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TRIARC COMPANIES INC
Form 8-K
September 04, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 8-K

CURRENT REPORT
PURSUANT TO SECTION 13 OR 15 (d) OF THE
SECURITIES EXCHANGE ACT OF 1934

Date of report (Date of earliest event reported): September 4, 2003

TRIARC COMPANIES, INC.

(Exact name of registrant as specified in its charter)

DELAWARE ----- (State or other jurisdiction of incorporation of organization)	1-2207 ----- (Commission File No.)	38-0471180 ----- (I.R.S. Employer Identification No.)
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280 Park Avenue, New York, NY 10017

(Address of principal executive office) (Zip Code)

Registrant's telephone number, including area code: (212) 451-3000

(Former name or former address,
if changed since last report)

Item 12. Results of Operations and Financial Condition

The information in this report is being furnished and shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that Section. In addition, the information in this report shall not be incorporated by reference into the filings of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except as shall be expressly set forth by specific reference in such filing.

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On August 11, 2003, Triarc Companies, Inc. (the "Company") declared a special stock distribution (the "Stock Distribution") of two shares of a newly designated series of its previously authorized class B common stock with a par value of \$.10 per share (the "Class B Common Stock") for each outstanding share of the Company's class A common stock with a par value of \$.10 per share (the "Class A Common Stock") held on August 21, 2003, with a distribution date of September 4, 2003. The Class B Common Stock will be entitled to one-tenth of a vote per share, will have a \$.01 per share liquidation preference and will be entitled to receive regular quarterly cash dividends per share of at least 110% of any regular quarterly cash dividends per share when, as and if, declared on the Class A Common Stock through September 4, 2006. Thereafter, the Class B Common Stock will participate equally on a per share basis with the Class A Common Stock in any cash dividends.

The Company is hereby providing summary consolidated operating data in the table below to report the effect of the Stock Distribution on its previously reported income (loss) per share. The income (loss) per share amounts in the summary consolidated operating data have been set forth on both a historical pre-distribution and a pro forma post-distribution basis, since the distribution has been declared but has not yet been made. The summary consolidated operating data for the years ended January 2, 2000 and December 31, 2000 also retroactively reflect the effect of the adoption of Statement of Financial Accounting Standards No. 145 ("SFAS 145") resulting in the reclassification of charges related to the early extinguishment of debt previously reported as extraordinary charges. The summary consolidated operating data (i) for each of the fiscal years in the five-year period ended December 29, 2002 have been derived and reclassified from the Company's audited consolidated income statements contained in the Company's Annual Reports on Form 10-K for each of the five fiscal years and (ii) for the six-month periods ended June 29, 2003 and June 30, 2002 (the "Six-Month Periods") have been derived and reclassified from the Company's unaudited condensed consolidated statements of operations included in its Quarterly Report on Form 10-Q for the quarter ended June 29, 2003. In the opinion of the Company, the unaudited summary consolidated operating data for the Six-Month Periods contains all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company's results for those periods. The Company's results for the Six-Month Periods are not necessarily indicative of the results that may be expected for the Company's entire fiscal year. The summary consolidated operating data should be read together with the Company's consolidated financial statements and accompanying notes, as well as management's discussion and analysis of financial condition and results of operations, all of which can be found in the publicly available documents referred to above.

SUMMARY CONSOLIDATED OPERATING DATA

Year Ended (1) (2)			
January 3, 1999 (3)	January 2, 2000 (3)	December 31, 2000 (3)	December 30, 2001
			2

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	(In thousands except per share a				
Revenues:					
Net sales.....	\$ --	\$ --	\$ --	\$ --	\$ --
Royalties and franchise and related fees..	78,429	81,658	87,450	92,823	9
	-----	-----	-----	-----	-----
	78,429	81,658	87,450	92,823	9
	-----	-----	-----	-----	-----
Costs and expenses:					
Cost of sales, excluding depreciation and amortization.....	--	--	--	--	
Selling, general and administrative.....	62,998	68,498	80,212 (8)	77,355 (9)	7
Depreciation and amortization, excluding amortization of deferred financing costs.....	4,916	5,423	5,313	6,506	
Capital market transaction related compensation.....	--	--	26,010 (8)	--	
Capital structure reorganization related charge.....	--	2,126 (7)	306	--	
	-----	-----	-----	-----	-----
	67,914	76,047	111,841	83,861	8
	-----	-----	-----	-----	-----
Operating profit (loss).....	10,515	5,611 (7)	(24,391) (8)	8,962 (9)	1
Interest expense.....	(13,031)	(1,260) (7)	(4,804)	(30,447)	(2)
Insurance expense related to long-term debt..	--	--	(550)	(4,805)	(
Early extinguishment of debt.....	--	(2,351) (7)	--	--	
Investment income, net.....	9,863	16,904	30,715	33,632	
Costs of proposed business acquisitions not consummated.....	(900)	(416)	--	(623)	(
Gain (loss) on sale of businesses, net.....	--	1,188	--	500	(
Other income (expense), net.....	1,572	2,827	1,241	10,191	
	-----	-----	-----	-----	-----
Income (loss) from continuing operations before income taxes and minority interests.....	8,019	22,503 (7)	2,211 (8)	17,410 (9)	(1)
(Provision for) benefit from income taxes....	(4,832)	(6,328) (7)	(12,368) (8)	(8,696) (9)	(1)
Minority interests in loss of a consolidated subsidiary.....	--	--	--	252	
	-----	-----	-----	-----	-----
Income (loss) from continuing operations.....	3,187	16,175 (7)	(10,157) (8)	8,966 (9)	(
Income (loss) from discontinued operations...	11,449 (6)	(6,051) (7)	451,398 (8)	43,450 (9)	1
	-----	-----	-----	-----	-----
Net income (loss).....	\$ 14,636 (6)	\$ 10,124 (7)	\$ 441,241 (8)	\$ 52,416 (9)	\$
	=====	=====	=====	=====	=====
Basic income (loss) per share (4):					
Continuing operations	\$.11	\$.62	\$ (.44)	\$.42	\$
Discontinued operations .....	.37	(.23)	19.43	2.02	
	-----	-----	-----	-----	-----
Net income (loss).....	\$.48	\$.39	\$ 18.99	\$ 2.44	\$
	=====	=====	=====	=====	=====
Diluted income (loss) per share (4):					
Continuing operations	\$.10	\$.60	\$ (.44)	\$.40	\$
Discontinued operations .....	.36	(.23)	19.43	1.91	
	-----	-----	-----	-----	-----
Net income (loss).....	\$.46	\$.37	\$ 18.99	\$ 2.31	\$
	=====	=====	=====	=====	=====
Pro forma basic income (loss) per share (5):					
Continuing operations	\$.03	\$.21	\$ (.15)	\$.14	\$
Discontinued operations13	(.08)	6.48	.67	

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Net income (loss).....	\$.16	\$.13	\$ 6.33	\$.81	\$
	=====	=====	=====	=====	=====
Pro forma diluted income (loss)per share (5):					
Continuing operations	\$.03	\$.20	\$ (.15)	\$.13	\$
Discontinued operations .....	.12	(.07)	6.48	.64	
	-----	-----	-----	-----	-----
Net income (loss).....	\$.15	\$.13	\$ 6.33	\$.77	\$
	=====	=====	=====	=====	=====
Weighted average common shares outstanding:					
Historical pre-distribution.....	30,306	26,015	23,232	21,532	2
Pro forma post-distribution.....	90,918	78,045	69,696	64,596	6

Notes to Summary Consolidated Operating Data

- (1) The Company reports on a fiscal year basis consisting of 52 or 53 weeks ending on the Sunday closest to December 31. In accordance with this method, the Company's 1998 fiscal year contained 53 weeks and each of the Company's 1999, 2000, 2001 and 2002 fiscal years contained 52 weeks. Each of the Company's Six-Month Periods contained 26 weeks.
- (2) Certain amounts included in the prior periods' Summary Consolidated Operating Data have been reclassified to (a) retroactively reflect the adoption on December 30, 2002 of SFAS 145 and (b) otherwise conform with the current period's presentation. The adoption of SFAS 145 resulted in the reclassification of charges for early extinguishment of debt in fiscal 2000 and 2001 previously reported as extraordinary charges to either early extinguishment of debt on a pre-tax basis or income (loss) from discontinued operations, as applicable.
- (3) Summary Consolidated Operating Data for the fiscal years ended on or prior to the fiscal year ended December 31, 2000 reflect the discontinuance of the Company's beverage businesses sold in October 2000 and for the years ended on or prior to the fiscal year ended January 2, 2000 reflect the discontinuance of the Company's propane business sold in July 1999.
- (4) Basic and diluted income (loss) per share are the same for the fiscal years 2000 and 2002 and for the Six-Month Periods since all potentially dilutive securities would have had an antidilutive effect based on the loss from continuing operations for each of those periods. The shares used in the calculation of diluted income (loss) per share for the fiscal years 1998 (31,527,000), 1999 (26,943,000) and 2001 (22,692,000) consist of the weighted average number of common shares outstanding and potential common shares reflecting the effect of dilutive stock options of 1,221,000, 818,000 and 1,160,000, respectively, and for the fiscal year 1999 the effect of a dilutive forward purchase obligation for common stock of 110,000 shares.
- (5) Pro forma basic income (loss) per share has been computed by dividing the net income (loss) attributable to the Class A Common Shares and Class B Common Shares by the weighted average number of shares of each class assuming the Stock Distribution had occurred at the beginning of each period presented. Pro forma diluted income (loss) per share has been computed by dividing the net income (loss) attributable to the Class A Common Shares and Class B Common Shares by the weighted average number of commons shares and potential common shares of each class assuming the Stock

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Distribution had occurred at the beginning of each period presented. Pro forma basic and diluted income (loss) per share are the same for the fiscal years 2000 and 2002 and for the Six-Month Periods since all potentially dilutive securities would have had an antidilutive effect based on the loss from continuing operations for each of those periods. The shares used in the calculation of pro forma diluted income (loss) per share for the fiscal years 1998 (94,581,000), 1999 (80,829,000) and 2001 (68,076,000) consist of the weighted average number of common shares outstanding and potential common shares reflecting the effect of dilutive stock options of 3,663,000, 2,454,000 and 3,480,000, respectively, and for the fiscal year 1999 the effect of a dilutive forward purchase obligation for common stock of 330,000 shares. Since there were no dividends declared or contractually payable in any of the periods presented, the net income (loss) was allocated one-third to the Class A Common Shares and two-thirds to the Class B Common Shares based on how each class would have shared in the net income (loss) in accordance with the Stock Distribution. Pro forma basic and diluted income (loss) per share is the same for each of the two classes of common stock since there were no dividends declared or contractually payable during any of the periods presented.

- (6) Reflects certain significant credits recorded during fiscal 1998 as follows: \$7,074,000 credited to net income representing (1) \$3,067,000 included in the income from operations of the discontinued businesses consisting of \$5,016,000 of gain on sale of businesses less \$1,949,000 of related income taxes and (2) \$4,007,000 of gain on disposal of discontinued operations.
- (7) Reflects certain significant charges and credits recorded during fiscal 1999 as follows: \$2,126,000 charged to operating profit representing a capital structure reorganization related charge related to equitable adjustments made to the terms of outstanding stock options for stock of a former subsidiary held by corporate employees; \$1,425,000 charged to income from continuing operations before income taxes and minority interests representing (1) the aforementioned \$2,126,000 charged to operating profit and (2) a \$2,351,000 charge from the early extinguishment of debt, both less \$3,052,000 of reversal of excess interest expense accruals for interest due the Internal Revenue Service (the "IRS") in connection with the completion of their examinations of the Company's Federal income tax returns for prior years; \$4,262,000 credited to income from continuing operations representing \$5,127,000 of release of excess reserves for income taxes in connection with the completion of IRS examinations of the Company's Federal income tax returns less the aforementioned \$1,425,000 charged to income from continuing operations before income taxes and minority interests plus \$560,000 of related income tax benefit; and \$3,897,000 credited to net income representing (1) the aforementioned \$4,262,000 credited to income from continuing operations and (2) \$15,102,000 of gain on disposal of discontinued operations, both less \$15,467,000 of charges reported in loss from operations of the discontinued businesses consisting of (a) a \$16,757,000 charge from the early extinguishment of debt, (b) a \$3,348,000 capital structure reorganization related charge, similar to the charge in continuing operations, relating to option holders who were employees of the sold businesses, (c) \$411,000 of provision for interest due the IRS in connection with the completion of their examination of the Company's Federal income tax returns, all less \$7,651,000 of related income tax benefit and (d) \$2,602,000 of provision for income taxes in connection with the completion of IRS examinations of the Company's Federal income tax returns.
- (8) Reflects certain significant charges and credits recorded during fiscal 2000 as follows: \$36,432,000 charged to operating loss and income from continuing operations before income taxes and minority interests representing (1) a \$26,010,000 charge for capital market transaction

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related compensation and (2) a \$10,422,000 charge resulting from the Company's repurchase of 1,045,834 shares of its Class A Common Stock from certain of our officers and a director within six months after exercise of the related stock options by the officers and director included in selling, general and administrative; \$32,914,000 charged to loss from continuing operations representing the aforementioned \$36,432,000 less \$3,518,000 of related income tax benefit; and \$427,352,000 credited to net income representing \$460,266,000 of the then estimated gain on disposal of the Company's former beverage businesses credited to income from discontinued operations, net of a \$20,680,000 after-tax charge from the early extinguishment of debt relating to the former beverage businesses, less the aforementioned \$32,914,000 charged to loss from continuing operations.

- (9) Reflects certain significant credits recorded during fiscal 2001 as follows: \$5,000,000 credited to selling, general and administrative, operating profit and income from continuing operations before income taxes and minority interests representing the receipt of a \$5,000,000 note receivable from the Company's Chairman and Chief Executive Officer and President and Chief Operating Officer received in connection with the settlement of a class action lawsuit involving certain awards of compensation to those executives; \$3,200,000 credited to income from continuing operations representing the aforementioned \$5,000,000 less \$1,800,000 of related income tax expense; and \$46,650,000 credited to net income representing the aforementioned \$3,200,000 credited to income from continuing operations and \$43,450,000 of additional gain on disposal of the Company's former beverage businesses.
- (10) Reflects a significant credit recorded during fiscal 2002 as follows: \$11,100,000 credited to net income representing adjustments to the previously recognized gain on disposal of the Company's former beverage businesses due to the release of reserves for income taxes associated with the discontinued beverage operations in connection with the receipt of related income tax refunds.
- (11) The Company completed the acquisition of all of the voting equity interests of Sybra, Inc. ("Sybra") on December 27, 2002. Sybra owned and operated 239 Arby's restaurants as of the date of the acquisition of Sybra and, prior to the acquisition, was the second largest franchisee of Arby's restaurants. The Summary Consolidated Operating Data for the year ended December 29, 2002 includes the results of Sybra from its acquisition on December 27, 2002 through December 29, 2002 with the results of operations before income taxes reported in other income (expense), net for convenience. The Summary Consolidated Operating Data for the six-month period ended June 29, 2003 includes the results of Sybra but the consolidated operating data for the six-month period ended June 30, 2002 does not include the results of Sybra. However, the Summary Consolidated Operating Data for the six-month period ended June 30, 2002 includes royalties from Sybra of \$3,601,000 whereas the royalties from Sybra of \$3,450,000 for the six-month period ended June 29, 2003 were eliminated in consolidation.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on behalf by the undersigned hereunto duly authorized.

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TRIARC COMPANIES, INC.

By: /s/ FRANCIS T. MCCARRON

Francis T. McCarron
Senior Vice President and
Chief Financial Officer

Dated: September 4, 2003

operty to or with the Trustee; provide for the assumption by a successor of our obligations under the Indenture; add any Subsidiary Guarantor with respect to the debt securities; release Holly Energy Finance as an issuer under the Indenture under certain circumstances; change or eliminate any restriction on the payment of principal of, or premium, if any, on, any debt securities; secure the debt securities; add covenants for the benefit of the holders or surrender any right or power conferred upon us or any Subsidiary Guarantor; make any change that does not adversely affect the rights of any holder; add or appoint a successor or separate Trustee; comply with any requirement of the Commission in connection with the qualification of the Indenture under the Trust Indenture Act of 1939; conform the text of the Indenture or any guarantee to any provision of the Description of Debt Securities in this prospectus or any prospectus supplement, to the extent that such provision was intended to be a verbatim recitation of a provision of the Indenture or the guarantee; provide for the issuance of additional debt securities in accordance with the limitations set forth in the Indenture as of the date of the Indenture; or establish the form or terms of debt securities of any series to be issued under the Indenture.

In addition, we, the Trustee and any Subsidiary Guarantors, may amend the Indenture if the holders of a majority in principal amount of all debt securities of each series that would be affected then outstanding under such Indenture consent to it. We, the Trustee and any Subsidiary Guarantors, as applicable, may not, however, without the consent of each holder of outstanding debt securities of each series that would be affected, amend the Indenture to:

reduce the percentage in principal amount of debt securities of any series whose holders must consent to an amendment;

reduce the rate of or extend the time for payment of interest on any debt securities;

reduce the principal of or extend the stated maturity of any debt securities;

reduce the premium payable upon the redemption of any debt securities or change the time at which any debt securities may or shall be redeemed;

make any debt securities payable in other than U.S. dollars;

impair the right of any holder to receive payment of premium, principal or interest with respect to such holder's debt securities on or after the applicable due date;

Table of Contents

impair the right of any holder to institute suit for the enforcement of any payment with respect to such holder's debt securities;

release any security that has been granted in respect of the debt securities, other than in accordance with the Indenture;

make any change in the amendment provisions which require each holder's consent;

make any change in the waiver provisions; or

release any Subsidiary Guarantor or modify the guarantee of any Subsidiary Guarantor in any manner adverse to the holders.

The consent of the holders is not necessary under the Indenture to approve the particular form of any proposed amendment. It is sufficient if such consent approves the substance of the proposed amendment. After an amendment under the Indenture becomes effective, we are required to mail to all holders a notice briefly describing the amendment. The failure to give, or any defect in, such notice, however, will not impair or affect the validity of the amendment.

