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Solving the Frustrations of Investing in MLPs

Master Limited Partnerships (MLPs) can be compelling investments, but investors in these securities face a daunting array of challenges, including complex tax reporting, unrelated business taxable income, under-exposure to the asset class, double taxation, and single-issuer principal counter-party credit risk. Direct investment in MLPs or in various MLP investment vehicles may solve one or more of these issues, but each comes with its own drawback or limitation.

Here is a quick review of the challenges faced by MLP investors seeking to capture the investment opportunities in the asset class:

Complex Tax Reporting

Direct investment in MLPs involves complicated K-1 reporting for each individual MLP. In addition, direct investment may also require investors to file state tax returns for each state in which the MLPs operate. K-1s are notorious for being delivered late in the tax preparation season, which can force direct MLP investors to file extensions with the IRS.

Unrelated Business Taxable Income

Another potential drawback of direct investment in MLPs is that they can generate unrelated business taxable income (UBTI) for tax-exempt entities and retirement accounts. An organization that is recognized as a tax-exempt entity may be liable for tax if it engages in and derives income from unrelated business activity such as an MLP.

Double Taxation

Shareholders of MLP funds organized as C-Corporations may achieve full exposure to MLPs but can be double-taxed because, unlike Regulated Investment Companies (RICs), such funds pay fund-level corporate tax. This double taxation can be a drag on total returns over time.

Under-exposure to the Asset Class

To maintain their status as Regulated Investment Companies (RICs) under the Tax Code, some MLP-oriented mutual funds and ETFs limit their exposure to MLPs to 25%. While such funds are not taxed at the fund level, they typically do not provide broad exposure to MLPs, which investors may be seeking, and they may not track the index as closely as an all-MLP portfolio, potentially distorting investment results over time.

Single-Issuer Principal Counter-Party Risk

This risk is faced by Exchange-traded note (ETN) investors, as these securities are general debt obligations of the issuer, subjecting the noteholder to the principal counter-party risk of that issuer.

Solving all these obstacles collectively may seem an insurmountable task, but there is a potential solution. By using a portfolio approach that combines direct MLP investment with securities designed to replicate the returns of major MLP indices, such as total return swaps, investors can potentially gain fuller access to the returns and yield of the MLP market through a mutual fund that retains its RIC status for tax purposes.

	MLPs & TR Swaps	Direct MLP Investment	C-Corp Funds	Non-Pure Funds	ETN
Tax Reporting	Form 1099 ✓	K-1 and State (for each MLP) ✗	Form 1099 ✓	Form 1099 ✓	Form 1099 ✓
Unrelated Business Taxable Income (UBTI)	No ✓	Yes ✗	No ✓	No ✓	No ✓
Fund-Level Corporate Tax	No ✓	No ✓	Yes ✗	No ✓	No ✓
MLP Exposure	✓	✓	✓	<=25% ✗	✓
Single-Issuer Principal Counter-Party Credit Risk	No ✓	No ✓	No ✓	No ✓	Yes ✗

In this way, broad exposure to the return and yield profile of MLPs can be targeted in a portfolio that provides simplified tax reporting and avoids double taxation, UBTI, and single-Issuer principal counter-party risk.

To learn more about MLP investing, visit our website at Liberty Cove