

Making Sense of Master Limited Partnership Tax Rules

By Mary S. Lyman

Article Highlights

- Partnership income is what makes MLPs a tax-advantaged investment, but also makes them more complex.
- Unitholders pay taxes on their share of partnership income; any distribution above this amount reduces their cost basis.
- Gains realized at the time of sale are not completely taxed at capital gains rates.

So you've finally bought some shares in a master limited partnership (MLP) after hearing everyone rave about this equity investment that gives you a high yield, pays out cash every quarter and has tax advantages.

A couple of quarters go by, your investment pays off as promised, and you're a happy camper. Then tax season rolls around and instead of the familiar Form 1099, a new form called a Schedule K-1 (Form 1065) shows up in the mail, with numerous boxes labeled with different types of income and deductions. What's going on? What are you supposed to do with this?

The Basics

For those who are new to them, the first thing to understand is that an MLP is simply a publicly traded partnership (PTP). (Not all PTPs are MLPs, however; a number of PTPs are simply commodity pools.) By buying shares, technically referred to as "units," in an MLP, you become a partner (or a "unitholder") in this very large partnership. As a partner rather than a corporate shareholder, you enter a whole new world of taxation. Partnership taxation is what makes MLPs a tax-advantaged investment, but it also makes them more complex than many other investments.

As a partnership, an MLP is not considered to be a separate entity for tax purposes the way a corporation is, but rather is a pass-through entity—sort of an agglomera-



tion of all its partners. An MLP does not pay corporate tax; instead, all the things that go into calculating tax—income, deductions, gain, losses and credits—are divided up among the unitholders as if they had earned the income themselves. Part III of the K-1 tells you your total share of each of these items. You pay tax on your share of the partnership's taxable income, as determined by all the items on the K-1. It is important to remember that you will owe tax on this income whether or not you receive a cash distribution.

Distributions Are Not Dividends

What about the distributions? Do you pay tax on them as well? You might think so, since the quarterly cash distributions look a lot like dividends; however, MLP distributions are not dividends, but quite a different creature. When you fill out your tax return, the only thing you have to worry about paying tax on is your share of net partnership income. The portion of the distribution that is equal to net income is covered by that tax payment.

Any distribution over and above the taxable income is considered to be a return of capital—you're getting back some of the money you invested—and it is not taxed when you receive it. Rather, the distribution lowers the adjusted basis in your units. The lower basis increases the realized gain when you sell the units, and you pay more tax as a result; this is how the distributions ultimately get taxed. For the first few years that you hold the partnership unit, your taxable income will generally equal about 20% of your distribution, so you

can consider that tax is deferred on 80% of the cash you receive. We'll look more closely at adjusted basis later.

Another way that an MLP distribution differs from a corporate dividend is that the distribution per unit is often more than the net income. This is because MLPs don't look at net income when they calculate their distributions; they look at distributable cash flow (DCF). Distributable cash flow starts with net income, but adds back depreciation, because depreciation is an accounting entry that doesn't actually affect cash flow. [Editor's note: Depreciation is the amount of value an asset loses over time due to age and wear and tear.] Distributable cash flow also subtracts out the money that will be needed to keep capital assets in good working condition. There may be other adjustments as well. Most MLPs distribute most or all of their distributable cash flow.

Table 1 illustrates the differences between corporate shareholders and MLP unitholders using current (2012) federal tax rates. For simplification purposes, the chart assumes that the corporation pays out all of its aftertax income in dividends, which is, of course, very unlikely in real life.

Dealing With the K-1

Back to the Schedule K-1: What do you do with it? You can download your K-1 information from the MLP's website and let a tax software program handle it for you. Or, you can hand the whole thing over to an accountant. Failing that, you will need to take the K-1 and insert each number reported in Part III of the form into the correct place on your own tax return—which often is the same place you would report it if you had earned the money yourself. The IRS' Partner's Instructions for Schedule K-1 (Form 1065), available at www.irs.gov/

Table 1. Taxation of Dividends and Distributions Using 2012 Tax Rates

	Amount per Share/Unit	
	Corporation	Publicly Traded Partnership
Gross income	\$5.00	\$5.00
Deductions	(\$3.00)	(\$3.00)
Net income	\$2.00	\$2.00
Federal corporate tax (35%)	(\$0.70)	\$0.00
Aftertax net income	\$1.30	\$2.00
Corporate dividend/partnership distribution*	\$1.30	\$2.50
Shareholder's federal tax on dividend (@15%)	(\$0.20)	—
Unitholder's federal tax on share of net MLP income (\$2.00 × 33%)	—	\$0.66
Net income to shareholder/unitholder	\$0.80	\$1.34

*The MLP distribution of \$2.50 exceeds net income because, as discussed, distributions are made out of distributable cash flow rather than net earnings.

pub/irs-pdf/i1065sk1.pdf, will tell you where on your return each item goes; some information is also available on page 2 of the K-1. It is important to check with these instructions because some items, losses in particular, are handled differently for publicly traded partnerships than they are for other partnerships.

For the majority of MLPs, most of the income will be ordinary business income (Box 1), and will be reported on Schedule E of Form 1040. Interest and dividend income will be added to your own interest and dividend income on lines 8 and 9 of your 1040 (again—your distribution is not dividend income; this line is for your share of any dividends received by the MLP). Some items reported may be less simple, as they involve types of business income, deductions or credits that you are unlikely to have yourself, or they have special rules applying to MLPs. If you don't have the particular forms for these, you can find them on the IRS' Forms and Publications webpage, www.irs.gov/Forms-&-Pubs.

Passive Loss Rules

Passive loss rules are one area where MLPs are different from non-traded partnerships. These rules, section 469 of the tax code, categorize income and loss as "passive" when it comes from a

partnership in which you are a passive investor rather than an active participant in the business. The general rule is that income and loss from different passive investments may be offset against each other, but passive losses may not be used to offset non-passive income, like your salary. Publicly traded partnerships (including MLPs), however, have a stricter rule: Losses from a PTP can be deducted only from income from the same partnership. Any excess losses must be carried forward to be used against income in future years; if there is not sufficient income, excess losses are held until you sell your entire interest in the partnership. Moreover, net income from a publicly traded partnership is not treated as passive income.

For this reason, the Partner's Instructions for Schedule K-1 (page 4 of the 2011 version) tell you that rather than report passive income, gains and losses from a publicly traded partnership on Form 8582, the usual form for passive losses, you need to add up your share of income and gain items and subtract the deductions and losses. If the result is net income, the net amount (i.e., income minus loss) is not treated as passive income, but as investment income. The income and loss that offset each other are treated as passive and entered in the usual places on your return. If you have a net loss, the income and loss that offset each other are again treated as passive

MLPs and Retirement Accounts

Often investors would like to invest in MLPs through their individual retirement accounts (IRAs) or other qualified retirement accounts. MLPs can be held in these accounts, but there are some things you should consider before you do so. First, given that part of the benefit of an MLP investment is the tax deferral, you may not wish to “waste” this benefit on an account that is already tax-deferred.

More importantly, MLP investments held in an IRA or similar account are likely to be subject to “unrelated business income tax” (UBIT). UBIT is imposed on tax-exempt entities, including retirement plans, that earn “unrelated business income” (UBI)—income from a business that is not related to the purpose of their tax exemption. For instance, if a tax-exempt university operated a bowling alley off-campus that was not for the benefit of its students but simply a commercial enterprise, the income from the bowling alley would be UBI. This keeps the tax-exempt university from unfairly competing with taxable businesses, and also ensures that the income from operating this business gets taxed at least once.

Because MLPs are pass-through entities, tax-exempt unitholders (e.g., your IRA) are treated as directly “earning” the MLP’s business income and are taxed on it. Passive investment income such as interest, dividends and royalties are not considered UBI and will not be subject to UBIT if passed through to an IRA from an MLP.

The income subject to UBIT in an IRA is not the cash distributions. These are treated as return of capital in an IRA just as they are in a taxable account. It is the partnership’s business income, minus the deductions applying to that income, as reported on the K-1, which is subject to UBIT. In addition, the first \$1,000 of UBI can

be deducted, so only IRAs with net income over that amount will have to pay tax. The tax rate is the highest corporate rate, 35%.

Some analysts feel MLPs are a good investment for IRAs and other retirement funds despite the possibility of UBIT, because:

- The pass-through of depreciation and other deductions means net income may be below \$1,000. Many investors find that the UBIT reported for their IRA (which can be found in Box 20, code V of the K-1) is minimal or negative.
- Even if tax is owed, the cash distributions may still be sufficient to produce a very good return. Some important things to keep in mind:
- The \$1,000 deduction is per account, so you have a \$1,000 deduction for each IRA you own. If you have more than one MLP or other UBI generator in a specific account, their income would be aggregated before subtracting the \$1,000 in determining whether UBIT is owed.
- If your IRA (or other account) does owe UBIT, the IRA, not you, owes the tax. The plan custodian should file a return and pay tax from the plan’s funds.

