The Ultimate Guide to Choosing, Owning and Selling Master Limited Partnerships
Why Invest in Master Limited Partnerships (MLPs)?

Interest rates have been at historically low levels for years, which makes it easy for companies to raise money by issuing debt (which is supposed to help the economy grow) but makes it hard to live on the income from a portfolio of safe treasury and investment-grade bonds—as many retirees had always expected to do.

In response, many investors have broadened their definition of income investments, turning to dividend-paying common stocks and more aggressive assets for income.

One of these vehicles is the Master Limited Partnership, or MLP. MLPs are popular among income-seeking investors because they offer very high yields. No surprise there: MLPs are actually specifically designed to pass cash flows along to investors.

But a lot of investors don't fully understand MLPs.

Why are their yields so high? Are these yields sustainable? What are all these tax complications I've heard about with MLPs? And if they're so great, why doesn't everyone just hold all MLPs?

Don't worry, the answers aren't that complicated. And they're all here.

What is a Master Limited Partnership (MLP)?

A Master Limited Partnership is a unique type of business allowed under the U.S. tax code. They're similar to a “regular” limited partnership, with a few differences.

In addition to a limited partner or partners, who provide the MLP with capital and get a share of its cash flow in return, MLPs also have a General Partner (GP) that runs the business. We'll talk more about the importance of the GP a little later.

In addition, MLPs are publicly traded, by definition. The limited partners are public shareholders—who are called unitholders. The unitholders are entitled to a share of the MLP’s cash flow, which is paid to them as distributions. From an investor’s point of view, these distributions are similar to common stock dividends: their amount is usually declared (announced) at the beginning of the fiscal year, and the distributions are then paid to the unitholders quarterly or monthly.

There are some differences though, and most of the differences are related to the taxes you pay on those distributions.
That’s because the primary benefit of organizing a business as an MLP is that MLPs don’t pay corporate taxes on their revenue. Instead, the company’s cash flow is distributed, almost in its entirety, to its unitholders ... who are then responsible for some taxes.

That makes MLPs a very efficient way to pass along the cash flow of an income-generating enterprise to public shareholders. And that’s what accounts for their large distributions and very high yields.

It does make your taxes a bit more complicated. But we’ll get to that in a bit.

First, one more note on what makes an MLP: not just any business can be organized as an MLP. The tax code requires MLPs to derive about 90% of their revenue from natural resources, commodities or real estate. In practice, many MLPs own energy transportation or processing facilities, like oil or gas pipelines, although there are also MLPs that own unique assets like cemeteries. Any business in one of these industries that generates high regular cash flow, whether from rent, fees or simply selling goods, can make a good MLP.

**How to Assess MLPs**

Evaluating a Master Limited Partnership is a little different from evaluating an ordinary stock. While your questions will be similar—like, “can the MLP keep paying its distribution?”—you’ll find the answers differently.

**Distributable Cash Flow**

Cash is an important consideration, but for MLPs, traditional measures like earnings per share (EPS) and profits don’t tell us much, in part because of the companies’ massive depreciation of assets. Instead, we look at Distributable Cash Flow (DCF), which is calculated by subtracting interest and capital-spending costs (cash expenses) from earnings before interest, taxes, depreciation and amortization (EBITDA).

**Distributable Cash Flow (DCF) = EBITDA – Interest – Capital Spending**

DCF gives us a better picture of an MLP’s income situation than earnings or net income because the MLP usually keeps its depreciation, interest and capital spending deductions as high as possible to lower their tax liability. Most MLPs own significant physical assets, like pipelines, and they claim significant depreciation of these assets every year. Sometimes, EPS are actually negative because depreciation and other non-cash “expenditures” are larger than cash flow. But it’s cash we care about, not the non-cash stuff.

DCF is also important because that’s the number the MLP uses to determine its payout to unitholders (usually distributing a specified percentage).
The Distribution Coverage Ratio
Likewise, because MLPs are designed to pass almost all of their income onto unitholders, the usual payout ratio is not a useful measure of whether an MLP can “afford” its distributions. Instead, look at the percentage of DCF that is being paid out as distributions, sometimes called the Distribution Coverage Ratio. If the ratio is less than 100%, the MLP should be able to pay its distributions going forward. If it’s over 100%, find out why, and decide if the MLP is likely to continue overextending itself, or if the situation will be resolved in the next quarter or so.

Fees vs. Commodity Prices
One reason MLPs are prized by income investors is their consistency. Most MLPs are structured as simple pipelines (sometimes literal pipelines), earning lots of cash and passing it on to their unitholders. The more reliable an MLP’s revenues, the more reliable your distribution will be.

To find the most reliable cash generators, look for MLPs with primarily fee-based income. Those MLPs are getting most of their cash from fees for things like using pipelines or storage facilities.

By contrast, MLPs that get most of their revenue from commodity-price dependent sources, like propane production or mining royalties, are more likely to experience fluctuations in revenue.

