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Master Limited Partnership

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What is it?

Developed in the 1980s, a master limited partnership (MLP)--also known as a publicly traded partnership (PTP)--is a partnership whose shares are traded on an established securities market or are readily tradable on a secondary market (or its substantial equivalent). The substantial equivalent of a secondary market exists where the prospective buyers and sellers of the shares have the opportunity to buy, sell, or exchange interests in a time frame and with the regularity and continuity that the existence of a broker or dealer would provide. MLPs must register with the SEC and provide investors with a prospectus and other disclosures. Shares are typically marketed in amounts of \$1,000 to \$5,000 per share to as many limited partners as are desired. Although MLPs might be organized to further any of a number of financial objectives, oil and gas Limited partnerships and real estate tax credit limited partnerships are particularly common.

Tip: Some exchange-traded funds (ETFs) are legally structured as Master Limited Partnerships.

In the past, MLPs (like other limited partnerships) offered flow-through taxation; in other words, limited partners could use tax benefits such as depreciation, depletion, intangible drilling costs, and tax credits as deductions against personal taxable income. In addition, limited partnership operating losses could be deducted against ordinary income. Despite these benefits, illiquidity--the lack of a strong secondary market--was a problem with private limited partnership interests. To foster liquidity, MLPs were created in the 1980s. MLPs combined the tax advantages of partnerships with the liquidity of corporate stock. The Tax Reform Act of 1986, however, drastically curtailed the ability of limited partnerships to shelter income.

In 1987, MLPs were deemed taxable as corporations unless they met one of two exceptions. Although MLPs continue to be administered as partnerships, they are now usually recharacterized as corporations for income tax purposes. This has caused MLPs to be less popular. For more information, see below.

Exception 1: Master limited partnerships (MLPs) that derive 90 percent or more of their gross income from qualifying sources

MLPs that derive 90 percent or more of their gross income from qualifying passive sources are not treated as corporations for tax purposes; instead, they are treated as flow-through entities. Therefore, limited partners in these MLPs are taxed in the same manner as private limited partners and are subject to the IRS's passive loss limitation rules and the at-risk rules. In this case, however, investors must apply the passive loss limitation rules separately to each partnership; losses cannot be applied against gains from other MLPs or other passive activities. For information about the tax treatment of private limited partnerships, see Limited Partnerships.

For purposes of the 90 percent rule, qualifying passive income includes:

- Interest
- Dividends
- Real estate rents
- Gains from disposition of real estate
- Income or gains from certain mineral or natural resource operations
- Gains from disposition of capital assets or property held for the production of passive income

Technical Note: Several qualifications and limitations apply. For more information about this exception, consult a tax expert.

Exception 2: Grandfathered MLPs that made an election

MLPs whose shares were traded before December 18, 1987, are generally not taxed as corporations. This exception was scheduled to expire after December 31, 1997. However, an election was provided by the Taxpayer Relief Act of 1997, whereby an MLP in existence before December 18, 1987, could continue its status after 1997 as an electing 1987 partnership. Under this election, a 3.5 percent tax on the partnership's gross income from the active conduct of its trade or business is imposed annually, payable at the partnership level. Other than this tax, the partnership operates as a pass-through entity. Therefore, the limited partners are subject to the IRS's passive loss limitation rules and the at-risk rules. As in Exception 1, however, investors must apply the passive loss limitation rules separately to each partnership; losses cannot be applied against gains from other MLPs or other passive activities.

Technical Note: For more information about this exception, consult a tax expert.

Tip: If a grandfathered MLP adds a substantial line of business, it will no longer be considered an electing 1987 partnership.

When can it be done?

Meeting investment criteria

MLPs frequently charge anywhere from \$1,000 to \$5,000 per share. In addition, limited partnership offerings often involve suitability rules, requiring that individuals meet minimum net worth, income, and tax bracket criteria.

For information about investment criteria related to private limited partnerships, see Limited Partnerships.

There must be at least two partners

Any limited partnership must have two or more partners--at least one general partner and one limited partner--both of whom intend to carry on the business for profit.

Strengths

Shares are relatively liquid

Because MLP shares are traded on an established securities market or are readily tradable on a secondary market (or its equivalent), they are fairly liquid--certainly more liquid than private limited partnership shares. This is an advantage if you no longer wish to be a partner (for whatever reason), or if you have an immediate need for cash.

Shares are relatively inexpensive to purchase

MLP shares are typically marketed in amounts of \$1,000 to \$5,000 per share. This is relatively inexpensive compared to private limited partnership shares, which often require at least a \$20,000 initial investment. However, certain fees may be costly.

Professional management offers some stability

The limited partnership is managed by a general partner. Management is centralized and (usually) professional, offering a measure of stability or sense of security to limited partners.

Partnership may be commercially rated

Standard & Poor's Corporation rates a number of limited partnerships. In addition, several firms analyze limited partnerships and rate such factors as the offering terms. Because this information allows you to compare limited partnerships, it can help you to make a wise investment decision.

