The Taxation of Master Limited Partnerships

FAQs address the tax complexity of these unique investments

Master Limited Partnerships, or MLPs, have long been a popular way to invest in oil, gas and other businesses because of their combination of cash distributions and opportunity for appreciation. MLPs are not without their complexities, however. The answers to the following Frequently Asked Questions should help explain the unique tax issues associated with MLPs.

Overview of the Tax Rules for Partnerships

How are partnerships, including MLPs, taxed?	Even though MLP investments are often referred to as stocks, they are in fact investments in a partnership. Partnerships themselves are generally not subject to tax. Instead, a partnership files a tax return reporting its total net income, but then issues each investor a Schedule K-1 that shows their share of the MLP's income.
What does the individual investor do with the K-1?	Each investor is responsible for reporting the income from the K-1 on their personal tax return. K-1s sometimes contain uncommon items that individuals wouldn't normally report on their return, causing them to prepare forms and schedules they aren't familiar with. Also, because the partnership return must be filed before the K-1 can be delivered to the investor, the K-1 may not arrive until the later stages of tax season, causing the investor to have to wait to file their own return. Lastly, estimating the taxable income from an MLP during the year is an inexact science, so the taxpayer usually has very little idea just how much income, if any, will be reported on the K-1. This can make it difficult to do an accurate tax projection and schedule tax payments during the year.
Isn't the taxable income from the MLP equivalent to the dividends received during the year?	No. To start, the payments received by MLP investors are often called dividends, but they aren't dividends like investors in stocks or mutual funds receive. These distributions generally represent only the investor's share of the MLP's cash flow. Secondly, the MLP is able to claim a variety of deductions that cause some or all of the distribution to be treated as a tax-deferred (but not tax-free) return of capital, rather than taxable income. This means that the income reported on the K-1 is often much less than the cash flow received by the investor. On the other hand, those return-of-capital payments are a reduction to the investor's cost basis in the MLP, leading to a variety of tax issues when the MLP is sold.
Is it possible for an MLP to make distributions during the year but still report a loss on the K-1?	Yes, this does happen with MLPs. Because of tax deductions the MLP is eligible to claim, it's common for these investments to have positive net cash flow to distribute to investors but still report a loss for tax purposes.

Can losses from an MLP be used to offset other income in the year of the loss?	Generally no. Ordinary losses from an MLP are considered passive losses, and passive losses can only be used to offset passive income. Wages, retirement income, investment income (including interest, dividends and capital gains), etc. are not considered passive income for these purposes.
If an MLP has a net loss, can that loss be used to offset the income from a different MLP?	No, MLPs are subject to a unique set of rules that only apply to Publicly Traded Partnerships (PTPs). Losses from a PTP can only be used to offset income from the exact same PTP.
If an MLP has a net loss for a year, can that loss be carried forward to offset future income from that activity?	Yes, ordinary losses from an MLP that are not used in the current year can be carried over and used to offset future income from that entity. In the year an MLP is sold, all prior year accumulated losses become deductible.

Tax Treatment of MLPs upon Sale

How is the adjusted cost basis of an MLP calculated?	The initial cost basis is equal to the purchase price of the MLP units. This amount is then increased by income earned from the entity, and reduced by any losses reported by the MLP. The basis is also increased by additional unit purchases, and reduced by any distributions received by the unitholder. There may also be basis adjustments due to how certain transactions are reported for accounting purposes by the partnership. Because the annual gain and loss information is only reported to the shareholder on the K-1 and not to the investment firm that holds the units, cost basis information shown to investors on statements and 1099s should not be relied upon to determine the actual unrealized gain to the investor. Instead, any gain or loss should be calculated manually. When an MLP is sold, <u>the K-1 usually includes a schedule that shows the investor how to calculate their adjusted basis and resulting gain or loss</u>.
Does the sale of an MLP result in a capital gain or ordinary income for the shareholder?	Usually the sale results in both. Because the return of capital distributions are due to depreciation and other similar deductions claimed by the MLP, those deductions must be recaptured upon the sale – meaning that portion of the gain is taxed as ordinary income, not as a capital gain. Any appreciation in the value of the units since they were purchased would be taxed as a capital gain. However, this is a general rule; the exact amount of ordinary gain to realize upon a sale is calculated by the MLP at the time of the sale.
What about the loss carry overs from previous years?	When an MLP is sold, all loss carryovers for that particular MLP become deductible that year. At that time, those losses can be used to offset other income, including ordinary or capital gain income and income from other MLPs.

