

Master Limited Partnerships (MLPs) Demystified

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Many investors are seeking additional strategies to help improve portfolio diversification and increase the yield generated by their investment portfolio. MLPs have been receiving a lot of attention recently and may indeed help investors achieve both of these objectives as part of a thoughtful, well-planned investment strategy. However, MLPs are more complicated than traditional stock and bond investments and these complexities may seem intimidating to potential investors. With that, the goal of this piece is to help demystify MLPs by providing a broad framework for understanding these investments and, importantly, how to effectively implement in a client's portfolio. Given the accompanying tax complexities, investors should consult with a tax professional before investing in MLPs.

A Brief Look at the U.S. Energy Infrastructure

In order to provide some context for the investment implications of MLPs it's useful to have a general sense of the current energy landscape. Many MLPs are involved with the transportation of energy commodities from point of production to processing facilities. This pipeline network is vital to our country's economic health and infrastructure and forms our "economic cardiovascular system." Approximately two-thirds of the oil and petroleum products transported annually are via these pipelines. The map on page 3 illustrates the U.S.'s crude oil, carbon dioxide, liquid natural gas, and refined products pipeline network that serves the U.S.

U.S. Energy Production Growth and MLPs

Today, the United States is the fastest-growing energy-producing nation in the world and is rapidly becoming the new "Middle East" based on our energy reserves.

According to the U.S. Energy Information Administration (EIA), as of 2012 (the latest

results available), the U.S. was the second-largest oil producer in the world, just behind Saudi Arabia, and is expected to become the largest oil producer, perhaps as early as 2015. It is also now forecast that the United States may become energy independent by as early as 2020. It is generally estimated that between \$250 and \$300 billion will be invested in energy infrastructure in order to develop the U.S.'s unconventional shale reserves over the next 10-20 years in order to meet this growth potential. Portfolio managers that specialize in MLP investing routinely cite this as an important part of the investment rationale for investing in MLPs. The EIA reports that there are over 665 trillion cubic feet of technically recoverable shale gas and 58 billion barrels of technically recoverable shale oil resources in discovered shale plays. Indeed, the growth of MLPs is closely tied to the U.S. rebirth in oil and natural gas production and infrastructure.

Fairly recently, advances in hydraulic fracturing technology, or "fracking", have



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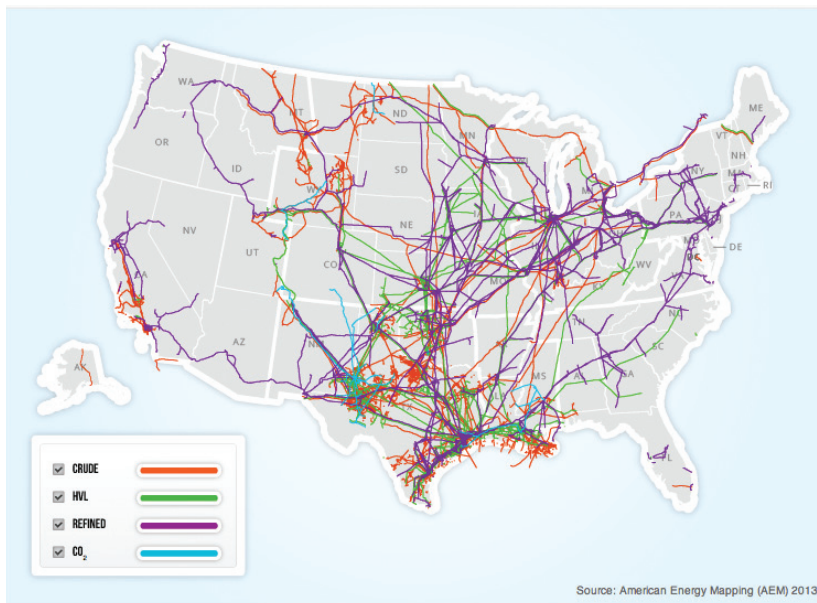
made the current shale drilling boom possible. Hydraulic fracturing involves the use of water pressure to create fractures in rock that allow the oil and natural gas it contains to escape and flow out of a well. This makes it possible for shale oil extraction to produce oil and natural gas in places where conventional technologies have been ineffective.

The shale gas map on page 4 shows the “plays” that are found throughout the country. These plays are geographic areas where companies are actively looking for natural gas and shale oil reserves in shale rock.

Defining MLPs and their Unique Features

As background, the publicly traded MLP structure was initially created in 1981 (formed by the Apache Oil Company), as

Where are Liquid Pipelines Located?



