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The Voice of America's Master Limited Partnerships

MASTER LIMITED PARTNERSHIPS 101:

Understanding MLPS

Updated August 2017

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Master Limited Partnerships 101

I. What is an MLP and why should I be interested?
II. History of MLPs
III. MLPs Today
IV. How MLPs Work
V. Owning MLP Units
VI. For more information…

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WHAT IS A MASTER LIMITED PARTNERSHIP (MLP)?

Master Limited Partnerships 101

- An MLP is a **publicly traded partnership** (PTP). This is the term used in the tax code.
- Simply, it is a partnership, or a limited liability company (LLC) that has chosen partnership taxation, that trades on a public exchange (NYSE, NASDAQ, etc.) or over the counter market.
- Shares in an MLP are called “units,” and shareholders are called “unitholders.”

Master Limited Partnerships 101

- Although people use the terms PTP and MLP interchangeably, technically they are not always the same thing.
- The term MLP is generally used to refer to publicly traded partnerships and LLCs taxed as partnerships that operate active businesses, primarily energy related.
- There are a substantial number of PTPs that do not operate businesses but are simply investment funds, usually commodity funds.
- These are generally not thought of as MLPs.

Reasons for Investing in MLPs

- Income from consistent cash flow streams
- Attractive rate of return
- Income in a low interest rate environment
- Participation in build-out of new energy infrastructure to facilitate production and delivery of natural gas, natural gas liquids (NGLs) and crude oil from shale plays

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HISTORY OF MLPS

Master limited partnerships over three decades

History of MLPs

- The first MLP was launched in **1981**: Apache Oil Company.
- Other oil and gas MLPs soon followed and were joined by real estate MLPs.
- Their purpose was to raise capital from smaller investors by offering them a partnership investment in an affordable and liquid security.

History of MLPs

Rapid Growth in the 1980s

- The number of MLPs grew rapidly.
- MLPs began to be used in other industries: hotels and motels, restaurants, cable TV, investment advisors, even an amusement park and the Boston Celtics.
- Congress and tax officials decided to limit MLPs to industries which had traditionally operated through partnerships.

History of MLPs

In 1987 Congress passed legislation to define and limit <u>publicly traded partnerships</u>. MLPs operate under those rules today.

- Congress created Section 7704 of the tax code (26 U.S.C. §7704), limiting partnership tax treatment to PTPs earning $\geq$90 percent of their income from specific sources. These represented industries important to the economy and traditionally using partnerships to raise capital.
- Existing PTPs with “bad” income were grandfathered. Most gradually went private, were acquired or converted to other structures; only three remain today.

History of MLPs

What kinds of income can a PTP earn?

- **Income and capital gains from natural resources activities**
- Rental income and capital gains from real estate
- Interest, dividends, and capital gains
- Income from commodity investments
- Capital gains from sale of assets used to generate the above types of income

History of MLPs

Qualifying ***Natural Resources*** include:

- Oil, gas, petroleum products
- Coal and other minerals
- Timber
- Any other resource that is depletable under section 613 of the federal tax code
- Industrial source carbon dioxide (added in 2008)
- Ethanol, biodiesel, and other alternative fuels- transportation and storage only (added in 2008)

History of MLPs

Qualifying Natural Resources ***Activities*** include:

- Exploration, development & production (E&P)
- Mining
- Gathering and processing
- Refining
- Compression
- Transportation (pipeline, ship, truck)
- Storage, marketing, distribution
- But not retail sales, except for propane

History of MLPs- Post 1987

- During the late 1980s and the 1990s, many of the original energy and real estate MLPs left the market due to adverse economic conditions.
- Integrated energy companies began selling or spinning off “midstream” assets (gathering, processing, pipelines, distribution) to MLPs focus on their core business. These became the core of the modern MLP universe.
- Over time, traditional midstream MLPs were joined by those engaged in marine transportation of petroleum products and in propane and refined fuel distribution.

History of MLPs - Post 1987

- Beginning in 2006 **E&P (upstream)** MLPs re-entered the market, with hedging programs that helped mitigate (but did not eliminate entirely) commodity price risks.
- In the same time frame the number of MLPs engaged in **“downstream”** activities (refining, distribution, marketing) has increased.
- The **coal** industry began using MLPs; the first coal MLP appeared in 1999.

History of MLPs - Post 1987

- Beginning in 2005, several **general partners of MLPs have gone public as MLPs**. While several of these were ultimately merged back into the original MLP, new publicly traded GPs have continued to come out, some as corporations for tax purposes, some as MLPs.

- Beginning in 2007 some **investment managers and private equity firms** turned their holding companies into PTPs (e.g., Blackstone and Fortress). These may or may not be seen as MLPs (many do not use that term to refer to themselves) and are not part of MLPA.

History of MLPs - Post 1987

In 2008 **qualifying income was expanded** by Congress for the first time since 1987.

- Qualifying “natural resources activities” now include **transportation and storage of biofuels** such as ethanol and biodiesel.
- **Industrial carbon dioxide** now qualifies as a “natural resource”.

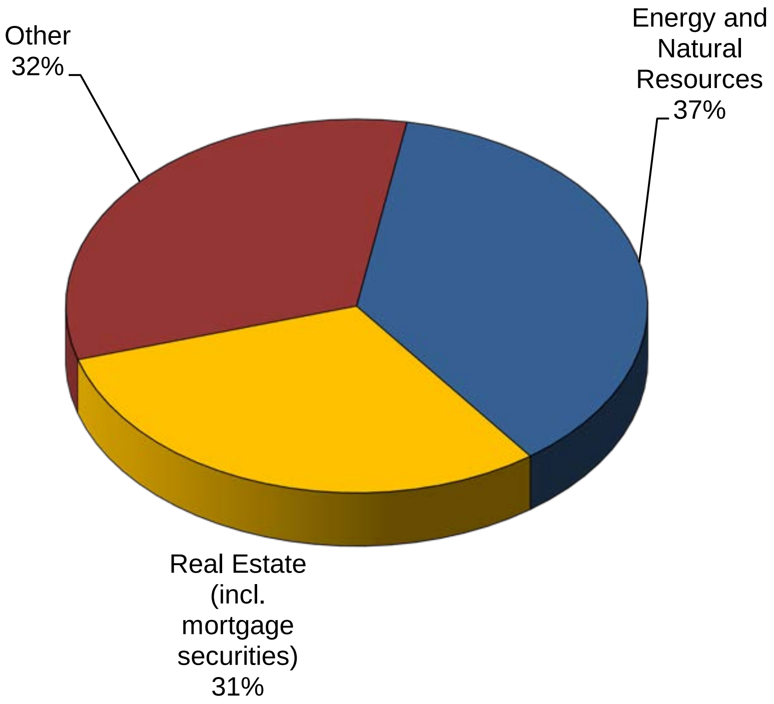
History of MLPs - Post 1987

Alternative fuels qualifying under the 2008 addition include:

