

under § 7704(b). X provides crude oil gathering services and natural gas gathering and processing services for customers as well as transportation and storage for oil and natural gas customers. In addition, X engages in interest rate swap, interest rate cap, and Treasury lock transactions (“Hedging Income”).

As part of its transportation services, X derives income from providing pipeline transportation and gathering services of crude oil, natural gas and other products thereof. Under Agreement 1, X receives volumes of crude oil into X’s gathering system at various receipt points and then redelivers the crude oil at various destination points. The customer pays a per barrel rate for volumes gathered by X. The customer is further obligated to meet an annual volume commitment and must pay X a shortfall amount to the extent the customer fails to reach the minimum volume amount. Under Agreement 2, X provides the customer capacity in X’s pipeline system for delivery at the customer’s pipeline system. The customer is obligated to pay a monthly demand charge based on the amount of reserved capacity on X’s pipeline system and in some cases, a commodity charge based on the actual quantity of gas shipped on the system. Pursuant to the transportation services under Agreement 3, X collects a fee for gathering natural gas produced by the customer. Under Agreement 1, Agreement 2, and Agreement 3, X constructs, owns and operates the pipeline and gathering systems.

X also derives income pursuant to parking agreements where X’s customers are charged a usage fee based on the quantities of natural gas stored (“parked”) at X’s facilities. Parking consists of (i) the receipt of gas by X for the customer’s accounts, (ii) the retention of such gas by X, and (iii) the subsequent removal of such gas for the customer’s account at the agreed upon time. In some cases, X will also engage in “cycling” agreements with customers. A cycling agreement is a parking activity that has an upper limit for the amount of natural gas that can be parked during a given time period.

X also derives transportation income from construction, maintenance and operation of lateral pipelines and new points of connection to X’s pipeline system (“interconnections”).

As part of its downstream services, X derives income from the transportation of “produced water” from crude oil and natural gas wells of its gathering system clients. The produced water consists of both natural occurring water and flowback fluids used for hydraulic fracturing. This water is high in salt content as well as various organic and inorganic compounds and small amounts of radiation and the only viable disposal option is transportation to a disposal well or injecting the water back down the well bore. X represents that the produced water pipelines have limited use outside of disposing of waste flowback and cannot easily be converted to another use other than supporting or performing oil or gas production or transportation activities under § 7704(d)(1)(E). X’s employees receive specialized training to operate and maintain the produced water pipelines. In the future, X intends to expand its water transportation services to include

produced water transportation services to non-gathering clients, transportation of produced water that is not naturally occurring but is water flooded into a well to stimulate production, and transportation of produced water by truck rather than pipeline.

X also intends to deliver fresh water, chemicals and other solutions to well sites for use in fracturing. With respect to the water delivery services, X will also collect, clean, recycle and otherwise dispose of the water in accordance with federal, state or local regulations concerning waste products. In connection with the provision of these services, X's employees will receive specialized training and will provide services on an ongoing and frequent basis.

Hedging Income

In order to finance asset acquisitions and conduct the operations of its business, X periodically (a) incurs debt with a floating interest rate and enters into interest rate swap agreements effectively converting its obligation on a portion of that debt into fixed rate debt; (b) incurs debt with a fixed interest rate and enters into interest rate swap agreements effectively converting its obligation on portion of that debt into floating rate debt; (c) enters into interest rate cap agreements; and (d) enters into Treasury lock agreements in anticipation of a future borrowing transaction.

In some cases, the financial transactions entered into by X are integrated with the related debt instruments under § 1.1275-6 of the Income Tax Regulations. X is requesting a ruling only on financial transactions that are not integrated.

Interest Rate Swaps

To manage the risk of interest rate movements on X's borrowings, X may enter into interest rate swap transactions with an unrelated party (the "Swap Counterparty"). These swap arrangements include: (i) floating-to-fixed swaps; (ii) fixed-to-floating swaps; and (iii) forward-start swaps.

Floating-to-fixed swaps. Under a floating-to-fixed swap, X agrees to pay the Swap Counterparty a fixed interest rate on a notional principal amount. In return, the Swap Counterparty agrees to pay X a floating interest rate (determined by reference to an established index, usually the London Interbank Offered Rate, or "LIBOR") on the notional amount. If the floating rate for a given month exceeds the fixed rate, the Swap Counterparty will owe X an amount equal to the difference between the two rates multiplied by the notional principal amount. If the fixed rate exceeds the floating rate in a month, X will owe the Swap Counterparty an amount equal to the difference between the two rates multiplied by the notional principal amount. Amounts owing will be netted, with net monthly settlements occurring during the swap's term.

Fixed-to-floating swaps. Under a fixed-to-floating swap, X agrees to pay the Swap Counterparty a floating interest rate on a notional principal amount. In return, the Swap Counterparty agrees to pay X a fixed interest rate. The terms of a fixed-to-floating swap are otherwise similar to those of a floating-to-fixed swap described above but they result in an opposite net income effect as the floating rate changes.

Forward-start swaps. To lock in a spot interest rate for a period prior to the issuance of its fixed-debt securities (a forward lock), X will agree to pay the Swap Counterparty a fixed interest rate on a notional principal amount. The Swap Counterparty agrees to pay X an amount equal to a floating index rate, determined by reference to some established index, multiplied by the notional principal amount for a fixed period that begins on the date of the anticipated debt issuance. If the index rate exceeds the fixed interest rate on the date of issuance of the debt securities, the Swap Counterparty owes X an amount equal to the excess of the index interest rate over the fixed interest rate multiplied by the notional principal amount over the term of the forward lock. On the other hand, if the fixed interest rate exceeds the floating index rate on the date of issuance of the debt securities, X will owe the Swap Counterparty the excess of the fixed rate over the floating index rate multiplied by the notional principal amount over the term of the forward lock. The amounts the parties owe to each other over the term of the forward lock are calculated and netted on the anticipated date of issuance of the debt securities.