Key Take-Aways

- Many investors are seeking additional strategies to help improve diversification and increase the yield within their investment portfolios. MLPs may be part of the solution for appropriate client portfolios.
- The future growth of U.S. energy production is a key underpinning to the investment thesis underlying MLPs.
- MLPs are unique investments which possess different characteristics than corporations. The main differences that direct investors need to be aware of include:
 - MLPs are not taxed at the entity-level like corporations, thus avoiding “double taxation” at both the entity-level and investor level.
 - Owners of MLPs are limited partners and receive pass-through tax items such as cash distributions, non-cash deductions, and reportable net taxable income from an MLP.
 - Filing taxes can be more complicated, and expensive, for investors of MLPs than for investors of stocks.
 - Unrelated Business Taxable Income (UBTI) and payment of some state income taxes may be an issue for some investors, particularly in IRAs.
- The main benefits of investing in MLPs include: total return potential, higher income, growth of income, diversification, and favorable tax treatment.
- The main risks of investing in MLPs include: market risk, legislative (tax treatment) risk, interest rate risk, and individual business risk.
- There are seven main ways to invest in MLPs: Purchase units directly in a brokerage account, utilize a portfolio manager that actively constructs a portfolio of MLP units in an SMA, open-end fund (C-corps and RICs), closed-end fund, ETN, or ETF. Each has their own set of advantages and disadvantages.
- In order to avoid UBIT in a retirement account, investors may choose to invest indirectly in MLPs by utilizing mutual funds, ETFs, or ETNs (these vehicles are not legally organized as master limited partnerships).
- MLPs are equity investments and should therefore be positioned in client accounts as such.
- MLPs have had low historical correlations with major asset classes over time.
- The individual MLP landscape is becoming more diverse (across quality, business type, and growth potential) and therefore active portfolio management is becoming more important.

Lower 48 States Shale Plays



Source: Energy Information Administration based on data from various published studies. Updated: May 9, 2011

publicly-traded securities called units. As such, limited partners are also called unit holders. In general, the general partner runs the business while the limited partner provides the capital.

The MLP industry has been growing rapidly in recent years. According to the National Association of Publicly Traded Partnerships (NAPTP), the aggregate market cap of the MLP industry has grown from approximately \$150 billion in 2007 to approximately \$500 billion at the end of 2013. While the number of MLPs is expected to continue to grow during the next decade, as of the end of 2013, there were only approximately 130 MLPs. Compared to other sectors, the investable universe of MLPs is still relatively small, which means that some MLP funds and separately managed accounts (SMAs) may have somewhat similar underlying holdings.

a means for the U.S. federal government to encourage the investment and build-out of the energy and natural resources infrastructure of the United States after the oil crisis of the 1970s. A broad array of industries began structuring themselves as an MLP to receive tax breaks. In 1987, the U.S. government limited publicly traded partnerships (including MLPs) to only those companies that generate 90% or more of their income from the exploration, development, mining/production, processing, refining, transportation (including pipelines), or marketing of minerals or natural resources.

An MLP is a publicly-traded limited partnership that has at least one general partner and many limited partners. Limited partners are the owners of the MLP's

A key point in understanding MLPs is that they are not structured as corporations. Therefore, there are important differences between the two structures that investors need to be aware of. The table below compares the characteristics of an MLP to those of a corporation.

Tax Issues

Another key element to understanding MLPs is their tax treatment. The unique structure of MLPs provides their investors with beneficial tax treatment and in most cases investors can defer paying some or all taxes on the distributions they receive from MLPs until the units are sold. As long as specific IRS guidelines are followed (such as the generation of at least of 90% of income from energy-related sources), an MLP's earnings are not subject to federal corporate income

Characteristic	MLPs	Corporations
Taxable at the Entity Level	No	Yes
Firm-Level Tax Items "Pass Through" Directly to Investors	Yes	No
Potential Deferral of Annual Tax Payments on Periodic Distributions	Yes	No
Type of Tax Forms for an Investor to File	K-1	1099-Div
Investor Voting Rights	No	Yes

Source: National Association of Publicly Traded Partnerships

tax. This is a benefit since this allows the MLP to either internally invest more capital than it otherwise could to grow its operations or pay a higher cash distribution to its unit holders. The partnership's earnings, and tax burden, "pass-through" to the unit holders of MLPs who are then taxed at their own individual tax rate. This arrangement avoids the "double taxation" that investors in corporations face, as MLP earnings are only taxed once at the unit holder level.