The holders of a majority in aggregate principal amount of the outstanding debt securities of each affected series, on behalf of all such holders, and subject to certain rights of the Trustee, may waive:

compliance by us or a Subsidiary Guarantor with certain restrictive provisions of the Indenture; and

any past default or Event of Default under the Indenture, subject to certain rights of the Trustee under the Indenture;

except that such majority of holders may not waive a default:
in the payment of principal, premium or interest; or

in respect of a provision that under the Indenture cannot be amended without the consent of all holders of the series of debt securities that is affected.

Defeasance and Discharge

At any time, we may terminate, with respect to debt securities of a particular series, all our obligations under such series of debt securities and the Indenture, which we call a legal defeasance. If we decide to make a legal defeasance, however, we may not terminate our obligations:

relating to the defeasance trust;

to register the transfer or exchange of the debt securities;

to replace mutilated, destroyed, lost or stolen debt securities; or

to maintain a registrar and paying agent in respect of the debt securities.

If we exercise our legal defeasance option, any guarantee will terminate with respect to that series of debt securities.

At any time we may also effect a covenant defeasance, which means we have elected to terminate our obligations under:

covenants applicable to a series of debt securities, including any covenant that is added specifically for such series and is described in a prospectus supplement;

the bankruptcy provisions with respect to any Significant Subsidiary Guarantor or group of Subsidiary Guarantors that, taken together, constitute a Significant Subsidiary Guarantor; and

the guarantee provision described under Events of Default, Remedies and Notices Events of Default above with respect to a series of debt securities, if applicable, and any Events of Default that is added specifically for such series and described in a prospectus supplement.

Table of Contents

We may exercise our legal defeasance option notwithstanding our prior exercise of our covenant defeasance option. If we exercise our legal defeasance option, payment of the affected series of debt securities may not be accelerated because of an Event of Default with respect to that series. If we exercise our covenant defeasance option, payment of the defeased series of debt securities may not be accelerated because of an Event of Default specified in the fourth, fifth (with respect only to a Subsidiary Guarantor (if any)) or sixth bullet points under Events of Default above or an Event of Default that is added specifically for such series and described in a prospectus supplement.

In order to exercise either defeasance option, we must:

irrevocably deposit in trust with the Trustee money or certain U.S. government obligations for the payment of principal, premium, if any, and interest on the series of debt securities to redemption or maturity, as the case may be;

comply with certain other conditions, including that no default has occurred and is continuing after the deposit in trust; and

deliver to the Trustee of an opinion of counsel to the effect that holders of the series of debt securities will not recognize income, gain or loss for Federal income tax purposes as a result of such defeasance and will be subject to Federal income tax on the same amount and in the same manner and at the same times as would have been the case if such deposit and defeasance had not occurred. In the case of legal defeasance only, such opinion of counsel must be based on a ruling of the Internal Revenue Service or other change in applicable Federal income tax law.

If we exercise either our legal defeasance option or our covenant defeasance option, any guarantee by a Subsidiary Guarantor will terminate with respect to the defeased series of debt securities.

In addition, we may discharge all our obligations under the Indenture with respect to debt securities of a particular series, other than our obligation to register the transfer of and exchange such debt securities, provided that we either: deliver all outstanding debt securities of such series to the Trustee for cancellation; or

all such debt securities not so delivered for cancellation have either become due and payable or will become due and payable at their stated maturity within one year or are called for redemption within one year, and in the case of this bullet point, we have deposited with the Trustee in trust an amount of cash sufficient to pay the entire indebtedness of such debt securities, including interest to the stated maturity or applicable redemption date.

No Personal Liability of Directors, Officers, Employees and Unitholders

No director, officer, partner, member, employee, incorporator, manager or unitholder or other owner of any equity interest in us, our general partner or partners or any Subsidiary Guarantors, as applicable, will have any liability for any obligations of us or any Subsidiary Guarantors under any debt securities, any Indenture, any guarantee of any debt securities or for any claim based on, in respect of, or by reason of, such obligations or their creation. Each holder of any debt security accepting such debt security waives and releases all such liability. The waiver and release are part of the consideration for issuance of any debt securities and any guarantee. The waiver may not be effective to waive liabilities under the federal securities laws.

Subordination

Debt securities of a series may be subordinated to our Senior Indebtedness, which we define generally to include any obligation created or assumed by us (or, if the series is guaranteed, any Subsidiary Guarantors) for the repayment of borrowed money, purchase money obligation created or assumed by us, and any guarantee therefor, whether outstanding or hereafter issued, unless, by the terms of the instrument creating or evidencing such obligation, it is provided that such obligation is subordinate or not superior in right of payment to the debt securities (or, if the series is guaranteed, the guarantee of any Subsidiary

Table of Contents

Guarantor), or to other obligations which are pari passu with or subordinated to the debt securities (or, if the series is guaranteed, the guarantee of any Subsidiary Guarantor). Subordinated debt securities will be subordinate in right of payment, to the extent and in the manner set forth in the Indenture and the prospectus supplement relating to such series, to the prior payment of all of our indebtedness and that of any Subsidiary Guarantor that is designated as Senior Indebtedness with respect to the series.

The holders of Senior Indebtedness of ours or, if applicable, any Subsidiary Guarantor, will receive payment in full of the Senior Indebtedness before holders of any subordinated debt securities will receive any payment of principal, premium or interest with respect to the subordinated debt securities upon any payment or distribution of our assets or, if applicable to any series of outstanding debt securities, the Subsidiary Guarantors' assets, to creditors:

upon a liquidation or dissolution of us or, if applicable to any series of outstanding debt securities, the Subsidiary Guarantors; or

in a bankruptcy, receivership or similar proceeding relating to us or, if applicable to any series of outstanding debt securities, to the Subsidiary Guarantors.

Until the Senior Indebtedness is paid in full, any distribution to which holders of subordinated debt securities would otherwise be entitled will be made to the holders of Senior Indebtedness, except that the holders of subordinated debt securities may receive units representing limited partner interests and any debt securities that are subordinated to Senior Indebtedness to at least the same extent as the subordinated debt securities.

If we do not pay any principal, premium or interest with respect to Senior Indebtedness within any applicable grace period (including at maturity), or any other default on Senior Indebtedness occurs and the maturity of the Senior Indebtedness is accelerated in accordance with its terms, we may not:

make any payments of principal, premium, if any, or interest with respect to subordinated debt securities;

make any deposit for the purpose of defeasance of the subordinated debt securities; or

repurchase, redeem or otherwise retire any subordinated debt securities, except that in the case of subordinated debt securities that provide for a mandatory sinking fund, we may deliver subordinated debt securities to the Trustee in satisfaction of our sinking fund obligation, unless, in either case,

the default has been cured or waived and any declaration of acceleration has been rescinded;

the Senior Indebtedness has been paid in full in cash; or

we and the Trustee receive written notice approving the payment from the representatives of each issue of Designated Senior Indebtedness.

Generally, Designated Senior Indebtedness will include:

any specified issue of Senior Indebtedness of at least \$100 million; and

any other Senior Indebtedness that we may designate in respect of any series of subordinated debt securities.

During the continuance of any default, other than a default described in the immediately preceding paragraph, that may cause the maturity of any Designated Senior Indebtedness to be accelerated immediately without further notice, other than any notice required to effect such acceleration, or the expiration of any applicable grace periods, we may not pay the subordinated debt securities for a period called the Payment Blockage Period. A Payment Blockage Period will commence on the receipt by us and the Trustee of written notice of the default, called a Blockage Notice, from the representative of any Designated Senior Indebtedness specifying an election to effect a Payment Blockage Period and will end 179 days thereafter.

Table of Contents

The Payment Blockage Period may be terminated before its expiration:

by written notice from the person or persons who gave the Blockage Notice;

by repayment in full in cash of the Designated Senior Indebtedness with respect to which the Blockage Notice was given; or

if the default giving rise to the Payment Blockage Period is no longer continuing.

Unless the holders of the Designated Senior Indebtedness have accelerated the maturity of the Designated Senior Indebtedness, we may resume payments on the subordinated debt securities after the expiration of the Payment Blockage Period.

Generally, not more than one Blockage Notice may be given in any period of 360 consecutive days. The total number of days during which any one or more Payment Blockage Periods are in effect, however, may not exceed an aggregate of 179 days during any period of 360 consecutive days.

After all Senior Indebtedness is paid in full and until the subordinated debt securities are paid in full, holders of the subordinated debt securities shall be subrogated to the rights of holders of Senior Indebtedness to receive distributions applicable to Senior Indebtedness.

As a result of the subordination provisions described above, in the event of insolvency, the holders of Senior Indebtedness, as well as certain of our general creditors, may recover more, ratably, than the holders of the subordinated debt securities.

Book-Entry System

We may issue debt securities of a series in the form of one or more global certificates, each of which we refer to as a global security, registered in the name of a depository or a nominee of a depository. We expect that The Depository Trust Company, New York, New York, or DTC, will act as depository. If we issue debt securities of a series in book-entry form, we will issue one or more global certificates that will be deposited with or on behalf of DTC and will not issue physical certificates to each holder. A global security may not be transferred unless it is exchanged in whole or in part for a certificated security, except that DTC, its nominees and their successors may transfer a global security as a whole to one another.

Beneficial interests in global debt securities will be shown on, and transfers of global debt securities will be made only through, records maintained by DTC and its participants.

DTC has advised us as follows:

DTC is a limited-purpose trust company organized under the New York Banking Law, a banking organization within the meaning of the New York Banking Law, a member of the Federal Reserve System, a clearing corporation within the meaning of the New York Uniform Commercial Code, and a clearing agency registered pursuant to the provisions of Section 17A of the Exchange Act.

DTC holds securities that its participants deposit with DTC and facilitates the settlement among direct participants of securities transactions, such as transfers and pledges, in deposited securities, through electronic computerized book-entry changes in direct participants' accounts, thereby eliminating the need for physical movement of securities certificates.

Direct participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations.

DTC is owned by a number of its direct participants and by the New York Stock Exchange, Inc., the American Stock Exchange LLC and the National Association of Securities Dealers, Inc.

Access to the DTC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain a custodial relationship with a direct participant, either directly or

indirectly.

Table of Contents

The rules applicable to DTC and its direct and indirect participants are on file with the Commission.

Any purchases of debt securities under the DTC system must be made by or through direct participants, which will receive a credit for the debt securities on DTC's records. The ownership interest of each actual purchaser of debt securities is in turn to be recorded on the direct and indirect participants' records. Beneficial owners of the debt securities will not receive written confirmation from DTC of their purchase, but beneficial owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the direct or indirect participants through which the beneficial owner entered into the transaction. Transfers of ownership interests in the debt securities are to be accomplished by entries made on the books of direct and indirect participants acting on behalf of beneficial owners. Beneficial owners will not receive certificates representing their ownership interests in the debt securities, except in the event that use of the book-entry system for the debt securities is discontinued.

Because DTC can only act on behalf of direct participants, who in turn act on behalf of indirect DTC participants and certain banks, the ability of a person having a beneficial interest in a security held in DTC to transfer or pledge that interest to persons or entities that do not participate in the DTC system, or otherwise take actions in respect of that interest, may be affected by the lack of a physical certificate of that interest. The laws of some states of the United States require that certain persons take physical delivery of securities in definitive form in order to transfer or perfect a security interest in those securities. Consequently, the ability to transfer beneficial interests in a security held in DTC to those persons may be limited.

DTC has advised us that it will take any action permitted to be taken by a holder of debt securities (including, without limitation, the presentation of debt securities for exchange) only at the direction of one or more of the participants to whose accounts with DTC interests in the relevant debt securities are credited, and only in respect of the portion of the aggregate principal amount of the debt securities as to which that participant or those participants has or have given the direction. However, in certain circumstances, DTC will exchange the global securities held by it for certificated debt securities, which it will distribute to its participants.

To facilitate subsequent transfers of ownership interests in the debt securities, all debt securities deposited by direct participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of debt securities with DTC and their registration in the name of Cede & Co. or such other nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual beneficial owners of the debt securities; DTC's records reflect only the identity of the direct participants to whose accounts such debt securities are credited, which may or may not be the beneficial owners. The direct and indirect participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to direct participants, by direct participants to indirect participants, and by direct participants and indirect participants to beneficial owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to the global securities. Under its usual procedures, DTC mails an omnibus proxy to the issuer as soon as possible after the record date. The omnibus proxy assigns Cede & Co.'s consenting or voting rights to those direct participants to whose accounts the debt securities are credited on the record date (identified in the listing attached to the omnibus proxy).

All payments on the global securities will be made to Cede & Co., as holder of record, or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit direct participants' accounts upon DTC's receipt of funds and corresponding detail information from us or the Trustee on payment dates in accordance with their respective holdings shown on DTC's records. Payments by participants to beneficial owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in street name,

Table of Contents

and will be the responsibility of such participant and not of DTC, us, the Trustee or any Subsidiary Guarantor, as applicable, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal, premium, if any, and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) shall be the responsibility of us or the Trustee. Disbursement of such payments to direct participants shall be the responsibility of DTC, and disbursement of such payments to the beneficial owners shall be the responsibility of direct and indirect participants.

Neither we, the Trustee nor any Subsidiary Guarantor, as applicable, will have any responsibility or obligation to direct or indirect participants, or the persons for whom they act as nominees, with respect to the accuracy of the records of DTC, its nominee, any other depositary or its nominee, or any participant with respect to any ownership interest in any debt securities, or payments to, or the providing of notice to participants or beneficial owners.

The Trustee

We may appoint a separate trustee for any series of debt securities. We may maintain banking and other commercial relationships with the Trustee and its affiliates in the ordinary course of business, and the Trustee may own debt securities.

Governing Law

The Indenture for any series of debt securities will be governed by, and construed in accordance with, the laws of the State of New York.

Table of Contents

DESCRIPTION OF OUR COMMON UNITS

Our common units represent limited partner interests that entitle the holders to participate in our cash distributions and to exercise the rights and privileges available to limited partners under our partnership agreement. For a description of the relative rights and preferences of holders of common units and our general partner in and to cash distributions, please carefully review this section and the section Cash Distribution Policy in this prospectus.

Our outstanding common units are listed on the New York Stock Exchange, or NYSE, under the symbol HEP. Any additional common units we issue will also be listed on the NYSE.

The transfer agent and registrar for our common units is American Stock Transfer & Trust Company.

Number of Units

We currently have outstanding 8,170,000 common units, 7,000,000 subordinated units and 937,500 Class B subordinated units which were issued to Alon in connection with the acquisition of certain pipelines, terminals and related assets. See Subordinated Units. There is currently no established public trading market for our subordinated units or Class B subordinated units.

Status as Limited Partner or Assignee

Except as described below under Limited Liability, the common units will be fully paid, and unitholders will not be required to make additional capital contributions to us.

Limited Liability

Assuming that a limited partner does not participate in the control of our business within the meaning of the Delaware Act and that he otherwise acts in conformity with the provisions of our partnership agreement, his liability under the Delaware Act will be limited, subject to some possible exceptions, generally to the amount of capital he is obligated to contribute to us in respect of his units plus his share of any undistributed profits and assets.

Under the Delaware Act, a limited partnership may not make a distribution to a partner to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities of the partnership, other than liabilities to partners on account of their partnership interests and liabilities for which the recourse of creditors is limited to specific property of the partnership, exceed the fair value of the assets of the limited partnership.

For the purposes of determining the fair value of the assets of a limited partnership, the Delaware Act provides that the fair value of the property subject to liability of which recourse of creditors is limited shall be included in the assets of the limited partnership only to the extent that the fair value of that property exceeds the nonrecourse liability. The Delaware Act provides that a limited partner who receives a distribution and knew at the time of the distribution that the distribution was in violation of the Delaware Act is liable to the limited partnership for the amount of the distribution for three years from the date of the distribution.

Subordinated Units

Our subordinated units are a separate class of limited partner interests in our partnership, and the rights of holders of subordinated units to participate in distributions to partners differ from, and are subordinated to, the rights of the holders of our common units. Our Class B subordinated units are a separate series of subordinated units and generally rank equally with our previously existing subordinated units and are entitled to the same cash distributions and to exercise the same rights and privileges available to holders of our subordinated units, except under certain circumstances described below. During the subordination period, our subordinated units and our Class B subordinated units will not be entitled to

Table of Contents

receive any distributions until our common units have received the minimum quarterly distribution plus any arrearages from prior quarters.

The subordination period for our subordinated units will end once we meet the financial tests in the partnership agreement and as further described in the section **Cash Distribution Policy Subordination Period Definition of Subordination Period**, but generally cannot end before June 30, 2009.

Our Class B subordinated units were created by Amendment No. 1 to our partnership agreement and issued to Alon USA Inc. on February 28, 2005 as partial consideration for certain pipelines, terminals and related assets acquired by us from Alon. The Class B subordinated units rank equally with our previously existing subordinated units and receive the same cash distributions, rights and privileges as such subordinated units, except (i) the subordination period with respect to the Class B subordinated units will terminate on the first day of any quarter ending on or after March 31, 2010 if Alon has not defaulted on its minimum volume commitment payment obligations under the pipelines and terminals agreement it entered into with us, subject to certain conditions, and (ii) distributions to Alon with respect to the Class B subordinated units will be suspended if Alon defaults on its payments due us pursuant to its minimum volume commitment under the Alon pipelines and terminals agreement.

When the applicable subordination period ends, all related subordinated units will convert into common units on a one-for-one basis, and the common units will no longer be entitled to arrearages once all subordination periods have ended.

Voting Rights

Unless otherwise noted or the context otherwise requires, references in this section **Voting Rights** to subordinated units include both our subordinated units and our Class B subordinated units.

Our general partner manages and operates us. Unlike the holders of common stock in a corporation, the holders of our units have only limited voting rights on matters affecting our business. They have no right to elect our general partner, or the directors of our general partner, on an annual or other continuing basis. On those matters that are submitted to a vote of unitholders, each record holder of a unit has a vote according to his percentage interest in us, although additional limited partner interests having special voting rights could be issued. However, if at any time any person or group, other than the general partner and its affiliates, or a direct or subsequently approved transferee of the general partner or its affiliates, acquires, in the aggregate, beneficial ownership of 20% or more of any class of units then outstanding, that person or group will lose voting rights on all of its units and the units may not be voted on any matter and will not be considered to be outstanding when sending notices of a meeting of unitholders, calculating required votes, determining the presence of a quorum, or for other similar purposes.