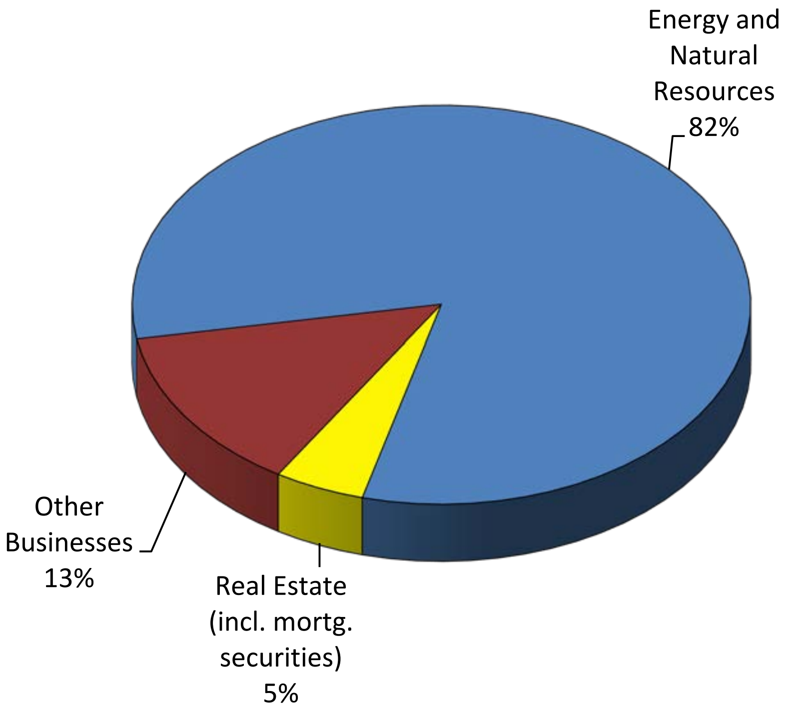
- Ethanol and methanol and other alcohol fuels and fuel mixtures
- Biodiesel fuels and biodiesel mixtures
- Liquefied petroleum gas
- Liquefied hydrogen
- Liquefied or compressed natural gas
- Liquid fuels derived from coal
- Liquid fuels derived from biomass

History of MLPs: Changes in Industry

MLPs by Industry Group - 1990

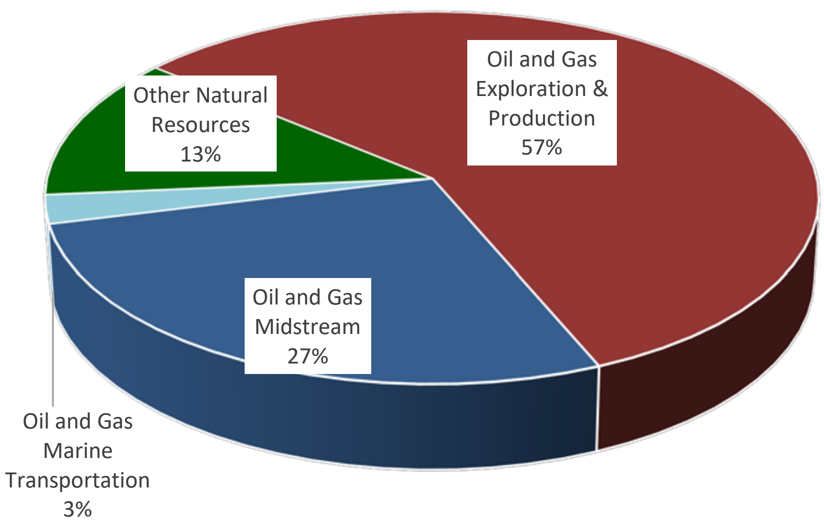


MLPs by Industry Group - 2017

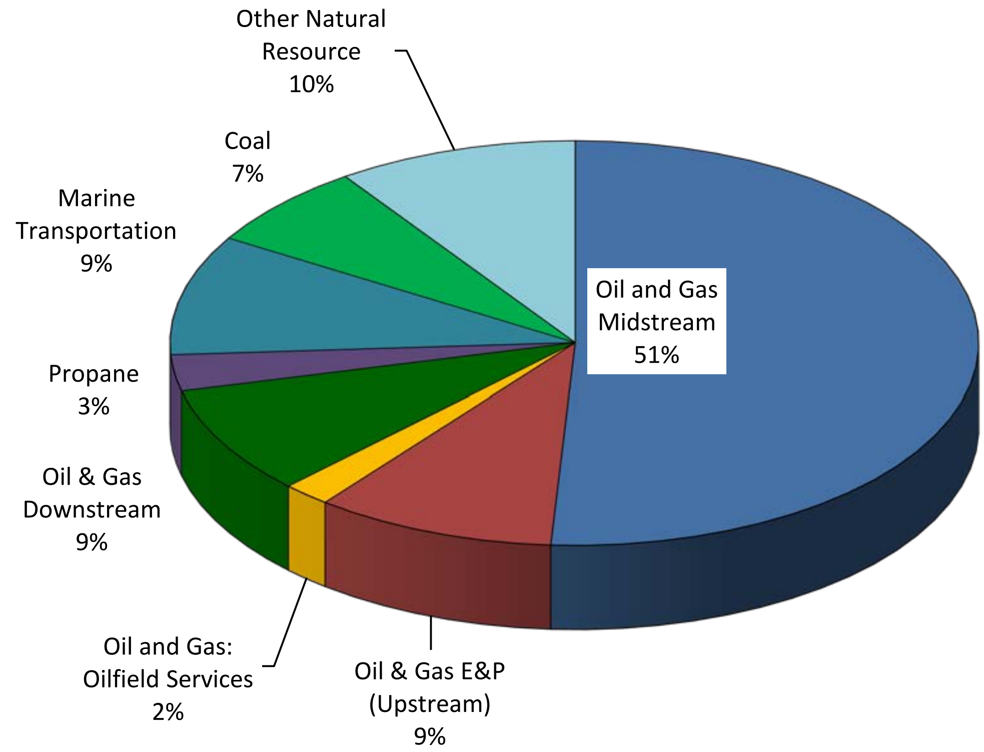


History of MLPs: Changes in Industry

Natural Resource MLPs 1990



Natural Resource MLPs 2017



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MLPS TODAY

MLPs Today

- Approximately 127 MLPs (if financial PTPs are included, 112 if they are not) are trading on major exchanges or, in a few cases, over the counter.
- Today's MLPs primarily focus on energy-related industries and natural resources.
- The majority engage in **oil and gas midstream** activities--gathering, processing, natural gas compression, transportation, storage, terminalling—and **downstream** activities (refining, marketing, distribution).
- MLPs engaged in **upstream** activities-oil and gas production-are 8% of the total. Several have experienced financial difficulties related to the drop in oil prices.