Taxes Paid on Cash Distributions to Unit Holders: An MLP is a pass-through entity which pays no taxes itself. With that, MLPs will typically pay quarterly distributions to unit holders. According to the NAPTP, an MLP unit holder pays the taxes on the income from the MLP minus any deductions such as depreciation. Non-cash items such as depreciation are typically very large (given the equipment-intensive nature of MLPs) and may significantly reduce the taxable income that the unit holder must pay during the tax year that the distribution was received. These deductions (due to their significant size) may result in a high percentage of an individual's taxes owed from distributions being deferred. When the MLP distributes cash payments that are greater than its net income, the excess portion of the distribution is considered a "return of capital." Return of capital reduces the cost basis of the original MLP investment and is not immediately considered taxable income.

Taxes Paid When a Unit Holder sells MLP Units: When a unit holder sells their MLP units in a taxable account, as with any investment, a taxable event is triggered. Unlike a stock's cost basis, according to the NAPTP, an MLP investor's cost basis is adjusted by the subsequent receipt of distributions after initial purchase. Specifically, any return of capital reduces the unit holder's original cost basis. In a simplified example, if an investor buys a unit of an MLP for \$10 and then receives a cash distribution where \$0.50 is classified as return of capital, the new cost basis would then become \$9.50. Additionally, any net taxable income received by an investor adjusts the cost basis upwards. Therefore,

when a unit holder sells an MLP unit(s), the taxable gain that is triggered is adjusted by the amounts and types of previous distributions. The idea is that all income received by the MLP is taxed only once, either during the tax year received or upon sale of the MLP units.

The NAPTP clarifies that not all of the gains on MLP units are taxed at an investor's capital gains tax rate when sold. There are two components regarding the treatment of the sale of MLP units. First, the portion of the gain upon selling the units that is attributable to previous returns of capital is taxed as ordinary income. This is called "recapture" and can be thought of as paying the deferred taxes that the unit holder didn't pay when the cash distribution was originally received. Secondly, the remainder of the capital gain from selling the MLP unit(s) is taxed at the applicable capital gains rate, which depends on an investor's holding period and current tax laws. There may be other MLP-specific tax issues that may have to be accounted for when filing taxes and this paper is only intended to provide a general view of how taxes are treated upon receipt of distributions and when units are sold.

Given the tax complexities involved with investing in MLPs, it is important to maintain thorough tax records and to consult with a tax professional that has a strong working knowledge of MLP tax strategy.

MLPs and State Taxes

MLPs often operate in multiple states and, technically, unit holders are responsible for paying state income taxes (based on their share of an MLP's income), which are allocated across all of the states in which an MLP operates. However, according to the NAPTP after an MLP's income is divided among all partners and all states, and with significant depreciation and other deductions applied, a unit holder's taxable income in each state may likely be too low to be taxed. Large investors of MLPs are more likely to incur state income taxes. Additionally, many MLPs operate in Alaska, Texas, Wyoming, Nevada, Tennessee, and South Dakota, which according to the IRS, do not currently apply



The partnership's earnings, and tax burden, "pass-through" to the unit holders of MLPs who are then taxed at their own individual tax rate.



The potential for capital appreciation, combined with the ability to grow cash distributions as well as the large relative distributions themselves, make MLPs an intriguing total return vehicle.

a state income tax. Despite this, it is still important for taxable investors to be aware of the fact that they may be responsible for filing multiple state income tax returns related to their investment in an MLP.

Unrelated Business Taxable Income (UBTI)

Even though certain entities such as charities or other non-profits (or more germane, IRA) are recognized as having tax-qualified status by the IRS, it still may be liable for paying taxes on its unrelated business income. According to the IRS, an unrelated business activity is one that is not substantially related to furthering the tax-exempt purpose of the organization. Since an IRA's tax-exempt purpose is not related to the business goals of an MLP, some pass-through income from an MLP may be considered UBTI. According to the IRS, a tax-exempt entity (again, including an IRA) that receives more than \$1,000 per year of UBTI may be liable for subsequent tax payments. A Form 990-T, "Exempt Organization Business Tax Return," will need to be filed if UBTI received is over \$1,000. While some IRA custodians will complete the Form 990-T for an MLP unit holder, the MLP unit holder is ultimately responsible for ensuring that the proper forms are filed with the IRS.

UBTI in an IRA may add considerable complexity and trigger taxes owed for the tax year received which is counter to the benefit of a tax-qualified IRA. Investors should carefully consider, with the assistance of a tax professional, whether or not to invest directly in MLPs within an IRA. We discuss strategies later in this paper to gain MLP exposure in an IRA while avoiding the potential hassles of UBTI.