Limited liability for limited partners

In general, limited partners are not personally liable for the debts and obligations of the limited partnership as a business entity. More specifically, you're liable for partnership liabilities only to the extent of your capital contributions to the partnership, including any contributions you may have agreed to make in the future.

Tradeoffs

MLPs are usually taxed as corporations

MLPs are usually recharacterized as corporations for federal income tax purposes. Income is taxed at the partnership level, and taxed again at the individual partner level when the earnings are distributed as dividends to the shareholders. In contrast to private limited partners, individual MLP investors are unable to take certain tax benefits, such as depreciation deductions and tax credits, on their own tax returns. Losses are not passed through to the partners, but are used as net operating loss carryovers by the partnership.

Possibility of losing principal

The safety of your principal depends on the type of limited partnership and quality of its holdings. Programs aimed at high capital gains involve commensurate risk. For instance, with oil and gas MLPs, there may be risk as to whether oil or gas will be found at all, and, if found, whether the well will dry up sooner than expected.

High fees may apply

Brokerage commissions and other front-end costs often total 20 percent or more of the amount invested. There may be additional management fees, as well.

No participation in management

Because limited partners do not possess an active role in the management of the partnership, much depends on the integrity and management ability of the general partner.

How to do it

Investors purchase shares in a limited partnership through a securities broker-dealer or a financial planner. MLPs often market shares in amounts of \$1,000 to \$5,000 per share. Offerings frequently involve suitability rules requiring that individuals meet minimum net worth, income, and tax bracket criteria. As an investor, you should be aware that many limited partnerships intend to dispose of their holdings within a specified period (often, 7 to 10 years) and distribute the proceeds as capital gains to investors.

State law and the partnership agreement will govern the limited partnership. The partnership agreement should contain, among other things, the amount of each partner's distributive share of partnership profits and losses. In cases where the partnership agreement fails to address an issue, state law will dictate how the partnership is to operate.

Tax considerations

MLPs are generally treated as corporations for federal income tax purposes

As mentioned earlier, MLPs were recharacterized as corporations for federal income tax purposes in 1987 unless an exception applied. Consequently, many MLPs converted to corporate form in advance of that deadline. With MLPs, income is taxed at the partnership level, and taxed again at the individual partner level when the earnings are distributed as dividends to the shareholders. In contrast to private limited partners, individual MLP investors are unable to take tax benefits such as depreciation deductions and tax credits on their own tax returns. Losses are not passed through to the partners, but are used as net operating loss carryovers by the partnership.

MLPs are usually not subject to the passive loss limitation rules and the at-risk rules

In some ways, MLPs do not follow the same IRS rules as other limited partnerships. With private limited partnerships, limited partners are subject to the passive activity loss limitation rules. Therefore, on their personal income tax returns, these limited partners are able to deduct their share of partnership losses only if they have passive gains from another investment to match against them.

Example(s): Assume Hal invests \$20,000 in a newly organized private limited partnership. This is Hal's only passive investment. At the end of the year, the limited partnership suffers an operating loss, \$2,000 of which flows through to Hal as a limited partner. Because Hal does not possess passive income from another source, he cannot utilize the loss on his federal tax return this year. Nevertheless, Hal may carry forward the unused loss to offset passive income in future years.

Example(s): Assume, now, that the above partnership was an MLP. Because MLPs are usually recharacterized as corporations for federal income tax purposes, Hal would not be subject to the passive loss limitation rules. Nevertheless, he would not be allowed to utilize the loss on his personal income tax return. The net operating loss would belong to the partnership only.

Private limited partners are also subject to the at-risk rules, which limit a partner's share of losses in a partnership to his or her financial risk therein. Because MLPs are taxed as corporations, however, they are not subject to the at-risk rules.

Questions & Answers***If you invest in a limited partnership, how long will your principal usually be tied up?***

The partnership's anticipated duration will be detailed in the prospectus. Although the lifespan will typically run anywhere from 5 to 15 years, the general partner can decide when to liquidate. Although MLP shares are certainly more liquid than private limited partnership shares, you should be prepared to hold on to them for a number of years, or risk selling at a loss.

If a limited partnership is not traded on an established securities market, when might it be treated as readily tradable on a secondary market or the substantial equivalent thereof?

The partnership will be treated as readily tradable on a secondary market or the substantial equivalent thereof if, taking into account all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market. This occurs in several cases, including if (1) partnership interests are regularly quoted by any person making a market in the interests (i.e., a broker/dealer), or (2) an investor has a readily available, regular, and ongoing opportunity to sell or exchange the partnership interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership.

However, interests in a partnership will not be treated as readily tradable on a secondary market or the substantial equivalent thereof unless (1) the partnership participates in the establishment of the market or the inclusion of its interests thereon, or (2) the partnership recognizes transfers made on that market. For more information, see Internal Revenue Code Reg. 1.7704-1(d) and consult a tax expert.

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