Unitholders will not have voting rights except with respect to the following matters which require the unitholder vote specified below. Matters requiring the approval of a unit majority require:

during the subordination period for the subordinated units, (i) the approval of a majority of the common units, excluding those common units held by our general partner and its affiliates, and (ii) the approval of a majority of the subordinated units and Class B subordinated units voting as a single class;

after the end of the subordination period for the subordinated units but prior to the end of the subordination period for the Class B subordinated units, the approval of a majority of the outstanding units; and

after the end of the subordination periods for both our subordinated units and our Class B subordinated units, the approval of a majority of the outstanding units.

In voting their common and subordinated units, the general partner and its affiliates will have no fiduciary duty or obligation whatsoever to us or the limited partners, including any duty to act in good faith or in the best interests of us and the limited partners.

Table of Contents

Issuance of additional common units or units of equal rank with the common units during the subordination period	Unit majority, with certain exceptions.
Issuance of units senior to the common units during the subordination period	Unit majority.
Issuance of units junior to the common units during the subordination period	No approval right.
Issuance of additional units after the subordination period	No approval rights.
Amendment of the partnership agreement	Certain amendments may be made by the general partner without the approval of the unitholders. Other amendments generally require the approval of a unit majority.
Merger of our partnership or the sale of all or substantially all of our assets	Unit majority.
Amendment of the partnership agreement of our operating partnership and other action taken by us as a limited partner of the operating partnership	Unit majority if such amendment or other action would adversely affect our limited partners (or any particular class of limited partners) in any material respect.
Dissolution of our partnership	Unit majority.
Reconstitution of our partnership upon dissolution	Unit majority.
Withdrawal of the general partner	Under most circumstances, the approval of a majority of the common units, excluding common units held by the general partner and its affiliates, is required for the withdrawal of the general partner prior to June 30, 2014 in a manner which would cause a dissolution of our partnership.
Removal of the general partner	Not less than 66 ² / ₃ % of the outstanding units, voting as a single class, including units held by our general partner and its affiliates.
Transfer of the general partner interest	Our general partner may transfer all, but not less than all, of its general partner interest in us without a vote of our unitholders to an affiliate or another person in connection with its merger or consolidation with or into, or sale of all or

substantially all of its assets to such person. The approval of a majority of the common units, excluding common units held by the general partner and its affiliates, is required in other circumstances for a transfer of the general partner interest to a third party prior to June 30, 2014.

Transfer of incentive distribution rights

Except for transfers to an affiliate or another person as part of the general partner's merger or consolidation with or

38

Table of Contents

into, or sale of all or substantially all of its assets to such person, the approval of a majority of the common units, excluding common units held by our general partner and its affiliates, voting separately as a class, is required in most circumstances for a transfer of the incentive distribution rights to a third party prior to June 30, 2014.

Transfer of ownership interests in the general partner

No approval required at any time.

Transfer of Common Units

The purchase of any common units offered by this prospectus and any prospectus supplement is accomplished through the completion, execution and delivery of a transfer application. Additionally, any later transfers of common units will not be recorded by the transfer agent or recognized by us unless the transferee executes and delivers a transfer application. By executing and delivering a transfer application, a purchaser or transferee of common units: becomes the record holder of the common units and is an assignee until admitted into our partnership as a substituted limited partner;

automatically requests admission as a substituted limited partner in our partnership;

agrees to be bound by the terms and conditions of, and executes, our partnership agreement;

represents that such transferee has the capacity, power and authority to enter into the partnership agreement;

grants powers of attorney to officers of our general partner and any liquidator of us as specified in the partnership agreement; and

gives the consents and approvals contained in our partnership agreement.

An assignee will become a substituted limited partner of our partnership for the transferred common units upon admission by our general partner and the recording of the name of the assignee on our books and records. Our general partner intends to admit assignees as substituted limited partners on a quarterly basis.

A transferee's broker, agent or nominee may complete, execute and deliver a transfer application. We are entitled to treat the nominee holder of a common unit as the absolute owner. In that case, the beneficial holder's rights are limited solely to those that it has against the nominee holder as a result of any agreement between the beneficial owner and the nominee holder.

Common units are securities and are transferable according to the laws governing transfer of securities. In addition to other rights acquired upon transfer, the transferor gives the transferee the right to request admission as a substituted limited partner in our partnership for the transferred common units. A purchaser or transferee of common units who does not execute and deliver a transfer application obtains only:

the right to assign the common unit to a purchaser or other transferee; and

the right to transfer the right to seek admission as a substituted limited partner in our partnership for the transferred common units.

Thus, a purchaser or transferee of common units who does not execute and deliver a transfer application:

will not receive cash distributions or federal income tax allocations, unless the common units are held in a nominee or street name account and the nominee or broker has executed and delivered a transfer application; and

Table of Contents

may not receive some federal income tax information or reports furnished to record holders of common units.

The transferor of common units has a duty to provide the transferee with all information that may be necessary to transfer the common units. The transferor does not have a duty to insure the execution of the transfer application by the transferee and has no liability or responsibility if the transferee neglects or chooses not to execute and forward the transfer application to the transfer agent. Until a common unit has been transferred on our books, we and the transfer agent may treat the record holder of the unit as the absolute owner for all purposes, except as otherwise required by law or stock exchange regulations.

Reports and Records

As soon as practicable, but in no event later than 120 days after the close of each fiscal year, our general partner will furnish or make available to each unitholder of record (as of a record date selected by our general partner) an annual report containing our audited financial statements and a report on those financial statements by our independent public accountants. These financial statements will be prepared in accordance with generally accepted accounting principles. Except for our fourth quarter, we will also furnish or make available summary financial information within 90 days after the close of each quarter.

We will also furnish each unitholder of record with information reasonably required for tax reporting purposes within 90 days after the close of each calendar year. This information is expected to be furnished in summary form so that some complex calculations normally required of partners can be avoided. Our ability to furnish this summary information to unitholders will depend on the cooperation of unitholders in supplying us with specific information. Every unitholder will receive information to assist him in determining his federal and state tax liability and filing his federal and state income tax returns, regardless of whether he supplies us with information.

A limited partner can, for a purpose reasonably related to the limited partner's interest as a limited partner, upon reasonable demand and at his own expense, have furnished to him:

a current list of the name and last known address of each partner;

a copy of our tax returns;

information as to the amount of cash and a description and statement of the agreed value of any other property or services, contributed or to be contributed by each partner and the date on which each became a partner;

copies of our partnership agreement, our certificate of limited partnership, amendments to either of them and powers of attorney which have been executed under our partnership agreement;

information regarding the status of our business and financial condition; and

any other information regarding our affairs as is just and reasonable.

Our general partner may, and intends to, keep confidential from the limited partners trade secrets and other information the disclosure of which our general partner believes in good faith is not in our best interest or which we are required by law or by agreements with third parties to keep confidential.

Table of Contents

CASH DISTRIBUTION POLICY

Unless otherwise noted or the context otherwise requires, references in this section to subordinated units includes both subordinated units and Class B subordinated units of Holly Energy Partners.

Distributions of Available Cash

General. Our partnership agreement provides that we will distribute all of our available cash to unitholders of record on the applicable record date within 45 days after the end of each quarter.

Definition of Available Cash. Available cash generally means, for each fiscal quarter, all cash on hand at the end of the quarter:

less the amount of cash reserves established by our general partner to:
provide for the proper conduct of our business;

comply with applicable law, any of our debt instruments, or other agreements; or

provide funds for distributions to our unitholders and to our general partner for any one or more of the next four quarters;

plus all cash on hand on the date of determination of available cash for the quarter resulting from working capital borrowings made after the end of the quarter. Working capital borrowings are generally borrowings that are made under our credit facility and in all cases are used solely for working capital purposes or to pay distributions to partners.

Operating Surplus and Capital Surplus

General. All cash distributed to unitholders will be characterized as either operating surplus or capital surplus. We distribute available cash from operating surplus differently than available cash from capital surplus.

Definition of Operating Surplus. Operating surplus for any period generally means:

our cash balance on the closing date of our initial public offering; plus

\$10.0 million (as described below); plus

all of our cash receipts after the closing of our initial public offering, excluding cash from borrowings that are not working capital borrowings, sales of equity and debt securities and sales or other dispositions of assets outside the ordinary course of business; plus

working capital borrowings made after the end of a quarter but before the date of determination of operating surplus for the quarter; less

all of our operating expenditures after the closing of our initial public offering, including the repayment of working capital borrowings, but not the repayment of other borrowings, and including maintenance capital expenditures; less

the amount of cash reserves established by our general partner to provide funds for future operating expenditures.

Definition of Capital Surplus. Generally, capital surplus will be generated only by:

borrowings other than working capital borrowings;

sales of debt and equity securities; and

sales or other disposition of assets for cash, other than inventory, accounts receivable and other current assets sold in the ordinary course of business or as part of normal retirements or replacements of assets.

Table of Contents

Characterization of Cash Distributions. We will treat all available cash distributed as coming from operating surplus until the sum of all available cash distributed since we began operations equals the operating surplus as of the most recent date of determination of available cash. We will treat any amount distributed in excess of operating surplus, regardless of its source, as capital surplus. As reflected above, operating surplus includes \$10.0 million in addition to our cash balance on July 13, 2004, the closing date of our initial public offering, cash receipts from our operations and cash from working capital borrowings. This amount does not reflect actual cash on hand at closing that is available for distribution to our unitholders. Rather, it is a provision that will enable us, if we choose, to distribute as operating surplus up to \$10.0 million of cash we receive in the future from non-operating sources, such as asset sales, issuances of securities, and long-term borrowings, that would otherwise be distributed as capital surplus.

Subordination Periods

General. During the subordination periods, the common units will have the right to receive distributions of available cash from operating surplus in an amount equal to the minimum quarterly distribution, plus any arrearages in the payment of the minimum quarterly distribution on the common units from prior quarters, before any distributions of available cash from operating surplus may be made on the subordinated units. As described in the section

Description of Our Common Units Subordinated Units, our Class B subordinated units are subject to additional possible restrictions on cash distributions. The purpose of the subordinated units is to increase the likelihood that during the subordination period there is available cash to be distributed on the common units.

Definition of Subordination Period. The subordination period for the subordinated units commenced upon the closing of our initial public offering and generally extends until the first day of any quarter beginning after June 30, 2009, that each of the following tests are met:

distributions of available cash from operating surplus on each of the outstanding common units and subordinated units equaled or exceeded the minimum quarterly distribution for each of the three consecutive, non-overlapping four-quarter periods immediately preceding that date;

the adjusted operating surplus generated during each of the three consecutive, non-overlapping four-quarter periods immediately preceding that date equaled or exceeded the sum of the minimum quarterly distributions on all of the outstanding common units and subordinated units during those periods on a fully diluted basis and the related distribution on the 2% general partner interest during those periods; and

there are no arrearages in payment of the minimum quarterly distribution on the common units.

Definition of Class B Subordination Period. The subordination period for the Class B subordinated units commenced upon the issuance of the Class B subordinated units and generally extends until the first day of any quarter beginning after March 31, 2010 that no Alon event of default in respect of payments due under Alon's pipelines and terminals agreement existed with respect to each of the three consecutive, non-overlapping four-quarter periods immediately preceding such date.

Definition of Adjusted Operating Surplus. Adjusted operating surplus for any period generally means: operating surplus generated with respect to that period; less

any net increase in working capital borrowings with respect to that period; less

any net reduction in cash reserves for operating expenditures with respect to that period not relating to an operating expenditure made with respect to that period; plus

any net decrease in working capital borrowings with respect to that period; plus

any net increase in cash reserves for operating expenditures with respect to that period required by any debt instrument for the repayment of principal, interest or premium.

Table of Contents

Adjusted operating surplus is intended to reflect the cash generated from operations during a particular period and therefore excludes net increases in working capital borrowings and net drawdowns of reserves of cash generated in prior periods.

Effect of Expiration of the Subordination Period. Upon expiration of the applicable subordination period, each outstanding subordinated unit or Class B subordinated unit, as the case may be, will convert into one common unit and will then participate pro rata with the other common units in distributions of available cash. In addition, if the unitholders remove our general partner other than for cause and units held by the general partner and its affiliates are not voted in favor of such removal:

the subordination period for our subordinated units and our Class B subordinated units will end and each subordinated unit and Class B subordinated unit will immediately convert into one common unit;

any existing arrearages in payment of the minimum quarterly distribution on the common units will be extinguished; and

the general partner will have the right to convert its general partner interest and its incentive distribution rights into common units or to receive cash in exchange for those interests.

Distributions of Available Cash from Operating Surplus during the Subordination Periods

We make distributions of available cash from operating surplus for any quarter during the subordination periods in the following manner:

First, 98% to the common unitholders, pro rata, and 2% to the general partner, until we distribute for each outstanding common unit an amount equal to the minimum quarterly distribution for that quarter;

Second, 98% to the common unitholders, pro rata, and 2% to the general partner, until we distribute for each outstanding common unit an amount equal to any arrearages in payment of the minimum quarterly distribution on the common units for any prior quarters during the subordination period;

Third, 98% to the subordinated unitholders and the Class B subordinated unitholders, pro rata, and 2% to the general partner, until we distribute for each subordinated unit and Class B subordinated unit an amount equal to the minimum quarterly distribution for that quarter; and

Thereafter, in the manner described in **Incentive Distribution Rights** below; *provided, however*, that distributions on the Class B subordinated units may be suspended or reduced if Alon defaults on its payments due us pursuant to its minimum volume commitment under the Alon pipelines and terminals agreement.

Distributions of Available Cash from Operating Surplus after the Subordination Period

We make distributions of available cash from operating surplus for any quarter after the subordination period in the following manner:

First, 98% to all unitholders, pro rata, and 2% to the general partner, until we distribute for each outstanding unit an amount equal to the minimum quarterly distribution for that quarter; and

Thereafter, in the manner described in **Incentive Distribution Rights** below.

Incentive Distribution Rights

Incentive distribution rights represent the right to receive an increasing percentage of quarterly distributions of available cash from operating surplus after the minimum quarterly distribution and the target distribution levels have been achieved. Our general partner currently holds the incentive distribution rights, but may transfer these rights separately from its general partner interest, subject to restrictions in the partnership agreement.

Table of Contents

If for any quarter:

we have distributed available cash from operating surplus to the common and subordinated unitholders in an amount equal to the minimum quarterly distribution; and

we have distributed available cash from operating surplus on outstanding common units in an amount necessary to eliminate any cumulative arrearages in payment of the minimum quarterly distribution; then, we will distribute any additional available cash from operating surplus for that quarter among the unitholders and the general partner in the following manner:

First, 98% to all unitholders, pro rata, and 2% to the general partner, until each unitholder receives a total of \$0.55 per unit for that quarter (the first target distribution);

Second, 85% to all unitholders, pro rata, and 15% to the general partner, until each unitholder receives a total of \$0.625 per unit for that quarter (the second target distribution);

Third, 75% to all unitholders, pro rata, and 25% to the general partner, until each unitholder receives a total of \$0.75 per unit for that quarter (the third target distribution); and

Thereafter, 50% to all unitholders, pro rata, and 50% to the general partner.

In each case, the amount of the target distribution set forth above is exclusive of any distributions to common unitholders to eliminate any cumulative arrearages in payment of the minimum quarterly distribution. The percentage interests set forth above for our general partner include its 2% general partner interest and assume the general partner has not transferred its incentive distribution rights.

Percentage Allocations of Available Cash from Operating Surplus

The following table illustrates the percentage allocations of the additional available cash from operating surplus between the unitholders and our general partner up to the various target distribution levels. The amounts set forth under Marginal Percentage Interest in Distributions are the percentage interests of our general partner and the unitholders in any available cash from operating surplus we distribute up to and including the corresponding amount in the column Total Quarterly Distribution, until available cash from operating surplus we distribute reaches the next target distribution level, if any. The percentage interests shown for the unitholders and the general partner for the minimum quarterly distribution are also applicable to quarterly distribution amounts that are less than the minimum quarterly distribution. The percentage interests set forth below for our general partner include its 2% general partner interest and assume the general partner has not transferred its incentive distribution rights.

	Total Quarterly Distribution	Marginal Percentage Interest in Distributions	
	Target Amount	Unitholders	General Partner
Minimum Quarterly Distribution	\$0.50	98%	2%
First Target Distribution	up to \$0.55	98%	2%
Second Target Distribution	above \$0.55 up to \$0.625	85%	15%
Third Target Distribution	above \$0.625 up to \$0.75	75%	25%
Thereafter	above \$0.75	50%	50%

Distributions from Capital Surplus

How Distributions from Capital Surplus Are Made. We will make distributions of available cash from capital surplus, if any, in the following manner:

First, 98% to all unitholders, pro rata, and 2% to the general partner, until we distribute for each common unit, an amount of available cash from capital surplus equal to the initial public offering price;

Table of Contents

Second, 98% to the common unitholders, pro rata, and 2% to the general partner, until we distribute for each common unit, an amount of available cash from capital surplus equal to any unpaid arrearages in payment of the minimum quarterly distribution on the common units; and

Thereafter, we will make all distributions of available cash from capital surplus as if they were from operating surplus.

Effect of a Distribution from Capital Surplus. The partnership agreement treats a distribution of capital surplus as the repayment of the initial unit price from our initial public offering, which is a return of capital. The initial public offering price less any distributions of capital surplus per unit is referred to as the unrecovered initial unit price. Each time a distribution of capital surplus is made, the minimum quarterly distribution and the target distribution levels are reduced in the same proportion as the corresponding reduction in the unrecovered initial unit price. Because distributions of capital surplus will reduce the minimum quarterly distribution, after any of these distributions are made, it may be easier for the general partner to receive incentive distributions and for the subordinated units to convert into common units. However, any distribution of capital surplus before the unrecovered initial unit price is reduced to zero cannot be applied to the payment of the minimum quarterly distribution or any arrearages.