MLPs Today

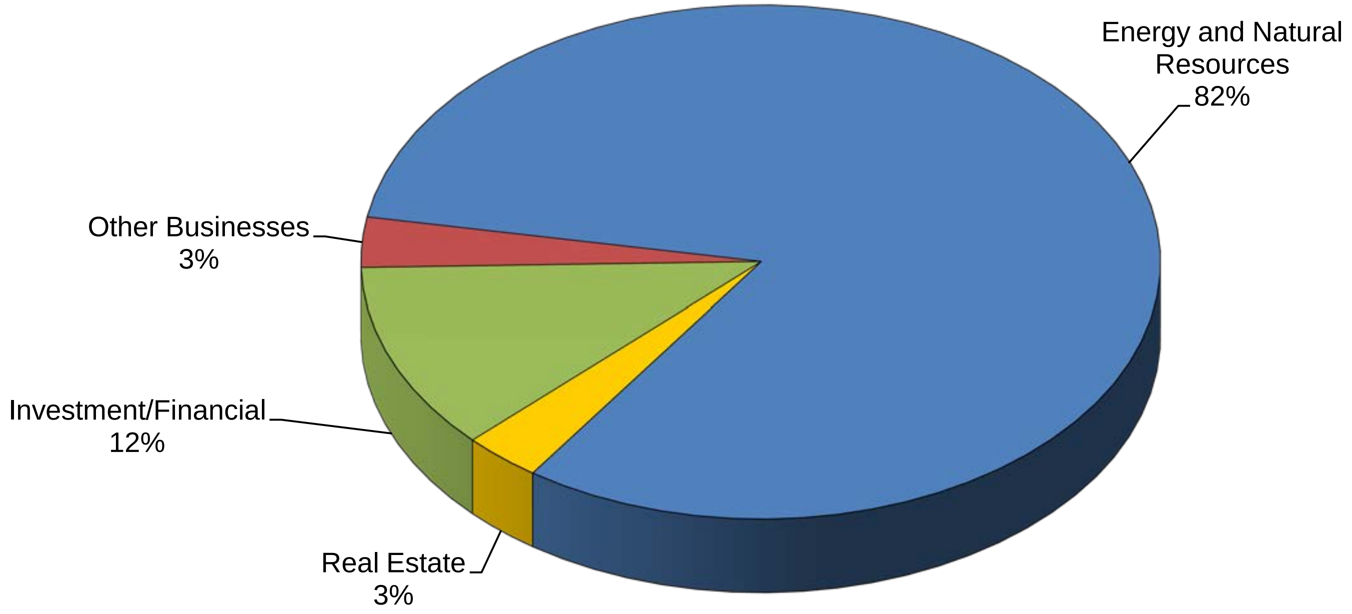
- A small but growing number of MLPs provide **services such as fluids handling to oilfield producers**. Recent IRS regulations including such services in qualifying income have encouraged this activity.
- There are several **shipping** MLPs, most of them based overseas.
- Coal MLPs continue, although some are diversifying into other natural resources due to coal industry difficulties.

MLPs Today

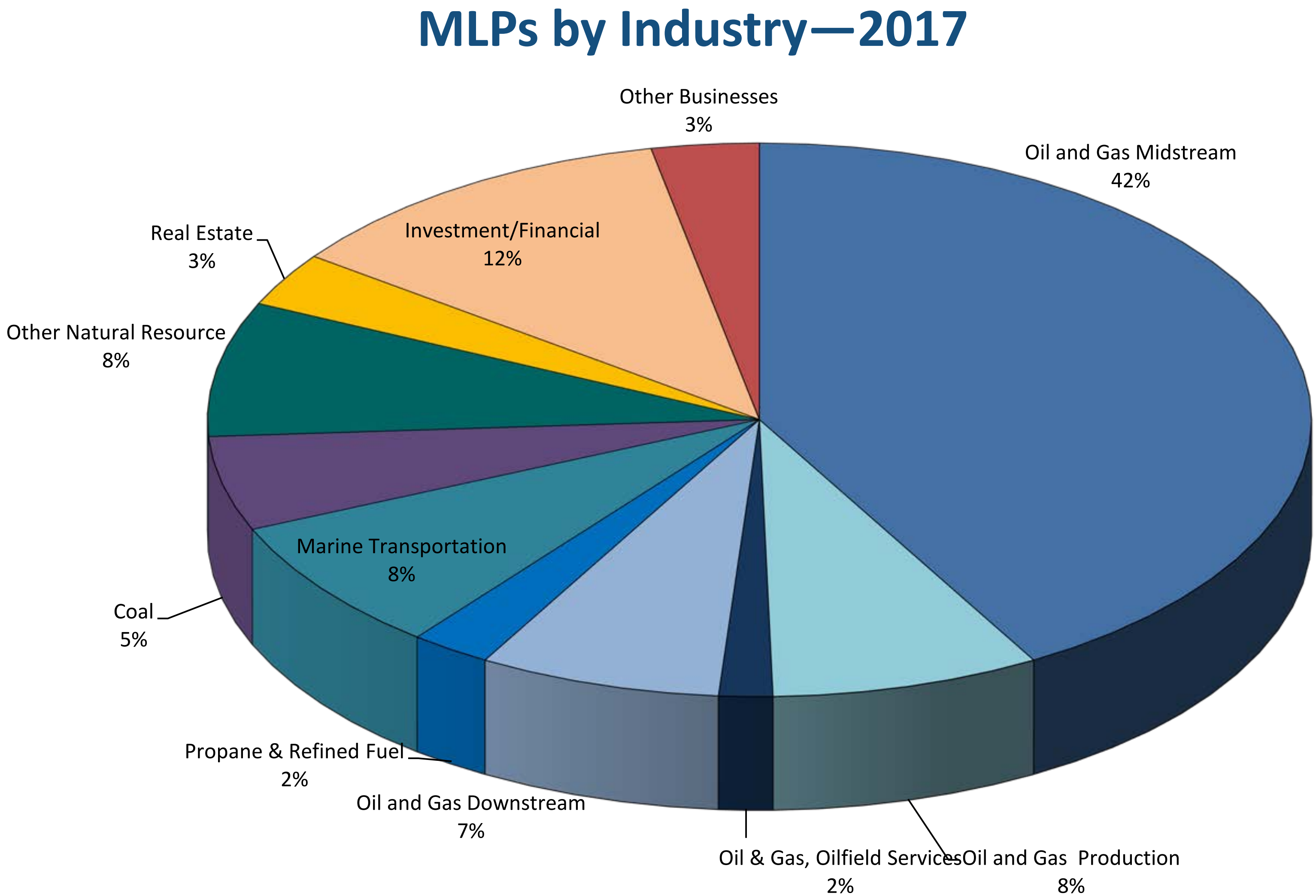
- Some MLPs are involved with other non-petroleum natural resources such as fertilizer, fracking sand, trona ore, and wood pellets.
- A small number of real estate and other MLPs round out the universe of MLPs which are the focus of MLPA.
- The PTPs devoted to investment and financial activities tend to be structured differently from the traditional MLP model we discuss here.

