

Mastering MLPs

Master limited partnerships offer high yields, tax advantages, and a chance to stay above water should interest rates rise.

By Donald Jay Korn

June 1, 2004- One of Michael Cohen's clients sold the assets of his company recently. "It was an S corporation that had been a C corporation," says Cohen, a partner with Levun, Goodman & Cohen, a law firm in Northbrook, Ill. "It had approximately \$1 million worth of earnings and profits from its time as a C corporation. That could have led to a steep tax bill and, eventually, loss of its S corporation status," explains Cohen, a co-author of the monthly "Partner's Perspective" column accompanying the *CCH Partnership Tax Planning and Practice Guide*.

What does partnership taxation have to do with S or C corporations? "Publicly traded partnerships, also called master limited partnerships [MLPs], are one solution," Cohen says. "Investing just a modest amount of the sales proceeds in MLPs solves the problems."

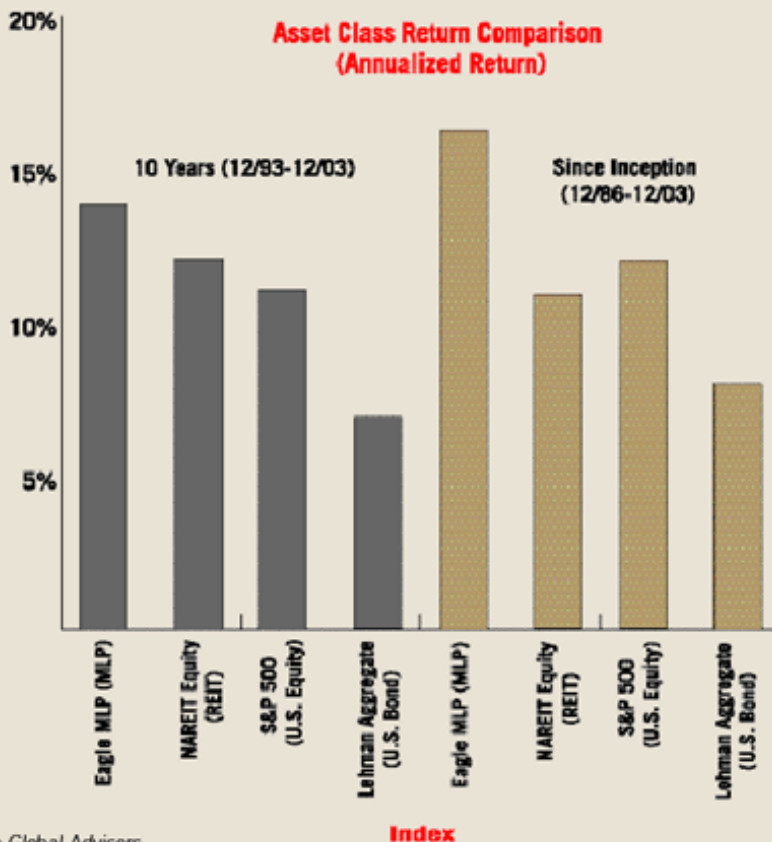
In today's environment, investing in MLPs also might solve other types of problems. Many clients want substantial levels of investment income, but yields are low. What's more, the growing threat of rising interest rates may deter financial advisers from recommending high-yielding bonds or bond funds.

"Master limited partnerships may be less sensitive to rising interest rates than other high-yield investments, like junk bonds and REITs [real estate investment trusts]," says Ron Londe, an analyst with A.G. Edwards in St. Louis. "They also offer the potential for distribution increases, which can offset weakness from rising interest rates. MLPs have been increasing distributions at around 6% per year, faster than the inflation rate, and this is likely to continue."

Although MLPs are relatively new on the scene, their past performance suggests they may deliver high, increasing yields and solid total returns. "Our index reports MLPs returned nearly 14% per year for the last 10 years, through 2003," says Malcom Day, portfolio manager at Eagle Global Advisors, a Houston-based firm that provides investment management expertise for MLP portfolios. "In the first quarter of 2004, the total return was 3.7%." The returns are higher than both stock and REIT returns over the last decade, and with less volatility (see "Standing Alone" below).