An alternative would be to invest your IRA in one of the many MLP funds now available. The number of these has grown considerably over the past few years, and several open-end and closed-end mutual funds, as well as exchange-traded funds (ETFs), are now available. You will lose some of the return to management fees and other costs, but the IRA will receive a dividend and avoid UBIT problems. These are also an option for individuals who want to avoid the K-1 and state tax hassles in their taxable accounts.

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and entered in the usual places

Adjusted Basis

Another aspect of being an MLP unitholder is that it is very important to keep track of your adjusted basis in your MLP units. With an MLP, or any partnership investment, your adjusted basis changes every year. The adjusted basis determines not only your gain when you sell your units, but whether your distributions continue to be tax-deferred. Here is how it works:

- Your initial basis is the price you

paid for your units;

- Distributions lower your basis;
- Your share of partnership income reported on the K-1 each year adjusts the basis upward; and
- Your share of deductions reported on the K-1 each year adjusts the basis downward.

(Or more simply, net taxable income raises your basis and a net loss lowers it.)

Because distributions usually are more than K-1 income, it is likely that your adjusted basis will drop each year. However, your adjusted basis cannot go below zero. Once you reach zero,

the portion of the distribution that was return of capital now becomes taxable—all your investment capital has been returned. Taxation of this portion of the distribution will occur at the capital gains rate.

Table 2 provides a very simple example of how it works.

Selling Your Units

As Table 2 shows, the calculation of your tax when you sell your units is also somewhat more complicated than with other investments. As discussed

earlier, the difference between your adjusted basis at the time you sell your units and the price for which you sell them is your gain—but not all of that gain is taxed at capital gains rates. That is because with most MLPs, your taxable income each year is substantially lowered by depreciation deductions—that is why your taxable income is so low compared to distributions. As you know, if you have been involved in a real estate investment, the tax law requires that you “recapture” those depreciation deductions when you sell your investment by taxing that portion of the gain as ordinary income rather than capital gain.

In the Table 2 example, the unitholder had a \$1,500 depreciation deduction. So \$1,500 of the \$4,000 is taxed as ordinary income and \$2,500 as capital gain. As the years go by and you deduct more depreciation, the portion of gain that will be taxed as ordinary “recapture income” increases. However, this is mitigated to some extent by increases in the value of the units.

A point worth noting for estate planning: Like other securities, MLP units get a basis step-up to fair market value at the owner’s death. The heir inherits the units with a fresh fair market value

Table 2. Simplified Example of Adjusted Basis

Year 1: 1,000 units purchased @ \$30.00. Basis is:		\$30,000
Investor receives total cash distributions of \$2.50 per unit		(\$2,500)
Investor is allocated \$2.00 of income on the K-1	2,000	
and is allocated \$1.50 of depreciation deductions,	(\$1,500)	
for net income of \$0.50 per unit.	=	\$500
Adjusted basis: \$30.00 – \$2.00 = \$28.00 per unit		\$28,000
Year 2: All units sold @ \$32.00 per unit		\$32,000
Gain per unit: \$32.00 – \$28.00 = \$4.00		\$4,000
Depreciation recapture—taxed at ordinary income rates		\$1,500
Amount taxed at capital gain rates		\$2,500

basis, and the previous years’ distributions remain untaxed.

State Taxes

By now the question may have occurred to you: Does this pass-through system apply to state taxes, too? Yes, it does. Because you are treated as if you directly earned the partnership’s income, you may owe tax on your share of the MLP’s income in every state in which it operates.

The good news is that most MLP investors will not actually owe tax in states where they don’t reside. By the time an MLP’s income is allocated among all the states in which it operates

and divided among tens of thousands of unitholders, the amount for one unitholder in any one state is likely to be very small, well below the threshold for owing tax. The master limited partnership will include in your K-1 package a list of your share of income in each state.

The bad news is that some states require you to file a return anyway. The Federation of Tax Administrators has a good website (www.taxadmin.org) with links to state tax information, including state tax rates, brackets and exemptions at www.taxadmin.org/fta/rate/ind_inc.pdf; and state tax forms and filing options at www.taxadmin.org/fta/link/default.php?lnk=2#. ▲

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