MLPs Today

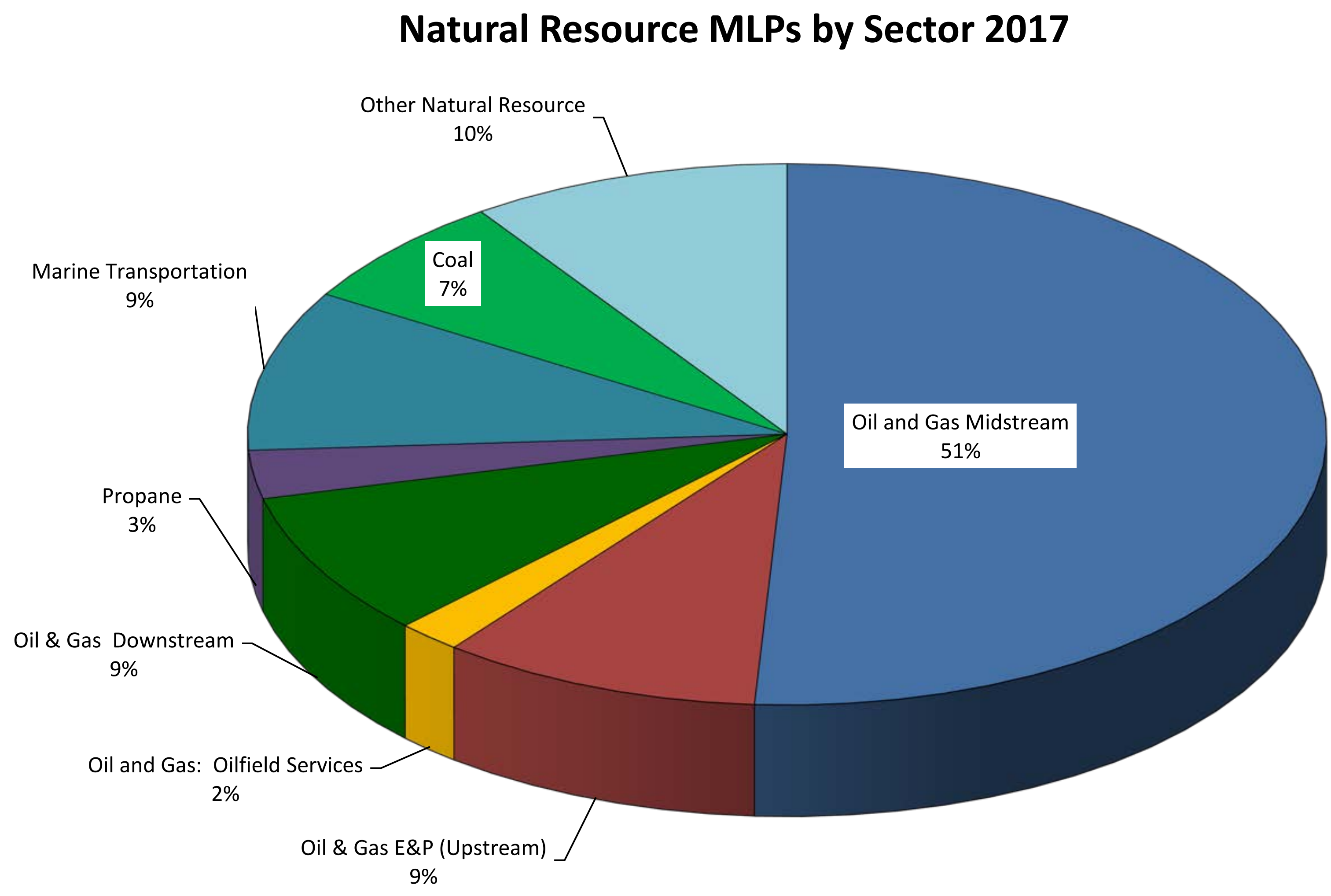
MLPs by Industry Group- 2017



MLPs Today


MLPs by Industry—2017
Other Businesses
3%
Oil and Gas Midstream
42%
Investment/Financial
12%
Real Estate
3%
Other Natural Resource
8%
Marine Transportation
8%
Coal
5%
Propane & Refined Fuel
2%
Oil and Gas Downstream
7%
Oil & Gas, Oilfield Services
2%
Oil and Gas Production
8%

