Financial Planning
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Updated Friday, July 10, 2015 as of 6:43 PM ET

30 DAYS 30 WAYS

MLP Taxes Can Be Tricky

Many master limited partnerships pay investors around 5% a year, partially tax-deferred, while some have even higher yields. However, MLP investments come in many forms. Knowing the basics can help interested advisors decide which path or paths to take.

DIRECT INVESTMENTS

With MLPs, investors benefit from tax-deferred cash flow when cash distributions exceed the reported income from the trust, says Brooke Salvini, principal at Salvini Financial Planning in Avila Beach, Calif. If a $100 distribution is 20% taxable and 80% an untaxed return of capital, that $80 would be subtracted from the investor's cost basis, perhaps increasing the tax on a future sale.

"This flow-through tax reporting can be a headache," says Salvini.
Investors in an MLP get a K-1 form showing them which income is taxable.
"Things can get complicated if the MLP operates in multiple states and an investor's MLP net income exceeds a state's minimum filing requirements." In that case, says Salvini, additional state tax returns will be required.

FOCUSING ON FUNDS

Salvini notes that the tax reporting complications of MLPs can be eliminated by investing through a fund. "Investors own shares of the fund and receive a 1099 at year-end, which is much simpler," she says. "The fund passes the tax-deferred distributions through to investors." MLP funds may take the form of mutual funds, closed-end funds, and ETFs.

"A fund with more than 25% invested in MLPs will be organized as a corporation, with corporate level tax liability," Salvini says. The added tax can drag down investors' returns.

"Another option is an MLP exchange-traded note (ETN), which also can simplify tax reporting," says Salvini. ETNs don't own MLP units. Instead, the issuer of the notes guarantees that they'll pay out the return of a benchmark MLP index, less management expenses. "There is no tax deferral with ETNs, which makes them better candidates for retirement accounts as long as investors understand that they're buying a credit instrument."

MIX & MATCH

Advisors can choose among MLP vehicles, or they can take a diversified approach. "We invest in individual MLPs, MLP mutual funds, and MLP ETFs," says Ron Weiner, CFP, founder, president and CEO of RDM Financial Group, which has offices in Westport, Conn., and Boca Raton, Fla. "Direct purchase of MLPs" – rather than through funds – "generates as much as 30% greater income." Among MLPs, his firm looks for attractive yields, distribution growth, solid distribution coverage ratios, and the potential for price appreciation.

Even though they may owe more tax than individual MLPs, Weiner invests in MLP mutual funds and ETFs for professional management, broad diversification, and specific strategies for total return or high income. Weiner says his firm has strategies that include baskets of MLPs for certain clients, "but when there is limited capital we can use mutual funds or ETFs to get broader diversification with fewer dollars."

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This story is part of a 30-day series on Social Security and retirement income strategies.

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