K-1's

The K-1 form is a document that an MLP unit holder receives that displays an investor's share of each item of partnership income, gain, loss, deductions, UBTI, and credits. The K-1 form is included in the "tax package" that each MLP provides, and includes information necessary for an investor to complete their tax return. MLP investors receive this form instead of the 1099-DIV, which is associated with common stocks.

While K-1s are generally not made available in January as with the Form 1099-DIV, MLPs work hard to provide the K-1 in a timely manner. Usually an investor can download the K-1 from an MLP's website in late February or March, which should be in time to meet the standard tax filing deadline on April 15. For example, Kinder Morgan Energy Partners, L.P. provided its investors with their "tax package" (which includes the K-1) in late February of 2014.

It's important to note that tax preparers may assess an additional fee to process K-1s at tax time. Typical charges may be \$25-\$100 per K-1. Other tax preparers may not charge a fee or may charge by the hour. This is something that investors should discuss with their tax professionals before investing in MLPs. Some MLP portfolio managers recommend that investors have a substantial amount of assets to invest in MLPs (perhaps \$250,000 or more) in order to reduce the impact of the additional tax preparer's cost relative to the value of the investments.

The Investment Benefits of MLPs

MLPs offer several benefits to investors.

Total Return Potential: While MLPs have been known as yield-oriented investments, they also have the potential to deliver total return (blending growth and income). Supporting this view, the Alerian MLP Index (which is comprised of the 50 most prominent MLPs) has delivered an average annual total return of 14.95% during the past 10 years, through March 31, 2014. This trend has strengthened during the past five years, as MLPs have gained an average of 27.30% annually. The potential for capital appreciation, combined with the ability to grow cash distributions as well as the large relative distributions themselves, make MLPs an intriguing total return vehicle. It's important to underscore that MLPs are equity investments and are not bonds. Therefore, MLPs and bonds provide exposure to different sources of risk and return. Please refer to the table below for historical returns data.

Asset Class Returns (by index)	Total Return YTD	Total Return 1-Year	Total Return Annualized 3-Year	Total Return Annualized 5-Year	Total Return Annualized 10-Year	Standard Deviation 10-Year
Alerian MLP Index	1.87	8.54	13.53	27.30	14.95	16.53
DJ UBS Commodity	6.99	-2.10	-7.37	4.24	0.43	18.00
S&P GSCI Energy Index	0.49	2.43	-1.80	7.74	-0.74	29.81
DJ UBS Sub WTI Crude Oil Index	4.37	6.99	-4.25	4.78	N/A	N/A
DJ US Select REIT Index	10.35	4.35	10.27	28.92	8.05	26.91
S&P 500 Index	1.81	21.86	14.66	21.16	7.42	14.71
Russell 2000 Index	1.12	24.90	13.18	24.31	8.53	19.74
MSCI EAFE Index	0.77	18.06	7.72	16.56	7.01	18.28
Barclays US Agg Bond Index	1.84	-0.10	3.75	4.80	4.46	3.38
Barclays US Corporate High Yield Index	2.98	7.54	9.00	18.25	8.68	10.44
Barclays US TIPS Index	1.95	-6.49	3.50	4.91	4.52	6.49
Barclays Municipal Index	3.32	0.39	5.79	5.71	4.45	4.48

Source: Morningstar Direct, returns as of March 31, 2014.

High Income: Historically, MLPs have offered yields higher than that of many other asset classes. This is due primarily to a couple of reasons. First, MLPs distribute nearly all available cash to their unit holders. Secondly, since MLPs are not taxed at the entity-level, they have more cash to distribute to investors. These characteristics have attracted investors seeking higher income to MLPs.

MLP portfolio managers cite that yield levels for MLPs have historically been attractive and currently compare favorably to the yields of other income-oriented asset classes. As of March 31, 2014, MLPs yielded 5.6% as measured by the Alerian MLP Index. By comparison, REITs and utilities had yields of 2.63% and 3.69%, respectively, while the S&P 500 Index offered a yield of 2.03%.

