National Association of Publicly Traded Partnerships

MLP Basics for Investors

What are MLPs?

MLPs (master limited partnerships) are publicly traded partnerships: limited partnerships which are traded on stock exchanges. A share in an MLP is called a "unit," and owning MLP units makes you a limited partner. Sometimes an MLP is technically not a partnership but a publicly traded limited liability company (LLC) which has chosen partnership taxation. There are some differences between the two, but for tax purposes they are the same.

Why should I consider investing in MLPs?

In a time of insecurity in the stock markets, securities paying income can help mitigate the effect of fluctuating stock prices. MLPs are an income-oriented investment: their organizational mandate is to pay out all earnings not needed for current operations and maintenance of capital assets to their unitholders in the form of quarterly cash distributions. Many MLPs are also growth-oriented, striving to increase their distributions as often as is possible and prudent. In addition, MLPs are a tax-advantaged investment. As explained below, investors pay tax only on their proportionate share of the MLP's income, which is greatly reduced by their share of depreciation and other deductions; distributions are largely tax-deferred. Finally most MLPs are in essential industries, providing energy and energy infrastructure, for which demand is likely to continue and increase.

What kinds of companies operate as MLPs?

Due to the requirements of the tax code, the great majority of MLPs—about 80 percent by number, representing close to 90 percent of MLP market capital--are in energy-related businesses. The largest number of MLPs is in the midstream sector which gathers, processes, transports, and stores oil, natural gas, and refined petroleum products. There are also MLPs engaged in the production of oil and natural gas, distribution of propane and other refined products, coal leasing and mining, and marine transportation of petroleum products. In addition, there are some publicly traded partnerships in the investment industry, and in various other businesses.

How are MLP units different from corporate stock?

The big difference is in how MLPs and their investors are taxed. Unlike corporations, MLPs and other partnerships are not considered as separate entities for tax purposes. Rather, MLPs and other partnerships are "pass-through" entities. No tax is paid at the partnership level; partnership income passes through and is taxed only at one level - that of the individual partner. Since deductions such as depreciation and depletion are also passed through to individual partners, taxable income is often quite low. Most MLPs make quarterly distributions to their partners that will significantly exceed any tax owed.

What does that mean for MLP investors?

Since the MLP itself does not pay tax, it is able to pass along more of its earnings to its investors than a corporation. It does this in the form of quarterly cash distributions. From a tax standpoint these distributions are treated more favorably than corporate dividends. Rather than taxable investment income, the amount of distribution beyond net income is considered to be a return of capital and reduces the partner's basis in the partnership units. The partner will not be taxed on these amounts until the MLP units are sold and tax paid on the gain, including distributions, or when the basis reaches zero.

What if the income and deductions passed through by the MLP come out to a net loss?

Unless you are an active participant in the MLP's management, a net loss from an MLP is considered a "passive loss" under the tax code. If you come out with a net loss for the tax year, you cannot deduct it from your taxable income, not even income from other MLPs. However, you can carry it forward into future tax years and use it to reduce your taxable income from the same MLP. Any remaining loss may be used against other income when you dispose of your entire interest in the MLP.

.What happen when units are sold?

When the units are sold, the difference between the sales price and the adjusted basis equals the taxable gain (or loss). Some of the tax on the capital gain from selling the interest will be taxed at the capital gains rate. That portion of the gain that results from a downward adjustment of the basis after allocation of depreciation or depletion deductions will be taxed at the ordinary income rate.

What is a K-1? Will it delay my tax filing?

The K-1 form is the document an MLP investor will receive during tax season showing the investor's share of each item of partnership income, gain, and loss, deductions, and credits. The K-1 provides the information necessary for an investor's tax return. MLP investors receive this form instead of the 1099. While K-1's cannot be made available in January as is done with the 1099, MLPs work hard to provide the K-1 on a timely basis. Usually an investor can download the K-1 from a company website in time to meet tax filing deadlines.

Can I hold MLPs in my IRA?

Yes, but MLPs may not represent the best investment for a retirement plan. First, an MLP offers significant tax benefits that are better utilized in a taxable account. Secondly, an IRA (or any tax-exempt entity earning income from an outside business) is subject to the "unrelated business income tax" (UBIT) after the first $1,000 of net income from a business that is unrelated to its exempt purpose (unrelated business taxable income, or UBTI). Since an MLP is a pass-through entity, the IRA would be considered to be "earning" the MLP's business income, which is almost always considered to be unrelated to the IRA's exempt purpose. If the IRA's UBTI from all sources is over $1,000, the fund custodian will have to file a return and pay tax on the excess out of the IRA's funds. Most advisors feel that unless there is reasonable certainty that the net income received from MLPs will be less than $1,000 each year, it is better not to hold them in an IRA. This is equally true of regular and Roth IRAs.

How can I or my retirement plan invest in MLPs without the tax hassle?

There are several closed-end mutual funds and some open-end funds that concentrate on MLPs. If you invest through one of these funds, they will deal with the tax issues of being a limited partner and pass the income they receive from the MLPs on to you or your retirement account as a dividend, some of which will be treated as return of capital. You will receive a 1099 form instead of a K-1. The downside is that you will not get the full tax benefits of direct investment in an MLP, and some of the income will be retained by the fund for fees and expenses.

How can I find out more about MLPs?

Visit the website of the National Association of Publicly Traded Partnerships at www.naptp.org.

This fact sheet is for informational purposes only and should not be construed as offering tax or investment advice. Consult the appropriate professional advisor regarding your own situation.

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Basic Tax Principles for MLP Investors

Owning units (shares) in an MLP is different from owning corporate stock in a number of ways, most notably their taxation. That is because an MLP is a partnership, and you, as an investor, are a limited partner. To understand how an MLP investor is taxed, it helps to know the basic principles of partnership taxation.

Partnership Tax Basics: Income

- An MLP, like all partnerships, is a pass-though entity which pays no tax itself. It is treated by the tax code not as a separate entity but as a collection of partners.
- The unitholder, as a limited partner, is treated for tax purposes as if he is directly earning his share of the MLP's income.
- Each unitholder is allocated on paper a proportionate share of the MLP's income, gain, deductions, losses, and credits. This is reported annually on the K-1 form.
- The unitholder enters these items on his tax return and pays tax on the net income at his own tax rate. The tax is owed whether or not the unitholder receives a cash distribution.
- If there is a net loss, it cannot be used to offset the unitholder's other income. It must be carried forward and used against future income from the same MLP. Any loss still remaining may be deducted against other income when the unitholder sells his entire interest in the MLP.

Partnership Tax Basics: Distributions

- The quarterly cash distributions are not the same as your share of the MLP's income.
- Under the tax code, the distributions are a return of capital and are not taxed when received.
- Your basis in your partnership units (the amount you paid, increased or decreased by various adjustments) is lowered by the amount of the distribution.
- Thus, when you sell your units, your taxable gain (sales price minus adjusted basis) is increased by the amount of the distributions.
- Often you will hear someone say that "80% (or a similar number) of the MLP's distribution is tax-deferred." What they mean is that your share of the MLP's net taxable income, as reported on the K-1 form, equals about 20% of the tax-deferred cash distribution.

Basis Adjustments

- Basis is used to determine your gain or loss when you sell your units.
- Your initial basis is the price you paid for your units.
- Your cash distributions adjust your basis downwards. Your share of taxable partnership income each year adjusts the basis upwards; your share of deductions like depreciation adjusts it

downwards. Or in other words, your basis is adjusted upwards by your share of income minus your share of deductions.

- As long as your adjusted basis is above zero, tax on your distributions is deferred until you sell your units. If it reaches zero, future cash distributions will be taxed as capital gain in the year received.
- If a unitholder dies and the units pass to his heirs, the basis is reset to the fair market value of the units on the date of death, and the prior distributions are not taxed.

Gain and Recapture

- When you sell your MLP units, your taxable gain is the difference between the sales price and your adjusted basis.
- Not all of the gain when units are sold is taxed at capital gains rates.
  - The gain resulting from basis reductions due to depreciation is taxed at ordinary income rates—this is called "recapture."
  - Gain attributable to your share of some types of assets held by the MLP—substantially appreciated inventory and unrealized receivables—is also taxed as ordinary income.
- These items will be reported on the K-1 for the year in which you sell your units.

Simplified Example	
Year 1: 1,000 units purchased @ $30.00. **Basis is**:	**$30,000**
Investor receives total cash distributions of $2.50/unit	- $2,500
Investor is allocated and pays tax on net taxable income of $.50/unit, including $2.00 of income and $1.50 of depreciation	+ $ 500
Adjusted Basis	**$28,000**
Year 2: All units sold @ $32.00	$32,000
Gain per unit: $32.00 - $28.00 = $4.00	**$ 4,000**
Depreciation recapture-taxed at ordinary income rates	$1,500
Taxed at capital gain rates*	$2,500
*Assumes MLP has no "ordinary income" assets	

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MLPs and Retirement Accounts

Investors often ask if they can invest in MLPs through their retirement accounts -- IRAs, 401(k)s, and similar plans which are allowed to earn tax-deferred income under the Internal Revenue Code. The quarterly cash distributions offered by MLPs make them an appealing possibility for investors wishing to build up retirement funds.

You Can, But….

The answer is **yes, IRAs, 401(k)s, and other qualified retirement accounts are allowed to invest in MLPs** the same as any other traded security**.** Before you add MLPs to your retirement account, however, there are some special considerations that you need to weigh carefully.

First, remember that **one reason many people buy MLPs is for the tax advantages** -- the tax-deferred distribution and the ability to offset taxable income passed through from the MLP with depreciation and other deductions. In a retirement account, however, the income is already tax-deferred, so the tax benefits of an MLP are, in a sense, "wasted."

More importantly, contrary as it may seem, **holding MLPs in a retirement account can result in the account owing tax.**

Unrelated Business Income Tax

There is a concept in the tax code (I.R.C. §§511-514) called **"unrelated business income tax" (UBIT)**. Under the UBIT rules, tax-exempt organizations and retirement accounts must pay tax on their **"unrelated business taxable income" (UBTI)**--income from a business that is not related to their exempt purpose (a university operating a business that had nothing to do with education would be an example).

If your IRA invests in an MLP, it becomes a limited partner in that MLP, just as you would if you invested directly. Because an MLP, like all partnerships, is a pass-through entity (no tax is paid by the partnership, all tax items flow through to the limited partners/shareholders, who pay tax on their share), the partners are treated by the tax code as if they are directly earning the MLP's income. Thus, as a partner in the MLP, the IRA or other account is considered to be "earning" its share of the MLP's business income. The MLP's business is not related to the retirement account's tax-exempt purpose; therefore the IRA's share of the MLP's income is treated as UBTI and is taxed accordingly.

The tax is owed on the retirement account's share of the MLP's taxable business income, minus its share of depreciation and other deductions related to the business, as reported on the K-1 form (**not** on the quarterly distributions). The K-1 contains a line reporting how much UBTI the MLP is passing through. The tax rate is the top corporate rate, currently

35%. There is a deduction that covers the first $1,000 of UBTI from all sources; after that, the retirement account will owe tax.

It is important to remember that **you are not** the one who will owe any unrelated business income tax on MLP units held in your retirement account. **The tax is owed by the IRA or other account itself, as it is the partner in the MLP.** It is the responsibility of the custodian of the account to file a tax return (form 990-T) and pay any tax owed out of the account's funds.

Should I Hold MLPs in my Retirement Account?

Investment advisors who follow MLPs differ on whether it is a good idea to include them in a retirement account:

- Some analysts feel it's inappropriate to put an MLP in a retirement account. They argue that because the tax benefits are such an important feature of MLPs, this investment should be in a taxable account where the benefits can be realized. They also feel that placing MLP investments in an account where they are subject to UBIT unnecessarily diminishes the return and creates additional complexity.

- Others argue that because MLPs' income is largely offset by deductions like depreciation, taxable income for many retirement accounts may well be below the $1,000 UBIT deduction. They also feel that the income aspect of the MLP is the most important benefit, and that even if the retirement account does have to pay tax, the cash distributions will still provide a highly desirable return on an after-tax basis.

This is a decision that investors need to make for themselves after weighing their priorities, consulting their tax and investment advisors, and running the numbers on the MLPs that interest them.

Other Alternatives for Retirement Accounts

If the prospect of incurring UBIT makes you shy away from a direct investment in MLPs for your retirement account, there are alternatives that will still provide many of the rewards of MLP investment without the adverse tax consequences. There are currently several mutual funds which invest in MLPs and pass their MLP income through to their investors as dividends. In addition, a few MLPs have affiliates that issue special shares that pay distributions in the form of additional shares and do not trigger UBIT; an additional MLP has formed an affiliate that pays cash dividends. If you want this income opportunity for your retirement account but don't to risk incurring UBIT, you may want to check out these options.

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