

The best way to own master LPs

Calculating cost basis is such a hassle that many investors prefer receiving a 1099 over a K-1

By Robert N. Gordon

April 24, 2011

Master limited partnerships are legal entities that trade on an exchange but are not corporations. As partnerships, they pay no tax themselves; an MLP's partners/owners are allocated the profits or losses of the entity through the issuance of K-1s. The MLP owners then reflect those results on their individual tax returns.

Since many investors don't want the complexity of dealing with the profits and losses of the underlying MLPs, Wall Street has spawned a variety of products that offer MLPs' market exposure but not the hassle. These include exchange-traded funds, exchange-traded notes, closed-end funds, options on MLPs, options on ETFs and other novel structures. But does an investor give up something for the convenience of receiving a 1099 instead of a K-1?

To answer that question, we first must discuss the tax impact of owning MLPs, which is not the same as owning stock. MLPs distribute cash flow to their partners. Historically, about 80% of the cash flow is characterized as a return of capital with the remaining 20% considered taxable income. A payment received that is a return of capital reduces the investor's cost basis. For example, if an investor bought an MLP at \$20, and then received \$2 as a return of capital, his cost basis would be adjusted downward to \$18.

There exists a common misperception that if that same client sold his MLP shares at \$20, the \$2 difference between cost basis and sale price would be capital gain. Due to depreciation recapture, this is not the case.

Cash flow earned and distributed by an MLP is sheltered by depreciation deductions. In our example, the depreciation that sheltered 80% of the cash flow from taxes would come back as ordinary income, not capital gain. Any amount realized upon the sale above \$20, however, would be capital gain.

If the investor sold at \$18, that would not be a wash but instead create \$2 of ordinary income and \$2 of capital loss. See why investors don't want a K-1? And you can't own MLPs in a tax-sheltered account without worrying about unrelated business taxable income.

Recently, several ETFs and closed-end funds dedicated to owning MLPs have been issued. Since mutual funds can't have more than 25% of their assets in MLPs, these new MLP ETFs and funds have chosen to forsake the mutual fund tax shield and be taxed as regular corporations instead. That's an extra 35% tax on the distributions before they get to the investor. We conclude that the after-tax income that is paid out to the investor should be taxed either as qualifying dividend income or eventually as capital gains upon sale.

ETNs on MLPs are structured to pay out what an investor would have received as the MLP owner, minus management fees. Payments are taxed as interest; capital gains or losses are realized upon sale. Of course, investors expose themselves to credit risk by buying an ETN, a risk that would not be present if they bought an ETF, a closed-end fund or an MLP itself.

FOLLOWING THE MONEY

Let us see what would happen to \$1 of MLP cash flow under the various ownership structures:

- Owning the MLP directly lets investors keep 65 cents of the cash flow (assuming today's highest rate). They pay some of the tax as time goes by, and the bulk of the tax is deferred and realized upon sale, at ordinary income rates.

ETN owners also receive 65 cents (minus the management fee), which is taxed at the highest rate as it is received. There is no deferral of income recapture.

- For owners of ETFs and closed-end funds that hold MLPs, the \$1 of MLP cash flow is treated differently. The ETF or fund receiving the \$1 deducts its management fee and other expenses in order to arrive at its taxable income, on which it pays the corporate tax of 35%. What's left is then paid to shareholders as dividend income. If we assume the current 15% tax on qualifying dividends, the investor would be left with 55 1/4 cents under a best-case scenario.

- Investors with very long time horizons might be best served with direct MLP investments because the taxable income from deferred recapture can be forgiven at death through the operation of the step-up in basis and the MLP's Section 754 election. The other methods of ownership do not wind up having the same effect.

Bottom line: There are lots of ways to get exposure to MLPs; make sure you're choosing the one that is best for you and your clients.

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