Growth of Income: MLPs have generally demonstrated historical growth in quarterly distributions as a group over time, despite the economic turbulence we have experienced during the past five-plus years. This is partially due to the fact that most pipelines are quasi-monopolies in a given area and typically are able to increase their fees via contract renewals at least by the rate of inflation (which is regulated by the Federal Energy Regulatory Commission). Historically, roughly half of MLP returns have been driven by the growth rate of distributions. This feature is especially beneficial within the context of an inflationary and/or a rising interest rate environment. This provides an edge over many fixed income investments which typically make static coupon payments. For this reason, it has been said that MLPs

Yield by Investment Type	3/31/14	2013	2012	2011	2010	2009	2008	2007	2006
MLPs	5.67	5.70	6.15	5.73	5.74	6.60	10.55	5.65	5.62
Utilities	3.69	4.01	4.35	3.99	4.36	4.22	4.50	2.87	3.13
REITs	2.63	2.93	2.91	3.21	2.99	4.13	6.87	4.57	3.44
S&P 500	2.03	1.93	2.18	2.07	1.80	1.92	3.12	1.88	1.72
Russell 2000 Index	1.35	1.29	2.05	1.53	1.30	1.37	2.39	1.67	1.33
High Yield Bonds	5.23	5.64	6.13	8.36	7.51	9.06	19.43	9.64	7.70
Barclays Aggregate Bond Index	2.39	2.48	1.74	2.24	2.97	3.68	3.99	4.90	5.34

Source: Strategas, Inc.

Cumulative Performance When Interest Rates Rise

	1	2	3	4	Average
Trough	9/30/93	9/30/98	5/31/03	12/31/08	
Peak	11/30/94	1/31/00	6/30/06	12/31/09	
S&P 500 REITs	NA	NA	65.4%	18.7%	42.0%
Russell 2000 Index	-3.4%	36.5%	64.3%	25.2%	30.6%
Alerian MLP	NA	-11.6%	35.6%	61.9%	28.6%
High Yield	2.0%	4.1%	31.9%	58.2%	24.0%
S&P 500	-1.1%	37.1%	31.8%	23.5%	22.8%
CRB Commodity Index	16.8%	-10.6%	32.9%	35.6%	18.7%
S&P 500 Utilities	-23.2%	-2.0%	46.9%	6.8%	7.1%
Barclays Aggregate	-3.5%	-0.8%	6.1%	5.9%	1.9%

Source: Strategas



offer “unfixed income.” As a result, MLPs have been able to outperform other yield-oriented asset classes during rising rate environments. Furthermore, MLPs that have grown their distributions faster than average have generally outperformed MLPs with slower distribution growth.

The above table and graph display the returns of the Alerian MLP Index, as well as other asset class returns, during periods of rising interest rates (as measured by the 10-year Treasury yield).

Diversification: MLPs have historically had lower correlations with other major asset classes. Analyzing correlations is tricky because MLPs possess both equity and bond attributes. As investor sentiment

Correlation Coefficients 2006 – 3/31/2014	Alerian MLP Index
Alerian MLP Index	1.000
Barclays US High Yield Index	.614
MSCI EAFE Index	.527
S&P 500 Index	.522
Russell 2000 Index	.477
DJ UBS Commodity Index	.441
S&P GSCI Energy Index	.409
DJ UBS Sub WTI Crude Oil Index	.392
DJ US Select REIT Index	.364
Barclays Muni Index	.271
Barclays US TIPS Index	.065
Barclays US Agg Bond Index	-.119

Data source: Morningstar Direct

favors bonds vs. stocks during different time periods, their respective correlations to MLPs may fluctuate as a result. Also, macro-environment changes will have an effect on the relationship between various asset classes throughout time (such as during 2008). Additionally, the relatively small (but growing) previous size of the MLP market and limited history are reasons why correlations should only be used as one consideration. Over long periods of time, however, correlation coefficients between MLPs and other major asset classes have generally been low, which indicates that MLPs may offer diversification benefits for most portfolios.

The chart on the previous page illustrates the correlation coefficients beginning in January 2006 through March 2014 between MLPs and other asset classes that an investor may typically hold.

Favorable Tax Treatment: Tax treatment is one of the characteristics which often draw investors to individual MLPs. As previously discussed, as long as specific guidelines are followed, an MLP's earnings are not subject to federal corporate income tax. Additionally, a large portion of MLP distributions to investors are classified as returns of capital, which lower an investor's cost basis in the units owned and defer taxes until the investor sells their MLP units.

The Main Risks of Investing in MLPs

Every investment has its risks and MLPs are no different. This section is not exhaustive but is intended to identify and discuss the main risks specific to MLPs.

Market Risk: Despite low long-term correlations with the S&P 500 Index, MLPs are indeed equities and trade on stock exchanges. MLPs have also sold off significantly during broad equity market swoons. For example, the drawdown of the Alerian MLP Index was -42% (during the 2008 financial crisis). As a comparison, the S&P 500 Index's drawdown during this time frame was 51%.

Legislative Risk: If the U.S. government were to reduce or eliminate the favorable pass-through entity structure of MLPs, the sector would likely suffer. If MLPs were to be treated as corporations for tax purposes, the new corporate taxes would likely lead to lower distributions to unit holders. Additionally, if yields were significantly lowered on MLPs, investors would likely not find MLPs as attractive; this would make it harder for MLPs to raise capital to fund new projects and suppress valuations.

Interest Rate Risk: Historically low interest rates have materially helped pipeline and other midstream MLPs raise capital at a reasonable cost, facilitating the generation of returns well above the cost of capital. That has supported cash distribution growth and investor total returns. The effects of higher interest rates on borrowing costs would serve to increase overall cost of capital for an MLP. If interest rates rise, MLPs would find it more expensive to obtain debt financing, which could mean that some projects would not be as profitable or even approved because the rate of return would not be large enough to cover the increase in interest expenses. Generally speaking, MLPs with debt that is shorter-dated are more susceptible to higher rates and MLPs with longer-dated debt are less sensitive to a short-term rise in interest rates. Additionally, if an MLP has a larger proportion of its debt structured as fixed-rate, instead of floating rate, it will be less susceptible to a short-term rise in interest rates.

Individual Business Risk: The quality of the management of an MLP, its financing options, as well as its specific business risk and opportunity set will significantly impact the success of that particular business. Additionally, as with any equity security, if an MLP's valuation is viewed as too expensive by investors given its business prospects, this may lead to a drop in value.

How to Invest in MLPs

There are seven main ways to invest in MLPs. Each has their unique benefits and drawbacks specific to MLP investing that

are discussed below. Ultimately, the final decision needs to be based on an investor's circumstances and preferences.

The following chart summarizes the key differences between the main ways of investing in MLPs. Of note, a fund that is structured as a C-Corp is subject to paying taxes at the portfolio level and then investors also pay taxes on their gains and

dividend payments. So, there is a double-taxation element. Funds structured as a regulated investment company (RIC) are not taxed at the portfolio level but can only invest up to 25% of fund assets in MLPs directly, so these funds aren't designed to provide "pure" MLP exposure. These funds may invest the rest of the portfolio in related vehicles or industries, however.

MLP Investment Vehicle Comparison								
	Active or Passive	Direct MLP Ownership	Tax Form	Structure	Double Taxation	UBIT	Advantages	Disadvantages
Direct Investment in MLPs	Active	Yes	K-1	Partnership	No	Yes	<ol style="list-style-type: none"> 1. No expense ratio 2. Self-directed 3. Avoidance of double taxation 4. Potential deferral of taxes on distributions 5. Transparency of holdings 6. Customization 	<ol style="list-style-type: none"> 1. Burden of research and trading 2. Filing K-1s 3. Possible multiple state income tax return filings 4. Possible UBIT in IRAs 5. Possible extension for tax return filing (unlikely) 6. Larger tax record-keeping and reporting burden 7. Additional tax preparer fees (possibly substantial)
Separately Managed Accounts (SMAs)	Active	Yes	K-1	Partnership	No	Yes	<ol style="list-style-type: none"> 1. Professional portfolio management 2. Avoidance of double-taxation 3. Potential deferral of yearly taxes on distributions 4. Transparency of holdings 5. Customization (portfolio manager permitting) 	<ol style="list-style-type: none"> 1. Payment of expense ratio 2. Multiple K-1s (typically 15-25) 3. Possible multiple state income tax return filings 4. Possible UBIT in IRAs 5. Possible extension for tax return filing 6. Larger tax record-keeping and reporting burden 7. Higher investment minimums 8. Additional tax preparer fees (possibly substantial)
Open-End Mutual Funds (C-Corp)	Active	No	1099	Corporation	Yes	No	<ol style="list-style-type: none"> 1. Professional portfolio management 2. No K-1 (Form 1099 Instead) 3. No chance of tax filing extension due to late K-1 4. Lower investment minimums 5. Convenience 	<ol style="list-style-type: none"> 1. Payment of expense ratio 2. Double taxation is a significant drag on returns 3. No deferral of yearly taxes owed on distributions 4. Only trades at end of trading session 5. Lower transparency—delayed holdings reporting

