



NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS



Basic Tax Principles for MLP Investors

Owning units (shares) in an MLP 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. To understand how an MLP investor is taxed, it helps to know the basic principles of partnership taxation.

Partnership Tax Basics: Income

- 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.
- The unitholder, as a limited partner, is treated for tax purposes as if he is directly earning the MLP's income.
- Each unitholder is allocated on paper a proportionate share of the MLP's income, gain, deductions, losses, and credits. This is reported annually on the K-1 form.
- The unitholder calculates his share of taxable income and pays tax on it at his own tax rate. The tax is owed whether or not the unitholder receives a cash distribution.

Partnership Tax Basics: Distributions

- The quarterly cash distributions are not the same as your share of the MLP's income.
- Under the tax code, the distributions are a return of capital and are not taxed when received.
- Your basis in your partnership units (the amount you paid, increased or decreased by various adjustments) is lowered by the amount of the distribution.
- Thus, when you sell your units, your taxable gain (sales price minus adjusted basis) is increased by the amount of the distributions.
- Often you will hear someone say that "80% (or a similar number) of the MLP's distribution is tax-deferred." As long as your distribution is less than your basis, it is 100% tax-deferred. What they mean is that your share of the MLP's net taxable income equals about 20% of the tax-deferred distribution.

Partnership Tax Basics: Basis **Adjustments**

- Basis is used to determine your gain or loss when you sell your units.
- Your initial basis is the price you paid for your units.
- Your cash distributions adjust your basis downwards.

- Your share of taxable partnership income each year adjusts the basis upwards.
- Your share of deductions like depreciation adjusts it downwards.
- As long as your adjusted basis is above zero, tax on your distributions is deferred until you sell your units. If it reaches zero, future cash distributions will be taxed as capital gain in the year received.
- If a unitholder dies and the units pass to his heirs, the basis is reset to the fair market value of the units on the date of death, and the prior distributions are not taxed.

Partnership Tax Basics: Gain and Recapture

- When you sell your MLP units, your taxable gain is the difference between the sales price and your adjusted basis.
- Not all of the gain when units are sold is taxed at capital gains rates.
 - The gain resulting from basis reductions due to depreciation is taxed at ordinary income rates—this is called “recapture.”
 - Gain attributable to your share of some types of assets held by the MLP—substantially appreciated inventory and unrealized receivables—is also taxed as ordinary income.
- These items will be reported to you on the K-1 form for the year in which you sell your units.

Simplified Example	
Year 1: 1,000 units purchased @ \$30.00. