Master limited partnerships: separating fact from fiction

A brief guide providing clarity on the misconceptions surrounding MLPs

Fact or fiction

Understanding the nuances and drivers of various asset classes is no easy task. Particularly with master limited partnerships (MLPs), a myriad of product structures and complex tax terminology can make navigating through the options a daunting task, with the potential for blurred concepts, partial facts and even misinformation.

At Tortoise, we have managed MLP investment products for well over a decade. Founded in 2002, we formed the first listed MLP fund in 2004 to provide access and simplicity to MLP investors. Today, we offer a wide range of pipeline and MLP investment solutions for institutions and individual investors.

In this paper, we apply our experience as an industry leader to examine several misconceptions surrounding MLP investing in an effort to provide clarity.

Myth #1:

MLPs are analogous to pipelines

We believe the primary advantage of investing in MLPs is ultimately their underlying assets and the source of their cash flows. MLPs are often described in a way that implies that the entire asset class generates predictable, fee-based cash flows. However, this description is more suited to a subset of MLPs (for example, MLPs that operate pipeline assets).

Of the approximately 130 total publicly listed MLPs that exist today, less than half are pipeline MLPs[1].

It is important to understand that the risk spectrum shifts depending on the underlying assets of MLPs (particularly whether they are pipelines or not), the nature of the pipelines themselves, leverage, partnership structures and many other factors. Some MLPs may generate seemingly high current income, while carrying correspondingly higher risk. In addition, there are a significant number of pipeline companies that are not structured as MLPs, but own pipeline assets.

Fact: Not all MLPs are created equal, and not all MLPs are pipeline companies. The composition and risk characteristics within the asset class can vary greatly. Look under the hood and understand the risks.

Myth #2:

Dividends are the only relevant component of total return

Total return has two components – current distributions and growth of capital. It is easy to only focus on the former, highlighting the "here and now" jewel of current income – particularly when it is relatively attractive and may be even tax-deferred at the present. And while current tax-deferred income may stand out, it is important to examine the costs – either on the portfolio side or to capital growth potential.

The tax drag in taxable open-end MLP products can significantly hamper the benefit of current income (even tax-deferred income) so that the overall total return potential is reduced. It is important not to be misled by the idea that tax-deferred income overpowers any potential tax drag. Current income is only one element of total return potential. The tax drag accrues based on the overall return less the tax basis – in essence, the full return.

Fact: Product structure matters. Assess if the current yield as compared to the historical return is intuitive. It is important to assess the full total return potential, which includes both current income and capital growth.

[1]As of 3/31/2018

Past performance is no guarantee of future results. Please see important disclosures at the end of the presentation.

Myth #3:

Tax drag means distributions are tax-deferred

As we explore this myth, we find that some investors are left with the understanding that open-end MLP funds (which accrue a deferred tax liability, reducing their NAV) overpower the detriments of the "tax drag" due to tax-deferred distributions. The misguided logic is that because the distributions are tax-deferred, the tax drag doesn't matter. In reality, these are two very different concepts.

Funds that invest up to 100% of their assets in MLPs are taxable corporations. As such, under accounting rules, they must accrue a deferred tax liability that reflects the difference between their current market value and their tax basis (which is reduced by any tax-deferred distributions). Essentially, they must assume that their entire portfolio is liquidated today and accrue the associated tax.

For open-end MLP investment products in which NAV is the only "price" (in contrast to closed-end funds, which have a market price[1]), this can create a tax drag of up to nearly 26% (21% bid + 5% state, assuming current effective state and federal taxes) from what the total return would otherwise have been. Because the tax drag is applied to the entire return, and tax deferral only applies to the yield component, the tax drag can outweigh the benefits of the tax deferral for open-end MLP products.

Additionally, tax deferral of distributions has to do with the character of distributions paid and whether those distributions are subject to tax today or in the future. While there are some near-term benefits to tax deferral, it does reduce the tax basis of the security, and taxes will be eventually due. Unless the holding period is very long, it is difficult to overcome the double taxation for taxable open-end products, even with the potential for some tax-deferred current income.

Fact: Tax can't be "set aside" by mixing apples and oranges. In an open-end taxable MLP fund, tax-deferred distributions do not erase the tax drag, which can significantly hamper the total return potential.

Myth #4:

Tax deferral is permanent

Due to loose terminology, some investors mistakenly believe that tax-deferred equates to tax-free. This is not the case, as a tax-deferred distribution merely defers tax when the distribution is received. An investor's tax basis is reduced by the amount of the distribution, and tax is still due when the security is sold.

