from the delivery of water to affiliates or third parties where “Y” does not also collect and clean, recycle, or otherwise dispose of the delivered water after use.

PLR-130812-14 / No. 201545002 11/6/2015

**Summary:** Yes, is qualifying income (with qualifications)

In this case, the IRS concludes that the income directly or indirectly derived by “X” from the delivery of water and the collection, treatment, and transport of flowback, produced water, and other fluids will constitute qualifying income for purposes of section 7704(d)(1)(E). The ruling is not applicable to any income derived from the delivery of water, including recycled produced water, to affiliates or third parties where “X” does not also collect and clean, recycle, or otherwise dispose of the delivered water after use.

PLR-102779-14 / No. 201549004 12/4/2015

**Summary:** Yes, is qualifying income (with qualifications)

“Y” was engaged in the exploration, development, and acquisition of natural gas, natural gas liquids, and oil properties. During an IPO, “Y” contributed its business to “X” and its services to “Z”. (“Z” provides handling, treatment, processing, etc. services to “Y” under a long-term services contract, but “Z” has the right to use excess system capacity to provide any excess services that “Y” does not use to other oil and gas producers. The services are rendered in all three phases of the exploration and production of oil and gas: upstream of the well site, at the well site, and downstream of the well site. “Z”’s services are related to fracking and require substantial assets and equipment that are dedicated exclusively to use in the exploration and production of oil and gas.) In this case, the IRS ruled that gross income derived by “X” from the collection, treatment, and transport of (undisclosed substance) will constitute qualifying income for purposes of §7704(d)(1)(E). There is a qualification that the ruling is not applicable to any income derived by “X” from (unknown activity/substance) relating to affiliates or third parties under (undisclosed circumstances) relating to the after use. The ruling also says nothing about “Z”’s services.

The following summary comes from PLR No. 201602004, the two PLRs which were issued in the following months have very similar facts and a similar summary.

**Summary:** Yes, is qualifying income (with qualifications)

“X” will derive income from its PTP “Y” by providing a full site of fluid, solid, and oilfield waste handling, treatment, and disposal services to oil and natural gas producers engaged in the exploration, development, and production of oil and gas. As part of the upstream services that “Y” will provide various solutions, including brine, to well sites for use in fracking. “Y” will also provide inter-well site water transportation services, as well as processing, treating, and disposing of waste solids and fluids associated with E&P activities. Moreover, “Y” will earn income from washout activities and disposal of waste fluids as part of its downstream services. In this case, the IRS ruled that gross income derived by “Y” from the delivery of fluids, provision of inter-well water transfer services, and the processing, treatment and disposal of waste solids and waste fluids, including washout services, will constitute qualifying income for purposes of §7704(d)(1)(E). Further, gross income derived by “Y” from the recovery, recycling, and marketing of brine, chemicals, and drilling mud to oil and gas producers and of hydrocarbons other than to end users at the retail level constitutes qualifying income within the meaning of §7704(d)(1)(E). The ruling specifically mentions that the conclusion is not applicable to any income derived by “Y” from the delivery of water, brine, drilling mud, or other materials to affiliates or third parties where “Y” does not also collect and clean, recycle, or otherwise dispose of the delivered materials after use.
MIDSTREAM

PLR-103868-15 / No. 201537007 9/11/2015
Summary: Yes, is qualifying income
"X" has income flowing up from an affiliated disregarded entity which will construct and own liquefaction facilities that process and convert natural gas into LNG, and requested a ruling that its distributive share of income derived from contracts for the processing, regasification, liquefaction, and storage of natural gas constitutes qualifying income. In this case, the IRS concluded that the income derived directly or indirectly by "X" from contracts for the processing, regasification, liquefaction, and storage of natural gas constitutes qualifying income under §7704(d)(1)(E).

PLR-117504-14 / No. 2015370149/11/2015
Summary: Yes, is qualifying income
"X" expects to earn income principally by assessing fees for gathering, transporting, processing, treating and disposing of saltwater produced in the exploration and production of oil and natural gas ("produced water"). As a complement to its primary business, "X" will remove "skim oil" from drilling waste during the disposal process at its facilities and earn income by retailing the skim oil to customers other than end users. In this case, the IRS concluded that the income derived by "X" from the gathering, transporting, processing, treating and disposing of saltwater produced in the exploration and production of oil and natural gas constitutes qualifying income within the meaning of §7704(d)(1)(E), and that income derived by "X" from the recovery and marketing of skim oil other than to end users at the retail level constitutes qualifying income within the meaning of §7704(d)(1)(E).

PLR-149182-13 / No. 201538012 9/18/2015
Summary: Yes, is qualifying income
"X" requested a ruling that income derived from storage, transportation of, marketing of, and terminal services for an unknown substance(s) at an unknown location(s). In this case, the IRS concluded that the income directly or indirectly derived by "X" from the following activities will constitute qualifying income under §7704(d)(1)(E):
- Storage of [unknown substance]
- Transportation of [unknown substance]
- Marketing of [unknown substance]
- Revenue from the undisclosed agreements

PLR-110213-14 / No. 201541008 10/9/2015
Summary: Yes, is qualifying income (with qualifications)
"X" derives its income from leasing raw land and building rooftops from owners for purposes of entering Ground Leases with third parties for construction and maintenance of cellular towers, rooftop wireless and broadband internet installations, billboards, wind turbines and solar arrays. In this case, the IRS ruled that income earned attributable to the Ground Leases qualifies as "rents from real property" under §856(d), as modified by §7704(d)(3), and therefore, constitute qualifying income within the meaning of §7704(d)(1)(C).

NON-ENERGY

PLR-147157-13 / No. 201523018 6/5/2015
Summary: Yes, is qualifying income (with qualifications)
"X" submitted a request that income derived from standard interest rate swaps, forward-start interest rate swaps, interest rate caps and treasury locks is qualifying income within the meaning of §7704(d)(1). In this case, the IRS concluded that the income derived by "X" in each of the four specifically identified types of Financial Transactions is qualifying income within the meaning of §7704(d)(1) and §1.7704-3(a)(1). Specifically excluded from this ruling were whether "X"s" Financial Transactions can be integrated with the related debt instruments under §1.1275-6, whether "X" is taxable as a partnership for federal tax purposes, and whether the Forward-Start Interest Rate Swaps or the Treasury Locks meet the definition of a notional principal contract in §1.446-3.

PLR-106909-15 / No. 201549013 12/4/2015
Summary: Yes, is qualifying income
"X" derives its income from leasing raw land and building rooftops from owners for purposes of entering Ground Leases with third parties for construction and maintenance of cellular towers, rooftop wireless and broadband internet installations, billboards, wind turbines and solar arrays. In this case, the IRS ruled that income earned attributable to the Ground Leases qualifies as "rents from real property" under §856(d), as modified by §7704(d)(3), and therefore, constitute qualifying income within the meaning of §7704(d)(1)(C).
“Save The Date”
Spring Tax Executive Roundtable
May 25, 2016
Houston, TX

For questions on this event, please contact Corene West @ (214) 754-4563 or corene.west@pwc.com