

# **MALONEY & KENNEDY, PLLC**

## **CERTIFIED PUBLIC ACCOUNTANTS**

<http://www.maloneyandkennedy.com>

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RICHARD J. MALONEY, CPA, ABV  
KEVIN C. KENNEDY, CPA, CFE  
ANTHONY M. MESSINA, CPA

15 DARTMOUTH DRIVE, SUITE 203  
AUBURN, NH 03032  
PHONE: (603) 624-8819  
FAX: (603) 625-6371

9 TRIANGLE PARK DRIVE, SUITE 2  
CONCORD, NH 03301  
PHONE: (603) 736-9536

## **OBSERVATIONS**

<b>MASTER LIMITED PARTNERSHIPS (MLPs)</b>
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Master Limited Partnerships (MLPs), also known as Publicly Traded Partnerships (PTPs) have become popular investment vehicles in recent years. They are a refinement of the limited partnerships (Shelter LPs) that were in vogue in the tax shelter era of the 1970s. The following discussion addresses the tax implications of MLPs and is subject to the prime directive that investments should be evaluated as investments first, and then consideration should be given to the tax issues as a refinement to that analysis.

Unlike the Shelter LPs, MLPs trade like stocks on public exchanges, are priced like stocks (i.e. not in terms of thousands of dollars per units), and usually own operating businesses rather than real estate.

Unlike stocks, however, MLPs are subject to an entirely different tax structure and this gives rise to the complications of owning MLPs. MLPs operate within the partnership tax rules, which were first enacted in the simpler days of local businesses and professional firms operating in partnership format. Thus, today's MLPs operate under tax rules that really are a suit made for a thinner and shorter person. Add the complexity of the passive loss rules and you have tax reporting that is a quantum leap from that associated with stock ownership.

First, MLPs do not pay tax; the partners pay tax on their pro rata share of the partnership income. As an economic concept, this is a plus (avoiding the double layer of taxes in the corporation/shareholder relationship). But this is where complications start. Under the partnership rules, the partnership activity must be 'separately stated', i.e. unlike a corporate dividend, where the income is one number, reported as a dividend, partnerships report the activity on a Schedule K-1 (copy attached). Therefore, operating income (or loss) is reported on Schedule E (either page 1 or page 2, depending on the type of activity), interest and dividend income on Schedule B, credits on the applicable credit schedule, etc.

Second, operating losses and real estate losses in turn are subject to the passive loss restrictions, which means that, generally, the losses are not deductible until there are items of passive income

or until the investment is sold. Curiously, passive losses for non-public partnerships are reported on the tax return and tracked as a carry forward; however, MLP losses are not reported and therefore must be tracked on separate work papers.

Third, MLP distributions are not subject to tax (unless the distribution exceeds the remaining basis). In many cases, that means that investors receive tax deferred (not tax free) distributions. On the other hand, if distributions exceed basis, then income is recognized.

Fourth, when the MLP is sold, the difference between the sales price and the basis will be taxable gain. Now we arrive at a complication. The amount of cost basis reported on the brokerage statement is in fact not the real basis. For an MLP unit, the cost basis is increased by any income reported to the partner, but reduced by any losses, deductions or distributions. However, these amounts are not tracked by the brokerage firm.

All of this means that when an MLP unit is sold, the basis must be recalculated to determine the gain or loss, and how much is capital gain and how much is ordinary gain. On the other hand, the suspended losses (see above) that have floated in the background now become deductible.

Fortunately, some of the information is usually available at the MLP's website; log onto the website, enter the taxpayers Social Security Number, and the underlying tax data is reported. The other will have been maintained by the tax return preparer. Nonetheless, there will be a significant amount of information to be inputted to cover all the tax bases.

With MLPs, as with any investment, the first question is the investment quality. Once the investor is comfortable with the MLP as an investment, consider the tax ramifications. The fact that the MLPs do not pay taxes is, economically, an additional advantage. The caveat is the cost of dealing with tax complexity and the taxes due at sale.

## ***RJM***

*\*IRS CIRCULAR 230 DISCLOSURE: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.*

Schedule K-1 (Form 1065)

2013

Department of the Treasury Internal Revenue Service

For calendar year 2013, or tax year beginning \_\_\_\_\_, 2013 ending \_\_\_\_\_, 20\_\_\_\_\_

Partner's Share of Income, Deductions, Credits, etc. See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
B Partnership's name, address, city, state, and ZIP code
C IRS Center where partnership filed return
D Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
F Partner's name, address, city, state, and ZIP code
G General partner or LLC member-manager / Limited partner or other LLC member
H Domestic partner / Foreign partner
I1 What type of entity is this partner?
I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here
J Partner's share of profit, loss, and capital (see instructions):
K Partner's share of liabilities at year end:

L Partner's capital account analysis:
Beginning capital account
Capital contributed during the year
Current year increase (decrease)
Withdrawals & distributions
Ending capital account
M Did the partner contribute property with a built-in gain or loss?

