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THE ESSENTIALS
OF INVESTING
IN MLPS

The Essentials of Investing in

MLPs

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Dividend.com Essentials of MLP Investing

Master Limited Partnerships, or **MLPs**, are popular among dividend investors for their higher-than-average yields, tax-deferred distributions, and relative safety in volatile markets. Investing in MLPs requires special attention, however.

These investments include a unique company structure and particular tax ramifications, so be sure to fully understand MLPs before putting your investment dollars to work.

In fact, all investors should consult a tax specialist before investing in Master Limited Partnerships (MLPs).

MLP Basics: Structure, Type, Ownership, and Distributions

What are MLPs?

Master Limited Partnerships (commonly known as MLPs) trade like any other common stock on U.S. exchanges. MLPs are not corporations, however, and have very little in common with run-of-the-mill common stocks -- particularly in the way that taxes are calculated.

- **As limited partnerships, MLPs are considered “pass-through entities” and do not pay income tax. Instead, the tax obligation is passed onto their collection of limited partners (shareholders).** *We’ll delve deeper into this topic later, because it is the single most important factor to consider when investing in MLPs.*

So, when you buy shares of MLPs, you are actually buying partnership units. For taxation purposes, you are considered a partner in the company, not a common shareholder.

Types of MLPs

By law, MLPs can only engage in certain types of businesses. The Internal Revenue Service (IRS) requires these companies to generate a minimum of 90% of their income from “qualifying” sources, mostly relating to energy production and distribution. However, a few other types of businesses have organized as MLPs as well. Below are the general categories most MLPs fall under:

- **Pipeline operators** transport oil, natural gas, or a combination of both through a network of pipelines. The vast majority of all MLPs are in this grouping.
- **Propane retailers** market and sell propane to commercial and residential customers.
- **Exploration and production** firms seek out and produce oil, natural gas, coal, and other natural resources.
- **Shipping** MLPs transport oil and related products via oil tankers and other non-pipeline means.

Other companies that have organized as MLPs include a few real estate investment and financing companies, a couple of investment management firms, an amusement park operator, and a cemetery operator. These businesses operated as MLPs before the now much-more-rigid rules regarding MLPs were enacted, however, and are “grandfathered in,” so to speak.

Who Owns MLPs?

Master Limited Partnership ownership is split into two categories:

1. A **General Partner** (known as the “GP”) manages and controls the company’s operations. The GP typically owns a 2% general partnership stake in the company, along with some additional limited partnership units. Normally, general partnerships are privately-held companies, but a few have also begun trading publicly.

General partners are entitled to a certain percentage of the company’s accumulated cash flow before distributions (dividends) are paid to limited partners. The percentage due to the GP, called “incentive distribution rights,” can vary from as little as 5% to as much as 50%, depending on the size of the company’s cash flow.

2. **Limited Partners** are simply investors in the company. As a shareholder, you will be considered a limited partner in an MLP.

MLP Distributions (Dividends)

Similar to Real Estate Investment Trusts (REITs), Master Limited Partnerships are obligated to pay out the vast majority of their earnings to shareholders in the form of distributions (dividends). This fact helps make MLPs one of the highest-yielding equity investments available today.

All MLPs pay distributions on a quarterly basis and stick to a very rigid payout schedule. The high yields offered by many MLPs come with a few caveats, however. In the next section, we’ll review the unique tax consequences of MLP investing.

Tax Ramifications of MLPs

Now that you understand the basic structure of MLPs, it's time to delve into the single most important factor in MLP investing: income taxes.

Speak with a Tax Specialist Before Investing in MLPs!

Due to their special company structure, limited partnerships do not pay corporate income tax at a state or federal level. Instead, the tax burden is passed completely onto its limited partners (shareholders). Because of these special tax issues, **you should always consult with an accountant before investing in MLPs.**

Please note the following information should not be considered tax advice.

MLP Tax Basics

As a limited partner (shareholder) in an MLP, it is your responsibility to pay your share of the company's income tax on its earnings. These earnings are treated differently from the regular distributions (dividends) an MLP pays out. Thus, it is useful to separate partnership *income* from partnership *distributions* when trying to understand how these investments are taxed.

Partnership Income

Remember, an MLP is a pass-through entity that does not pay taxes itself. The partners (shareholders) are responsible for paying taxes. In fact, as a limited partner, you will be treated as if you are directly earning the company's income yourself.

You will receive a K-1 form each year from the MLP whose units you own. This document will indicate, on paper, a proportionate share of the MLP's income gain, losses, deductions, credits, etc. You will then be responsible for paying tax on your share of the partnership's taxable income at your personal tax rate.

Partnership Distributions

The quarterly distributions (dividends) you receive from an MLP are separate from the partnership income. These dividends are actually considered "return of capital" and are not taxed when received.

When you receive a distribution, your cost basis in the units you own is lowered by the amount of that distribution. Conversely, when it comes time to sell your shares, your cost basis will be increased by the amount of your distributions. So, although a portion of the distributions (dividends) from MLPs are tax-deferred, when selling your MLP shares, the basis on which you are taxed will rise.

Each year, normally in February or March, MLPs will mail out K-1 forms to each limited partner (shareholder). These forms will indicate how much of their payouts are tax-deferred.

Sound complicated? It is. That's why **we recommend investors speak with a tax professional regarding investing in MLPs.**

MLPs and Retirement Accounts

Most retirement accounts, such as IRAs and 401(k)'s, are allowed to hold MLPs as investments. However, **MLPs may not be suitable for these tax-deferred accounts.**

One of the biggest advantages of MLPs is that a portion of their dividend payouts (distributions) are tax-deferred. This tax-deferred portion will be exempt from normal income taxes. Since IRAs and 401(k)'s are already tax-exempt accounts, however, this advantage is nullified. Plus, **you may wind up owing tax in your retirement account by owning MLPs.**

For more information on MLPs in retirement accounts, please see:

http://naptp.org/PTP101/MLPs_Retirement_Accounts.htm

Additional MLP Issues to Consider

Shares Offerings are Common for MLPs

Many limited partnerships will periodically sell additional partnership shares in order to fund operations, and in some cases, to help fund their dividend payouts. On the whole, however, MLPs have very stable cash flow because of the nature of their businesses.

Forget About Payout Ratio

Payout ratio is a common tool used to evaluate a traditional company's ability to maintain its current dividend payout level. This metric simply isn't useful when it comes to MLPs, however.

Remember, MLPs don't actually pay dividends. Rather, their distributions are actually a return of capital. As a shareholder, you receive your portion of distributable cash from the partnership. Furthermore, payout ratio is based on earnings per share, which also does not apply to MLPs because of their unique company structure.

The Best Way to Evaluate MLPs

At Dividend.com, we look mainly at two factors when evaluating MLPs: **yield** and **price performance**. A recent history of distribution (dividend) increases is another element to consider, since it will indicate the partnership is growing its cash flow. A dividend yield of around 5% is a good starting point for your research.

Conclusion

Master Limited Partnerships can be a great addition to your portfolio, particularly for income investors. They offer high yields, make consistent distributions, and also can also provide capital gains over time. MLPs carry special tax consequences, however, and are generally not suitable for tax-advantaged retirement accounts.

Additional Resources

Dividend.com's List of Master Limited Partnerships (MLPs):

<http://www.dividend.com/dividend-stocks/mlp-dividend-stocks.php>

National Association of Publicly Traded Partnerships:

http://naptf.org/Navigation/PTP101/PTP101_Main.htm

We hope you find this report interesting and useful, and we welcome all comments and feedback via e-mail to contact@dividend.com.

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