A related myth is that if a distribution is tax-deferred today, it will always be. Not necessarily, as each year can differ. The tax deferral depends on a variety of factors, including portfolio turnover. For instance, open-ended products are subject to unpredictable inflows and outflows, and thus unpredictable portfolio turnover; therefore, the character of the distribution may be impacted and result in no tax deferral in a given year.

Fact: Tax-deferred is not the same as tax-free. There is no free lunch. Taxes will be due.

[1]In contrast to open-end MLP funds, closed-end MLP funds offer liquidity at a market price, which may reflect, among other things, the present value of the deferred tax liability. As a result, the tax liability can be significantly delayed in a closed-end fund's price. In addition, closed-end funds are permanent capital vehicles, which provide a myriad of tax-related benefits, including the ability to manage the tax liability through detailed tax planning integrated into the portfolio management process. Open-end taxable MLP funds also face certain challenges, as daily inflows and outflows can make it more difficult to manage taxes within the fund.

Myth #5:
I'm buying at NAV so the tax drag doesn't impact me

The assumption behind this myth is that because NAV is already reduced by a tax drag, when you purchase an open-end taxable MLP fund at NAV, you will have no future drag. However, the deferred tax liability applies to any increase from such point in time.

Assume you invest $100 at NAV. That portfolio increases by 10%. In addition to the growth, the net impact to the fund's NAV would include a reduction of nearly $2.60 (to reflect the current effective combined federal and state income tax rates[2]). Therefore, the net growth reflected in NAV would be $7.40 ($10.00 - $2.60). So, you are still impacted by the tax drag in the form of a NAV reduction.

Fact: Buying at NAV does not free an investor from tax drag; it is still reflected in the NAV as the portfolio moves.

Myth #6:
Tax is a predictable buffer in down markets

We must consider this myth at a very basic level. Saying that taxes have a positive impact on returns strikes at basic common sense. Taxes provide a negative skew in any market environment.

We invest with the assumption that over the long term, markets will produce positive returns. In an up market, the full upward potential of an investment cannot be realized due to the tax drag discussed earlier. Furthermore, this illogical myth assumes a down-trending market. While in various down-trending months there may be a slight buffer, you may be starting with a lower base anyway (due to the tax drag).

In addition, you still cannot be assured of a tax buffer. In order to fully accrue a deferred tax asset (which would mean an increase to NAV), a taxable fund must have a defendable belief that it can fully recognize the deferred tax asset in a reasonable period of time. If not, it must take a valuation allowance, which essentially decreases the deferred tax asset. In 2008, many of the taxable MLP funds took a valuation allowance, demonstrating that in volatile times, the deferred tax asset may not be reliable.

Fact: Trust your instincts and common sense. Tax is a cost and not a reliable buffer. It is important to consider in context over the life of your investment, not just in a particular month here or there.

Concluding thoughts

It's often difficult to make sense of the fairly complicated MLP structural and tax concepts that have been, at times, loosely and inadequately defined. Because MLP investing can be complicated, it may be hard to see where the truth lies. We hope this paper provides some clarity surrounding the myths and facts associated with MLP investing. We have a strong conviction in the merits of this asset class, but believe it is important that all investors have a clear and accurate understanding of the benefits and drawbacks in order to make educated decisions to achieve their investment goals.

[2]The current combined effective federal and state income tax rate reflects the sum of the (i) maximum 21% effective federal income tax rate for corporations and (ii) average state tax rate (net of federal benefit) that has historically ranged from ~2% to 5%.

About Tortoise

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For more information, please visit www.tortoiseadvisors.com.

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MLPs are subject to many risks, including those that differ from the risks involved in an investment in the common stock of a corporation. Holders of MLP units have limited control and voting rights on matters affecting the partnership. Holders of units issued by an MLP are exposed to a remote possibility of liability for all of the obligations of that MLP in the event that a court determines that the rights of the holders of MLP units to vote to remove or replace the general partner of that MLP, to approve amendments to that MLP's partnership agreement, or to take other action under the partnership agreement of that MLP would constitute "control" of the business of that MLP, or a court or governmental agency determines that the MLP is conducting business in a state without complying with the partnership statute of that state. Holders of MLP units are also exposed to the risk that they will be required to repay amounts to the MLP that are wrongfully distributed to them. In addition, the value of the investment in an MLP will depend largely on the MLP's treatment as a partnership for U.S. federal income tax purposes. If an MLP does not meet current legal requirements to maintain partnership status, or if it is unable to do so because of tax law changes, it would be treated as a corporation for U.S. federal income tax purposes. In that case, the MLP would be obligated to pay income tax at the entity level and distributions received generally would be taxed as dividend income. Furthermore, MLP interests may not be as liquid as other more commonly traded equity securities.

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