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

Table with 4 columns: Line number, Description, Column number, and Other information. Rows include Ordinary business income (loss), Net rental real estate income (loss), Other net rental income (loss), Guaranteed payments, Interest income, Ordinary dividends, Qualified dividends, Royalties, Net short-term capital gain (loss), Net long-term capital gain (loss), Collectibles (28%) gain (loss), Unrecaptured section 1250 gain, Net section 1231 gain (loss), Other income (loss), Section 179 deduction, Other deductions, Self-employment earnings (loss).

\*See attached statement for additional information.
For IRS Use Only

**This list identifies the codes used on Schedule K-1 for all partners and provides summarized reporting information for partners who file Form 1040. For detailed reporting and filing information, see the separate Partner's Instructions for Schedule K-1 and the instructions for your income tax return.**

**1. Ordinary business income (loss).** Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.

Passive loss	Report on
Passive income	See the Partner's Instructions
Nonpassive loss	Schedule E, line 28, column (g)
Nonpassive income	Schedule E, line 28, column (h)
	Schedule E, line 28, column (j)

**2. Net rental real estate income (loss)**  
**3. Other net rental income (loss)**

Net income	Schedule E, line 28, column (g)
Net loss	See the Partner's Instructions

**4. Guaranteed payments**

	Schedule E, line 28, column (j)
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**5. Interest income**

	Form 1040, line 8a
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**6a. Ordinary dividends**

	Form 1040, line 9a
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**6b. Qualified dividends**

	Form 1040, line 9b
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**7. Royalties**

	Schedule E, line 4
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**8. Net short-term capital gain (loss)**

	Schedule D, line 5
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**9a. Net long-term capital gain (loss)**

	Schedule D, line 12
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**9b. Collectibles (28%) gain (loss)**

	28% Rate Gain Worksheet, line 4 (Schedule D instructions)
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**9c. Unrecaptured section 1250 gain**

	See the Partner's Instructions
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**10. Net section 1231 gain (loss)**

	See the Partner's Instructions
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**11. Other income (loss)**

Code	
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<b>A</b> Other portfolio income (loss)	See the Partner's Instructions
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<b>B</b> Involuntary conversions	See the Partner's Instructions
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<b>C</b> Sec. 1256 contracts & straddles	Form 6781, line 1
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<b>D</b> Mining exploration costs recapture	See Pub. 535
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<b>E</b> Cancellation of debt	Form 1040, line 21 or Form 982
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<b>F</b> Other income (loss)	See the Partner's Instructions
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**12. Section 179 deduction**

	See the Partner's Instructions
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**13. Other deductions**

<b>A</b> Cash contributions (50%)	} See the Partner's Instructions
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<b>B</b> Cash contributions (30%)
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<b>C</b> Noncash contributions (50%)
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<b>D</b> Noncash contributions (30%)
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<b>E</b> Capital gain property to a 50% organization (30%)
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<b>F</b> Capital gain property (20%)
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<b>G</b> Contributions (100%)
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<b>H</b> Investment interest expense	Form 4952, line 1
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<b>I</b> Deductions—royalty income	Schedule E, line 19
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<b>J</b> Section 59(e)(2) expenditures	See the Partner's Instructions
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<b>K</b> Deductions—portfolio (2% floor)	Schedule A, line 23
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<b>L</b> Deductions—portfolio (other)	Schedule A, line 28
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<b>M</b> Amounts paid for medical insurance	Schedule A, line 1 or Form 1040, line 29
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<b>N</b> Educational assistance benefits	See the Partner's Instructions
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<b>O</b> Dependent care benefits	Form 2441, line 12
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<b>P</b> Preproductive period expenses	See the Partner's Instructions
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<b>Q</b> Commercial revitalization deduction	See Form 8582 instructions
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<b>R</b> from rental real estate activities	
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<b>S</b> Pensions and IRAs	See the Partner's Instructions
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<b>T</b> Reforestation expense deduction	See the Partner's Instructions
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<b>U</b> Domestic production activities information	See Form 8903 instructions
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<b>V</b> Qualified production activities income	Form 8903, line 7b
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<b>W</b> Employer's Form W-2 wages	Form 8903, line 17
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<b>X</b> Other deductions	See the Partner's Instructions
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**14. Self-employment earnings (loss)**

**Note.** If you have a section 179 deduction or any partner-level deductions, see the Partner's Instructions before completing Schedule SE.