Standing Alone

Over the past 10 years, master limited partnerships, as measured by the Eagle MLP Index, have outperformed domestic stocks and bonds and REITs.



As their name suggests, MLPs are firms with both general partners, who manage the business operations, and limited partners, who are passive investors. The "master" signifies that they trade publicly (many on the New York Stock Exchange). "Under a law passed in the 1980s, MLPs can avoid paying corporate taxes if they show that they receive 90% of their income from natural resources and related activities," Day explains. "So most of today's MLPs are involved in energy and other natural resources."

According to the Coalition of Publicly Traded Partnerships in Washington, there are over 50 MLPs, two-thirds of which are in the oil, gas, coal, minerals, or timber categories. For these industries, the elimination of double taxation via an MLP lowers the cost of capital.

"By avoiding corporate taxes, MLPs have more income to distribute to their investors," Day adds. Yields currently are around 7%, although they do vary among MLPs. "What's more, investors get tax advantages from MLP distributions," says Barry Miller, partner and co-section head of the tax department at Vinson & Elkins, a law firm in Houston.

Miller cites an investor who buys an MLP at \$20 per share ("unit" in MLP terminology) and gets \$2 in quarterly distributions in year one. "The investors don't actually owe tax on those distributions. The tax they owe is based on their share of partnership income," he says.

The partnership income may be low, especially after taking advantage of various entity-level tax breaks. So this investor might pick up only 40 cents per unit of partnership income. "It is not at all unusual for 70%-80% of an investor's distribution to be a return of basis," Miller says. In this example, the investor would owe tax on 40 cents of ordinary income, while \$1.60 is a tax-free payout.

"The \$2 distribution would reduce the investor's basis from \$20 to \$18, and the 40 cents in taxable income would increase that basis to \$18.40," Miller continues. "If there is a subsequent sale for \$21,

then the investor's taxable gain in this case would be \$2.60--\$21 less the adjusted basis of \$18.40."

Of that \$2.60, the \$1.60 untaxed distribution would be treated as ordinary income, while the \$1 of price appreciation would be a capital gain. The bottom line, Miller explains, is that MLP investors receive hefty distributions and can defer the tax on most of them until after the units are sold.

"This tax treatment can go on indefinitely, even after an investor's basis is reduced to zero," says Michael O'Leary, a partner with Andrews Kurth in Houston. "Any negative tax capital account would then be recognized on a sale." But depending on future tax law, MLP units that are held until death might get a basis step-up to market value, and the deferred income tax could go unpaid.

MLPs report their annual tax results on a Form K-1 for partnerships, rather than the 1099s used to report stock dividends. "Investors shouldn't avoid them just because they'll receive K-1s," says Miller. "A K-1 has only a few numbers, which go on the federal tax return. A tax professional can handle it easily."

O'Leary cautions that a few MLPs have Canadian operations, increasing the complexity faced by U.S. investors. Miller adds that state taxation can be complicated, while others say tax reporting should be a consideration.

"It doesn't make sense to own only 100 shares of one MLP," Londe says. "The extra income you'll receive won't offset the costs of tax preparation. We suggest investors have 5%-10% of their portfolio in MLPs, enough so extra cash flow exceeds costs. They should hold at least five issues to get a good mix of companies, perhaps one propane MLP, one in coal, and three pipelines."

Pipelines get predictable, regulated fees that may rise in line with inflation. Since those fees are paid for transporting petroleum products, MLPs are not exposed to fluctuations in energy prices.

"They're the lowest-cost means of moving oil and gas, so pipeline revenues are not as sensitive to the economy or world events," Londe notes. "After the September 11 attacks, the volume of jet fuel went down, but gasoline was up, as people did more driving." Long term, economic expansion is likely to lead to increased energy use, greater revenues for pipelines, and higher distributions.

"In most MLPs, there are incentives for distributions to increase over time," Miller explains. "A typical offering will have minimum distributions in place for the first three to five years. The general partner, who also may hold some limited partnership interests, won't receive anything until the public investors get that minimum distribution."

