Taxation of Master Limited Partnerships (MLPs)

A Master Limited Partnership (MLP) is a limited partnership that trades on an established market. It is subject to the same tax rules and reporting requirements as limited partnerships.

For tax purposes, a partnership is a pass-through entity. The partnership itself usually does not pay taxes, but instead passes through its income / losses to partners. It is the proportionate share allocated to each partner that represents the partner's share of taxable income / loss. That income or loss is reported to each partner via a form K-1 which is mailed to investors directly by the general partners.

Investors in MLPs receive cash distributions; the amount of the cash distribution is not necessarily equal to the amount of taxable income. That's because for tax purposes, the partnership can claim a number of deductions that do not require the use of cash flow. The most common non-cash deductions are depreciation and depletion, which are both ratable write-offs of capital expenditures. For example, suppose a partnership received cash receipts of $10,000 in a year. Its annual operating expenses were $6,000. In addition the partnership owns a building and claims annual depreciation deductions of $1,500. Cash flow available for distribution to partners is $4,000 ($10,000 - $6,000); but reportable taxable income is $2,500 ($4,000 - $1,500). If a limited partner owned a 1% interest in the partnership, he or she would receive $40 in cash distributions but report only $25 as taxable income.

Passive Activity Loss Limitations

Passive activity losses (tax losses derived from passive activities such as limited partnerships or rental property) are not necessarily fully deductible against ordinary income each year. The deduction for a passive activity loss is limited to income from a passive activity. Income or losses from MLPs are considered passive. However, in contrast to passive income generated from other passive activities, passive income and losses from MLPs are only passive unto themselves. That is, an investor may not use the income generated from an MLP to "soak up" losses from another passive activity (e.g. an old limited partnership investment or MLP). Additionally, passive losses from MLPs cannot be used to offset income from other activities or even other MLPs. The losses are suspended and may only be used to offset income in subsequent years from the same MLP. When an MLP is sold, any unused losses first offset gains from the sale, then passive income from other MLPs, and finally any other income or capital gains.

Effect on Cost Basis

The tax shelter feature of an MLP as described at left is not a permanent escape from taxation, but instead represents deferral of taxation until a later date – usually the time the partnership interest is sold. That's because cash distributions and reportable taxable income cause a limited partner's basis in the partnership to be adjusted. Cash distributions reduce cost basis and taxable income increases cost basis. In a partnership where cash distributions exceed taxable income, the result is a continuing reduction in cost basis.

Continuing with our previous example, if our limited partner purchased his or her units for $3,000, after one year of operation the basis in the partnership interest would be reduced to $2,985 ($3,000 - $40 cash distribution + $25 taxable income).

The excess of cash distributions over taxable income results in a basis reduction and not in an immediate tax consequence. However, if annual cost basis reductions result in a cost basis being reduced to zero, any additional basis reductions (cash distributions in excess of taxable income) will result in a long-term capital gain even if the units have not been sold.

Consequences at Sale

When a limited partner sells an interest in an MLP, the partner must compare the sale proceeds with the adjusted cost basis to determine gain or loss. Once the amount of profit or loss is determined, the partner must still determine the character of that gain or loss as capital or ordinary.

In general, reductions in basis caused by depreciation (or depletion) deductions must be recaptured as ordinary income at the time of sale. That's because a deduction against ordinary income was claimed as a result of the depreciation (or depletion), so it must be recaptured as ordinary income at the time of sale. Suppose, after owning the partnership for over one year, the same hypothetical partner sold the partnership interest for $3,300 (which is more than the $3,000 originally paid for the interest). The partner would compute the total taxable gain from the sale as $315 ($3,300 - $2,985 cost basis). But that gain would be reported as $15 ordinary income resulting from depreciation recapture and $300 long-term capital gain because the MLP units were held for more than one year.

Taxation of Master Limited Partnerships (MLPs) *(continued)*

Consequences at Sale *(continued)*

Because of the substantial difference in tax rates imposed on ordinary income versus capital gains (35% maximum rate on ordinary income versus 15% maximum tax rate on long-term capital gains), it is important to understand that there must be an increase in market value between the time of sale and the time of purchase for a long-term capital gain to be created. You cannot produce a long-term capital gain merely because of the recapture of previously created basis reductions.

Consequences at Death

In general, assets held in an individual's name at the time of her or her death receive a "step-up / step-down" to fair market value as of the date of his or her death (or an alternate valuation date six months later). MLP interests are no exception. If in our previous example the limited partner died while still owning his interest (rather than selling his MLP interest for $3,300), the entire value of the MLP will be included in the investor's taxable estate and the interest or cost basis will be increased from $2,985 to $3,300.

In addition to avoiding ordinary income taxes or capital gains taxes, the partnership (upon being informed of the limited partner's death), can make an election to step-up the basis of the underlying assets owned by the partnership. That means that depreciation deductions for the heirs inheriting that interest will be increased. This is possible due to an increased basis of the asset giving rise to the depreciation deduction. The effect is that a higher tax deferral percentage may be available for new limited partners acquiring their interests by inheritance. However, due to the administrative burden of its implementation, many MLPs do not make this election.

Tax Reporting Issues

As previously discussed, tax reporting for MLPs is accomplished via a form K-1 which is provided by the partnership to investors. Because information required for completion of the K-1 comes from the partnership's informational tax return, it takes longer for an MLP to distribute K-1 information than the Jan. 31 deadline the IRS imposes on 1099 reporters. MLP investors typically receive their K-1 information during the month of March for the preceding tax year. However, since the partnership is not required to file its tax return until April 15, the K-1 may be received at a later date.

Tax Reporting Issues *(continued)*

A schedule attached to Form K-1 also provides a breakdown of taxable income by state based on the location of the MLP's operations. The investor uses this information to file state income tax returns. Investors should discuss state tax filings with their tax advisor. The investor may be required to file a state income tax return in each state where the MLP operates depending on the filing requirements of each individual state.

Because of the delayed tax reporting information and because the K-1 is more complex than standard 1099 reporting, investors who prepare their own tax return should consider the added complexity of tax reporting. On the other hand, for investors who have a professional tax preparer, a K-1 form is not so uncommon as to significantly complicate the tax preparation process.

Tax Issues for IRAs, Retirement Plans, Other Tax-Exempt Accounts

To qualify for tax-exempt status, income earned by a tax-exempt account (such as a retirement account) must be related to the exempt purpose of the account. In general, investment income qualifies as being consistent with such an account's exempt purpose. However, income generated from the operation of a business will be considered unrelated to the exempt function of the account and will be classified as UBTI, or unrelated business taxable income. An exempt entity may generate a total (from all MLPs held) of up to $1,000 per year in UBTI without tax. However, to the extent total UBTI generated exceeds $1,000, the otherwise exempt entity will be required to pay income taxes at trust rates.

An investment in an MLP is an investment in a direct participation program. As such, to determine if UBTI will result if purchased by an exempt account, the underlying activity being engaged in by the partnership must be examined. If that activity is that of an operating business, then UBTI will result. Conversely, if the activity of the partnership is not that of an active business, but instead involves the receipt of portfolio income, the UBTI characterization would not apply.

For any questions regarding whether a particular investment will generate UBTI, please refer to the MLP offering materials or contact your tax or legal advisor.

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