Once we distribute capital surplus on a unit equal to the initial unit price, we will reduce the minimum quarterly distribution and the target distribution levels to zero. We will then make all future distributions from operating surplus, with 50% being paid to the holders of units and 50% to the general partner. The percentage interests shown for our general partner include its 2% general partner interest and assume the general partner has not transferred the incentive distribution rights.

Adjustment to the Minimum Quarterly Distribution and Target Distribution Levels

In addition to adjusting the minimum quarterly distribution and target distribution levels to reflect a distribution of capital surplus, if we combine our units into fewer units or subdivide our units into a greater number of units, we will proportionately adjust:

the minimum quarterly distribution;

target distribution levels;

the unrecovered initial unit price;

the number of common units issuable during the subordination period without a unitholder vote; and

the number of common units into which a subordinated unit is convertible.

For example, if a two-for-one split of the common units should occur, the minimum quarterly distribution, the target distribution levels and the unrecovered initial unit price would each be reduced to 50% of its initial level, the number of common units issuable during the subordination period without unitholder vote would double and each subordinated unit would be convertible into two common units. We will not make any adjustment by reason of the issuance of additional units for cash or property.

In addition, if legislation is enacted or if existing law is modified or interpreted by a governmental taxing authority, so that we become taxable as a corporation or otherwise subject to taxation as an entity for federal, state or local income tax purposes, we will reduce the minimum quarterly distribution and the target distribution levels for each quarter by multiplying each distribution level by a fraction, the numerator of which is available cash for that quarter and the denominator of which is the sum of available cash for that quarter plus the general partner's estimate of our aggregate liability for the quarter for such income taxes payable by reason of such legislation or interpretation. To the extent that the actual tax liability differs from the estimated tax liability for any quarter, the difference will be accounted for in subsequent quarters.

Table of Contents

Distributions of Cash Upon Liquidation

General. If we dissolve in accordance with the partnership agreement, we will sell or otherwise dispose of our assets in a process called liquidation. We will first apply the proceeds of liquidation to the payment of our creditors. We will distribute any remaining proceeds to the unitholders and the general partner, in accordance with their capital account balances, as adjusted to reflect any gain or loss upon the sale or other disposition of our assets in liquidation.

The allocations of gain and loss upon liquidation are intended, to the extent possible, to entitle the holders of outstanding common units to a preference over the holders of outstanding subordinated units upon our liquidation, to the extent required to permit common unitholders to receive their unrecovered initial unit price plus the minimum quarterly distribution for the quarter during which liquidation occurs plus any unpaid arrearages in payment of the minimum quarterly distribution on the common units. However, there may not be sufficient gain upon our liquidation to enable the holders of common units to fully recover all of these amounts, even though there may be cash available for distribution to the holders of subordinated units. Any further net gain recognized upon liquidation will be allocated in a manner that takes into account the incentive distribution rights of the general partner.

Manner of Adjustments for Gain. The manner of the adjustment for gain is set forth in the partnership agreement. If our liquidation occurs before the end of the subordination period, we will allocate any gain to the partners in the following manner:

First, to the general partner and the holders of units who have negative balances in their capital accounts to the extent of and in proportion to those negative balances;

Second, 98% to the common unitholders, pro rata, and 2% to the general partner, until the capital account for each common unit is equal to the sum of: (1) the unrecovered initial unit price; (2) the amount of the minimum quarterly distribution for the quarter during which our liquidation occurs; and (3) any unpaid arrearages in payment of the minimum quarterly distribution;

Third, 98% to the subordinated unitholders, pro rata, and 2% to the general partner until the capital account for each subordinated unit is equal to the sum of: (1) the unrecovered initial unit price; and (2) the amount of the minimum quarterly distribution for the quarter during which our liquidation occurs;

Fourth, 98% to all unitholders, pro rata, and 2% to the general partner, until we allocate under this paragraph an amount per unit equal to: (1) the sum of the excess of the first target distribution per unit over the minimum quarterly distribution per unit for each quarter of our existence; less (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the minimum quarterly distribution per unit that we distributed 98% to the unitholders, pro rata, and 2% to the general partner, for each quarter of our existence;

Fifth, 85% to all unitholders, pro rata, and 15% to the general partner, until we allocate under this paragraph an amount per unit equal to: (1) the sum of the excess of the second target distribution per unit over the first target distribution per unit for each quarter of our existence; less (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the first target distribution per unit that we distributed 85% to the unitholders, pro rata, and 15% to the general partner for each quarter of our existence;

Sixth, 75% to all unitholders, pro rata, and 25% to the general partner, until we allocate under this paragraph an amount per unit equal to: (1) the sum of the excess of the third target distribution per unit over the second target distribution per unit for each quarter of our existence; less (2) the cumulative amount per unit of any distributions of available cash from operating surplus in excess of the second target distribution per unit that we distributed 75% to the unitholders, pro rata, and 25% to the general partner for each quarter of our existence; and

Thereafter, 50% to all unitholders, pro rata, and 50% to the general partner.

Table of Contents

The percentage interests set forth above for our general partner include its 2% general partner interest and assume the general partner has not transferred the incentive distribution rights.

If the liquidation occurs after the end of the subordination period, the distinction between common units and subordinated units will disappear, so that clause (3) of the second bullet point above and all of the third bullet point above will no longer be applicable.

Manner of Adjustments for Losses. If our liquidation occurs before the end of the subordination period, we will generally allocate any loss to the general partner and the unitholders in the following manner:

First, 98% to holders of subordinated units in proportion to the positive balances in their capital accounts and 2% to the general partner, until the capital accounts of the subordinated unitholders have been reduced to zero;

Second, 98% to the holders of common units in proportion to the positive balances in their capital accounts and 2% to the general partner, until the capital accounts of the common unitholders have been reduced to zero; and

Thereafter, 100% to the general partner.

If the liquidation occurs after the end of the subordination period, the distinction between common units and subordinated units will disappear, so that all of the first bullet point above will no longer be applicable.

Adjustments to Capital Accounts. We will make adjustments to capital accounts upon the issuance of additional units. In doing so, we will allocate any unrealized and, for tax purposes, unrecognized gain or loss resulting from the adjustments to the unitholders and the general partner in the same manner as we allocate gain or loss upon liquidation. In the event that we make positive adjustments to the capital accounts upon the issuance of additional units, we will allocate any later negative adjustments to the capital accounts resulting from the issuance of additional units or upon our liquidation in a manner which results, to the extent possible, in the general partner's capital account balances equaling the amount which they would have been if no earlier positive adjustments to the capital accounts had been made.

Table of Contents

DESCRIPTION OF OUR PARTNERSHIP AGREEMENT

The following is a summary of the material provisions of our partnership agreement. Our amended and restated partnership agreement has been filed with the Commission. The following provisions of our partnership agreement are summarized elsewhere in this prospectus:

distributions of our available cash are described under Cash Distribution Policy;

allocations of taxable income and other matters are described under Material Tax Consequences; and

rights of holders of common units are described under Description of Our Common Units.

Unless otherwise noted, references in this Description of Our Partnership Agreement to subordinated units include both of Holly Energy Partners subordinated units and Class B subordinated units.

Purpose

Our purpose under our partnership agreement is to serve as the limited partner of our operating partnership and to engage in any business activities that may be engaged in by our operating partnership or that are approved by our general partner. The partnership agreement of our operating partnership provides that the operating partnership may, directly indirectly, engage in (i) its operations as conducted immediately before our initial public offering, (ii) any other activity approved by the general partner but only to the extent that the general partner determines that, as of the date of the acquisition or commencement of the activity, the activity generates qualifying income as this term is defined in Section 7704 of the Internal Revenue Code, or (iii) any activity that enhances the operations of an activity that is described in clause (i) or (ii).

Power of Attorney

Each limited partner, and each person who acquires a unit from a unitholder and executes and delivers a transfer application, grants to our general partner and, if appointed, a liquidator, a power of attorney to, among other things, execute and file documents required for our qualification, continuance or dissolution. The power of attorney also grants the authority for the amendment of, and to make consents and waivers under, our partnership agreement.

Reimbursements of Our General Partner

Our general partner does not receive any compensation for its services as our general partner. It is, however, entitled to be reimbursed for all of its costs incurred in managing and operating our business. Our partnership agreement provides that our general partner will determine the expenses that are allocable to us in any reasonable manner determined by our general partner in its sole discretion.

Issuance of Additional Securities

Our partnership agreement authorizes us to issue an unlimited number of additional partnership securities and rights to buy partnership securities for the consideration and on the terms and conditions determined by our general partner in its sole discretion without the approval of the unitholders. During the subordination periods, however, except as we discuss in the following paragraph, we may not issue equity securities ranking senior to the common units or an aggregate of more than 3,500,000 additional common units or units on a parity with the common units, in each case, without the approval of the holders of a unit majority.

Table of Contents

During or after the subordination period, we may issue an unlimited number of common units as follows:

upon conversion of the subordinated units;

under employee benefit plans;

upon conversion of the general partner interest and incentive distribution rights as a result of a withdrawal or removal of the general partner;

in connection with the conversion of units of equal rank with the common units into common units under certain circumstances;

in the event of a combination or subdivision of common units;

in connection with an acquisition or a capital improvement that increases cash flow from operations per unit on an estimated pro forma basis;

if the proceeds of the issuance are used to repay indebtedness the cost of which to service is greater than the distribution obligations associated with the units issued in connection with the debt's retirement; or

in connection with the redemption of common units if the net proceeds from the issuance of the new common units are used to redeem an equal number of common units outstanding at the time of such issuance, at a price per unit equal to the net proceeds per newly issued common unit, before expenses.

It is possible that we will fund acquisitions through the issuance of additional common units, subordinated units, Class B subordinated units or other equity securities. Holders of any additional common units, subordinated units, Class B subordinated units or other equity securities we issue may be entitled to share equally with the then-existing holders of such common units, subordinated units, Class B subordinated units or other equity securities in our cash distributions. In addition, the issuance of additional partnership interests may dilute the value of the interests of the then-existing holders of common units in our net assets.

In accordance with Delaware law and the provisions of our partnership agreement, we may also issue additional partnership interests that, in the sole discretion of our general partner, may have special voting rights to which common units are not entitled.

Upon issuance of additional partnership securities, the general partner will be required to make additional capital contributions to the extent necessary to maintain its 2% general partner interest in us. Moreover, the general partner will have the right, which it may from time to time assign in whole or in part to any of its affiliates, to purchase common units, subordinated units or other equity securities whenever, and on the same terms that, we issue those securities to persons other than the general partner and its affiliates, to the extent necessary to maintain its and its affiliates percentage interest, including its interest represented by common units and subordinated units, that existed immediately prior to each issuance. The holders of common units do not have preemptive rights to acquire additional common units or other partnership securities.

Amendments to Our Partnership Agreement

Amendments to our partnership agreement may be proposed only by, or with the consent of, our general partner, which consent may be given or withheld at its option, except as set forth in our partnership agreement. Any amendment that materially and adversely affects the rights or preferences of any type or class of limited partner interests in relation to other types or classes of limited partner interests or our general partner interest will require the approval of at least a majority of the type or class of limited partner interests or general partner interests so affected. However, in some circumstances, more particularly described in our partnership agreement, our general partner may make amendments to our partnership agreement without the approval of our limited partners or assignees.

Table of Contents

Withdrawal or Removal of Our General Partner

Except as described below, our general partner has agreed not to withdraw voluntarily as our general partner prior to June 30, 2014 without obtaining the approval of the holders of at least a majority of the outstanding common units, excluding common units held by the general partner and its affiliates, and furnishing an opinion of counsel regarding limited liability and tax matters. On or after June 30, 2014, our general partner may withdraw as general partner without first obtaining approval of any unitholder by giving 90 days written notice, and that withdrawal will not constitute a violation of the partnership agreement. Notwithstanding the information above, our general partner may withdraw without unitholder approval upon 90 days notice to the limited partners if at least 50% of the outstanding common units are held or controlled by one person and its affiliates other than the general partner and its affiliates. In addition, the partnership agreement permits our general partner in some instances to sell or otherwise transfer all of its general partner interest in us without the approval of the unitholders.

Upon withdrawal of our general partner under any circumstances, other than as a result of a transfer by the general partner of all or a part of its general partner interest in us, the holders of a majority of the outstanding common units and subordinated units, voting as separate classes, may select a successor to that withdrawing general partner. If a successor is not elected, or is elected but an opinion of counsel regarding limited liability and tax matters cannot be obtained, we will be dissolved, wound up, and liquidated, unless within a specified period of time after that withdrawal, the holders of a unit majority agree in writing to continue our business and to appoint a successor general partner.

Our general partner may not be removed unless that removal is approved by the vote of the holders of not less than 66²/₃% of our outstanding units, voting together as a single class, including units held by the general partner and its affiliates, and we receive an opinion of counsel regarding limited liability and tax matters. Any removal of our general partner is also subject to the approval of a successor general partner by the vote of the holders of a majority of the outstanding common units and subordinated units, voting as separate classes.

Our partnership agreement also provides that if our general partner is removed as our general partner under circumstances where cause does not exist and units held by the general partner and its affiliates are not voted in favor of that removal:

the subordination period will end and all outstanding subordinated units will immediately convert into common units on a one-for-one basis;

any existing arrearages in payment of the minimum quarterly distribution on the common units will be extinguished; and

the general partner will have the right to convert its general partner interest and its incentive distribution rights into common units or to receive cash in exchange for those interests based on the fair market value of the interests at the time.

In the event of removal of our general partner under circumstances where cause exists or withdrawal of the general partner where that withdrawal violates the partnership agreement, a successor general partner will have the option to purchase the general partner interest and incentive distribution rights of the departing general partner for a cash payment equal to the fair market value of those interests. Under all other circumstances where the general partner withdraws or is removed by the limited partners, the departing general partner will have the option to require the successor general partner to purchase the general partner interest of the departing general partner and its incentive distribution rights for their fair market value. In each case, this fair market value will be determined by agreement between the departing general partner and the successor general partner. If no agreement is reached, an independent investment banking firm or other independent expert selected by the departing general partner and the successor general partner will determine the fair market value. Or, if the departing general partner and the successor general partner cannot agree upon an expert, then an expert chosen by agreement of the experts selected by each of them will determine the fair market value.

Table of Contents

If the option described above is not exercised by either the departing general partner or the successor general partner, the departing general partner's general partner interest and its incentive distribution rights will automatically convert into common units equal to the fair market value of those interests as determined by an investment banking firm or other independent expert selected in the manner described in the preceding paragraph.

In addition, we will be required to reimburse the departing general partner for all amounts due the departing general partner, including, without limitation, all employee-related liabilities, including severance liabilities, incurred for the termination of any employees employed by the departing general partner or its affiliates for our benefit.

Liquidation and Distribution of Proceeds

Upon our dissolution, unless we are reconstituted and continued as a new limited partnership, the person authorized to wind up our affairs (the liquidator) will, acting with all the powers of our general partner that the liquidator deems necessary or desirable in its good faith judgment, liquidate our assets and apply the proceeds of the liquidation as provided in Cash Distribution Policy Distributions of Cash Upon Liquidation. The liquidator may defer liquidation or distribution of our assets for a reasonable period or distribute assets to partners in kind if it determines that a sale would be impractical or would cause undue loss to the partners.

Transfer of General Partner Interests

Except for transfer by our general partner of all, but not less than all, of its general partner interest in us to:

an affiliate of the general partner (other than an individual), or

another entity as part of the merger or consolidation of the general partner with or into another entity or the transfer by the general partner of all or substantially all of its assets to another entity.

our general partner may not transfer all or any part of its general partner interest in us to another person prior to June 30, 2014 without the approval of the holders of at least a majority of the outstanding common units, excluding common units held by the general partner and its affiliates. As a condition of this transfer, the transferee must, among other things, assume the rights and duties of the general partner, agree to be bound by the provisions of the partnership agreement, and furnish an opinion of counsel regarding limited liability and tax matters.

Our general partner and its affiliates may at any time transfer units to one or more persons, without unitholder approval, except that they may not transfer subordinated units to us.

Transfer of Ownership Interests in Our General Partner and in Holly Logistic Services, L.L.C.

At any time, the partners of our general partner and the members of Holly Logistic Services, L.L.C. may sell or transfer all or part of their respective partnership or membership interests in our general partner or Holly Logistic Services, L.L.C. to an affiliate or a third party without the approval of our unitholders.

Transfer of Incentive Distribution Rights

Our general partner or its affiliates or a subsequent holder may transfer its incentive distribution rights to an affiliate of the holder (other than an individual) or another entity as part of the merger or consolidation of such holder with or into another entity, or sale of all or substantially all of its assets to, that entity without the prior approval of the unitholders. Prior to June 30, 2014, other transfers of the incentive distribution rights will require the affirmative vote of holders of a majority of the outstanding common units excluding common units held by the general partner and its affiliates. On or after June 30, 2014, the incentive distribution rights will be freely transferable.

Table of Contents

Change of Management Provisions

Our partnership agreement contains specific provisions that are intended to discourage a person or group from attempting to remove HEP Logistics Holdings, L.P. as our general partner or otherwise change management. If any person or group other than the general partner and its affiliates acquires beneficial ownership of 20% or more of any class of units, that person or group loses voting rights on all of its units. This loss of voting rights does not apply to any person or group that acquires the units from our general partner or its affiliates and any transferees of that person or group approved by our general partner or to any person or group who acquires the units with the prior approval of the board of directors.

The partnership agreement also provides that if the general partner is removed under circumstances where cause does not exist and units held by the general partner and its affiliates are not voted in favor of that removal:

the subordination period will end and all outstanding subordinated units will immediately convert into common units on a one-for-one basis;

any existing arrearages in payment of the minimum quarterly distribution on the common units will be extinguished; and

the general partner will have the right to convert its general partner interest and its incentive distribution rights into common units or to receive cash in exchange for those interests.