Beyond that minimum, the sponsor gets a percentage of incremental cash flow. "The general partner's share might go from 15% to as much as 50% of the increased cash flow," Miller says. "The parties' interests are aligned, and the general partner has an incentive to bump up cash distributions for investors."

Some observers see this fee structure as being overly rich for the general partner, but Miller claims investors can be well-served by these arrangements. Day points out that several MLPs have produced impressive returns while operating at a 50% incentive distribution split.

Despite such success stories, MLP investors may bear operating risks, particularly with companies that stray from proven cash-generating activities. "One MLP had a division of Enron as the general partner, and it went out of business," Cohen recalls.

There may also be tax risks. MLP units will generate unrelated business taxable income (UBTI) for tax-exempt investors; if such income exceeds \$1,000 per year, tax must be paid. "In theory, an investor might decide the income and potential appreciation would make it worthwhile to hold MLPs in an IRA or another tax-deferred plan," Miller says. "But a benefit of those plans--tax deferral--would be lost. So MLPs are usually held in taxable accounts."

Another drawback is that suppressed demand may cap the upside potential of MLPs. The UBTI keeps pension funds from investing, so all of the buying is done by individuals. (A few MLPs have units designed for tax-exempt investors.) "Mutual funds can't invest in MLPs," adds Mary Lyman, general counsel for the Coalition of Publicly Traded Partnerships. "We're trying to change that."

Mutual funds must obtain 90% of their income from sources listed in the tax code in order to avoid tax on earnings at the corporate level, and MLPs aren't on that list. "A provision to add publicly-traded partnerships to the list of permitted mutual fund investments has been in some tax legislation, but either the bills were vetoed for other reasons or the provision was dropped," Lyman

says.

Until such legislation passes, clients won't be able to invest in MLPs through mutual funds. "Our firm offers a partnership for accredited investors, with a minimum of \$250,000, that holds a basket of MLPs," Day notes. "For the most part, however, investors who want to hold MLPs will have to buy specific issues."

Another possibility emerged in 2004, when Tortoise Energy Infrastructure began to trade on the NYSE. "This closed-end fund holds MLPs," O'Leary explains. "It offers relatively high yields and is structured so tax-exempt entities can invest. But the yields to investors are treated as corporate dividends, not as MLP distributions."

If planners are going to look for individual MLPs, they should check on the debt-to-capital ratios. "That ratio is typically in the 40%-60% range," O'Leary relates. "MLPs at the upper end of that range are considered highly leveraged and may be vulnerable to downturns."

Besides leverage, O'Leary points to absolute distribution levels, cash flow growth, and distribution coverage as critical factors. (Distribution coverage is the relationship of cash flow, before accounting adjustments, to the amount distributed.) Distributions should be fully covered without support from the general partner's parent firm; as a general rule, most cash flow is paid out to investors.

"A history of successful acquisitions or market-driven expansion is critical," Londe says. "Acquisitions have helped MLPs to increase their cash distributions, and we expect that to continue."

If the results of the past decade are repeated in the next 10 years, MLPs may offer the following multiple benefits to planners and clients:

Income. "There aren't many investments that give you as much cash-on-cash return," Miller notes. Among competitive high-yield vehicles, REITs may be more sensitive to a weak economy, if property markets soften, Londe says, and MLPs offer a higher quality stream of income than junk bonds do. "After the 1998 Asian collapse, MLPs bounced back faster than high-yield bonds did because fundamentals held up and distributions increased," Londe points out.

Diversification. "MLPs also have diversification benefits for a portfolio," Day notes. "Their investment returns aren't well correlated with stocks, bonds, or commodities returns."

Tax benefits. In addition to offering tax-deferred income, MLPs may provide advantages in special situations, as previously noted. "Clients who sold assets from S corporations with earnings and profits from a C corporation might want to own MLPs that produce lots of revenue dollars per dollar of investment," Cohen says. "A small investment, perhaps 3% of the amount of earnings and profits, may generate enough trade or business income to let the S corporation continue without paying extra tax."

For income-seeking clients and those in special situations, MLPs may offer a means of mastering the tax code. Advisers may want to give them a look.

Senior Editor Donald Jay Korn has been writing about investments and tax and estate planning for Financial Planning since 1985.
