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A Practical Guide to the Tax Issues of Investing in Master Limited Partnerships

TAX CLINIC

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According to the National Association of Publicly Traded Partnerships website, as of May 2008, there are over 100 partnerships currently trading on major exchanges (www.naptp.org/PTP101/CurrentPTPs.htm). This is a significant increase over the approximately 50 or so partnerships that were publicly traded only five years ago. Many of these entities have met the requirements under Sec. 7704 to be taxed as a partnership and are generally referred to as master limited partnerships (MLPs).

The tax reporting related to these types of investments has become an increasingly significant issue facing the tax practitioner community. Specifically, questions arise as to whether tax practitioners have done an appropriate job of educating taxpayers and investment advisers on the tax complexity and issues associated with these investments, of ensuring the appropriate level of compliance related to these investments by assisting clients with identifying and reporting income on the investments, and of having sufficiently met their professional responsibilities.

What Is an MLP?

Sec. 7704(b) defines a publicly traded partnership (PTP) as any partnership in which (1) the interests in that partnership are traded on an established securities market, or (2) the interests in the partnership are readily tradable on a secondary market. Not all PTPs are taxed as partnerships. Under Sec. 7704(a), a PTP is generally taxed as a corporation. An exception to the general rule applies for partnerships with passive-type income. Under Sec. 7704(c), a PTP may be taxed as a partnership if it meets the qualifying income test—i.e., when “90 percent or more of the gross income of such partnership for such taxable year consists of qualifying income.” For purposes of this definition, qualifying income is defined as interest, dividends, real property rents, gains from the sale or other disposition of real property, income and gains derived from natural resources, gains from the sale or disposition of a capital asset, and income and gains from commodities. An MLP is a PTP that meets the requirements under Sec. 7704(c) to be taxed as a partnership.

Identification of an MLP

Perhaps one of the biggest issues in dealing with a taxpayer's investment in an MLP is determining whether or not the taxpayer has in fact invested in one. Clearly, the most basic way to identify this type of investment is upon the receipt of a Schedule K-1 that has marked on its face that the entity is a publicly traded partnership. Many taxpayers do not know that they have invested in MLPs until they receive the K-1. Taxpayers, as well as their investment advisers, generally do not comprehend the fact that publicly traded entities may be taxed as flowthrough entities for income tax purposes. They are used to traditional investments, from which they receive dividend payments that are reflected on a Form 1099-DIV at year end, and having capital gains or losses upon the sale of their ownership.

Accordingly, it may be necessary to review and compare the taxpayer's list of investments held at year end and those investments bought and sold during the year to determine if any are MLPs. Although there are a relatively small number of MLPs, this process could be cumbersome and time consuming. In many cases, a combined Form 1099 may indicate MLP distributions made to the taxpayer, which may provide an avenue to identify whether the taxpayer should be receiving a Schedule K-1 from an MLP. However, this form of identification will only assist the practitioner in identifying those MLPs that have made distributions to the taxpayer in a particular year.

Once an MLP investment has been identified, both the practitioner and the taxpayer need to be aware that receipt of the Schedule K-1 from the MLP may not occur until late March, early April, or potentially even later, since the MLP return may not be due until October. What is the most appropriate way to handle this timing issue? Is the taxpayer

willing to extend his or her return in order to file once they have received their K-1? Does the taxpayer's return get filed prior to receipt of the Schedule K-1 using some sort of estimate, potentially with the filing of a Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)? The timing of the receipt of MLP tax information is a pertinent topic that should be thoroughly discussed with the taxpayer, especially when these investments are in a flowthrough entity, which may be reporting flowthrough income from investments it has made.

After identifying an investment as an MLP, the practitioner will need the MLP's Schedule K-1 in order to prepare an accurate return for the client/taxpayer. Many MLPs offer an investor relations website that allows an individual to enter relatively little information (Social Security number/employer identification number and the name on the account) to view his or her Schedule K-1 from the entity. However, not all MLPs have this type of service, and the taxpayer (or tax practitioner with appropriate permission) may need to contact the entity's investor relations department directly in order to obtain the relevant information copy of the Schedule K-1.

Income Reporting

While tax practitioners deal with passthrough entities on a regular basis and understand the general reporting requirements of income from passthrough entities, there are some unique issues related to MLP investments that need to be considered.

One of the potentially most unusual tax compliance issues is dealing with the passive activity rules for PTPs under Sec. 469(k), in which the passive activity loss limitation rules are applied to MLPs on an entity-by-entity basis. Basically, this requires that each unit holder of an MLP treat any loss from the MLP separately from any income or loss generated from any other passive activity (including other MLPs). For example, if the taxpayer has passive income from MLP A and passive losses from MLP B, the losses from B will carry over to the next tax year because they cannot be used to reduce the passive income recognized from A. However, if in the next tax year B has passive income, the passive losses from the previous year can then be used to offset the current year's passive income from B.

Furthermore, the rules under Sec. 469(e)(1) state that passive income does not include any gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of business; expenses that are clearly and directly allocable to those types of income; and gains or losses not derived in the ordinary course of a trade or business attributable to producing the portfolio income described above or otherwise held for investment. This means that portfolio income shown on the Schedule K-1 from an MLP is generally taxable to the unit holder, but any losses considered to be passive may be suspended under Sec. 469.