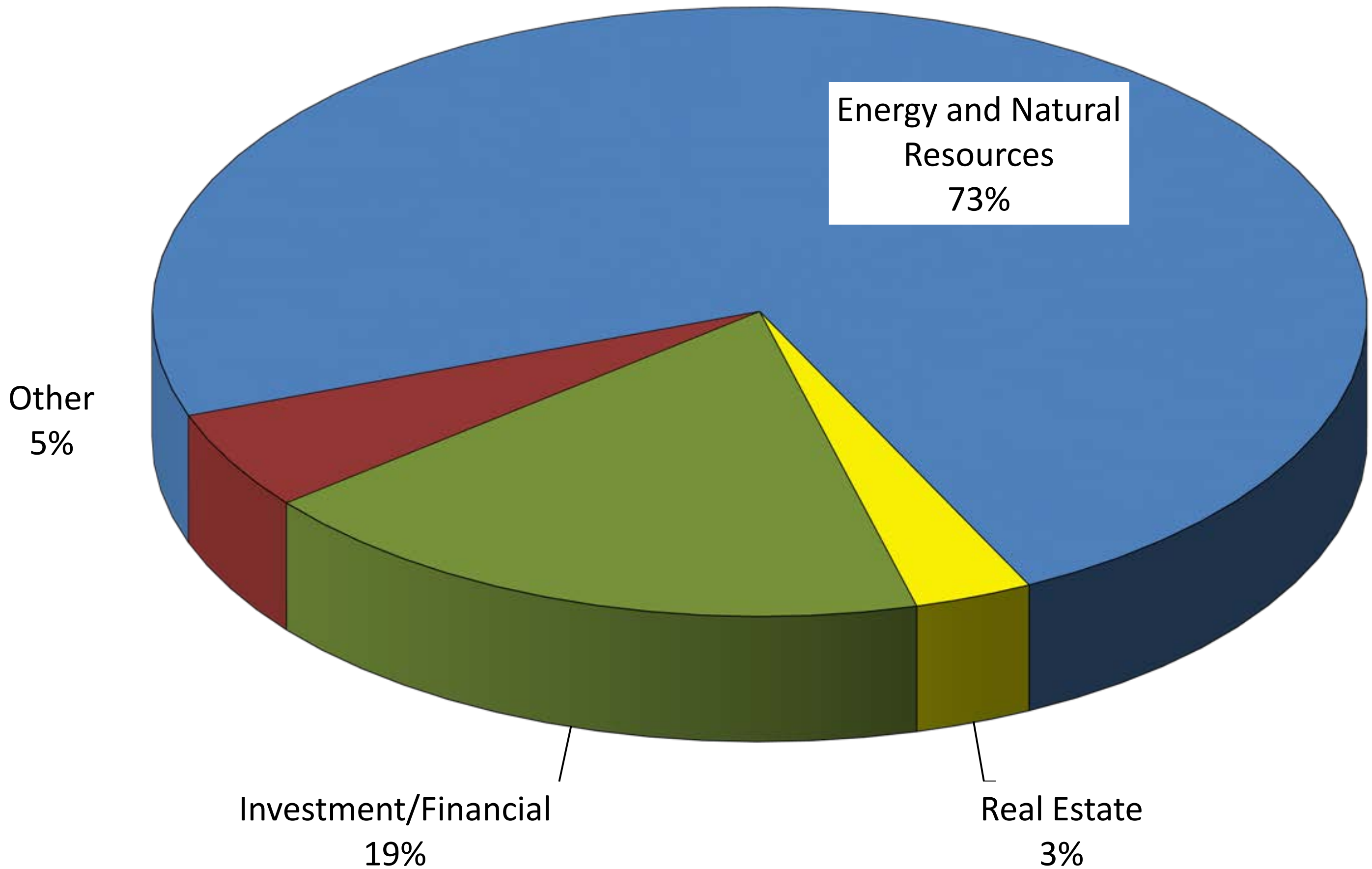
Natural Resource MLPs



MLPs Today: Market Capital

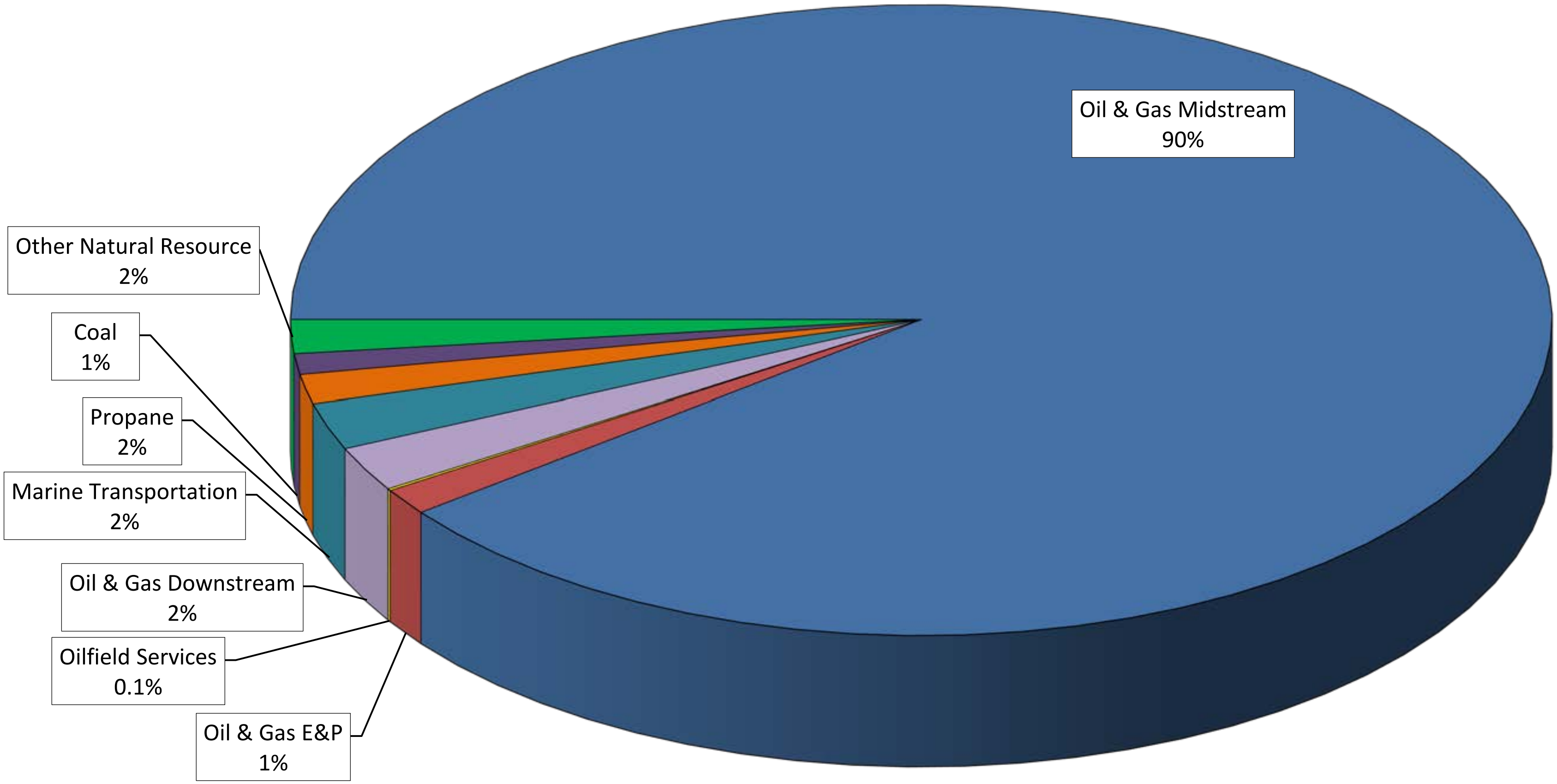
- Total MLP market capital, including financial MLPs is currently over $500 billion.
- About 73% of the total, roughly $390 billion, is attributable to energy and natural resource MLPs, primarily the midstream group, which holds 90% of natural resource MLP market capital.

MLPs Today: Market Capital



Market Capital on 6/30/2017

Natural Resource MLPs-Market Capital



Market Capital on 6/30/17

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HOW MLPS WORK

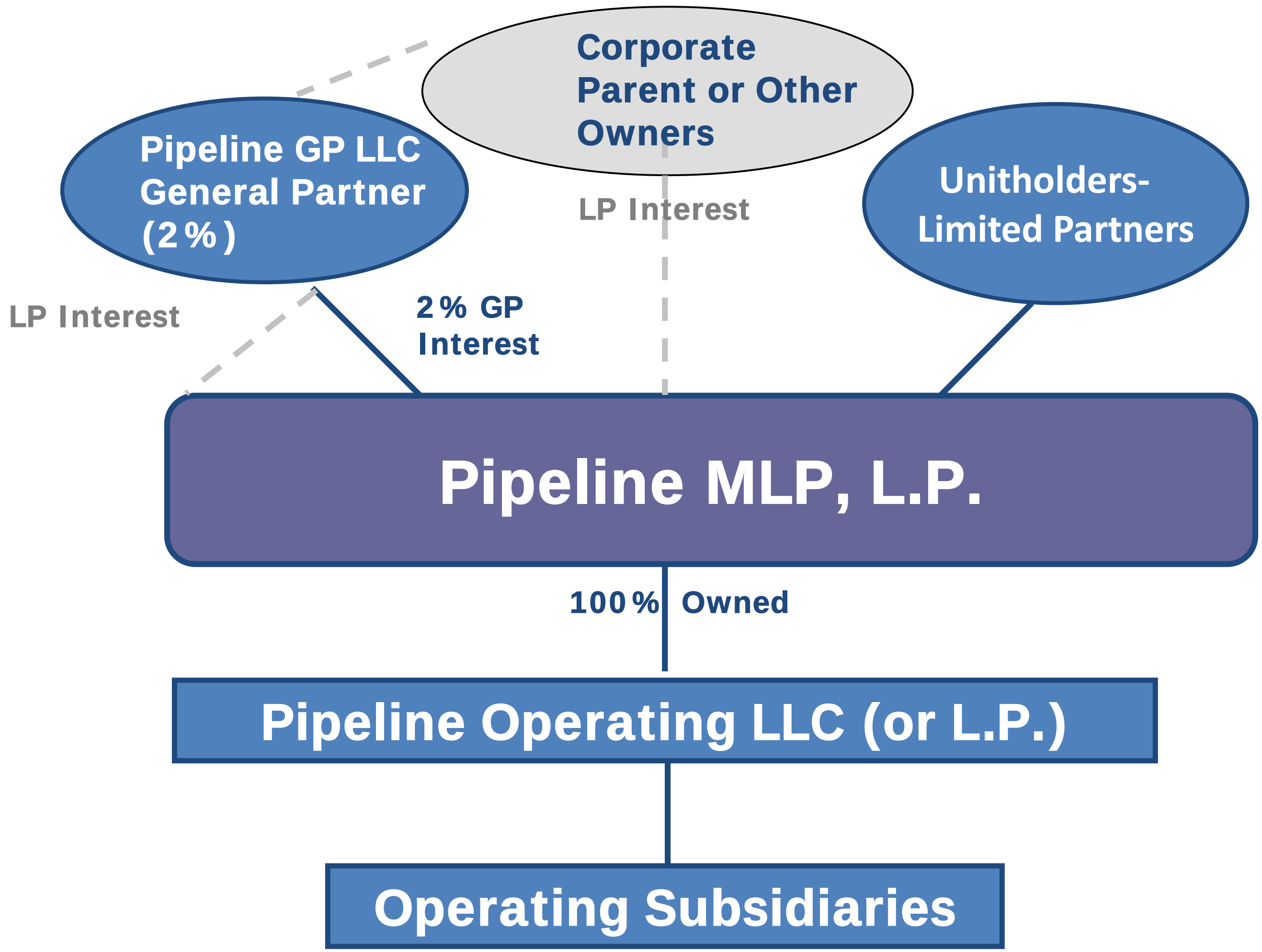
How MLPs Work: LP Structure

Most MLPs are limited partnerships. They have:

