

## The tax lure of MLPs and REITS

Investors should know what they're getting into when they put their money in these alternatives

**By Robert N. Gordon**

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Looking for alternative investments after the market crash, many investors turned to master limited partnerships and real estate investment trusts. One of the attractions of such investments is that MLPs and REITs do not pay taxes as they would if they were set up as corporations.

Although investing in an entity that does not pay a corporate level of tax is enticing, investors should make sure they know what they're getting into.

Between 1981, when the first MLP started trading on an exchange, and 1987, many MLPs were formed. Regular taxpaying corporations converted into MLPs, while other MLPs were spun off.

Borden converted from a corporate form to an MLP. So did Sahara Resorts, National Healthcare, ServiceMaster and USACafes. The Boston Celtics traded as an MLP.

Investors were rewarded for owning these new entities. Karen Denning and Kuldeep Shastri measured an 11.55% "excess return" from being an MLP versus a corporation from 1985 to 1987, in their paper "Changes in Organizational Structure and Shareholder Wealth: The Case for Limited Partnerships" (Journal of Financial and Quantitative Analysis, 1993).

In "Taxes and the Relative Valuations of S Corporations and C Corporations" (Journal of Applied Finance, 2002), authors David Denis and Atulya Sarin concluded that there was a 12% premium received by unit holders for being an MLP from 1984 to 1985 and a 43% higher market value as measured from 1985 through 1995.

The trend of taxpaying companies' turning themselves into MLPs threatened the government's tax revenue from corporations. In 1987, to stop further conversions, Section 7704 of the Internal Revenue Code was passed. It limited what an MLP could and could not do. Not surprisingly, new MLPs could not operate businesses. Those MLPs operating businesses that converted before 1987 were grandfathered into the law for a 10-year period. After 1997, they had to go back to paying taxes.

The MLP wave has reached a point that it appears some issuers are calling themselves MLPs to get attention they might not garner otherwise.

Seadrill Ltd. just spun off Seadrill Partners LLC, an entity that the company and Wall Street are calling an MLP, even though it is a taxpaying corporation.

Linn Energy LLC, an MLP, has issued a new share class that will not be taxed like a partnership. These new shares represent the ownership of a taxpaying company that in turn owns Linn MLP units. These shares were created for tax-exempt investors who cannot own MLPs directly. This share class does not seem the best way for a taxpayer to invest in Linn.

A mutual fund cannot have more than 25% of its assets in MLPs without flunking the mutual fund test. Because of this, these funds are taxed at the corporate level and distribute only what they have left after taxes. A taxpaying investor is leaving a lot of money on the table investing in MLPs through mutual funds.

Real estate investment trusts have been around since 1960 and are similar to mutual funds. As long as the REIT distributes at least 90% of its income to its shareholders, it does not have to pay any corporate tax.

Right now, we are experiencing the same kind of activity in REITs that we saw in the "80s in MLPs. Many companies are either turning themselves into REITs or are spinning off their real estate holdings into a REIT and leasing them back.

A more recent tax ruling loosening the definition of what is allowed in a REIT is the catalyst behind this movement. Obviously, companies are trying to create a premium to the enterprise value, compared with if they remain in corporate form.

Recent converts include three REITs that run data centers. Prison companies are looking to convert, as is Iron Mountain Inc., a storage company. Lamar Advertising Co., which specializes in billboards, is looking to convert, as well as companies that own cellphone towers. Analysts estimate that American Tower Corp. (now a REIT) will save more than \$400 million in taxes a year by 2017 by virtue of converting. Penn National Gaming Inc. is claiming REIT status for its casinos.

The conversion from corporation to REIT does create a tax hit at the time of conversion for shareholders. The converting company must pay out all of its undistributed "earnings and profits" as a dividend. In the case of Penn National, that is \$15.40 per share (only \$5.35 will be paid in cash, the rest is "phantom income").

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