Limited Call Right

If at any time the general partner and its affiliates hold more than 80% of the then-issued and outstanding partnership securities of any class, the general partner will have the right, which it may assign in whole or in part to any of its affiliates or to us, to acquire all, but not less than all, of the remaining partnership securities of the class held by unaffiliated persons as of a record date to be selected by the general partner, on at least ten but not more than 60 days notice. The purchase price in the event of this purchase is the greater of: (1) the highest cash price paid by either of the general partner or any of its affiliates for any partnership securities of the class purchased within the 90 days preceding the date on which the general partner first mails notice of its election to purchase those partnership securities; and (2) the current market price as of the date three days before the date the notice is mailed.

As a result of the general partner's right to purchase outstanding partnership securities, a holder of partnership securities may have his partnership securities purchased at an undesirable time or price. The tax consequences to a unitholder of the exercise of this call right are the same as a sale by that unitholder of his common units in the market. Please read **Material Tax Consequences – Disposition of Common Units**.

Indemnification

Under our partnership agreement, in most circumstances, we will indemnify the following persons, to the fullest extent permitted by law, from and against all losses, claims, damages, or similar events:

our general partner;

the general partner of our general partner;

any departing general partner;

any person who is or was an affiliate of the general partner of our general partner or any departing general partner;

any person who is or was an officer, director, member or partner of any entity described in the first four bullet-points above; or

any person designated by the general partner of the general partner.

Table of Contents

Any indemnification under these provisions will only be out of our assets. Unless it otherwise agrees, the general partner will not be personally liable for, or have any obligation to contribute or loan funds or assets to us to enable us to effectuate, indemnification. We may purchase insurance against liabilities asserted against and expenses incurred by persons for our activities, regardless of whether we would have the power to indemnify the person against liabilities under the partnership agreement.

Registration Rights

Under our partnership agreement, we have agreed to register for resale under the Securities Act and applicable state securities laws any common units, subordinated units or other partnership securities proposed to be sold by our general partner or any of its affiliates or their assignees if an exemption from the registration requirements is not otherwise available. These registration rights continue for two years following any withdrawal or removal of HEP Logistics Holdings, L.P. as our general partner. We are obligated to pay all expenses incidental to the registration, excluding underwriting discounts and commissions.

Table of Contents

CONFLICTS OF INTEREST AND FIDUCIARY DUTIES

Conflicts of Interest

Conflicts of interest exist and may arise in the future as a result of the relationships between our general partner and its affiliates, including Holly Corporation, on the one hand, and us and our limited partners, on the other hand. The directors and officers of the general partner of our general partner, Holly Logistic Services, L.L.C., have fiduciary duties to manage the general partner in a manner beneficial to its owners. At the same time, our general partner has a fiduciary duty to manage us in a manner beneficial to us and our unitholders.

Whenever a conflict arises between our general partner or its affiliates, on the one hand, and us or any other partner, on the other, our general partner will resolve that conflict. Our partnership agreement contains provisions that modify and limit our general partner's fiduciary duties to the unitholders. Our partnership agreement also restricts the remedies available to unitholders for actions taken that, without those limitations, might constitute breaches of fiduciary duty.

Our general partner will not be in breach of its obligations under the partnership agreement or its duties to us or our unitholders if the resolution of the conflict is:

approved by the conflicts committee, although our general partner is not obligated to seek such approval;

approved by the vote of a majority of the outstanding common units, excluding any common units owned by our general partner or any of its affiliates;

on terms no less favorable to us than those generally being provided to or available from unrelated third parties; or

fair and reasonable to us, taking into account the totality of the relationships between the parties involved, including other transactions that may be particularly favorable or advantageous to us.

Our general partner may, but is not required to, seek the approval of such resolution from the conflicts committee of the board of directors of Holly Logistic Services, L.L.C. If our general partner does not seek approval from the conflicts committee and the board of directors of Holly Logistic Services, L.L.C. determines that the resolution or course of action taken with respect to the conflict of interest satisfies either of the standards set forth in the third and fourth bullet points above, then the resolution or course of action taken by the general partner will be permitted and deemed approved by the unitholders and will not constitute a breach of its obligations under the partnership agreement or its duties to us or the unitholders. Unless the resolution of a conflict is specifically provided for in our partnership agreement, our general partner or the conflicts committee may consider any factors it determines in good faith to consider when resolving a conflict. When our partnership agreement requires someone to act in good faith, it requires that person to reasonably believe that he is acting in the best interests of the partnership, unless the context otherwise requires.

Conflicts of interest could arise in the situations described below, among others.

Actions taken by our general partner may affect the amount of cash available for distribution to unitholders or accelerate the right to convert subordinated units.

The amount of cash that is available for distribution to unitholders is affected by decisions of our general partner regarding such matters as:

amount and timing of asset purchases and sales;

cash expenditures;

borrowings;

Table of Contents

issuance of additional units; and

the creation, reduction, or increase of reserves in any quarter.

In addition, borrowings by us and our affiliates do not constitute a breach of any duty owed by the general partner to our unitholders, including borrowings that have the purpose or effect of:

enabling our general partner or its affiliates to receive distributions on any subordinated units held by them or the incentive distribution rights; or

hastening the expiration of the subordination period.

For example, in the event we have not generated sufficient cash from our operations to pay the minimum quarterly distribution on our common units and our subordinated units, our partnership agreement permits us to borrow funds, which would enable us to make this distribution on all outstanding units.

Our partnership agreement provides that we and our subsidiaries may borrow funds from our general partner and its affiliates. Our general partner and its affiliates may not borrow funds from us, our operating partnership, or its operating subsidiaries, other than in connection with Holly Corporation's centralized cash management program.

We do not have any officers or employees and rely solely on officers and employees of Holly Logistic Services, L.L.C. and its affiliates.

Affiliates of Holly Logistic Services, L.L.C. conduct businesses and activities of their own in which we have no economic interest. If these separate activities are significantly greater than our activities, there could be material competition for the time and effort of the officers and employees who provide services to Holly Logistic Services, L.L.C. The officers of Holly Logistic Services, L.L.C. are not required to work full time on our affairs. These officers are required to devote time to the affairs of Holly Corporation or its affiliates and are compensated by them for the services rendered to them.

We will reimburse the general partner and its affiliates for expenses.

We will reimburse the general partner and its affiliates for costs incurred in managing and operating us, including costs incurred in rendering corporate staff and support services to us. Our partnership agreement provides that the general partner will determine the expenses that are allocable to us in good faith.

Our general partner intends to limit its liability regarding our obligations.

Our general partner intends to limit its liability under contractual arrangements so that the other party has recourse only to our assets and not against the general partner or its assets or any affiliate of the general partner or its assets. Our partnership agreement provides that any action taken by our general partner to limit its or our liability is not a breach of the general partner's fiduciary duties, even if we could have obtained terms that are more favorable without the limitation on liability.

Common unitholders will have no right to enforce obligations of our general partner and its affiliates under agreements with us.

Any agreements between us, on the one hand, and our general partner and its affiliates, on the other, will not grant to the unitholders, separate and apart from us, the right to enforce the obligations of our general partner and its affiliates in our favor.

Table of Contents

Contracts between us, on the one hand, and our general partner and its affiliates, on the other, will not be the result of arm s-length negotiations.

Our partnership agreement allows our general partner to determine, in good faith, any amounts to pay itself or its affiliates for any services rendered to us. Our general partner may also enter into additional contractual arrangements with any of its affiliates on our behalf. Neither our partnership agreement nor any of the other agreements, contracts, and arrangements between us and the general partner and its affiliates are or will be the result of arm s-length negotiations. However, any of these transactions are to be on terms that are fair and reasonable to us.

Our general partner and its affiliates will have no obligation to permit us to use any facilities or assets of the general partner and its affiliates, except as may be provided in contracts entered into specifically dealing with that use. There is no obligation of our general partner and its affiliates to enter into any contracts of this kind.

Common units are subject to our general partner s limited call right.

Our general partner may exercise its right to call and purchase common units as provided in the partnership agreement or assign this right to one of its affiliates or to us. Our general partner may use its own discretion, free of fiduciary duty restrictions, in determining whether to exercise this right. As a result, a common unitholder may have his common units purchased from him at an undesirable time or price.

We may not choose to retain separate counsel for ourselves or for the holders of common units.

The attorneys, independent accountants, and others who perform services for us have been retained by our general partner. Attorneys, independent accountants, and others who perform services for us are selected by our general partner or the conflicts committee and may perform services for our general partner and its affiliates. We may retain separate counsel for ourselves or the holders of common units in the event of a conflict of interest between our general partner and its affiliates, on the one hand, and us or the holders of common units, on the other, depending on the nature of the conflict. We do not intend to do so in most cases.

Our general partner s affiliates may compete with us.

Our partnership agreement provides that our general partner will be restricted from engaging in any business activities other than those incidental to its ownership of interests in us and certain services the employees of our general partner are currently providing to Holly Corporation and its affiliates. Except as provided in our partnership agreement and the omnibus agreement among us, Holly Corporation and our general partner, affiliates of our general partner are not prohibited from engaging in other businesses or activities, including those that might be in direct competition with us.

Fiduciary Duties

Our general partner is accountable to us and our unitholders as a fiduciary. Fiduciary duties owed to unitholders by our general partner are prescribed by law and the partnership agreement. The Delaware Revised Uniform Limited Partnership Act, which we refer to in this prospectus as the Delaware Act, provides that Delaware limited partnerships may, in their partnership agreements, restrict or expand the fiduciary duties owed by a general partner to limited partners and the partnership.

Table of Contents

Our partnership agreement contains various provisions restricting the fiduciary duties that might otherwise be owed by our general partner. These modifications are detrimental to the common unitholders because they restrict the remedies available to unitholders for actions that, without those limitations, might constitute breaches of fiduciary duty, as described below. The following is a summary of the material restrictions of the fiduciary duties owed by our general partner to the limited partners:

State law fiduciary duty standards

Fiduciary duties are generally considered to include an obligation to act in good faith and with due care and loyalty. The duty of care, in the absence of a provision in a partnership agreement providing otherwise, would generally require a general partner to act for the partnership in the same manner as a prudent person would act on his own behalf. The duty of loyalty, in the absence of a provision in a partnership agreement providing otherwise, would generally prohibit a general partner of a Delaware limited partnership from taking any action or engaging in any transaction where a conflict of interest is present.

The Delaware Act generally provides that a limited partner may institute legal action on behalf of the partnership to recover damages from a third party where a general partner has refused to institute the action or where an effort to cause a general partner to do so is not likely to succeed. In addition, the statutory or case law of some jurisdictions may permit a limited partner to institute legal action on behalf of himself and all other similarly situated limited partners to recover damages from a general partner for violations of its fiduciary duties to the limited partners.

Partnership agreement modified standards

Our partnership agreement contains provisions that waive or consent to conduct by our general partner and its affiliates that might otherwise raise issues as to compliance with fiduciary duties or applicable law. For example, our partnership agreement provides that when our general partner is acting in its capacity as our general partner, as opposed to in its individual capacity, it must act in good faith and will not be subject to any other standard under applicable law. In addition, when our general partner is acting in its individual capacity, as opposed to in its capacity as our general partner, it may act without any fiduciary obligation to us or the unitholders whatsoever. These standards reduce the obligations to which the general partner would otherwise be held.

Our partnership agreement generally provides that affiliated transactions and resolutions of conflicts of interest not involving a vote of unitholders and that are not approved by the conflicts committee of the board of directors of our general partner's general partner must be:

on terms no less favorable to us than those generally being provided to or available from unrelated third parties; or

Table of Contents

fair and reasonable to us, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to us).

If our general partner does not seek approval from the conflicts committee and the board of directors of our general partner's general partner determines that the resolution or course of action taken with respect to the conflict of interest satisfies either of the standards set forth in the bullet points above, then the resolution or course of action taken by the general partner will be permitted and deemed approved by the unitholders and will not constitute a breach of its obligations under the partnership agreement or its duties to us or the unitholders. These standards reduce the obligations to which our general partner would otherwise be held.

In addition to the other more specific provisions limiting the obligations of our general partner, our partnership agreement further provides that our general partner, its general partner and its officers and directors will not be liable for monetary damages to us, our limited partners, or assignees for errors of judgment or for any acts or omissions unless there has been a final and non-appealable judgment by a court of competent jurisdiction determining that the general partner or its officers and directors acted in bad faith or engaged in fraud, willful misconduct or gross negligence.

In order to become one of our limited partners, a common unitholder is required to agree to be bound by the provisions in the partnership agreement, including the provisions discussed above. This is in accordance with the policy of the Delaware Act favoring the principle of freedom of contract and the enforceability of partnership agreements. The failure of a limited partner or assignee to sign a partnership agreement does not render the partnership agreement unenforceable against that person.

We must indemnify our general partner and Holly Logistic Services, L.L.C. and their officers, directors, and managers, to the fullest extent permitted by law, against liabilities, costs and expenses incurred by the general partner, Holly Logistic Services, L.L.C. or these other persons. We must provide this indemnification unless there has been a final and non-appealable judgment by a court of competent jurisdiction determining that these persons acted in bad faith or engaged in fraud, willful misconduct or gross negligence. We also must provide this indemnification for criminal proceedings unless our general partner, Holly Logistic Services, L.L.C. or these other persons acted with knowledge that their conduct was unlawful. Thus, our general partner and Holly Logistic Services, L.L.C. could be indemnified for their negligent acts if they met requirements set forth above. To the extent that these provisions purport to include indemnification for liabilities arising under the Securities Act, in the opinion of the Securities and Exchange Commission, such indemnification is contrary to public policy and therefore unenforceable.

Table of Contents**MATERIAL TAX CONSEQUENCES**

This section is a summary of the material tax consequences that may be relevant to prospective unitholders who are individual citizens or residents of the United States and, unless otherwise noted in the following discussion, represents the opinion of Vinson & Elkins L.L.P., special counsel to the general partner and us, insofar as it relates to matters of United States federal income tax law matters. This section is based upon current provisions of the Internal Revenue Code, existing and proposed regulations and current administrative rulings and court decisions, all of which are subject to change. Later changes in these authorities may cause the tax consequences to vary substantially from the consequences described below.

The following discussion does not comment on all federal income tax matters affecting us or the unitholders. Moreover, the discussion focuses on unitholders who are individual citizens or residents of the United States and has only limited application to corporations, estates, trusts, nonresident aliens or other unitholders subject to specialized tax treatment, such as tax-exempt institutions, foreign persons, individual retirement accounts (IRAs), real estate investment trusts (REITs) or mutual funds. Accordingly, we recommend that each prospective unitholder consult, and depend on, his own tax advisor in analyzing the federal, state, local and foreign tax consequences particular to him of the ownership or disposition of common units.

All statements as to matters of law and legal conclusions, but not as to factual matters, contained in this section, unless otherwise noted, are the opinion of Vinson & Elkins L.L.P. and are based on the accuracy of the representations made by us.

No ruling has been or will be requested from the IRS regarding any matter affecting us or prospective unitholders. Instead, we will rely on opinions and advice of Vinson & Elkins L.L.P. Unlike a ruling, an opinion of counsel represents only that counsel's best legal judgment and does not bind the IRS or the courts. Accordingly, the opinions and statements made here may not be sustained by a court if contested by the IRS. Any contest of this sort with the IRS may materially and adversely impact the market for the common units and the prices at which common units trade. In addition, the costs of any contest with the IRS will be borne directly or indirectly by the unitholders and the general partner. Furthermore, the tax treatment of us, or of an investment in us, may be significantly modified by future legislative or administrative changes or court decisions. Any modifications may or may not be retroactively applied.

For the reasons described below, Vinson & Elkins L.L.P. has not rendered an opinion with respect to the following specific federal income tax issues:

- (1) the treatment of a unitholder whose common units are loaned to a short seller to cover a short sale of common units (please read [Tax Consequences of Unit Ownership – Treatment of Short Sales](#));
- (2) whether our monthly convention for allocating taxable income and losses is permitted by existing Treasury Regulations (please read [Disposition of Common Units – Allocations Between Transferors and Transferees](#)); and
- (3) whether our method for depreciating Section 743 adjustments is sustainable (please read [Tax Consequences of Unit Ownership – Section 754 Election](#)).

Partnership Status

A partnership is not a taxable entity and incurs no federal income tax liability. Instead, each partner of a partnership is required to take into account his share of items of income, gain, loss and deduction of the partnership in computing his federal income tax liability, regardless of whether cash distributions are made to him by the partnership. Distributions by a partnership to a partner are generally not taxable unless the amount of cash distributed is in excess of the partner's adjusted basis in his partnership interest.

Section 7704 of the Internal Revenue Code provides that publicly-traded partnerships will, as a general rule, be taxed as corporations. However, an exception, referred to as the [Qualifying Income](#)

Table of Contents

Exception, exists with respect to a publicly-traded partnership of which 90% or more of the gross income for every taxable year consists of qualifying income. Qualifying income includes income and gains derived from the transportation, storage and processing of crude oil, natural gas and products thereof. Other types of qualifying income include interest other than from a financial business, dividends, gains from the sale of real property and gains from the sale or other disposition of assets held for the production of income that otherwise constitutes qualifying income. We estimate that less than 3% of our current gross income is not qualifying income; however, this estimate could change from time to time. Based upon and subject to this estimate, the factual representations made by us and the general partner and a review of the applicable legal authorities, Vinson & Elkins L.L.P. is of the opinion that at least 90% of our current gross income constitutes qualifying income.

No ruling has been or will be sought from the IRS and the IRS has made no determination as to our status as a partnership for federal income tax purposes. Instead, we will rely on the opinion of Vinson & Elkins L.L.P. that, based upon the Internal Revenue Code, its regulations, published revenue rulings and court decisions and the representations described below, we (together with the operating partnership and its subsidiaries) will be classified as a partnership for federal income tax purposes.

In rendering its opinion, Vinson & Elkins L.L.P. has relied on factual representations made by us and the general partner. The representations made by us and our general partner upon which Vinson & Elkins L.L.P. has relied are:

(a) Neither we, the general partner of the operating partnership nor the operating partnership has elected or will elect to be treated as a corporation for federal income tax purposes; and

(b) For each taxable year, more than 90% of our gross income has been and will be income that Vinson & Elkins L.L.P. has opined or will opine is qualifying income within the meaning of Section 7704(d) of the Internal Revenue Code.