- One or More General Partners (GPs)
  - GP Manages the partnership
  - Generally has ~2% ownership stake in partnership
  - May have incentive distribution rights (IDRs)
- Thousands of Limited Partners (LPs)/Unitholders
  - Unitholders = LPs holding publicly traded units
  - Provide capital
  - Have no role in partnership’s operations or management
  - Receive quarterly cash distributions

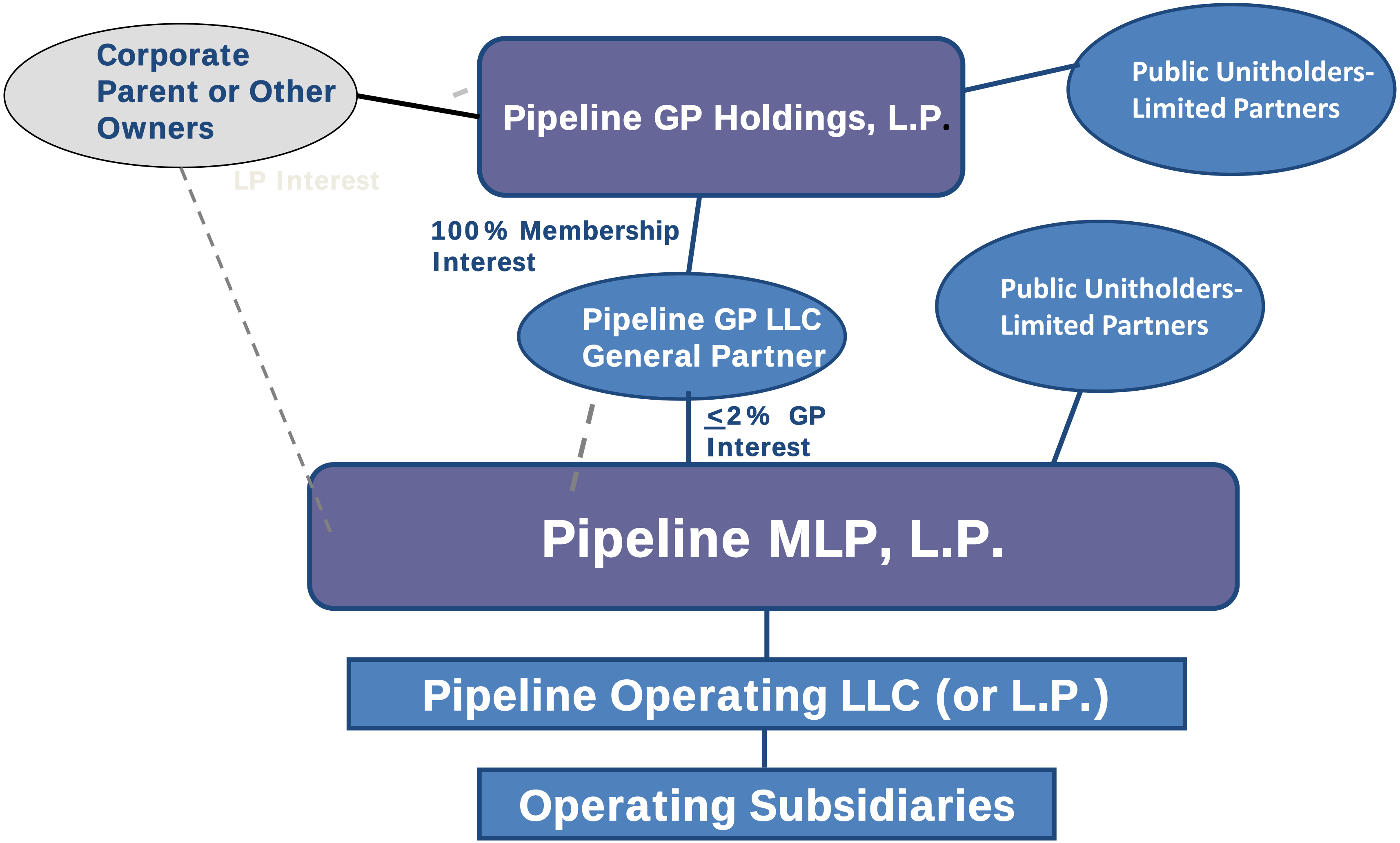
How MLPs Work: LP Structure

Typical LP Structure



How MLPs Work: LP Structure

MLP whose GP is also an MLP



How MLPs Work: LP Structure

Incentive Distribution Rights (IDRs)

- The IDR is a share of cash distributions paid to the GP in many MLPs. It generally starts at 2% of distributable cash (vs. 98% to LPs).

- As the quarterly distribution to LPs goes up, and targeted distribution levels are achieved, IDRs to the GP increase with each marginal increase in distributions.

How MLPs Work: LP Structure

Example: Incentive Distribution Tiers (from an MLP prospectus)

	LP %	GP%	Quarterly distribution
Minimum distribution			$.1875
Tier 1	100%	0%	> $.1875 up to $.2156
Tier 2	85%	15%	> $.2156 up to $.2344
Tier 3	75%	25%	> $.2344 up to $.2813
Tier 4	50%	50%	Above $.2813

How MLPs Work: LP Structure

IDR Pros and Cons

- Incentive for General Partner to grow the business.
- GP typically retains subordinated units for a period after the IPO—IDRs are compensation for unit subordination.
- If GP is publicly traded, it may draw investors interested in sharing in the IDRs.
- ***But*****,** IDRs increase cost of capital—each new asset must yield a return high enough to cover both GP and LP distributions.
- This may be a problem when higher tiers are reached.
- Several MLPs have eliminated IDRs--some by having the GP give them up in return for compensation, some by folding the GP and the LP into one entity.

