

Understanding MLPs

For many large master limited partnerships, 70% or more of their dividends – technically distributions – are tax-deferred. That’s because dividends usually are far greater than reported net income, largely as a result of non-cash depreciation expenses.

Let’s say an MLP pays a \$2 annual dividend, 80% of which is tax-deferred. An investor would owe income taxes on only 40 cents of that dividend (but the 40 cents would be taxed at regular-income rates, not the preferential dividend rate). The other \$1.60 wouldn’t be taxed and instead would reduce the investor’s cost. If the investor paid \$25 a share for an MLP, the cost basis would be reduced to \$23.40. Taxes would be paid on the \$1.60 when the shares are sold. (check with your tax professional for details)

Many investors – particularly the elderly – simply hold MLP shares, with the intention of putting them in their estates. This essentially results in permanent tax deferral and a muni-like income stream, if the investor’s estate isn’t subject to federal inheritance taxes. Taxes on the sale of a long-held MLP can be high because an investor’s cost basis can drop toward zero after many years of dividends.

MLPs are best held in taxable accounts: they can cause tax headaches in IRAs and other tax-deferred accounts. Investors need to know that they will get an annual K-1 tax form, not a standard 1099, and that can complicate annual filings. Another wrinkle: MLPs often share annual income gains with general partners, or GPs, some of which are publicly traded. This can limit dividend increases.