If we fail to meet the Qualifying Income Exception, other than a failure that is determined by the IRS to be inadvertent and that is cured within a reasonable time after discovery, we will be treated as if we had transferred all of our assets, subject to liabilities, to a newly formed corporation, on the first day of the year in which we fail to meet the Qualifying Income Exception, in return for stock in that corporation, and then distributed that stock to the unitholders in liquidation of their interests in us. This contribution and liquidation should be tax-free to unitholders and us so long as we, at that time, do not have liabilities in excess of the tax basis of our assets. Thereafter, we would be treated as a corporation for federal income tax purposes.

If we were taxable as a corporation in any taxable year, either as a result of a failure to meet the Qualifying Income Exception or otherwise, our items of income, gain, loss and deduction would be reflected only on our tax return rather than being passed through to the unitholders, and our net income would be taxed to us at corporate rates. In addition, any distribution made to a unitholder would be treated as either taxable dividend income, to the extent of our current or accumulated earnings and profits, or, in the absence of earnings and profits, a nontaxable return of capital, to the extent of the unitholder's tax basis in his common units, or taxable capital gain, after the unitholder's tax basis in his common units is reduced to zero. Accordingly, taxation as a corporation would result in a material reduction in a unitholder's cash flow and after-tax return and thus would likely result in a substantial reduction of the value of the units.

The discussion below is based on Vinson & Elkins L.L.P.'s opinion that we will be classified as a partnership for federal income tax purposes.

Table of Contents

Limited Partner Status

Unitholders who have become limited partners of Holly Energy Partners will be treated as partners of Holly Energy Partners for federal income tax purposes. Also:

(a) assignees who have executed and delivered transfer applications, and are awaiting admission as limited partners, and

(b) unitholders whose common units are held in street name or by a nominee and who have the right to direct the nominee in the exercise of all substantive rights attendant to the ownership of their common units, will be treated as partners of Holly Energy Partners for federal income tax purposes. As there is no direct authority addressing assignees of common units who are entitled to execute and deliver transfer applications and thereby become entitled to direct the exercise of attendant rights, but who fail to execute and deliver transfer applications, Vinson & Elkins L.L.P.'s opinion does not extend to these persons. Furthermore, a purchaser or other transferee of common units who does not execute and deliver a transfer application may not receive some federal income tax information or reports furnished to record holders of common units unless the common units are held in a nominee or street name account and the nominee or broker has executed and delivered a transfer application for those common units.

A beneficial owner of common units whose units have been transferred to a short seller to complete a short sale would appear to lose his status as a partner with respect to those units for federal income tax purposes. Please read *Tax Consequences of Unit Ownership – Treatment of Short Sales*.

Income, gains, deductions or losses would not appear to be reportable by a unitholder who is not a partner for federal income tax purposes, and any cash distributions received by a unitholder who is not a partner for federal income tax purposes would therefore be fully taxable as ordinary income. Prospective unitholders are urged to consult with their own tax advisors with respect to their status as partners in Holly Energy Partners for federal income tax purposes.

Tax Consequences of Unit Ownership

Flow-through of Taxable Income. We will not pay any federal income tax. Instead, each unitholder will be required to report on his income tax return his share of our income, gains, losses and deductions without regard to whether corresponding cash distributions are received by him. Consequently, we may allocate income to a unitholder even if he has not received a cash distribution. Each unitholder will be required to include in income his allocable share of our income, gains, losses and deductions for our taxable year ending with or within his taxable year.

Treatment of Distributions. Distributions by us to a unitholder generally will not be taxable to the unitholder for federal income tax purposes to the extent of his tax basis in his common units immediately before the distribution. Our cash distributions in excess of a unitholder's tax basis generally will be considered to be gain from the sale or exchange of the common units, taxable in accordance with the rules described under *Disposition of Common Units* below. Any reduction in a unitholder's share of our liabilities for which no partner, including the general partner, bears the economic risk of loss, known as nonrecourse liabilities, will be treated as a distribution of cash to that unitholder. To the extent our distributions cause a unitholder's at risk amount to be less than zero at the end of any taxable year, he must recapture any losses deducted in previous years. Please read *Limitations on Deductibility of Losses*.

A decrease in a unitholder's percentage interest in us because of our issuance of additional common units will decrease his share of our nonrecourse liabilities, and thus will result in a corresponding deemed distribution of cash. A non-pro rata distribution of money or property may result in ordinary income to a unitholder, regardless of his tax basis in his common units, if the distribution reduces the unitholder's share of our unrealized receivables, including depreciation recapture, and/or substantially appreciated inventory items, both as defined in the Internal Revenue Code, and collectively, *Section 751 Assets*.

Table of Contents

To that extent, he will be treated as having been distributed his proportionate share of the Section 751 Assets and having exchanged those assets with us in return for the non-pro rata portion of the actual distribution made to him. This latter deemed exchange will generally result in the unitholder's realization of ordinary income, which will equal the excess of (1) the non-pro rata portion of that distribution over (2) the unitholder's tax basis for the share of Section 751 Assets deemed relinquished in the exchange.

Basis of Common Units. A unitholder's initial tax basis for his common units will be the amount he paid for the common units plus his share of our nonrecourse liabilities. That basis will be increased by his share of our income and by any increases in his share of our nonrecourse liabilities. That basis will be decreased, but not below zero, by distributions from us, by the unitholder's share of our losses, by any decreases in his share of our nonrecourse liabilities and by his share of our expenditures that are not deductible in computing taxable income and are not required to be capitalized. A unitholder will have no share of our debt which is recourse to the general partner, but will have a share, generally based on his share of profits, of our nonrecourse liabilities. Please read *Disposition of Common Units - Recognition of Gain or Loss*.

Limitations on Deductibility of Losses. The deduction by a unitholder of his share of our losses will be limited to the tax basis in his units and, in the case of an individual unitholder or a corporate unitholder, if more than 50% of the value of the corporate unitholder's stock is owned directly or indirectly by five or fewer individuals or some tax-exempt organizations, to the amount for which the unitholder is considered to be at risk with respect to our activities, if that is less than his tax basis. A unitholder must recapture losses deducted in previous years to the extent that distributions cause his at risk amount to be less than zero at the end of any taxable year. Losses disallowed to a unitholder or recaptured as a result of these limitations will carry forward and will be allowable to the extent that his tax basis or at risk amount, whichever is the limiting factor, is subsequently increased. Upon the taxable disposition of a unit, any gain recognized by a unitholder can be offset by losses that were previously suspended by the at risk limitation but may not be offset by losses suspended by the basis limitation. Any excess loss above that gain previously suspended by the at risk or basis limitations is no longer utilizable.

In general, a unitholder will be at risk to the extent of the tax basis of his units, excluding any portion of that basis attributable to his share of our nonrecourse liabilities, reduced by any amount of money he borrows to acquire or hold his units, if the lender of those borrowed funds owns an interest in us, is related to the unitholder or can look only to the units for repayment. A unitholder's at risk amount will increase or decrease as the tax basis of the unitholder's units increases or decreases, other than tax basis increases or decreases attributable to increases or decreases in his share of our nonrecourse liabilities.

The passive loss limitations generally provide that individuals, estates, trusts and some closely-held corporations and personal service corporations can deduct losses from passive activities, which are generally corporate or partnership activities in which the taxpayer does not materially participate, only to the extent of the taxpayer's income from those passive activities. The passive loss limitations are applied separately with respect to each publicly-traded partnership. Consequently, any passive losses we generate will be available to offset only our passive income generated in the future and will not be available to offset income from other passive activities or investments, including our investments or investments in other publicly-traded partnerships, or salary or active business income. Passive losses that are not deductible because they exceed a unitholder's share of income we generate may be deducted in full when he disposes of his entire investment in us in a fully taxable transaction with an unrelated party. The passive activity loss rules are applied after other applicable limitations on deductions, including the at risk rules and the basis limitation.

A unitholder's share of our net income may be offset by any suspended passive losses, but it may not be offset by any other current or carryover losses from other passive activities, including those attributable to other publicly-traded partnerships.

Table of Contents

Limitations on Interest Deductions. The deductibility of a non-corporate taxpayer's investment interest expense is generally limited to the amount of that taxpayer's net investment income. Investment interest expense includes:

interest on indebtedness properly allocable to property held for investment;

our interest expense attributed to portfolio income; and

the portion of interest expense incurred to purchase or carry an interest in a passive activity to the extent attributable to portfolio income.

The computation of a unitholder's investment interest expense will take into account interest on any margin account borrowing or other loan incurred to purchase or carry a unit. Net investment income includes gross income from property held for investment and amounts treated as portfolio income under the passive loss rules, less deductible expenses, other than interest, directly connected with the production of investment income, but generally does not include gains attributable to the disposition of property held for investment. The IRS has indicated that net passive income earned by a publicly-traded partnership will be treated as investment income to its unitholders. In addition, the unitholder's share of our portfolio income will be treated as investment income.

Entity-Level Collections. If we are required or elect under applicable law to pay any federal, state, local or foreign income tax on behalf of any unitholder or the general partner or any former unitholder, we are authorized to pay those taxes from our funds. That payment, if made, will be treated as a distribution of cash to the partner on whose behalf the payment was made. If the payment is made on behalf of a person whose identity cannot be determined, we are authorized to treat the payment as a distribution to all current unitholders. We are authorized to amend the partnership agreement in the manner necessary to maintain uniformity of intrinsic tax characteristics of units and to adjust later distributions, so that after giving effect to these distributions, the priority and characterization of distributions otherwise applicable under the partnership agreement is maintained as nearly as is practicable. Payments by us as described above could give rise to an overpayment of tax on behalf of an individual partner in which event the partner would be required to file a claim in order to obtain a credit or refund.

Allocation of Income, Gain, Loss and Deduction. In general, if we have a net profit, our items of income, gain, loss and deduction will be allocated among the general partner and the unitholders in accordance with their percentage interests in us. At any time that distributions are made to the common units in excess of distributions to the subordinated units, or incentive distributions are made to the general partner, gross income will be allocated to the recipients to the extent of these distributions. If we have a net loss for the entire year, that loss will be allocated first to the general partner and the unitholders in accordance with their percentage interests in us to the extent of their positive capital accounts and, second, to the general partner.

Specified items of our income, gain, loss and deduction will be allocated to account for the difference between the tax basis and fair market value of property contributed to us by the general partner and its affiliates, referred to in this discussion as Contributed Property. The effect of these allocations to a unitholder purchasing common units in an offering will be essentially the same as if the tax basis of our assets were equal to their fair market value at the time of the offering. In addition, items of recapture income will be allocated to the extent possible to the partner who was allocated the deduction giving rise to the treatment of that gain as recapture income in order to minimize the recognition of ordinary income by some unitholders. Finally, although we do not expect that our operations will result in the creation of negative capital accounts, if negative capital accounts nevertheless result, items of our income and gain will be allocated in an amount and manner to eliminate the negative balance as quickly as possible.

An allocation of items of our income, gain, loss or deduction, other than an allocation required by the Internal Revenue Code to eliminate the difference between a partner's book capital account, credited with the fair market value of Contributed Property, and tax capital account, credited with the tax basis of Contributed Property, referred to in this discussion as the Book-Tax Disparity, will generally be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or

Table of Contents

deduction only if the allocation has substantial economic effect. In any other case, a partner's share of an item will be determined on the basis of his interest in us, which will be determined by taking into account all the facts and circumstances, including:

his relative contributions to us;

the interests of all the partners in profits and losses;

the interest of all the partners in cash flow and other nonliquidating distributions; and

the rights of all the partners to distributions of capital upon liquidation.

Vinson & Elkins L.L.P. is of the opinion that, with the exception of the issues described in *Tax Consequences of Unit Ownership Section 754 Election and Disposition of Common Units Allocations Between Transferors and Transferees*, allocations under our partnership agreement will be given effect for federal income tax purposes in determining a partner's share of an item of income, gain, loss or deduction.

Treatment of Short Sales. A unitholder whose units are loaned to a short seller to cover a short sale of units may be considered as having disposed of those units. If so, he would no longer be a partner for those units during the period of the loan and may recognize gain or loss from the disposition. As a result, during this period:

any of our income, gain, loss or deduction with respect to those units would not be reportable by the unitholder;

any cash distributions received by the unitholder as to those units would be fully taxable; and

all of these distributions would appear to be ordinary income.

Vinson & Elkins L.L.P. has not rendered an opinion regarding the treatment of a unitholder whose common units are loaned to a short seller to cover a short sale of common units; therefore, unitholders desiring to assure their status as partners and avoid the risk of gain recognition from a loan to a short seller are urged to modify any applicable brokerage account agreements to prohibit their brokers from borrowing their units. The IRS has announced that it is actively studying issues relating to the tax treatment of short sales of partnership interests. Please also read

Disposition of Common Units Recognition of Gain or Loss.

Alternative Minimum Tax. Each unitholder will be required to take into account his distributive share of any items of our income, gain, loss or deduction for purposes of the alternative minimum tax. The current minimum tax rate for noncorporate taxpayers is 26% on the first \$175,000 of alternative minimum taxable income in excess of the exemption amount and 28% on any additional alternative minimum taxable income. We strongly recommend that prospective unitholders consult with their tax advisors as to the impact of an investment in units on their liability for the alternative minimum tax.

Tax Rates. In general the highest effective United States federal income tax rate for individuals currently is 35.0% and the maximum United States federal income tax rate for net capital gains of an individual is currently 15.0% if the asset disposed of was held for more than 12 months at the time of disposition.

Section 754 Election. We have made the election permitted by Section 754 of the Internal Revenue Code. That election is irrevocable without the consent of the IRS. The election generally permits us to adjust a common unit purchaser's tax basis in our assets (inside basis) under Section 743(b) of the Internal Revenue Code to reflect his purchase price. This election does not apply to a person who purchases common units directly from us. The Section 743(b) adjustment belongs to the purchaser and not to other unitholders. For purposes of this discussion, a unitholder's inside basis in our assets will be considered to have two components: (1) his share of our tax basis in our assets (common basis) and (2) his Section 743(b) adjustment to that basis.

Table of Contents

Treasury regulations under Section 743 of the Internal Revenue Code require that, if the remedial allocation method is adopted (which we have adopted), a portion of the Section 743(b) adjustment attributable to recovery property be depreciated over the remaining cost recovery period for the Section 704(c) built-in gain. Under Treasury regulation Section 1.167(c)-1(a)(6), a Section 743(b) adjustment attributable to property subject to depreciation under Section 167 of the Internal Revenue Code, rather than cost recovery deductions under Section 168, is generally required to be depreciated using either the straight-line method or the 150% declining balance method. Under our partnership agreement, our general partner is authorized to take a position to preserve the uniformity of units even if that position is not consistent with these Treasury Regulations. Please read *Tax Treatment of Operations* and *Uniformity of Units*.

Although Vinson & Elkins L.L.P. is unable to opine as to the validity of this approach because there is no clear authority on this issue, we intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the common basis of the property, or treat that portion as non-amortizable to the extent attributable to property the common basis of which is not amortizable. This method is consistent with the regulations under Section 743 of the Internal Revenue Code but is arguably inconsistent with Treasury regulation Section 1.167(c)-1(a)(6), which is not expected to directly apply to a material portion of our assets. To the extent this Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury regulations and legislative history. If we determine that this position cannot reasonably be taken, we may take a depreciation or amortization position under which all purchasers acquiring units in the same month would receive depreciation or amortization, whether attributable to common basis or a Section 743(b) adjustment, based upon the same applicable rate as if they had purchased a direct interest in our assets. This kind of aggregate approach may result in lower annual depreciation or amortization deductions than would otherwise be allowable to some unitholders. Please read *Tax Treatment of Operations* *Uniformity of Units*.

A Section 754 election is advantageous if the transferee's tax basis in his units is higher than the units' share of our common basis immediately prior to the transfer. In that case, as a result of the election, the transferee would have, among other items, a greater amount of depreciation and depletion deductions and his share of any gain or loss on a sale of our assets would be less. Conversely, a Section 754 election is disadvantageous if the transferee's tax basis in his units is lower than those units' share of the aggregate tax basis of our assets immediately prior to the transfer. Thus, the fair market value of the units may be affected either favorably or unfavorably by the election.

The calculations involved in the Section 754 election are complex and will be made on the basis of assumptions as to the value of our assets and other matters. For example, the allocation of the Section 743(b) adjustment among our assets must be made in accordance with the Internal Revenue Code. The IRS could seek to reallocate some or all of any Section 743(b) adjustment allocated by us to our tangible assets to goodwill instead. Goodwill, as an intangible asset, is generally amortizable over a longer period of time or under a less accelerated method than our tangible assets. We cannot assure you that the determinations we make will not be successfully challenged by the IRS and that the deductions resulting from them will not be reduced or disallowed altogether. Should the IRS require a different basis adjustment to be made, and should, in our opinion, the expense of compliance exceed the benefit of the election, we may seek permission from the IRS to revoke our Section 754 election. If permission is granted, a subsequent purchaser of units may be allocated more income than he would have been allocated had the election not been revoked.

Tax Treatment of Operations

Accounting Method and Taxable Year. We use the year ending December 31 as our taxable year and the accrual method of accounting for federal income tax purposes. Each unitholder will be required to include in income his share of our income, gain, loss and deduction for our taxable year ending within or

Table of Contents

with his taxable year. In addition, a unitholder who has a taxable year ending on a date other than December 31 and who disposes of all of his units following the close of our taxable year but before the close of his taxable year must include his share of our income, gain, loss and deduction in income for his taxable year, with the result that he will be required to include in income for his taxable year his share of more than one year of our income, gain, loss and deduction. Please read *Disposition of Common Units Allocations Between Transferors and Transferees*.

Tax Basis, Depreciation and Amortization. The tax basis of our assets will be used for purposes of computing depreciation and cost recovery deductions and, ultimately, gain or loss on the disposition of these assets. The federal income tax burden associated with the difference between the fair market value of our assets and their tax basis immediately prior to an offering will be borne by partners holding interests in us immediately prior to that offering. Please read *Tax Consequences of Unit Ownership Allocation of Income, Gain, Loss and Deduction*.