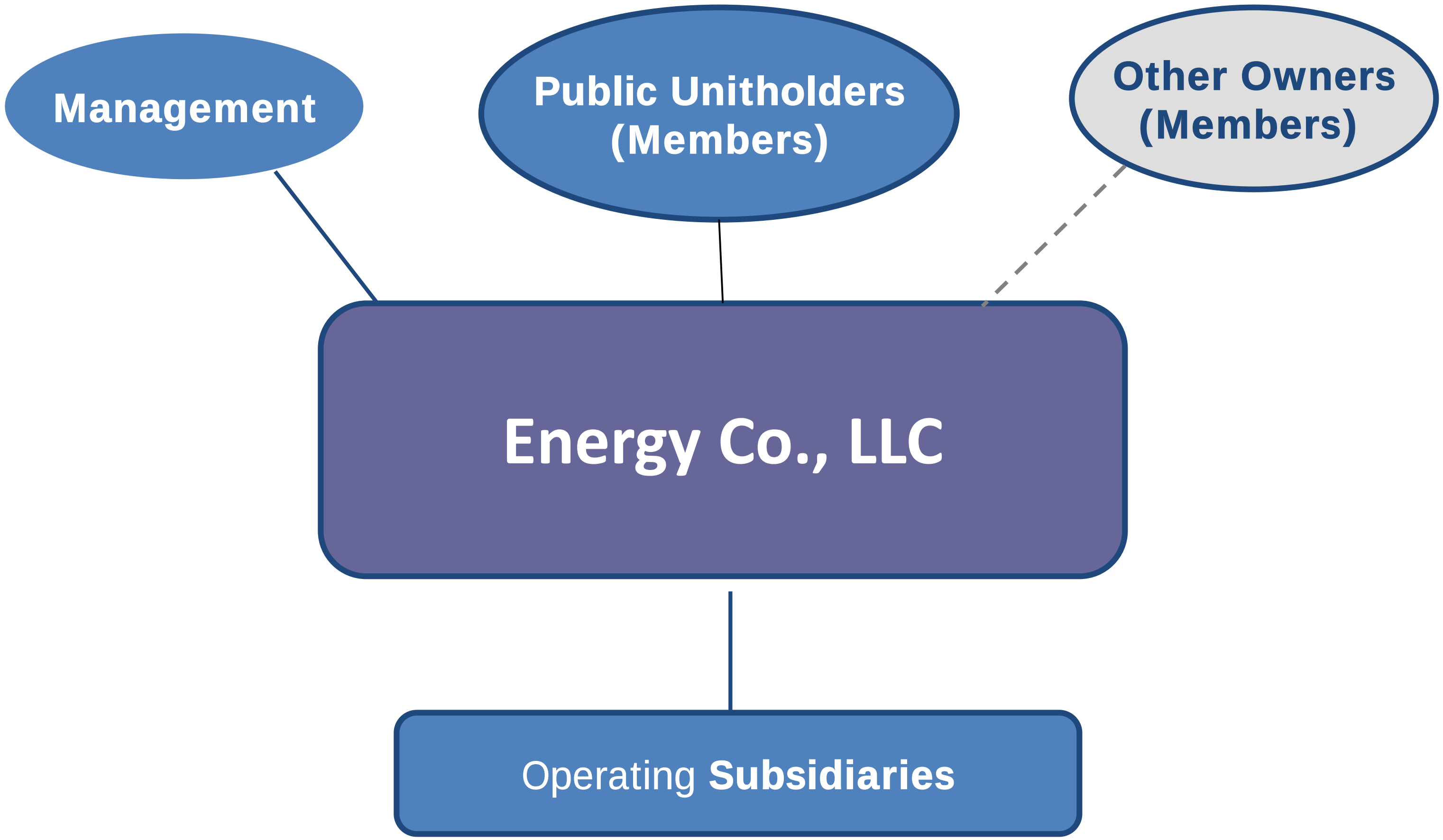
How MLPs Work: LLCs

A Few MLPs Are LLCs:

- Although they are taxed as partnerships, they have a different structure.
- Do not have a general partner. Both management and investors have same “membership interest.”
- Have no incentive distribution rights, although there may be other management incentives.
- All members, including public unitholders, have voting rights.

How MLPs Work

Typical LLC Structure



How MLPs Work

In both Limited Partnership and LLC MLPs:

- Lower-level entities, not the MLP, own the assets and conduct operations
- Taxation is on a pass-through basis
  - There is no corporate or other entity-level tax
  - All tax items flow through to the unitholders, who pay tax at their own rate

How MLPs Work

Characteristic	MLP	LLC	Corporation
Taxable at entity level	No	No	Yes
Tax Items Flow Through	Yes	Yes	No
Tax Deferral on Distributions	Yes	Yes	No
Tax Reporting	K-1	K-1	DIV-1099
General Partner	Yes	No	No
IDRs	Yes	No*	No
Investor Voting Rights	No	Yes	Yes

*But other management incentives may exist

How MLPs Work

Benefits of Operating as an MLP:

- Pass-through tax structure (no entity taxation) means lower cost of capital. This is important in capital intensive energy industries.
- Allows companies to build and operate low-return assets (e.g., rate-regulated pipelines) and still provide a sufficient rate of return to attract investors

How MLPs Work

Benefits of Operating as an MLP:

- Distribution of all available cash to investors seeking income, and liquidity from trading on a public exchange, allows an MLP to raise capital from a broader range of investors than non-traded partnerships.
- Greater control for corporate sponsors. Corporate sponsors may transfer assets to MLPs so that value can be realized by market while sponsor retains control.

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INVESTING IN MLPS

Investing in MLPs

Being an MLP unitholder is different from being a corporate stockholder:

- Taxation of your investment is very different and somewhat more complex
- You probably will not have the voting rights that a stockholder does (LPs generally don't; LLC members do)

Investing in MLPs: Taxation

Partnership Tax Basics: Income

- An MLP is a pass-though entity which pays no tax itself.
- The unitholder is treated for tax purposes as if he is directly earning the MLP's income.
- Each unitholder is allocated <u>on paper</u> a share of the MLP's income, gain, deductions, losses, and credits. This is reported annually on the K-1.
- The unitholder enters these items on his return and pays tax on the net income at his own tax rate.

Investing in MLPs

Simplified Tax Example: MLP vs. Corporation

Amount per share / unit:	Corporation	MLP
Gross Income	$4.00	$4.00
Deductions	-$3.00	-$3.00
Taxable Income	**$1.00**	**$1.00**
Federal corporate tax	-$0.35	$0.00
State tax (assumes 5% rate)	-$0.05	$0.00
Entity's net income	**$0.60**	**$1.00**
Shareholder's federal tax (15% rate for dividend, 28% rate for MLP income)	-$0.09	-$0.28
Shareholder's state tax (5%)	-$0.03	-$0.05
Net income to shareholder	**$0.48**	**$0.67**

Investing in MLPs: Taxation

Tax Basics: Distributions

- You will receive quarterly cash distributions, which are *not* the same as your share of the MLP's income.
- Distributions are based on distributable cash flow (DCF), which in its simplest form is:
  - Net earnings, *plus*
  - Depreciation (which is subtracted from income in the earnings calculation but is not a cash expense), *minus*
  - Amounts needed for maintenance and repair of assets used in producing income ("maintenance cap ex").

Investing in MLPs: Taxation

Tax Basics: Distributions

- Under the tax code, the distributions are a return of capital and are not taxed when received.
- Your basis in your partnership units (the amount you paid + or - adjustments) is lowered by the amount of the distribution.
- Thus, when you sell your units, your taxable gain (sales price minus adjusted basis) is increased by the amount of the distributions

Investing in MLPs: Taxation

- Often you will hear someone say that "80% of the MLP's distribution is tax-deferred."
- What they mean is that the unit-holder's allocated share of net income as reported on the K-1 ($1.00 per unit in the example) equals only 20% of the cash distribution.