<b>A</b> Net earnings (loss) from self-employment	Schedule SE, Section A or B
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<b>B</b> Gross farming or fishing income	See the Partner's Instructions
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<b>C</b> Gross non-farm income	See the Partner's Instructions
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**15. Credits**

<b>A</b> Low-income housing credit (section 42(j)(5)) from pre-2008 buildings	} See the Partner's Instructions
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<b>B</b> Low-income housing credit (other) from pre-2008 buildings
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<b>C</b> Low-income housing credit (section 42(j)(5)) from post-2007 buildings
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<b>D</b> Low-income housing credit (other) from post-2007 buildings
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<b>E</b> Qualified rehabilitation expenditures (rental real estate)
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<b>F</b> Other rental real estate credits
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<b>G</b> Other rental credits
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<b>H</b> Undistributed capital gains credit	Form 1040, line 71; check box a
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<b>I</b> Biofuel producer credit	} See the Partner's Instructions
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<b>J</b> Work opportunity credit
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<b>K</b> Disabled access credit
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<b>Code</b>	<b>Report on</b>
<b>L</b> Empowerment zone employment credit	} See the Partner's Instructions
<b>M</b> Credit for increasing research activities	
<b>N</b> Credit for employer social security and Medicare taxes	
<b>O</b> Backup withholding	
<b>P</b> Other credits	
<b>16. Foreign transactions</b>	
<b>A</b> Name of country or U.S. possession	} Form 1116, Part I
<b>B</b> Gross income from all sources	
<b>C</b> Gross income sourced at partner level	
<i>Foreign gross income sourced at partnership level</i>	
<b>D</b> Passive category	} Form 1116, Part I
<b>E</b> General category	
<b>F</b> Other	
<i>Deductions allocated and apportioned at partner level</i>	
<b>G</b> Interest expense	Form 1116, Part I
<b>H</b> Other	Form 1116, Part I
<i>Deductions allocated and apportioned at partnership level to foreign source income</i>	
<b>I</b> Passive category	} Form 1116, Part I
<b>J</b> General category	
<b>K</b> Other	
<i>Other information</i>	
<b>L</b> Total foreign taxes paid	Form 1116, Part II
<b>M</b> Total foreign taxes accrued	Form 1116, Part II
<b>N</b> Reduction in taxes available for credit	Form 1116, line 12
<b>O</b> Foreign trading gross receipts	Form 8873
<b>P</b> Extraterritorial income exclusion	Form 8873
<b>Q</b> Other foreign transactions	See the Partner's Instructions
<b>17. Alternative minimum tax (AMT) items</b>	
<b>A</b> Post-1986 depreciation adjustment	} See the Partner's Instructions and the Instructions for Form 6251
<b>B</b> Adjusted gain or loss	
<b>C</b> Depletion (other than oil & gas)	
<b>D</b> Oil, gas, & geothermal—gross income	
<b>E</b> Oil, gas, & geothermal—deductions	
<b>F</b> Other AMT items	
<b>18. Tax-exempt income and nondeductible expenses</b>	
<b>A</b> Tax-exempt interest income	Form 1040, line 8b
<b>B</b> Other tax-exempt income	See the Partner's Instructions
<b>C</b> Nondeductible expenses	See the Partner's Instructions
<b>19. Distributions</b>	
<b>A</b> Cash and marketable securities	} See the Partner's Instructions
<b>B</b> Distribution subject to section 737	
<b>C</b> Other property	
<b>20. Other information</b>	
<b>A</b> Investment income	Form 4952, line 4a
<b>B</b> Investment expenses	Form 4952, line 5
<b>C</b> Fuel tax credit information	Form 4136
<b>D</b> Qualified rehabilitation expenditures (other than rental real estate)	See the Partner's Instructions
<b>E</b> Basis of energy property	See the Partner's Instructions
<b>F</b> Recapture of low-income housing credit (section 42(j)(5))	Form 8611, line 8
<b>G</b> Recapture of low-income housing credit (other)	Form 8611, line 8
<b>H</b> Recapture of investment credit	See Form 4255
<b>I</b> Recapture of other credits	See the Partner's Instructions
<b>J</b> Look-back interest—completed long-term contracts	See Form 8697
<b>K</b> Look-back interest—income forecast method	See Form 8866
<b>L</b> Dispositions of property with section 179 deductions	} See the Partner's Instructions
<b>M</b> Recapture of section 179 deduction	
<b>N</b> Interest expense for corporate partners	
<b>O</b> Section 453(l)(3) information	
<b>P</b> Section 453A(c) information	
<b>Q</b> Section 1260(b) information	
<b>R</b> Interest allocable to production expenditures	
<b>S</b> CCF nonqualified withdrawals	
<b>T</b> Depletion information—oil and gas	
<b>U</b> Amortization of reforestation costs	
<b>V</b> Unrelated business taxable income	
<b>W</b> Precontribution gain (loss)	
<b>X</b> Section 108(l) information	
<b>Y</b> Net investment income	
<b>Z</b> Other information	