To the extent allowable, we may elect to use the depreciation and cost recovery methods that will result in the largest deductions being taken in the early years after assets are placed in service. We are not entitled to any amortization deductions with respect to any goodwill conveyed to us on formation. Property we subsequently acquire or construct may be depreciated using accelerated methods permitted by the Internal Revenue Code.

If we dispose of depreciable property by sale, foreclosure, or otherwise, all or a portion of any gain, determined by reference to the amount of depreciation previously deducted and the nature of the property, may be subject to the recapture rules and taxed as ordinary income rather than capital gain. Similarly, a common unitholder who has taken cost recovery or depreciation deductions with respect to property we own will likely be required to recapture some or all of those deductions as ordinary income upon a sale of his interest in us. Please read *Tax Consequences of Unit Ownership Allocation of Income, Gain, Loss and Deduction* and *Disposition of Common Units Recognition of Gain or Loss*.

The costs incurred in selling our units (called *syndication expenses*) must be capitalized and cannot be deducted currently, ratably or upon our termination. There are uncertainties regarding the classification of costs as organization expenses, which may be amortized by us, and as syndication expenses, which may not be amortized by us. The underwriting discounts and commissions we incur will be treated as syndication expenses.

Valuation and Tax Basis of Our Properties. The federal income tax consequences of the ownership and disposition of units will depend in part on our estimates of the relative fair market values, and the tax bases, of our assets. Although we may from time to time consult with professional appraisers regarding valuation matters, we will make many of the relative fair market value estimates ourselves. These estimates and determinations of basis are subject to challenge and will not be binding on the IRS or the courts. If the estimates of fair market value or basis are later found to be incorrect, the character and amount of items of income, gain, loss or deductions previously reported by unitholders might change, and unitholders might be required to adjust their tax liability for prior years and incur interest and penalties with respect to those adjustments.

Disposition of Common Units

Recognition of Gain or Loss. Gain or loss will be recognized on a sale of units equal to the difference between the amount realized and the unitholder's tax basis for the units sold. A unitholder's amount realized will be measured by the sum of the cash or the fair market value of other property received by him plus his share of our nonrecourse liabilities. Because the amount realized includes a unitholder's share of our nonrecourse liabilities, the gain recognized on the sale of units could result in a tax liability in excess of any cash received from the sale.

Prior distributions from us in excess of cumulative net taxable income for a common unit that decreased a unitholder's tax basis in that common unit will, in effect, become taxable income if the

Table of Contents

common unit is sold at a price greater than the unitholder's tax basis in that common unit, even if the price received is less than his original cost.

Except as noted below, gain or loss recognized by a unitholder, other than a dealer in units, on the sale or exchange of a unit held for more than one year will generally be taxable as capital gain or loss. Capital gain recognized by an individual on the sale of units held more than 12 months will generally be taxed at a maximum rate of 15%. A portion of this gain or loss, which will likely be substantial, however, will be separately computed and taxed as ordinary income or loss under Section 751 of the Internal Revenue Code to the extent attributable to assets giving rise to depreciation recapture or other unrealized receivables or to inventory items we own. The term unrealized receivables includes potential recapture items, including depreciation recapture. Ordinary income attributable to unrealized receivables, inventory items and depreciation recapture may exceed net taxable gain realized upon the sale of a unit and may be recognized even if there is a net taxable loss realized on the sale of a unit. Thus, a unitholder may recognize both ordinary income and a capital loss upon a sale of units. Net capital losses may offset capital gains and no more than \$3,000 of ordinary income, in the case of individuals, and may only be used to offset capital gains in the case of corporations.

The IRS has ruled that a partner who acquires interests in a partnership in separate transactions must combine those interests and maintain a single adjusted tax basis for all those interests. Upon a sale or other disposition of less than all of those interests, a portion of that tax basis must be allocated to the interests sold using an equitable apportionment method. Treasury Regulations under Section 1223 of the Internal Revenue Code allow a selling unitholder who can identify common units transferred with an ascertainable holding period to elect to use the actual holding period of the common units transferred. Thus, according to the ruling, a common unitholder will be unable to select high or low basis common units to sell as would be the case with corporate stock, but, according to the Treasury regulations, may designate specific common units sold for purposes of determining the holding period of units transferred. A unitholder electing to use the actual holding period of common units transferred must consistently use that identification method for all subsequent sales or exchanges of common units. We strongly recommend that a unitholder considering the purchase of additional units or a sale of common units purchased in separate transactions consult his tax advisor as to the possible consequences of this ruling and application of the regulations.

Specific provisions of the Internal Revenue Code affect the taxation of some financial products and securities, including partnership interests, by treating a taxpayer as having sold an appreciated partnership interest, one in which gain would be recognized if it were sold, assigned or terminated at its fair market value, if the taxpayer or related persons enter(s) into:

a short sale;

an offsetting notional principal contract; or

a futures or forward contract with respect to the partnership interest or substantially identical property.

Moreover, if a taxpayer has previously entered into a short sale, an offsetting notional principal contract or a futures or forward contract with respect to the partnership interest, the taxpayer will be treated as having sold that position if the taxpayer or a related person then acquires the partnership interest or substantially identical property. The Secretary of the Treasury is also authorized to issue regulations that treat a taxpayer that enters into transactions or positions that have substantially the same effect as the preceding transactions as having constructively sold the financial position.

Allocations Between Transferors and Transferees. In general, our taxable income and losses will be determined annually, will be prorated on a monthly basis and will be subsequently apportioned among the unitholders in proportion to the number of units owned by each of them as of the opening of the applicable exchange on the first business day of the month (the Allocation Date). However, gain or loss realized on a sale or other disposition of our assets other than in the ordinary course of business will be allocated among the unitholders on the Allocation Date in the month in which that gain or loss is

Table of Contents

recognized. As a result, a unitholder transferring units may be allocated income, gain, loss and deduction realized after the date of transfer.

The use of this method may not be permitted under existing Treasury Regulations. Accordingly, Vinson & Elkins L.L.P. is unable to opine on the validity of this method of allocating income and deductions between unitholders. If this method is not allowed under the Treasury Regulations, or only applies to transfers of less than all of the unitholder's interest, our taxable income or losses might be reallocated among the unitholders. We are authorized to revise our method of allocation between unitholders, as well as among unitholders whose interests vary during a taxable year, to conform to a method permitted under future Treasury Regulations.

A unitholder who owns units at any time during a quarter and who disposes of them prior to the record date set for a cash distribution for that quarter will be allocated items of our income, gain, loss and deductions attributable to that quarter but will not be entitled to receive that cash distribution.

Notification Requirements. A unitholder who sells or exchanges units, other than through a broker, generally is required to notify us in writing of that sale or exchange within 30 days after the sale or exchange (or, if earlier, January 15 of the year following the sale). A unitholder who acquires units generally is required to notify us in writing of that acquisition within 30 days of that purchase, unless a broker or nominee will satisfy such requirement. We are required to notify the IRS of any such transfers and to furnish specified information to the transferor and transferee. Failure to satisfy these reporting obligations may, in some cases, lead to the imposition of penalties.

Constructive Termination. We will be considered to have been terminated for tax purposes if there is a sale or exchange of 50% or more of the total interests in our capital and profits within a 12-month period. A constructive termination results in the closing of our taxable year for all unitholders. In the case of a unitholder reporting on a taxable year other than a fiscal year ending December 31, the closing of our taxable year may result in more than 12 months of our taxable income or loss being includable in his taxable income for the year of termination. We would be required to make new tax elections after a termination, including a new election under Section 754 of the Internal Revenue Code, and a termination would result in a deferral of our deductions for depreciation. A termination could also result in penalties if we were unable to determine that the termination had occurred. Moreover, a termination might either accelerate the application of, or subject us to, any tax legislation enacted before the termination.

Uniformity of Units

Because we cannot match transferors and transferees of units, we must maintain uniformity of the economic and tax characteristics of the units to a purchaser of these units. In the absence of uniformity, we may be unable to completely comply with a number of federal income tax requirements, both statutory and regulatory. A lack of uniformity can result from a literal application of Treasury Regulation Section 1.167(c)-1(a)(6). Any non-uniformity could have a negative impact on the value of the units. Please read Tax Consequences of Unit Ownership Section 754 Election.

We intend to depreciate the portion of a Section 743(b) adjustment attributable to unrealized appreciation in the value of Contributed Property, to the extent of any unamortized Book-Tax Disparity, using a rate of depreciation or amortization derived from the depreciation or amortization method and useful life applied to the common basis of that property, or treat that portion as nonamortizable, to the extent attributable to property the common basis of which is not amortizable, consistent with the regulations under Section 743 of the Internal Revenue Code, even though that position may be inconsistent with Treasury regulation Section 1.167(c)-1(a)(6). Please read Tax Consequences of Unit Ownership Section 754 Election. To the extent that the Section 743(b) adjustment is attributable to appreciation in value in excess of the unamortized Book-Tax Disparity, we will apply the rules described in the Treasury Regulations and legislative history. If we determine that this position cannot reasonably be taken, we may adopt a depreciation and amortization position under which all purchasers acquiring units in the same month would receive depreciation and amortization deductions, whether attributable to a common basis or Section 743(b) adjustment, based upon the same applicable rate as if they had

Table of Contents

purchased a direct interest in our property. If this position is adopted, it may result in lower annual depreciation and amortization deductions than would otherwise be allowable to some unitholders and risk the loss of depreciation and amortization deductions not taken in the year that these deductions are otherwise allowable. This position will not be adopted if we determine that the loss of depreciation and amortization deductions will have a material adverse effect on the unitholders. If we choose not to utilize this aggregate method, we may use any other reasonable depreciation and amortization method to preserve the uniformity of the intrinsic tax characteristics of any units that would not have a material adverse effect on the unitholders. The IRS may challenge any method of depreciating the Section 743(b) adjustment described in this paragraph. If this challenge were sustained, the uniformity of units might be affected, and the gain from the sale of units might be increased without the benefit of additional deductions. Please read

Disposition of Common Units Recognition of Gain or Loss.

Tax-Exempt Organizations and Other Investors

Ownership of units by employee benefit plans, other tax-exempt organizations, regulated investment companies, non-resident aliens, foreign corporations, and other foreign persons raises issues unique to those investors and, as described below, may have substantially adverse tax consequences to them.

Employee benefit plans and most other organizations exempt from federal income tax, including individual retirement accounts and other retirement plans, are subject to federal income tax on unrelated business taxable income. Virtually all of our income allocated to a unitholder that is a tax-exempt organization will be unrelated business taxable income and will be taxable to them.

A regulated investment company or mutual fund is required to derive 90% or more of its gross income from interest, dividends and gains from the sale of stocks or securities or foreign currency or specified related sources. Recent legislation treats net income derived from the ownership of certain publicly traded partnerships (including us) as qualifying income to a regulated investment company. However, this legislation is only effective for taxable years beginning after October 22, 2004, the date of enactment. For taxable years beginning prior to the date of enactment, very little of our income will be qualifying income to a regulated investment company.

Non-resident aliens and foreign corporations, trusts or estates that own units will be considered to be engaged in business in the United States because of the ownership of units. As a consequence they will be required to file federal tax returns to report their share of our income, gain, loss or deduction and pay federal income tax at regular rates on their share of our net income or gain. Moreover, under rules applicable to publicly traded partnerships, we will withhold at the highest applicable effective rate on cash distributions made quarterly to foreign unitholders. Each foreign unitholder must obtain a taxpayer identification number from the IRS and submit that number to our transfer agent on a Form W-8 BEN or applicable substitute form in order to obtain credit for these withholding taxes. A change in applicable law may require us to change these procedures.

In addition, because a foreign corporation that owns units will be treated as engaged in a United States trade or business, that corporation may be subject to the United States branch profits tax at a rate of 30%, in addition to regular federal income tax, on its share of our income and gain, as adjusted for changes in the foreign corporation's U.S. net equity, which are effectively connected with the conduct of a United States trade or business. That tax may be reduced or eliminated by an income tax treaty between the United States and the country in which the foreign corporate unitholder is a qualified resident. In addition, this type of unitholder is subject to special information reporting requirements under Section 6038C of the Internal Revenue Code.

Under a ruling of the IRS, a foreign unitholder who sells or otherwise disposes of a unit will be subject to federal income tax on gain realized on the sale or disposition of that unit to the extent that this gain is effectively connected with a United States trade or business of the foreign unitholder. Apart from the ruling, a foreign unitholder will not be taxed or subject to withholding upon the sale or disposition of a unit if he has owned less than 5% in value of the units during the five-year period ending on the date of

Table of Contents

the disposition and if the units are regularly traded on an established securities market at the time of the sale or disposition.

Administrative Matters

Information Returns and Audit Procedures. We intend to furnish to each unitholder, within 90 days after the close of each calendar year, specific tax information, including a Schedule K-1, which describes his share of our income, gain, loss and deduction for our preceding taxable year. In preparing this information, which will not be reviewed by Vinson & Elkins L.L.P., we will take various accounting and reporting positions, some of which have been mentioned earlier, to determine his share of income, gain, loss and deduction. We cannot assure you that those positions will yield a result that conforms to the requirements of the Internal Revenue Code, Treasury Regulations or administrative interpretations of the IRS. Neither we nor Vinson & Elkins L.L.P. can assure prospective unitholders that the IRS will not successfully contend in court that those positions are impermissible. Any challenge by the IRS could negatively affect the value of the units.

The IRS may audit our federal income tax information returns. Adjustments resulting from an IRS audit may require each unitholder to adjust a prior year's tax liability, and possibly may result in an audit of his own return. Any audit of a unitholder's return could result in adjustments not related to our returns as well as those related to our returns.

Partnerships generally are treated as separate entities for purposes of federal tax audits, judicial review of administrative adjustments by the IRS and tax settlement proceedings. The tax treatment of partnership items of income, gain, loss and deduction are determined in a partnership proceeding rather than in separate proceedings with the partners. The Internal Revenue Code requires that one partner be designated as the Tax Matters Partner for these purposes. The partnership agreement names our general partner as our Tax Matters Partner.

The Tax Matters Partner has made and will make some elections on our behalf and on behalf of unitholders. In addition, the Tax Matters Partner can extend the statute of limitations for assessment of tax deficiencies against unitholders for items in our returns. The Tax Matters Partner may bind a unitholder with less than a 1% profits interest in us to a settlement with the IRS unless that unitholder elects, by filing a statement with the IRS, not to give that authority to the Tax Matters Partner. The Tax Matters Partner may seek judicial review, by which all the unitholders are bound, of a final partnership administrative adjustment and, if the Tax Matters Partner fails to seek judicial review, judicial review may be sought by any unitholder having at least a 1% interest in profits or by any group of unitholders having in the aggregate at least a 5% interest in profits. However, only one action for judicial review will go forward, and each unitholder with an interest in the outcome may participate.

A unitholder must file a statement with the IRS identifying the treatment of any item on his federal income tax return that is not consistent with the treatment of the item on our return. Intentional or negligent disregard of this consistency requirement may subject a unitholder to substantial penalties.

Nominee Reporting. Persons who hold an interest in us as a nominee for another person are required to furnish to us:

- (a) the name, address and taxpayer identification number of the beneficial owner and the nominee;
- (b) whether the beneficial owner is
 - (1) a person that is not a United States person,
 - (2) a foreign government, an international organization or any wholly owned agency or instrumentality of either of the foregoing, or
 - (3) a tax-exempt entity;

Table of Contents

(c) the amount and description of units held, acquired or transferred for the beneficial owner; and

(d) specific information including the dates of acquisitions and transfers, means of acquisitions and transfers, and acquisition cost for purchases, as well as the amount of net proceeds from sales.

Brokers and financial institutions are required to furnish additional information, including whether they are United States persons and specific information on units they acquire, hold or transfer for their own account. A penalty of \$50 per failure, up to a maximum of \$100,000 per calendar year, is imposed by the Internal Revenue Code for failure to report that information to us. The nominee is required to supply the beneficial owner of the units with the information furnished to us.

Accuracy-related Penalties. An additional tax equal to 20% of the amount of any portion of an underpayment of tax that is attributable to one or more specified causes, including negligence or disregard of rules or regulations, substantial understatements of income tax and substantial valuation misstatements, is imposed by the Internal Revenue Code. No penalty will be imposed, however, for any portion of an underpayment if it is shown that there was a reasonable cause for that portion and that the taxpayer acted in good faith regarding that portion.

A substantial understatement of income tax in any taxable year exists if the amount of the understatement exceeds the greater of 10% of the tax required to be shown on the return for the taxable year or \$5,000 (\$10,000 for most corporations). The amount of any understatement subject to penalty generally is reduced if any portion is attributable to a position adopted on the return:

(1) for which there is, or was, substantial authority, or

(2) as to which there is a reasonable basis and the pertinent facts of that position are disclosed on the return.

If any item of income, gain, loss or deduction included in the distributive shares of unitholders might result in that kind of an understatement of income for which no substantial authority exists, we must disclose the pertinent facts on our return. In addition, we will make a reasonable effort to furnish sufficient information for unitholders to make adequate disclosure on their returns to avoid liability for this penalty. More stringent rules apply to tax shelters, a term that in this context does not appear to include us.

A substantial valuation misstatement exists if the value of any property, or the adjusted basis of any property, claimed on a tax return is 200% or more of the amount determined to be the correct amount of the valuation or adjusted basis. No penalty is imposed unless the portion of the underpayment attributable to a substantial valuation misstatement exceeds \$5,000 (\$10,000 for most corporations). If the valuation claimed on a return is 400% or more than the correct valuation, the penalty imposed increases to 40%.

Reportable Transactions. If we were to engage in a reportable transaction, we (and possibly you and others) would be required to make a detailed disclosure of the transaction to the IRS. A transaction may be a reportable transaction based upon any of several factors, including the fact that it is a type of tax avoidance transaction publicly identified by the IRS as a listed transaction or that it produces certain kinds of losses in excess of \$2 million. Our participation in a reportable transaction could increase the likelihood that our federal income tax information return (and possibly your tax return) would be audited by the IRS. Please read Information Returns and Audit Procedures above.