Industry
You should also look at what industry the MLP is in: cemeteries are pretty much as non-cyclical as it gets, while energy demand can change significantly.

Distribution Increases
Just as with common stocks, you want your income from your MLP holdings to keep rising. Frequent or recent distribution increases are a sure sign that the MLP is confident it can continue to afford its payout. Distribution increases are also a great indication of a growing business with increasing cash flow.

The General Partner
Another important factor to consider before buying an MLP is the partnership’s relationship with its General Partner (GP). As mentioned above, investors like you are an MLP’s limited partners. But MLPs also have a General Partner, which is a person or another company (sometimes also public) that’s responsible for running the MLP.

The General Partner has a direct stake in the MLP, like you, but usually also has incentive distribution rights, which entitle the GP to extra payments from the MLP. The amount of these incentive distributions is based on how much cash the MLP handed out to unitholders—so the more money unitholders get, the more money the GP gets. It’s the GP’s job to run the MLP, so it makes sense that the more cash it generates, the better it’s paid.
But some incentive distribution formulas are more unitholder-friendly than others. A good formula incentivizes distribution growth by rewarding the GP for increases in distributable cash flow, particularly early on, without ever becoming too generous to the GP. If the formula becomes too generous toward the GP at high distribution levels, unitholders may not see much additional cash when their MLPs start earning more. Before buying an MLP, always be sure you understand the incentive distribution formula, and how it’s likely to affect your payouts going forward. You can find the formula in the MLP’s registration statement.

So how does a good GP help their MLP grow distributable cash flow and distributions? One important tool is the **dropdown acquisition**. In a dropdown acquisition, the GP sells an asset it already owns—like a refinery, a shipping terminal or just land—to its MLP. Since the GP is a part owner of the MLP, and what’s good for the MLP is good for the GP, the GP usually sells the asset at a very advantageous price, usually described as “immediately accretive to distributable cash flow” in industry parlance.

Previous dropdown acquisitions made at advantageous prices and integrated successfully are a good sign for MLP investors. They mean that the MLP has good support from its general partner and may be able to grow its DCF and distributions with future dropdown acquisitions.

**How do I pay taxes on my MLPs?**

Because MLPs don’t pay taxes at the corporate level, you will owe tax on any MLP distributions you earn. But the distributions are heavily tax-advantaged, with most of your tax burden deferred until you sell the MLP. Here’s how it works.

MLP distributions are made based on the MLP’s **Distributable Cash Flow (DCF)**, which is similar to free cash flow (FCF).

This is important because an MLP’s DCF is usually much higher than its net income. That’s because MLPs have significant depreciation and other tax deductions, which lower their taxable net income significantly. (This is why certain types of businesses make better MLPs: huge tangible assets like oil pipelines have very high depreciation expenses.)

Here’s how it works: Revenue comes in, the MLP pays it out as distributions to you and other unitholders, then the MLP takes deductions on the revenue and reports its taxable net income to the government.

And, as you may have guessed, you only owe taxes on the portion of your distribution that came from the MLP's net income—which the MLP will inform you of in an annual form called a K-1.

You then have to pay regular income taxes (not the lower qualified dividend tax rate) on that portion of the distribution. While having to pay the regular income tax rate may seem disadvantageous, you’re usually only paying that rate on 10% to 20% of the total distribution.
What happens to the other 80% to 90% of the distribution?

The other 80% to 90% of the distribution is considered **Return of Capital**. Return of capital is not considered income, instead, it’s treated as if the MLP is simply giving some of the money you’ve invested in it back to you. As such, you’re not taxed on this portion of the distribution. Instead, it reduces your cost basis in the MLP.

Here’s an example:

Let’s say you buy an MLP for $50, and receive an annual distribution in your first year of $3.50, of which $0.30 is considered taxable net income. You owe regular income taxes (not the lower dividend tax rate of 15%) on that $0.30, but the remainder of the distribution, $3.20, is return of capital. Your cost basis in the investment will be reduced by $3.20, to $46.80.

And your cost basis will continue to be reduced by the return of capital amount (sometimes called shielded income) each tax year.

**What happens if all my capital is eventually returned?**

Since most of the MLP’s distributions are considered return of capital, eventually the total amount of these distributions may exceed your original cost basis in the investment, making your adjusted cost basis zero. If this happens, you can no longer decrease your cost basis, and you can no longer treat any distributions from that MLP as return of capital. Instead, you must pay taxes on the full amount of the distributions, at your regular income tax rate.

**The K-1**

At tax time, any MLPs you own will send you an annual K-1 instead of a 1099-DIV or similar form. The K-1 tells you what percentage of your distribution was return of capital and lists your pro-rata share of each income and expense item of the partnership. The form should also provide you all the information you need to enter this information into your taxes. (You likely will report these items on Schedule E, instead of the Schedule B where payouts from stocks, bonds and mutual funds are reported.) Some MLPs even allow you to download the data directly from your K-1 into your tax preparation software.

You can also take your K-1s to any decent accountant for help, or call the MLP’s investor relations contact for help.

