MASTER LIMITED PARTNERSHIPS (MLPs)

DEFINITION

Master Limited Partnerships (MLPs) are highlighted. You may have heard of these investments in the news media or read about them in financial publications as they are becoming increasingly popular given their annual yields and tax benefits. A Master Limited Partnership is a publicly traded limited partnership made up of general and limited partners.

HOW THEY WORK

OVERVIEW

The general partners manage the day-to-day operations of the MLP, while the limited partners provide the capital but do not participate in the management of partnership. 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 combines the pass-through tax benefits of a limited partnership with the liquidity of publicly traded securities.

DISTRIBUTIONS

Income distributions from MLPs are similar to dividends, and are usually paid on a quarterly basis. The amount of these distributions is typically stated in the contract between the general partner(s) and the limited partners. In most cases, the general partner’s management fee is tied to the amount of this distribution, with a higher income distribution to the limited partners resulting in a higher incentive for the general partner.

TAXATION

The primary reason for a company to establish itself as an MLP is tax avoidance. Investors in a corporation face double taxation, paying taxes both on earnings at the corporate level and then at the personal level when those earnings are received as dividends. However, partnerships are not taxed at the company level. The income is instead “passed-through” to the owners of the partnership, who receive an IRS Schedule K-1 from the MLP, and are taxed on their individual portions of the MLP's income, gains, losses, and deductions. This means MLP owners are taxed only once, at the individual level.

An investor’s initial tax basis in MLP units is generally the amount paid for the units. This basis is usually then decreased with each distribution and allocation for losses or deductions. Conversely, the basis is increased for each allocation of income. A portion of certain distributions may also qualify as a return of the investor's capital which will reduce the tax basis.

QUALIFICATION

To qualify for MLP status, a partnership must generate at least 90 percent of its income from interest, dividends, gains from the sale or disposition of real property, real estate rents, or income and gains from commodities, commodity futures, mineral activities, and natural resources activities. Due to these requirements, most MLPs operate within the energy industry.

GROWTH

Apache Oil Company was the first MLP and went public in 1981. Soon after, many other oil and gas MLPs became available and they quickly expanded to other industries such as hotels, restaurants, and cable TV companies. As a result, the U.S. government became concerned about more and more companies transitioning from the corporate structure to MLP structure, so in 1987, Congress passed Section 7704 of the U.S. tax code, limiting partnership tax treatment for MLPs that fall within certain operating categories, specifically energy and natural resource companies. The goal of maintaining the tax break for these companies was to encourage investment in energy infrastructure and natural resources in the United States.

TYPES

- Oil and Gas Pipelines - these assess a toll for transportation of a commodity and in most cases, the price of oil/gas does not matter since what determines profitability is the quantity being transported. These f MLPs have a large portion of revenues derived from fees and are usually more stable and less correlated with commodity prices.
- Distribution of Propane and Other Refined Products – with these MLPs, they often have low-growth potential but with high cash flow. The consumers of these refined products typically get it from only one provider so there is little risk of consumers switching to a competitor.
- Exploration & Production (E&P) – since they are engaged in E&P business, their cash flow is not as predictable compared to oil and gas pipelines and distribution of refined products.
- Transportation – they provide offshore energy transportation services through tankers and barges and are viewed as one of the risker types of MLPs.

PURCHASING

Investors can generally purchase MLP units from brokers. Investors who do not want to deal with the complexity of an MLP’s K-1 form for their personal income taxes can also invest in MLPs through mutual funds, exchange traded funds (ETFs), and exchange traded notes (ETNs). Some tax benefits are lost at both the company level and the investor level in using funds and ETNs, but it provides additional diversification for investors to be in several MLPs.