How can we anticipate the split between capital gain and ordinary income when an MLP is sold?	This can be difficult to plan for. The best answer is to keep track of the tax-free distributions received. These amounts likely will be recaptured and taxed as ordinary income. The schedule in the K-1 that is used to calculate the adjusted basis also shows what portion of the gain is ordinary or capital gain.
Is it possible to have both a capital loss and ordinary income as a result of a sale of an MLP?	Yes, this is possible. For example, say an MLP investment was bought for $5,000, but after adjustments due to losses and distributions over time, the investor's adjusted basis was reduced to $4,000. Because of a decline in the value of the MLP itself, it was then sold for just $3,500. In this case, it would appear as though there is a net loss of $500. ($3,500 sales proceeds less a $4,000 adjusted basis). However, because of the recapture that occurs when a partnership is sold, the MLP tells the investor that they have $900 of ordinary income on the sale. In this case, the investor is then able to report a capital loss of $1,400. The capital loss of $1,400 and ordinary income of $900 result in the total net loss of $500.
How is the capital loss treated?	A capital loss on the sale of an MLP is just like any other capital loss. It is first used to offset any capital gains from the sale of any other investments. If all other capital gains are absorbed and there is still a net loss, up to $3,000 of that loss can be used against ordinary income, and the rest is carried over to the next tax year.

Investing in MLPs Inside an IRA

Can these tax complexities be avoided by investing in MLPs in an IRA?	In some cases, yes. However, the Unrelated Business Income Tax, or UBIT, rules can still result in taxable income being recognized, even inside an IRA or other tax-sheltered account. Ownership in an IRA will also shift the burden of reporting the income from the investor to the IRA custodian.
What is the UBIT?	In general, the UBIT is a tax assessed against the income earned by a tax-exempt entity that is unrelated to its tax-exempt purpose. Retirement accounts, such as IRAs, Roth IRAs and others, can find themselves subject to this tax. This is especially true when a retirement account holds investments in MLPs.

What income from the MLP is subject to the UBIT?	There are two scenarios when an MLP can generate income subject to UBIT. On an annual basis, the income from the MLP's main business, such as the transportation of refined products or natural gas, is usually subject to the tax. However, investment income earned by the MLP such as interest and dividends is exempt from UBIT. The amount subject to the UBIT is reported on the partnership K-1 (on line 20V) and is often a relatively small amount. Most MLP investors who have a small investment in just one MLP typically do not have enough of this income to trigger the tax, although that is not always the case.
Can an MLP have an ordinary loss for UBIT?	Yes, and that loss is treated just like an ordinary loss from an MLP that is held in a taxable account. It is carried forward to the future and can only be used to offset income subject to UBIT from the same MLP. When that MLP is eventually sold, all accumulated loss carryovers become deductible for UBIT purposes that year.
What is the second scenario where UBIT can lead to a tax in a retirement account?	The second scenario occurs upon the sale of the MLP. When an MLP is sold, the gain itself is subject to UBIT, although the treatment is a bit unique. Recall that a sale of an MLP results in both ordinary income (from recapture) and capital gain (or loss). The ordinary income recognized upon a sale is subject to UBIT. However, a portion of the capital gain may be exempt from tax. Only the amount of the capital gain due to "debt financed activities" is considered subject to UBIT. The debt-financed gain is calculated by multiplying the ordinary portion of the gain by what is referred to as the UBIT Taxable Percentage. This percentage is determined by dividing the highest acquisition indebtedness for the preceding 12 months by the average adjusted cost basis for the year of sale.[1]
How is the tax under the UBIT calculated?	The first $1,000 of income subject to UBIT is exempt from tax; any income (ordinary or capital gain) over that amount is taxable. The tax rates applied are the same rates applied to trusts, which are much more condensed than those used by individuals. For 2016, the top ordinary tax rate of 39.6% is reached at just $12,400 of taxable ordinary income (after the $1,000 exemption). Capital gains can be taxed at a rate as high as 20%, but are not subject to the 3.8% Medicare tax in an IRA.

[1] Baird has engaged PricewaterhouseCoopers to calculate the amount of income subject to UBIT for our clients, and to then file the appropriate income tax returns (Form 990-T). They have determined the methodology they believe best captures the amount of income subject to the tax based on their interpretation of the Internal Revenue Code and Regulations. Baird does not provide tax advice.

If I'm considering selling an MLP investment, how can I estimate this tax liability?	This is very difficult to do as it requires details on the accounting practices at the partnership itself. Investors who sell MLPs have to wait until the final K-1 is received to fully calculate the ordinary and capital gain or loss to be realized. However, because this tax is primarily a result of distributions received over the years, <u>the longer an investor holds an MLP, the more of these distributions they would have received and the more likely they are to have enough gain to trigger the tax</u>.
How is the tax paid?	When it's determined that a retirement account has more than $1,000 of income subject to UBIT, a tax return must be filed by the trustee for the account. This is usually the brokerage firm or investment advisor that holds the account. The trustee will file Form 990-T, Exempt Organization Business Income Tax Return, and any tax due with this return must be paid from the retirement account itself.

Conclusion

So should I avoid investing in MLPs because of all this complexity and potential tax?	Like any other investment, the tax implications of MLPs should be considered, but they shouldn't be the only deciding factor. All investments have tax implications of some kind, and taxes should be evaluated along with any other expenses related to making that investment.