MLP Investment Vehicle Comparison

	Active or Passive	Direct MLP Ownership	Tax Form	Structure	Double Taxation	UBIT	Advantages	Disadvantages
Closed-End Mutual Funds (C-Corp)	Active	No	1099	Corporation	Yes	No	<ol style="list-style-type: none"> 1. Professional portfolio management 2. No K-1 (Form 1099 Instead) 3. No chance of tax filing extension due to late K-1 4. Lower investment minimums 5. Convenience 6. Trades like a stock throughout trading day 	<ol style="list-style-type: none"> 1. Payment of expense ratio 2. Double taxation is a significant drag on returns 3. No deferral of yearly taxes owed on distributions 4. May trade at a discount or premium 5. Lower transparency—delayed holdings reporting 6. Use of leverage—an additional risk and expense
Exchange-Traded Funds (ETFs) (C-Corp)	Passive	No	1099	Corporation	Yes	No	<ol style="list-style-type: none"> 1. No K-1 (Form 1099 Instead) 2. No chance of tax filing extension due to late K-1 3. Lower investment minimums 4. Convenience 5. Trades like a stock throughout trading day 	<ol style="list-style-type: none"> 1. Payment of expense ratio 2. Double taxation is a significant drag on returns 3. No deferral of yearly taxes owed on distributions 4. Possibly no professional management 5. Lower transparency—delayed holdings reporting
Mutual Funds/ETFs (RICs)	Active	No	1099	Corporation	No	No	<ol style="list-style-type: none"> 1. Avoidance of double-taxation 2. No K-1 (Form 1099 Instead) 3. No chance of tax filing extension due to late K-1 4. Lower investment minimums 5. Convenience 	<ol style="list-style-type: none"> 1. Maximum of 25% invested directly in MLPs 2. Payment of expense ratio 3. No deferral of yearly taxes owed on distributions 4. Only trades at end of trading session 5. Lower transparency—delayed holdings reporting
Exchange-Traded Notes (ETNs)	Passive	No	1099	Taxable Note	No	No	<ol style="list-style-type: none"> 1. Potentially lower expense ratio than MLP funds 2. No K-1 Filing (Form 1099 Instead) 3. No chance of tax filing extension due to late K-1 4. Lower investment minimums 5. Convenience 6. Lower potential tracking error to benchmark 7. Trades like a stock throughout trading day 	<ol style="list-style-type: none"> 1. No deferral of yearly taxes owed on distributions 2. Credit risk of the ETN issuer 3. High expense ratio for passive vehicle 4. ETN holder doesn't own any MLPs instead owns a note intended to track an index

Utilizing MLPs in Portfolio Construction

From a risk-return perspective, MLPs should either be included in the equity portion of an investor's portfolio or as a diversifying (aka a "satellite" holding) asset. While they do share some characteristics (and risks) of bonds, MLPs indeed are not bonds. The aforementioned risks - market, interest rate, legislative, and business risks - should be kept front-of-mind both before and while invested in MLPs.

Investing in MLPs in Retirement Accounts

Opinions differ on whether or not it is optimal to include MLPs in a retirement account, and given the potential complexities and UBTI, this issue should be carefully considered.

The case against investing in MLPs in a retirement account include: 1) the tax-deferred benefits of the income provided by MLPs won't be realized in a traditional IRA since income received in an IRA is already tax-deferred or tax free 2) If an MLP unit holder receives more than \$1,000 in UBTI, a separate tax return for your IRA will have to be filed through the broker, this can create additional administrative work and the additional taxes owed will diminish returns 3) An investor typically pays taxes when taking a distribution from a traditional IRA, an investor may be taxed twice on the UBTI.

The case some investors make for investing in MLPs in a retirement account focuses on the fact that much of an MLP's reportable taxable income is typically offset by

deductions such as depreciation. Therefore, UBTI received may be below the \$1,000 threshold for many MLP investors that don't hold large positions in MLPs. Further, proponents cite that the high level of income that MLPs provide is still desirable even after any taxes that may have to be paid on UBTI. Additionally, MLP investors in IRAs won't have to deal with filing K-1s as would investors in a taxable account and paying the associated additional tax preparation fees, though other tax forms may need to be filed.

Ultimately, despite some of the potential benefits of investing directly in MLPs in an IRA, there are significant pitfalls. Investors need to decide which account type would make the most sense for their situation after discussing with their financial professionals.

Investing in MLPs in an IRA While Avoiding UBTI

Open-end and closed-end mutual funds as well as ETFs and ETNs pay dividends to investors (not distributions like MLPs do) and avoid the adverse tax implications related to UBTI. These products may also be superior because investor-level taxes on dividends and capital gains are deferred or, in the case of a Roth IRA, may be eliminated. However, as already cited some of these products are also taxed at the entity-level and thus are subject to corporate income tax, which may represent up to a 35% drag on returns to their investors. Additionally, I-shares are available for a handful of MLPs, I-shares pay distributions in the form of additional shares (not cash) and do not trigger UBIT.