Investing in MLPs: Taxation

Basis Adjustments

Your basis is adjusted not only by distributions but by tax items:

- Your share of partnership income each year adjusts the basis upwards. Your share of deductions like depreciation adjusts it downwards.
- So your basis is lowered each year by the amount of the distributions minus your net partnership income.
- The idea is that all income you receive from the partnership is taxed once and only once—either in the year you receive it, or when you sell your units.

Investing in MLPs: Taxation

Adjusted Basis Example

Year 1: 1,000 units purchased @ $30.00. **Basis is**:	**$30,000**
Investor receives total cash distributions of $2.50/unit, which lower the basis	- $2,500
Investor is allocated $2.00 of income and $1.50 of depreciation.	
Investor pays tax on net taxable income of $.50/unit ($2.00 - $1.50), which increases the basis	+ $ 500
Adjusted Basis ($30,000-$2,500) + 500	**$28,000**
Year 2: All units sold @ $32.00	$32,000
Gain per unit - $32.00 - $28.00	**$ 4,000**

Investing in MLPs: Taxation

Important Note:

- Not all of the gain when units are sold is taxed at capital gains rates.
- A substantial amount of the gain comes from basis reductions due to depreciation and is taxed at ordinary income rates—this is called “recapture.”
- In our example, the unitholder had a $1,500 depreciation deduction. So $1,500 of the $4,000 is taxed as ordinary income and $2,500 as capital gain.

Investing in MLPs: Taxation

Summary

Corporations - Dividends

- Corporation pays tax on earnings
- After-tax earnings paid to shareholder as dividend
- Shareholder pays tax on dividend

Partnerships - Distributions

- Partnership does not pay tax; income and deductions flow through to partners
- Partners pay tax on net earnings (regardless of cash received)
- Cash distribution exceeding net income treated as tax deferred return of capital; lowers basis and is taxed on sale

Investing in MLPs: Advantages

- **Income:** MLPs generally provide consistent streams of cash flow in the form of quarterly distributions and growth
  - Most MLPs pay out cash not needed for current operations and maintenance of capital assets to their unitholders in the form of quarterly cash distributions.
  - Most MLPs strive to grow so as to increase their cash distributions.
  - Most MLPs cover their distributions with distributable cash flow generated, with some MLPs consistently having stronger coverage (the "coverage ratio," DCF/distribution, is an important metric).
  - Larger, capitalized MLPs provide multiple sources of cash flow from a large, diversified footprint of assets.

Investing in MLPs: Advantages

- **Tax benefits**: Deduction pass-throughs lower currently taxable income, tax deferral on distributions.
- **Liquidity:** MLPs provide the benefits of partnership investment without tying up your money for years.
- **Estate planning:** as with other securities, the basis in PTP units is stepped up to fair market value at death—the heir receives a fresh start.
- **Participation in essential industry:** Many MLPS provide a chance to invest in energy infrastructure, for which there will be high demand over thr next several years.

Investing in MLPs: Advantages

- **In sum, MLPs may be suitable for investors:**
  - Looking for a source of **regular income** payments
  - Motivated by **yield**
  - Seeking a combination of **income and growth**
  - Wanting to **reduce/defer taxes** on their investments
  - Interested in **estate planning** advantages

Investing in MLPs: Challenges

- As we’ve seen, tax reporting for an MLP investment is more complex than for shares in a corporation.
  - Investor receives a K-1 instead of a 1099.
  - The K-1 reports investor’s share of all MLP tax items, which investor must enter on his/her own return.
  - MLPs try to make the process as easy as possible. Many post K-1s online, and they can be downloaded into Turbotax.

Investing in MLPs: Challenges

- **State tax issues:**
    - Technically, partners owe tax on their share of income allocable to each state in which an MLP operates.
    - Practically, after the MLP’s income is divided among all partners and all states, and depreciation and other deductions applied, each unitholder’s income in each state will generally be too small to tax, except for those with large holdings.
    - Some states require nonresidents to file if they have *any* in-state income.

Investing in MLPs: Retirement Plans

Retirement Plan Issues

- Think carefully before investing your IRA, 401(k), or other tax-deferred retirement plan in MLPs.
- These plans are tax-deferred already, so don’t need the tax advantages.
- More importantly, the plan’s share of net partnership income over $1,000 (not the distributions) is likely to be subject to the “unrelated business income tax (UBIT).”

Investing in MLPs: Retirement Plans

- UBIT is imposed on tax-exempt entities (including retirement plans) that earn income from a business that is not related to the purpose of their tax exemption.
- Because MLPs are pass-through entities, tax-exempt partners (e.g., your IRA) are treated as if they are directly “earning” the MLP’s business income and are taxed on it.
- Investment income like interest, dividends, and royalties (as opposed to income generated by business operations) is not taxed.

Investing in MLPs: Retirement Plans

Some analysts feel MLPs are still a good investment for IRAs and other retirement funds, because:

- The tax is on <u>net</u> income. Pass-through of depreciation and other deductions means net income may be below $1,000.
- Even if tax is owed, the income may be sufficient to produce a very good return.
- If your IRA or 401(k) does owe UBIT, it, <u>not you</u>, is the taxpayer and owes the tax. The plan custodian should file a return and pay tax from the plan’s funds (not all financial institutions are good about this).

Investing in MLPs: Alternatives

Alternatives to Direct Investment in Partnership

- **Corporate Intermediary:** Several MLPs have corporate affiliates (including some organized as LPs but choosing corporate tax status) with a large share of ownership in the MLP. This allows indirect investment in the MLP (and the benefit of IDRs).
- **Invest in Shipping MLPs:** The foreign-based shipping MLPs have chosen corporate status in the U.S., but their income isn't taxed because it is earned offshore. You receive a dividend that is largely return of capital and a 1099 form rather than a K-1.

Investing in MLPs: Alternatives

Investing Through Funds

A number of options exist for investing in MLPs through funds

- **Closed-end mutual funds:** There are a variety of closed-end funds focusing on MLPs. The first fund came out in 2004 and now there are over 30 funds that focus either on MLPs primarily or on MLPs along with other energy assets.
- **Open-end mutual funds:** A more recent (2010) development. There are roughly two dozen open-end MLP mutual funds on the market.
- **Exchange Traded Funds:** Another fairly recent development—there are about 10 ETFs and about 15 ETNs pegged to MLP indexes.

Investing in MLPs: Alternatives

Advantages to investing through funds:

- A diverse MLP portfolio selected by experts.
- The fund is the limited partner; it rather than the investor deals with the K-1 form and paying federal and state taxes on partnership income.
- The investor receives a dividend and the familiar 1099 form.
- The dividend retains return of capital treatment to a large extent.
- The investment can be placed in a retirement account without generating UBIT.

Investing in MLPs: Alternatives

Disadvantages to Investing Through Funds

- **Taxation:** Unless MLPs are no more than 25% of their assets, the funds will not qualify as regulated investment companies (RICs). Instead they will be treated as ordinary corporations and must pay tax on their share of K-1 income at the corporate rate before paying you. You will not get the benefit of any deduction or loss pass-throughs.
- **Reduced return:** In addition to taxes, your return will be diminished by administrative fees and expenses charged by the fund. Be sure to examine and compare these before investing.

For more information:

- MLPA is the trade association representing MLPs.
- Go to our website at www.MLPAssociation.org for information, fact sheets, and lists of currently trading MLPs and MLP funds.
- Send your questions to lziebart@mlpassociation.org.

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