Special Report

Ultimate Tax Shelter for Income Investors

Thirty years ago a man named Buckley buried an incredible tax break for investors in a little-known section of the U.S. Tax Code. It was the creation of Master Limited Partnerships (MLPs). Some say these companies are one of the greatest gifts the government ever handed investors.

by Igor Greenwald and the team of analysts at Investing Daily

Owing units (shares) in a master limited partnership is different from owning corporate stock in a number of ways, most notably their taxation. That is because an MLP is a partnership, and you, as an investor, are a limited partner. MLPs offer investors a simple value proposition: high single digit, tax-advantaged yields and strong recession-resistant growth potential. Even better, MLPs represent one of the only ways for investors to avoid getting snared by any new taxes Washington may devise in coming years to balance the deficit-ridden federal budget. To date the government has made no moves to change the taxation of MLPs.

If you plan to hold onto them through thick and thin, which could include distribution cuts, before passing them on to your heirs, your constancy will be rewarded with the impressive tax benefits that are among MLPs’ main selling points. You will never have to pay the piper for all those untaxed returns of capital during your lifetime via personal income tax on recaptured depreciation. Neither will your heirs.

Buckley’s Tax Escape Hatch

An MLP, like all partnerships, is a pass-through entity which pays no tax itself. It is treated by the tax code not as a separate entity but as a collection of partners. So these partnerships aren’t subject to America’s 35% corporate tax rate, among the highest in the world. Because these partnerships do not have to pay corporate-level tax, they pass through most of their income to investors in regular quarterly distributions.

To qualify for MLP status, a partnership must receive at least 90% of its income from what the IRS calls “qualifying” sources—activities related to the production, processing or transportation of natural resources like oil, natural gas and coal. MLP distributions are highly tax-advantaged and offer a significant tax shield for investors. As a result of depreciation allowance, 80% to 90% of the distribution you receive from a typical MLP might be considered a return of capital by the IRS. You don’t pay taxes immediately on this portion of the distribution. Instead, return of capital payments serve to reduce your cost basis in the MLP. You’re not taxed on the return of capital until you sell the units. In other words, 80% to 90% of the distribution you receive from the MLP is tax-deferred.

The remaining piece of each distribution is taxed as ordinary income, not at the special dividend tax rate. But the piece taxed at full income tax rates might be only 10% to 20% of the total distribution; there’s still a huge deferred tax shield for unitholders.

For example: assume you own an MLP purchased for $50 and receive $5 in annual distribution payments, $4.50 of which is considered a return of capital. After one year, your cost basis on the MLP would drop to $45.50 ($50 minus $4.50); no income tax is paid on that $4.50. You’d pay normal income tax rates on the remaining 50 cents. When you finally sell the units or the cost basis drops to $0, a portion of the capital gains is taxed at the special long-term capital gains tax rate. The remainder is taxed at your personal income tax rate. But in most cases,
MLPs should be held for long periods to get the full benefit of distributions. You’re likely to be deferring 80% to 90% of taxes on the distributions for several years or perhaps indefinitely—a tremendous benefit for most investors.

Investors who leave the MLPs in their portfolios to heirs can thumb their nose at the taxman even in death, since inherited MLPs gain a step-up in basis like other stock-market investments, thereby minimizing the deferred tax hit.

**Sweet Spot for Dividend Growth**

The most important reason to buy MLPs now, however, is not current yield but growth. Dividend-paying stocks move up and down for many reasons in the near term. But they often ratchet higher over the long term as dividends grow. At the time of this writing, the best MLPs are truly in the sweet spot for dividend growth. For one thing, despite turmoil in the credit markets, capital costs are at an all-time low. Low capital costs mean even the lowest-risk project can produce outstanding returns. With production from America’s prolific shale oil and gas basins fueling demand for additional midstream capacity, MLPs have plenty of low-risk projects to drive growth. Every new project pushes cash flow higher. And as cash flow rises, it pushes distributions higher.

Enterprise Products Partners, for example, has now raised its distribution for 16 consecutive years, a period that includes some of the most turbulent years in U.S. economic history. Even during the 2008 crash—when oil went from over $150 a barrel to less than $30—Enterprise Products Partners kept on boosting its distribution while the banks went bust. That’s a safety record you won’t find at any other company growing so fast. To be sure, unit prices can be range bound (the value moves within a relatively tight range for a certain period of time) for months and even years, if investors are focused on risk. But so long as the MLPs themselves continue to grow by adding cash flows from high-quality assets, their unit prices should head higher. And that’s even as they generate a rising stream of distributions that beat the pants off bonds and virtually all stocks.

**Political Stability**

Changes in MLP taxation are extremely unlikely. For one thing, even taxing all of them as corporations would raise very little money for the U.S. Treasury. The combined market capitalization of the 50 largest energy-focused MLPs, for example, is $32 billion less than the market value of ExxonMobil (NYSE: XOM). It’s simply not worth it to tax them for the additional receipts, particularly considering how much it would hurt domestic energy development—a key Obama administration goal backed strongly by both Democrats and Republicans. In addition, the National Association of Publicly Traded Partnerships and the energy industry control powerful lobbies in Congress.

Elected representatives in Washington are aware of the potential political fallout from supporting a change in taxation that would increase energy prices. To date, the U.S. Treasury Dept. has yet to issue a proposal that changes how MLPs are taxed. A change of this nature would face a long and politically difficult route to passage, especially with the current level of congressional partnerships. At Investing Daily, we will monitor the political debate and keep you apprised of these developments. Meanwhile, we continue to focus on the underlying businesses and market conditions for the MLPs in our model Portfolios.

**IMPORTANT NOTES:**

Guidance concerning the stocks highlighted in this report is believed to be accurate and represent our best advice at the time of writing. However, market conditions change constantly and guidance at the time of this writing may not reflect our latest advice. For our current take on any MLP in this report, it is vitally important that you check the Portfolio tables on the website and confirm that the MLP still earns a buy rating. Furthermore, confirm that the MLP trades below our current buy limit. Do not buy any MLP above our recommended buy limit. If an MLP’s price exceeds our buy limit, wait for a pullback or invest in another Portfolio holding that trades below our buy limit. Any advice in the Portfolio tables, a recent issue of the publication, or our email alerts always trumps older advice in this special report.

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