Appendix: An Investors' Guide to Key MLP Terms

There are terms that are specific to MLPs that are important for investors to know and understand. The following is not intended to be exhaustive but should help provide investors with a working knowledge of the most common terms.

Master Limited Partnerships (MLPs):

Limited partnership investment vehicles consisting of units (rather than shares) that are traded on public exchanges. MLPs consist of a general partner and multiple limited partners. MLPs are also known as “publicly traded partnerships”.

General Partner (GP): Manages the day-to-day operations of the partnership, generally has a 2% ownership stake in the partnership, and may be eligible to receive an incentive distribution (through the ownership of the MLPs' incentive distribution rights).

Limited Partners (LP): Provide capital, have no role in the MLPs' operations or management, and receive quarterly distributions.

Distribution: In a typical partnership agreement, the MLP is required to distribute all of its “available cash.” MLPs typically distribute all available cash flow (i.e., cash flow from operations minus deductions and funds needed to effectively run the business) to unit holders in the form of distributions. However, management typically has some discretion over how much cash flow it chooses to pay out. Usually quarterly distribution increases must be approved by the MLP's board. Distributions are typically paid quarterly.

Dropdown: The sale of an asset from a parent company to the underlying partnership.

Incentive Distribution Rights (IDR): The GP is also generally eligible to receive incentive distributions if the GP operates the business in a manner which results in distributions paid per common unit surpassing specified target levels. As the GP increases cash

distributions to the LPs, the GP receives an increasingly higher percentage of the incremental cash distributions.

I-Shares: (institutional shares): I-share units are equivalent to MLP units in most aspects, except that the distributions are in the form of additional MLP units instead of cash. Investors in I-shares receive a 1099 statement (not a K-1). I-shares do not generate UBTI. According to NAPTP, Enbridge Energy Partners and Kinder Morgan Energy Partners were early participants. More recently, a few other MLPs have affiliates that have begun issuing I-shares.

Units: MLP ownership shares, similar to a corporation's shares of stock.

Unrelated Business Taxable Income (UBTI):

The IRS doesn't allow tax-exempt institutions (including charities and retirement accounts) to defer taxes on income that has been generated outside of their core businesses. Additionally, MLP distributions are considered earned directly by the partners (unit holders). Since IRAs are not intended to transport crude oil or natural gas, MLP income may be considered as unrelated business taxable income. According to the NAPTP, a tax-exempt entity that receives more than \$1,000 per year of UBTI may be liable for tax payments on that UBTI.

Unrelated Business Income Tax (UBIT):

Taxes payable due to UBTI.

Upstream: Refers to the production of oil and natural gas from a wellhead (also known as exploration and production).

Midstream: The gathering, treating, processing, transportation, or storage of a product after it is produced from a wellhead, but before it is distributed to the end use market for consumption. Many professionally-managed MLP portfolios primarily invest in midstream MLPs. Many of these MLPs have a pipeline-focused business plan.

Downstream: The refining and marketing sectors of the energy industry. It is also associated with the sale of products after they are refined or processed.

K-1 Statement: This is the statement that an MLP investor receives each year from the partnership that shows his or her share of the partnership's income, gain, loss, deductions, UBTI, and credits. A K-1 is similar in function to the Form 1099 that is received by shareholders of a corporation in order to file a tax return with the IRS.

Federal Energy Regulatory Commission (FERC): The Federal Energy Regulatory Commission, or FERC, is an independent agency that regulates the interstate transmission of natural gas, oil, and electricity. FERC also regulates natural gas and hydropower projects.

Regulated Investment Company (RIC): A regulated investment company is qualified under the Internal Revenue Service code to pass taxes onto investors, and to then be taxed at the individual investor level. A fund or trust must meet certain requirements in

order to qualify as a RIC. For example, at least 90% of its income must come from its investments as capital gains, dividends and interest. Examples of RIC's include some mutual funds, REITs, and Unit Investment Trusts. A RIC can hold a maximum of 25% of its investments in MLPs directly.

Alerian MLP Index: A float-adjusted, capitalization-weighted composite of the 50 largest MLPs. This is a widely-recognized MLP industry benchmark. Because it is cap-weighted, the top holdings represent a large portion of the index.

Variable Quarterly Distribution (VQD) MLP: There is no commitment of a quarterly distribution to be paid nor is there a minimum quarterly distribution. VQDs typically don't have as strong an ability to hedge against commodity exposure. In contrast, traditional MLPs that focus on pipelines have limited exposure to commodity prices. VQDs account for a relatively small portion of the MLP marketplace with roughly \$15B in market cap in late 2013.



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