If your state has an income tax, it likely will require you to either complete similar state versions of the form or attach a copy of the federal forms to your state return.

**What happens when I sell the MLP?**

As mentioned above, the primary tax advantage of holding an MLP is being able to defer most of your taxes on the investment until a later date—specifically, when you sell the MLP.
So when you eventually sell an MLP, you have to pay two types of taxes.

As with stocks, you have to pay long-term capital gains taxes on your profit on the investment. If you bought the MLP for $50 per unit, and sell for $70 per unit, you'll have to pay long-term capital gains taxes on the $20 per unit you made from the price appreciation.

You also have to pay the income taxes you've deferred over the life of the investment. That means you have to pay taxes, at your regular income tax rate, on the difference between your original purchase price and your reduced cost basis.

Let's say you buy an MLP for $50 per share, and your distributions that qualify as return of capital average $2 per share every year. If you decide to sell the MLP after 15 years, your cost basis per share will be $20, or $50 – ($2 x 15 years). You now owe income taxes on the $30 difference between your adjusted cost basis per share and your original price.

This might not seem attractive, but there are myriad reasons why deferring taxes, or paying them later, is preferable to paying them now. Working investors may be trying to defer their taxes until they retire and their income tax rate is lower. Retired investors may be trying to minimize the taxes on their current income. And any investor can see the logic in hanging onto the cash so you can invest and grow it now, and then pay the tax bill with it later.

Plus, there's a little perk for investors who plan to pass some of their investments on to their heirs. For tax purposes, the cost basis of MLP units is “reset” to the current market value if the original unitholder dies and passes on the investment. So the new owner won’t owe income tax on the difference between the original cost basis and the adjusted cost basis. This quirk can make MLPs a useful estate-planning tool.

**Do I have to pay taxes in every state where the MLP operates?**

This is a common rumor about MLPs, and while technically true, it actually rarely affects individual investors.

It's true that when you own an MLP, you are considered to be earning income in every state in which the MLP operates.

However, you're rarely going to “earn” enough income in any single state that you will have to pay state income taxes on it. Most states have a minimum income amount below which you do not have to pay state income taxes. And other states, including some where MLPs are especially active, like Texas, don't have state income tax at all.

Your K-1 will include a state-by-state breakdown of where the MLP's income was earned. If you have a particularly large stake in the MLP, it's possible you may owe income tax to one or more of these states, but usually that is not the case.
Can I hold MLPs in my IRA?

This is a common question from investors considering buying MLPs for income.

While you are allowed to hold MLPs in a tax-advantaged account like an IRA, it is generally not recommended (and the same applies to Roth IRAs).

That’s because the IRS considers MLP distributions paid into an IRA **Unrelated Business Taxable Income**, or UBTI. And if your IRA earns over $1,000 in UBTI (total from all sources, including distributions from different MLPs) in a single year, your IRA will be liable for paying tax on that income at corporate tax rates.

Some investors still hold MLPs in their IRA and don’t find themselves hitting the $1,000 limit—your experience will depend on the size of your IRA and how many MLPs you’re interested in holding. But if you do most of your investing through an IRA and would like to add the yield-boosting powers of MLPs to your account without worrying about UBTI, you might consider buying an MLP fund, which doesn’t pass the tax liabilities onto shareholders in the fund.

Some Examples

Here are some tables showing how some hypothetical MLP investments might play out.

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<th>Date</th>
<th>Adj. Cost Basis</th>
<th>Distribution</th>
<th>Percent of Distribution considered...</th>
<th>Current Price</th>
<th>Taxes due on this amount at Income Tax Rate...</th>
<th>at Long-Term Capital Gains Rate...</th>
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At Sale $0.00

$70 $50 $20
My second table shows the same example, but in this scenario, the investment is passed on to an heir after 29 years instead of being sold. Note the difference in the tax obligation the final year (I’ve also abridged this table by excising 10 years in the middle).

Lastly, here’s an example where the investor sells after 12 years, before his cost basis is reduced to zero. You’ll note that these are simplified examples, using made-up data. Future price and dividend payments are impossible to predict.

However, the bottom line is clear: MLPs are good long-term investments for investors who want to defer their taxes and earn high, low-tax income now, and make an especially powerful tax shelter when passed on to heirs.
About the Expert

Tom Hutchinson is the Chief Analyst of Cabot Dividend Investor, Cabot Income Advisor and Cabot Retirement Club. He is a Wall Street veteran with extensive experience in multiple areas within the financial world. His experience includes specialized work in mortgage banking, commodity trading and as a financial advisor at several of the nation's largest investment banks.

For more than a decade Tom created and actively managed investment portfolios for private investors, corporate clients, pension plans and 401Ks. He has a long track record of successfully building wealth as well as providing a high income while maintaining and growing principal. With Cabot Dividend Investor, Tom combines a scientific, quantitative approach to stock analysis with the practical, personal and honest advice that have characterized Cabot’s services since 1970.