Master Limited Partnerships

WHAT IS A MASTER LIMITED PARTNERSHIP (MLP)? YIELD WITH GROWTH

A MLP is a limited partnership that is publicly traded on a securities exchange, usually the NYSE or NASDAQ. A MLP is not a corporation, but rather a partnership that does not have a federal tax obligation. Thus, there is no double taxation with a MLP and the tax burden falls to the unitholders. MLPs own and operate assets in the natural resources industries (energy, timber, etc.). Similar to REITs, a MLP should derive its income from "qualified" sources and must meet certain distribution test. The following highlights some of the differences between MLPs and corporations:

- MLPs are made up of a general partner (GP) and limited partners (LPs). GPs are involved in the day-to-day operations of the partnership, while LPs have no involvement in the partnership's operations.
- The GP is typically paid on a sliding scale based on the distribution to the LPs and the number of LP units outstanding called incentive distribution rights, or IDRs, which can increase as the LP distribution increases.
- Investors buy units of the partnership rather than shares of a corporation and are referred to as unitholders.
- MLPs pay distributions rather than dividends.

A PORTION OF DISTRIBUTIONS ARE TAX DEFERRED UNTIL INVESTMENT IS SOLD

Cash distributions usually exceed the partnership's taxable income and the difference is counted as a "return of capital" to the LP, which goes to reduce his cost basis. When the investment is sold, the deferred amount is "recaptured" and taxed as ordinary income. MLPs typically start out with 70%-90% of their distribution as a "tax shield", but the percentage tends to decline over time until the cost basis is reduced completely. Then the distribution would become fully taxable.

TAX FORMS FOR MLPS ARE COMPLEX

MLPs issue a K-1 tax form, rather than the familiar 1099 form. The K-1 comes out later than the 1099 (most are out by mid-March). If investors are planning on investing in the group, we suggest they purchase a portfolio of MLPs (more than one name to effectively deal with the K-1 tax forms) and seek counsel from tax advisors.

MLP STRENGTHS

- ***Distribution Growth & Coverage:*** Historically, the MLPs, as a group, have grown their distributions above the inflation rate. Distribution coverage tends to average around 1.2x within the group.
- ***Yield:*** Most MLPs offer attractive yields in the 5%-10% range for limited partnerships and 4%-9% for general partnerships. Again, a portion of the distribution is typically tax deferred and "recaptured" on the sale of the units.
- ***Liquidity:*** Publicly traded partnerships, such as MLPs, tend to have better trading liquidity than private partnerships. In addition, there is no minimum size of investment. Most MLPs trade around $5/unit - $80/unit.
- ***Limited Liability:*** The LPs have limited liability, so investors are liable only to the extent of their investment.

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MLP RISKS

- ***MLPs Are Not Alike:*** MLPs may be a solid investment choice for income-oriented investors. However, MLPs are not all the same and hold assets with varying risks. Some MLPs throw off stable cash flow that covers the distribution payout at ratio of 1.0x. Others operate assets that throw off more volatile cash flow which may need a higher distribution coverage ratio to offset periods of weakness. Investors should carefully consider the pros and cons of a particular MLP, then consult with an advisor to help determine the tax implications of such an investment.
- ***MLPs Are Credit Sensitive Equity Instruments:*** Due to the payment of the distributions (and the yield) of MLPs, these securities are valued more like credit instruments and are sensitive to changes in interest rates or interest rate spreads. Since the LP units are considered equity and are below debt holders in the capital structure, it is possible to lose principal with an investment in MLPs.
- ***Removal of the MLP Designation by Congress:*** The tax "pass through" ability of the MLP group exists due to section 7704 of the Tax Code. There is a risk that Congress might one day bring about legislation that would end this "pass through" designation for the natural resources partnerships and expose them to federal income taxes.
- ***Trading Liquidity:*** While MLPs typically have better trading liquidity than their privately-held counterparts, their liquidity tends to be less than a similar-sized, public corporation as unitholders tend to hold onto them for the tax deferral benefits. This trading illiquidity can disrupt the valuation of MLPs, especially the smaller capitalized MLPs.
- ***Tax Complexities:*** Each unitholder is responsible for paying his or her share of the partnership's income taxes, and LPs might owe taxes on partnership income even if the units are held in a tax-free account due to unrelated business taxable income (UBTI). In addition, investors may be responsible for income earned in nonresident states. Many institutional investors shy away from investing in MLPs due to the K-1 tax form and other tax complexities. LPs could owe taxes based on the earnings of the partnership, even if they do not receive a distribution.
- ***LPs Have Limited Governance:*** Because limited partners are constrained to a less active role in the management of the partnership, much depends on the integrity and management ability of the GP. LPs typically do not have an annual shareholder meeting. In addition, the GP receives IDR payments based on the level of the LP distribution.

For more information on Master Limited Partnerships, please see the National Association of Publicly Traded Partnership's (NAPTP) website at www.naptp.org.