Moreover, if we were to participate in a reportable transaction with a significant purpose to avoid or evade tax, or in any listed transaction, you may be subject to the following provisions of the American Jobs Creation Act of 2004: accuracy-related penalties with a broader scope, significantly narrower exceptions, and potentially greater amounts than described above at Accuracy-related Penalties,

for those persons otherwise entitled to deduct interest on federal tax deficiencies, nondeductibility of interest on any resulting tax liability, and

Table of Contents

in the case of a listed transaction, an extended statute of limitations.

We do not expect to engage in any reportable transactions.

State, Local, Foreign and Other Tax Considerations

In addition to federal income taxes, a unitholder will likely be subject to other taxes, including state, local and foreign income taxes, unincorporated business taxes, and estate, inheritance or intangible taxes that may be imposed by the various jurisdictions in which we do business or own property or in which a unitholder is a resident. Although an analysis of those various taxes is not presented here, each prospective unitholder should consider their potential impact on his investment in us. We currently own property or do business in New Mexico, Arizona, Washington, Texas, Utah and Idaho. We may also own property or do business in other jurisdictions in the future. Although a unitholder may not be required to file a return and pay taxes in some jurisdictions because its income from that jurisdiction falls below the filing and payment requirement, unitholders will be required to file state income tax returns and to pay state income taxes in some or all of the states in which we do business or own property and may be subject to penalties for failure to comply with those requirements. In some states, tax losses may not produce a tax benefit in the year incurred and also may not be available to offset income in subsequent taxable years. Some of the states may require us, or we may elect, to withhold a percentage of income from amounts to be distributed to a unitholder who is not a resident of the state. Withholding, the amount of which may be greater or less than a particular unitholder's income tax liability to the state, generally does not relieve a nonresident unitholder from the obligation to file an income tax return. Amounts withheld may be treated as if distributed to unitholders for purposes of determining the amounts distributed by us. Please read Tax Consequences of Unit Ownership Entity-Level Collections. Based on current law and our estimate of our future operations, our general partner anticipates that any amounts required to be withheld will not be material. We may also own property or do business in other states in the future.

It is the responsibility of each unitholder to investigate the legal and tax consequences, under the laws of pertinent jurisdictions, of his investment in us. Accordingly, each prospective unitholder is urged to consult, and depend upon, his own tax counsel or other advisor with regard to those matters. Further, it is the responsibility of each unitholder to file all state, local, and foreign as well as United States federal tax returns, that may be required of him. Vinson & Elkins L.L.P. has not rendered an opinion on the state, local or foreign tax consequences of an investment in us.

Tax Consequences of Ownership of Debt Securities

A description of the material federal income tax consequences of the acquisition, ownership and disposition of debt securities will be set forth in the prospectus supplement relating to the offering of any debt securities.

Table of Contents**SELLING UNITHOLDERS**

In addition to covering our offering of securities, this prospectus covers the offering for resale of up to 1,170,000 common units by the selling unitholders. On July 8, 2005, we originally issued an aggregate of 1,100,000 of our unregistered common units to Fiduciary/ Claymore MLP Opportunity Fund, Perry Partners, L.P., Structured Finance Americas, LLC, Kayne Anderson MLP Investment Company and Kayne Anderson Energy Total Return Fund, Inc. (collectively, the Initial Purchasers) in a private sale of our common units exempt from the registration requirements of the Securities Act. In connection with the sale of our common units, we agreed to file a registration statement with the Commission to register those common units. Also on July 8, 2005, in a separate transaction for the acquisition of certain intermediate feedstock pipelines and related assets of Holly Corporation, we issued 70,000 of our unregistered common units to Holly Corporation as partial consideration for such acquisition.

As used in this prospectus, selling unitholders includes any or all of the Initial Purchasers and/or Holly Corporation and any of their donees, pledgees, transferees or other successors-in-interest who sell units received after the date of this prospectus from a named selling unitholder as a gift, pledge, partnership distribution or other non-sale related transfer. The selling unitholders may sell all, some or none of the common units covered by this prospectus. See Plan of Distribution Distribution by Selling Unitholders. We will bear all costs, expenses and fees in connection with the registration of the common units offered by this prospectus. Brokerage commissions and similar selling expenses, if any, attributable to the sale of the units will be borne by the selling unitholders. The following table sets forth information relating to the selling unitholders' beneficial ownership of our common units as of October 13, 2005:

Name of Selling Unitholder	Number and Percentage of Outstanding Common Units Beneficially Owned Prior to Completion of Offering(1)	Number of Common Units Offered Hereunder	Number and Percentage of Outstanding Common Units Owned After Completion of Offering(1)
Fiduciary/ Claymore MLP Opportunity Fund	659,450(2) 8.1%	600,000	59,450 0.7%
Perry Partners, L.P.(3)	350,000 4.3%	350,000	-0-
Structured Finance Americas, LLC(4)	100,000(5) 1.2%	100,000	-0-
Kayne Anderson MLP Investment Company	141,300(6) 1.7%	32,100	109,200 1.3%
Kayne Anderson Energy Total Return Fund, Inc.	64,600(6) 0.8%	17,900	46,700 0.6%
Holly Corporation	70,000 0.9%	70,000	-0-

(1) Percentage ownership is based on 8,170,000 common units outstanding on October 13, 2005.

(2)

Does not include 302,070 common units owned by Fiduciary Asset Management, LLC, an affiliate of Fiduciary/Claymore MLP Opportunity Fund, and its affiliates.

- (3) The general partner of Perry Partners, L.P. is Perry Corp., of which Richard C. Perry is the President and sole shareholder. Perry Corp. and Mr. Perry may be deemed to have voting and dispositive power with respect to the common units held by Perry Partners, L.P. Each of Mr. Perry and Perry Corp. disclaims beneficial ownership of such common units, except to the extent of his or its pecuniary interest therein, if any, and this prospectus shall not be deemed an admission that either Mr. Perry or

Table of Contents

Perry Corp. is the beneficial owner of the common units for purposes of Section 16 of the Securities Exchange Act of 1934 or for any other purpose.

- (4) This selling unitholder identified itself to us as an affiliate of a broker-dealer, and represented to us that (a) the common units shown above as being offered by such selling unitholder were purchased by such selling unitholder in the ordinary course of business, and (b) at the time of such purchase, such selling unitholder had no arrangements or understandings, directly or indirectly, with any person to distribute such common units.
- (5) Does not include 2,200 common units owned by Deutsche Bank AG, an affiliate of Structured Finance Americas, LLC, and its affiliates. Deutsche Bank AG is the ultimate parent of Structured Finance Americas, LLC and thus may be deemed to have voting and dispositive power with respect to the common units held by Structured Finance Americas, LLC.
- (6) Does not include 440,100 common units owned by Kayne Anderson Capital Advisors, L.P., an affiliate of Kayne Anderson MLP Investment Company and Kayne Anderson Energy Total Return Fund, Inc.

None of the Initial Purchasers has held a position or office or had any other material relationship with us or any predecessor affiliate during the last three years. Holly Corporation is the ultimate parent company of HEP Logistics Holdings, L.P., and may, therefore, be deemed to beneficially own the 7,000,000 subordinated units held by HEP Logistics Holdings, L.P.

Any prospectus supplement reflecting a sale of common units hereunder will set forth, with respect to the selling unitholders:

the name of the selling unitholders;

the nature of the position, office or other material relationship which the selling unitholders will have had within the prior three years with us or any of our affiliates;

the number of common units owned by the selling unitholders prior to the offering;

the number of common units to be offered for the selling unitholders account; and

the number and (if one percent or more) the percentage of common units to be owned by the selling unitholders after the completion of the offering.

Table of Contents

INVESTMENT IN US BY EMPLOYEE BENEFIT PLANS

An investment in us by an employee benefit plan is subject to certain additional considerations because the investments of such plans are subject to the fiduciary responsibility and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and restrictions imposed by Section 4975 of the Internal Revenue Code. As used herein, the term employee benefit plan includes, but is not limited to, qualified pension, profit-sharing and stock bonus plans, Keogh plans, simplified employee pension plans and tax deferred annuities or IRAs established or maintained by an employer or employee organization. Among other things, consideration should be given to (a) whether such investment is prudent under Section 404(a)(1)(B) of ERISA; (b) whether in making such investment, such plan will satisfy the diversification requirement of Section 404(a)(1)(C) of ERISA; and (c) whether such investment will result in recognition of unrelated business taxable income by such plan and, if so, the potential after-tax investment return. Please read Tax Considerations Tax-Exempt Organizations and Other Investors. The person with investment discretion with respect to the assets of an employee benefit plan (a fiduciary) should determine whether an investment in us is authorized by the appropriate governing instrument and is a proper investment for such plan.

Section 406 of ERISA and Section 4975 of the Internal Revenue Code (which also applies to IRAs that are not considered part of an employee benefit plan) prohibit an employee benefit plan from engaging in certain transactions involving plan assets with parties that are parties in interest under ERISA or disqualified persons under the Internal Revenue Code with respect to the plan.

In addition to considering whether the purchase of limited partnership units is a prohibited transaction, a fiduciary of an employee benefit plan should consider whether such plan will, by investing in us, be deemed to own an undivided interest in our assets, with the result that our general partner also would be a fiduciary of such plan and our operations would be subject to the regulatory restrictions of ERISA, including its prohibited transaction rules, as well as the prohibited transaction rules of the Internal Revenue Code.

The Department of Labor regulations provide guidance with respect to whether the assets of an entity in which employee benefit plans acquire equity interests would be deemed plan assets under certain circumstances. Pursuant to these regulations, an entity s assets would not be considered to be plan assets if, among other things, (a) the equity interest acquired by employee benefit plans are publicly offered securities i.e., the equity interests are widely held by 100 or more investors independent of the issuer and each other, freely transferable and registered pursuant to certain provisions of the federal securities laws, (b) the entity is an Operating Partnership i.e., it is primarily engaged in the production or sale of a product or service other than the investment of capital either directly or through a majority owned subsidiary or subsidiaries, or (c) there is no significant investment by benefit plan investors, which is defined to mean that less than 25% of the value of each class of equity interest (disregarding certain interests held by our general partner, its affiliates and certain other persons) is held by the employee benefit plans referred to above, IRAs and other employee benefit plans not subject to ERISA (such as governmental plans). Our assets should not be considered plan assets under these regulations because it is expected that the investment will satisfy the requirements in (a) and (b) above and may also satisfy the requirements in (c).

Plan fiduciaries contemplating a purchase of limited partnership units should consult with their own counsel regarding the consequences under ERISA and the Internal Revenue Code in light of the serious penalties imposed on persons who engage in prohibited transactions or other violations.

Table of Contents

PLAN OF DISTRIBUTION

We may sell the common units and debt securities being offered hereby directly, through agents or to or through underwriters or dealers.

We, or agents designated by us, may directly solicit, from time to time, offers to purchase the securities. Any such agent may be deemed to be an underwriter as that term is defined in the Securities Act. We will name the agents involved in the offer or sale of the securities and describe any commissions payable by us to these agents in the prospectus supplement. Unless otherwise indicated in the prospectus supplement, these agents will be acting on a best efforts basis for the period of their appointment. The agents may be entitled under agreements which may be entered into with us to indemnification by us against specific civil liabilities, including liabilities under the Securities Act. The agents may also be our customers or may engage in transactions with or perform services for us in the ordinary course of business.

If we utilize any underwriters in the sale of the securities in respect of which this prospectus is delivered, we will enter into an underwriting agreement with those underwriters at the time of sale to them. We will set forth the names of these underwriters and the terms of the transaction in the prospectus supplement, which will be used by the underwriters to make resales of the securities in respect of which this prospectus is delivered to the public. We may indemnify the underwriters under the relevant underwriting agreement against specific liabilities, including liabilities under the Securities Act. The underwriters may also be our customers or may engage in transactions with or perform services for us in the ordinary course of business.

If we utilize a dealer in the sale of the securities in respect of which this prospectus is delivered, we will sell those securities to the dealer, as principal. The dealer may then resell those securities to the public at varying prices to be determined by the dealer at the time of resale. We may indemnify the dealers against specific liabilities, including liabilities under the Securities Act. The dealers may also be our customers or may engage in transactions with, or perform services for us in the ordinary course of business.

Common units and debt securities may also be sold directly by us. In this case, no underwriters or agents would be involved. We may use electronic media, including the Internet, to sell offered securities directly.

To the extent required, this prospectus may be amended or supplemented from time to time to describe a specific plan of distribution. The place and time of delivery for the securities in respect of which this prospectus is delivered are set forth in the accompanying prospectus supplement.

Distribution by Selling Unitholders

Distributions of the common units by the selling unitholders, or by their partners, pledgees, donees (including charitable organizations), transferees or other successors in interest, may from time to time be offered for sale either directly by such person or entities, or through underwriters, dealers or agents or on any exchange on which the common units may from time to time be traded, in the over-the-counter market, or in independently negotiated transactions or otherwise. The methods by which the common units may be sold include:

a block trade (which may involve crosses) in which the broker or dealer so engaged will attempt to sell the securities as agent but may position and resell a portion of the block as principal to facilitate the transaction;

purchases by a broker or dealer as principal and resale by such broker or dealer for its own account pursuant to this prospectus;

exchange distributions and/or secondary distributions;

underwritten transactions;

ordinary brokerage transactions and transactions in which the broker solicits purchasers; and

direct sales or privately negotiated transactions.

Table of Contents

Such transactions may be effected by the selling unitholder at market prices prevailing at the time of sale or at negotiated prices. The selling unitholders may effect such transactions by selling the common units to underwriters or to or through broker-dealers, and such underwriters or broker-dealers may receive compensation in the form of discounts or commissions from the selling unitholders and may receive commissions from the purchasers of the common units for whom they may act as agent.

In connection with sales of the common units under this prospectus, the selling unitholders may enter into hedging transactions with broker-dealers, who may in turn engage in short sales of the common units in the course of hedging the positions they assume. The selling unitholders also may engage in short sales, short sales against the box, puts and calls and other transactions in common units, or derivatives thereof, and may sell and deliver their common units in connection therewith, or loan or pledge the common units to broker-dealers that in turn may sell them. In addition, the selling unitholders may from time to time sell their common units in transactions permitted by Rule 144 under the Securities Act.

The selling unitholders may agree to indemnify any underwriter, broker-dealer or agent that participates in transactions involving sales of the common units against certain liabilities, including liabilities arising under the Securities Act. We have agreed to register the common units for sale under the Securities Act and to indemnify the selling unitholders against certain civil liabilities, including certain liabilities under the Securities Act.

As of the date of this prospectus, neither we nor any selling unitholder has engaged any underwriter, broker, dealer or agent in connection with the distribution of common units pursuant to this prospectus by the selling unitholders. To the extent required, the number of common units to be sold, the purchase price, the name of any applicable agent, broker, dealer or underwriter and any applicable commissions with respect to a particular offer will be set forth in the applicable prospectus supplement. The aggregate net proceeds to the selling unitholders from the sale of their common units offered hereby will be the sale price of those common units, less any commissions, if any, and other expenses of issuance and distribution not borne by us.

The selling unitholders and any brokers, dealers, agents or underwriters that participate with the selling unitholders in the distribution of their common units may be deemed to be underwriters within the meaning of the Securities Act, in which event any discounts, concessions and commissions received by such brokers, dealers, agents or underwriters and any profit on the resale of the common units purchased by them may be deemed to be underwriting discounts and commissions under the Securities Act.

Table of Contents

WHERE YOU CAN FIND MORE INFORMATION

We file annual, quarterly and current reports, and other information with the Commission under the Exchange Act. You may read and copy any document we file at the Commission's public reference room at 100 F Street, NE, Washington, D.C. 20549. Please call the Commission at 1-800-732-0330 for further information on the public reference room. Our filings are also available to the public at the Commission's web site at <http://www.sec.gov>. In addition, documents filed by us can be inspected at the offices of the New York Stock Exchange, Inc. 20 Broad Street, New York, New York 10002.

The Commission allows us to incorporate by reference into this prospectus the information we file with it, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is considered to be part of this prospectus, and later information that we file with the Commission will automatically update and supersede this information. Therefore, before you decide to invest in a particular offering under this shelf registration, you should always check for reports we may have filed with the Commission after the date of this prospectus. We incorporate by reference the documents listed below filed by us and any future filings made after the date of the initial filing of the registration statement of which this prospectus is a part with the Commission under sections 13(a), 13(c), 14 or 15(d) of the Exchange Act until the termination of each offering under this prospectus (other than information furnished and not filed with the Commission).

the Annual Report on Form 10-K of Holly Energy Partners, L.P. for the year ended December 31, 2004, as filed with the Commission on February 24, 2005;

the Quarterly Report on Form 10-Q of Holly Energy Partners, L.P. for the quarter ended March 31, 2005, as filed with the Commission on May 5, 2005;

the Quarterly Report on Form 10-Q of Holly Energy Partners, L.P. for the quarter ended June 30, 2005, as filed with the Commission on August 4, 2005;

the Current Reports on Form 8-K of Holly Energy Partners, L.P., as filed with the Commission on March 4, 2005, June 15, 2005, June 30, 2005, July 8, 2005, July 12, 2005, July 27, 2005 and August 8, 2005; and

the description of our common units contained in our registration statement on Form 8-A, as filed with the Commission on June 21, 2004, and any subsequent amendment thereto filed for the purpose of updating such description.

We will provide without charge to each person, including any beneficial owner, to whom this prospectus is delivered, upon written or oral request, a copy of any document incorporated by reference in this prospectus, other than exhibits to any such document not specifically described above. Requests for such documents should be directed to Holly Energy Partners, L.P., 100 Crescent Court, Suite 1600, Dallas, Texas 75201, Attention: Chief Financial Officer; telephone number: (214) 220-7700.

Table of Contents

LEGAL MATTERS

Certain legal matters in connection with the securities will be passed upon by Vinson & Elkins L.L.P., as our counsel. Any underwriter will be advised about other issues relating to any offering by their own legal counsel.

EXPERTS

The consolidated financial statements of Holly Energy Partners, L.P. as of December 31, 2004 and 2003 and for each of the three years in the period ended December 31, 2004 included in Holly Energy Partners, L.P.'s Current Report (Form 8-K) filed with the Commission on July 27, 2005 and incorporated in this prospectus have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon and incorporated herein by reference, and are included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.