While not necessarily unique to MLP investments, another issue that needs to be considered is the appropriate level of state tax compliance. Many MLPs, especially those in oil and gas and related businesses, may have operations in multiple states. Generally these MLPs will provide information for income or loss from the activity that is allocable to each state. States each have their own separate rules as to who must file a return, and investing in passthrough entities with business operations in a particular state may trigger a filing requirement for the owner/taxpayer in that state. In practice, many individuals probably do not meet their state tax compliance obligations in this area.

However, the tax practitioner needs to consider the appropriateness of a position not to file in a particular state and inform the taxpayer of the potential exposure of a failure to file as compared with the costs of complying with the filing requirement. The tax practitioner should consider what his or her professional responsibilities are in the matter of the state tax compliance and—where appropriate—limit the scope of tax preparation services in the engagement letter to only those specific returns that the practitioner has been engaged by the client/taxpayer to prepare. The tax practitioner's engagement letter should affirmatively state that the client is responsible for determining filing requirements outside the scope of the engagement and for the preparation of all returns not included in the engagement letter.

Another potential trap for the unwary occurs when IRAs and other tax-exempt entities invest in MLPs. MLPs may generate unrelated business taxable income (UBTI) that should be reported to the tax-exempt investor on the MLP's Schedule K-1. Depending on the amount of UBTI, the tax-exempt entity may be required to pay unrelated business income tax (UBIT) and file the appropriate tax returns. To emphasize, many taxpayers and some investment advisers may not realize this or even realize that they are purchasing investments in passthrough entities. As such, the tax practitioner should focus on this educational process with all clients who rely on the practitioner for tax advice.

Disclosure Requirements

Another tax compliance issue to consider when dealing with MLPs relates to the proper disclosures taxpayers must make with respect to purchases and sales of MLP units. Many MLP K-1s suggest that a Sec. 754 disclosure statement (when partnership interests are bought because the interests may contain certain basis adjustments) and a Sec. 751 disclosure statement (when partnership interests are sold) may be required by the unit holder. The tax

practitioner should carefully read these K-1s for these and other types of disclosures (reportable transactions, PFICs, etc.) that may be required on the unit holder's tax return. The tax practitioner should also consider the appropriateness and the consequences of disclosing (or not disclosing) some of the information reported to the taxpayer on the Schedule K-1.

Sales of MLP Interest

Inevitably, taxpayers who invest in MLPs will sell some or all of their units of the MLP, and gain or loss will need to be calculated. How will the practitioner recognize a sales transaction? If the taxpayer has completely sold out of the position, the Schedule K-1 that the client receives should be marked as final. If the taxpayer sells only part of its interest, the sale may not be so clear. A unit purchases-and-sales schedule is often included with the Schedule K-1.

As with any investment in a partnership, the original purchase price will not be a true reflection of the taxpayer's basis in the partnership units. However, many reports of gains or losses received from brokers use original cost as the basis for sales in the MLP units. Accordingly, the tax practitioner should adjust these gain and loss schedules to appropriately reflect the taxpayer's adjustments to basis in the units for the flowthrough activity related to the units sold.

Some MLPs attach a schedule to the K-1, reflecting units sold and adjustments to basis, which enables the preparer to calculate the actual gain. In addition, the MLP will report the amount of ordinary gain under Sec. 751 and may provide the adjustments to basis for AMT purposes. However, some K-1s do not contain this information, and the tax practitioner or taxpayer will need to calculate the basis to be used for reporting the sale of the MLP units based on current and prior K-1s received. Accordingly, part of the annual tax return preparation process might include the calculation of a taxpayer's adjusted basis (including AMT basis) in these investments. A portion of the gain on the sale of an MLP interest may be considered ordinary gain under Sec. 751. As explained above, this will generally be noted as an attachment on the K-1 and should be considered accordingly in the tax preparation.

These types of basis adjustments and characterization of gains/losses for tax purposes may create some unanticipated tax consequences if not considered thoroughly. Also, the disposition of the taxpayer's full interest in the MLP activity would trigger the realization of any previously suspended passive activity losses from that activity.

The issues related to basis are also a concern due to proposed legislation that would make basis reporting mandatory for brokers of transactions involving publicly traded securities, which includes MLPs. On May 13, 2008, the House passed H.R. 3221, which included a provision that would require brokers to report cost basis information to shareholders and the IRS along with the long-term or short-term nature of any gain or loss. Ultimately, there are questions as to how tax information for MLPs may be reported to brokers so they can comply with these requirements. Since brokers are currently required to report only the proceeds from the sales of securities via a Form 1099-B, mandatory basis reporting would be a major shift that needs to be considered. In the meantime, the taxpayer, with guidance from his or her tax practitioner, will probably continue to bear the responsibility of calculating and tracking tax basis in these investments.

Conclusion

It is important for practitioners to inform their clients and/or investment advisers as to the tax compliance complexity related to investing in MLPs. As the focus of the taxpayer and the investment adviser is generally on investment performance, the tax compliance issues related to MLPs may not have been an important consideration. Over the past few years, MLPs holding oil, gas, and other energy-related properties have generated a lot of investor interest due to their return on investment. Experience indicates that, as a whole, tax practitioners have not educated their clients about the tax issues related to these investments. The complexities should not necessarily deter a taxpayer from investing in MLPs, but the taxpayer should be informed of the additional cost of compliance when considering whether to make the investment. It is up to the CPA profession to make clients aware of these complexities.

EditorNotes

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