Interest Rate Caps

In an interest rate cap, X will pay a counterparty an upfront fixed payment. The counterparty agrees to pay X an amount equal to a floating index rate, determined by reference to some established index, multiplied by a notional principal amount if, and only if, the floating index rate exceeds a specified cap rate on a specified payment date.

Treasury Locks

In a Treasury lock agreement an unrelated party (the "Lock Counterparty") notionally agrees to purchase Treasury bonds from X at a contract price that values the Treasury bonds using an interest rate equal to the prevailing interest rate on Treasury bonds in effect on the date of the agreement. If the prevailing interest rate on Treasury bonds increased during the agreement period, X will be entitled to receive a payment from the Lock Counterparty that is effectively equal to the excess of the contract price over the lower market price at which X could purchase Treasury bonds as a result of the increase in prevailing Treasury bond interest rates. The payment offsets X's increased cost of issuing its debt resulting from the increase in prevailing Treasury bond interest rates. If the prevailing interest rate on Treasury bonds decreases during the agreement period, X will be required to pay the Lock Counterparty an amount effectively equal to the excess of the higher market price at which X would have to purchase Treasury bonds as a result of the decrease in prevailing Treasury bond interest rates over the

contract price. That payment offsets X's decreased cost of issuing its debt resulting from the decrease in prevailing Treasury bond interest rates.

Law and Analysis

Section 7704(a) provides that, except as provided in § 7704(c), a publicly traded partnership will be treated as a corporation.

Section 7704(b) provides that the term "publicly traded partnership" means any partnership if (1) interests in that partnership are traded on an established securities market, or (2) interests in that partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides that § 7704(a) does not apply to a publicly traded partnership for any taxable year if such partnership meets the gross income requirements of § 7704(c)(2) for the taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

Section 7704(c)(2) provides, in relevant part, that a partnership meets the gross income requirements of § 7704(c)(2) for any taxable year if 90 percent or more of the gross income of the partnership for the taxable year consists of qualifying income.

Section 7704(d)(1)(E) provides that the term "qualifying income" includes income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber).

Section 7704(d)(1)(A) provides that, except as otherwise provided in § 7704(d), the term "qualifying income" includes interest.

Section 7704(d)(2) provides that interest shall not be treated as qualifying income if (A) such interest is derived in the conduct of a financial or insurance business, or (B) such interest would be excluded from the term "interest" under § 856(f).

Section 1.7704-3(a)(1) provides, in part, that for purposes of § 7704(d)(1), qualifying income includes income from notional principal contracts (as defined in § 1.446-3) and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership. Section 1.7704-3(a)(2)

provides, in part, that qualifying income described in § 1.7704-3(a)(1) does not include income derived in the ordinary course of a trade or business.

Section 1.446-3(c)(1) defines a notional principal contract as a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. Section 1.446-3(c)(1) further provides that this definition of a notional principal contract includes interest rate swaps and interest rate caps.

Payments due under an interest rate swap are not interest. There is no borrowing and, hence, no compensation for use of forbearance of money. However, such payments are measured by reference to an interest rate or interest rate index and have a cash flow that would not be excluded under § 856(f) if received as interest by X.

X's treasury locks and forward-start interest rate swaps are common and routine transactions and, like X's interest rate swaps, they are entered into for the purpose of managing the risk of interest rate movements on X's borrowings. Under § 1.7704-3(a)(1), the Commissioner may determine the extent to which income from ordinary and routine investments substantially similar to income from a notional principal contract is included in qualifying income.

Conclusion

Based solely on the facts submitted and the representations made, we conclude that income derived by X, directly or indirectly, from the following activities will constitute qualifying income under § 7704(d)(1)(E):

- Transportation of crude oil and natural gas pursuant to Agreement 1, Agreement 2, and Agreement 3;
- Natural gas parking activities including income from parking and cycling agreements to the extent parking income is separated from loaning income;
- Interconnect activities which enable customer's product to enter X's pipeline system;
- Transportation of produced water; and
- The delivery of fresh water and injectants where X will also collect, clean, recycle and dispose of such water.

Based solely on the facts and representations submitted, we also conclude that the income X derives from Hedging Income is qualifying income within the meaning of § 7704(d)(1) and § 1.7704-3(a)(1).

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or

referenced in this letter. In particular, no opinion is expressed as to whether X's Hedging Income can be integrated with the related debt instruments under § 1.1275-6, as well as to whether X is taxable as a partnership for federal tax purposes. We also express or imply no opinion as to whether the Forward-Start Interest Rate Swaps or the Treasury Locks meet the definition of a notional principal contract in § 1.446-3. Finally, no opinion is expressed or implied as to whether X meets the 90 percent gross income requirement of § 7704(c)(1) in any taxable year for which this ruling may apply.

This ruling is directed only to the taxpayer requesting it. However, in the event of a technical termination of X under § 708(b)(1)(B), the resulting partnership may continue to rely on this ruling in determining its qualifying income under § 7704(d)(1)(E). Section 6110(k)(3) of the Code provides that this letter may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Laura C. Fields

Laura C. Fields

Senior Technician Reviewer, Branch 1

Office of the Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosures (2):

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cc: