

MLPs In IRA/Keough Accounts

A number of FCs and clients have wondered if MLPs (Master Limited Partnerships) are appropriate investments in their tax-deferred accounts from a tax standpoint. We've researched the question on and off for years, with varying degrees of success---you will find very few tax professionals who understand this field (it is relatively new, though the operations contained in the MLPs are quite old and mature), and it is almost impossible to find anyone at the IRS with authoritative knowledge.

Having said that, and adding that we are not tax professionals nor do we provide tax advice, we thought you would be interested in the position of The Coalition of Publicly Trade Partnerships. That is the industry association for MLPs, which they prefer to call PTPs (Publicly Traded Partnerships).

As you know, PTPs do not pay corporate tax. Distributions to investors, are deemed, for tax purposes, to be tax-deferred "return of capital." Investors are allocated a share of the PTP's income and also a share of the PTP's deductions (such as depreciation) losses, and credits. These will offset most or all of the ordinary income. If there is a net loss (remember, this is a tax accounting fiction---our PTPs pay cash distributions) it is considered a "passive loss" and isn't deductible from income, though it may be used in future years to offset any ordinary income from the PTP or to offset other income when you sell your units. Passive income and loss from a PTP may only be used to offset income and loss from the same PTP. Your adjusted basis in the stock is reduced by the amount of any passive loss or tax deferral.

So much for the taxable investor. For the non-taxable investor, the Coalition offers the following Q&A, with our comments following:

"Can I hold PTP units in my IRA?"

"Yes, subject to some limitations. Partnership income allocated to a tax-exempt organization or a retirement trust like an IRA (including Roth IRAs) may be considered unrelated business taxable income (UBTI) subject to tax. However it will not be taxed as long as the amount of this income and all other sources of UBTI does not exceed \$1,000 in any one year. Even if there is some tax on the PTP income, the PTP distributions will generally be high enough to provide a favorable return on an after tax basis."

"If my IRAs PTP investment does generate UBTI exceeding \$1,000 do I have to pay the tax? How is it paid?"

"You do not pay any tax yourself: the IRA is the unitholder and therefore the taxpayer. The custodian of the IRA will be responsible for filing an IRS form 990T. The IRA's share of all PTP income and of the deductions connection with the production of that income...is netted and entered on line 5, 'Income (loss) from partnerships and S corporations'. The specific deduction of \$1,000 is entered on line 33...tax is paid (out of the IRA funds) on the result, at the corporate tax rate."

Our understanding is this: if you have UBTI from MLPs (PTPs) the custodian of your account is supposed to file a form 990T and pay tax *from funds in your account* on the net income from your aggregated MLPs (and any other partnerships you may have in your non-taxable account). In practical terms, we would not expect this to happen. Last year, for example, the aggregate K-1s for our Income-Equity account showed a substantial net loss for tax purposes (even though we received substantial cash from our investments). There was no “ordinary income” to be considered for UBTI.

This “no ordinary income” isn’t guaranteed every year, but any UBTI qualifying income is likely to be de minimus. Although we are not tax professionals, we would be comfortable in the thought that an account would have to be of institutional size (say, \$5 million and up) before it would possibly generate any UBTI above the exclusion. And, in the worst-case scenario, a custodian would have to pay tax on the excess of UBTI income over \$1,000. We wouldn’t have a problem with that, either, since MLPs have been among our best performers over the years---we expect them to perform well in the future---and well worth a small tax payment in the unlikely event such a requirement should ever arise. We won’t opine on the likelihood of a custodian recognizing and filing in such a situation.

In sum, no investor is doing anything wrong or violating any rule by holding MLPs in a non-taxable or tax-deferred account. Should there arise ordinary income characterized as UBTI the investor’s custodian would need to pay a tax on that income only, and we would consider that as a small price to pay for attractive income from an attractive asset. Further, the probabilities of actually realizing such income are very low in our opinion.