

## Commonly Asked Questions

### What Is a Master Limited Partnership?

*The immediate advantage of the partnership structure is the elimination of double taxation found within the traditional corporate framework.*

Master limited partnerships (MLPs) are structured as conduits through which the operating results of the business are passed on to unit-holders. MLPs are designed to distribute 85%–90% of their earnings and are not subject to corporate taxation. The immediate advantage of the MLP structure is the elimination of double taxation found within the traditional corporate framework. As a result, operating earnings flow directly to the unit-holders in the form of cash distributions. Distributions made to each partner are taxed at each unit-holder's individual income tax rate. Income taxes paid at the individual tax rate are generally less than the taxes paid if the MLP were classified as a corporation. Although the characteristics of an MLP closely resemble a traditional limited partnership, a major difference is that MLPs may trade on a public exchange or in the over-the-counter market. The ability to trade on a public exchange or in the over-the-counter market provides a certain amount of liquidity not found in many limited partnerships.

### Are There Any Tax Advantages from MLP Investing?

*Unit-holders receive their tax information in a Schedule K-1, which is distributed by the MLP each year; most MLPs are able to get this information out by the second week of March.*

All the MLPs in our universe provide tax advantages to unit-holders through partially tax-deferred cash distributions. The amount of the distribution that is tax deferred is treated as a return of capital and reduces the investor's tax basis in the investment. The amount of the cash distribution that is not tax deferred is taxed at the taxpayer's ordinary income tax rate, and when the unit-holder sells the MLP the gain will be taxed at the ordinary income tax rate. Of course, the longer an MLP is owned by an investor, the smaller the present value of the tax obligation. The tax-deferral feature also makes a MLP an attractive investment alternative to investors seeking an estate-planning vehicle. MLPs are an excellent diversification alternative to bonds, utilities, real estate investment trusts, and other high-yielding investments.

### How Sensitive Are MLPs to the Economic Environment?

*An ideal environment for MLPs is one in which interest rates are stable or declining and cash distributions are rising.*

The economic environment can play a significant role in determining how an MLP may perform over various time periods. Indeed, securities providing a high current yield, such as MLPs, are generally considered interest rate-sensitive investments. During periods of interest rate volatility, these interest rate-sensitive investments may provide lackluster total returns. To illustrate this point, consider an economic environment in which inflationary signs begin to surface and interest rates gradually increase. As interest rates climb, the yield spreads of most income-producing securities begin to erode, triggering a decline in the asset price. Conversely, in an environment in which interest rates are declining, prices of interest rate-sensitive assets begin to increase. An ideal environment for MLPs is one in which interest rates are stable or declining and cash distributions are steadily rising. Investors who recognize the inverse relationship between interest rates and MLP valuations should realize better investment results over time.

*Rising distributions typically lead to an improved yield valuation, since cash distribution growth drives unit price appreciation.*

## **How Does Distribution Growth Impact Total Return?**

For investors looking for more than just yield, several MLPs strive to maximize cash distribution growth through expansion projects and strategic acquisitions. These growth opportunities often provide MLPs a way to increase distributable cash flow and cash distributions payable to unit-holders. Rising distributions typically lead to an improved yield valuation, since distribution growth drives price appreciation and total return. Although many of the MLPs in our composite can achieve organic cash distribution growth of 5% annually, a modest level of acquisition activity can help to more than double this amount. This has certainly been the case for many MLPs over the past few years. Indeed, we think this is one of the major reasons our composite should continue to outperform the S&P 500 Index. When determining which MLP makes the most sense for an investment portfolio, we recommend that investors do not focus exclusively on an MLP's yield. Instead, we believe investors should also consider an MLP's distribution growth potential and expected total return.

*A ratio of 1:1 or better generally indicates adequate reserves to cover cash distributions.*

## **Are Distributions Guaranteed by the General Partner?**

Cash distributions payable to unit-holders are not guaranteed. Any changes in the supply or demand for energy that have a material adverse effect on an MLP's profitability could jeopardize the cash distribution. An examination of the cash flow coverage ratio could provide valuable information to an investor. Distributable cash flow coverage ratios are used to evaluate an MLP's ability to sustain its current cash distribution level. A ratio of 1:1 or better generally indicates adequate reserves to cover cash distributions. The risk of whether an MLP will be able to cover the minimum quarterly distribution increases when the ratio falls too far below one.

*One benefit the corporation enjoys is incentive distributions, which are unique to the MLP structure.*

## **Why Would a Corporation Want to Form an MLP?**

Common reasons for the formation of an MLP typically involve a corporation trying to increase shareholder value or using the structure as a corporate financing tool. A corporation that believes the value of its assets are not being correctly recognized by the market may decide to monetize a portion of its portfolio using the partnership structure. This strategy is based on the expectation that a more favorable valuation would be rewarded by the market once the assets are separated from the corporation. As a corporate financing tool, a corporation could obtain cash on its assets in an amount equal to its fair value, without surrendering control of the assets. Another benefit the corporation enjoys is incentive distributions, which are unique to the MLP structure. Incentive distributions enable a general partner to earn an increasing percentage of distributions once certain target distribution levels have been reached.

*We recommend that investors consult with their tax advisers regarding any retirement account investing.*

## **Are MLPs Appropriate Investment Vehicles for IRAs?**

Generally, all the taxable net income received by a tax-exempt investment vehicle such as an IRA, Keogh, or 401(k) plan from a MLP may be considered unrelated business taxable income (UBTI). Section 512 of the U.S. Tax Code states that the UBTI tax liability applies if the total amount of UBTI from all partnership interests exceeds \$1,000 in any taxable year. Therefore, a unit-holder may be subject to income taxes in an otherwise tax-exempt retirement account. We recommend that investors consult with their tax advisers regarding any retirement account investing.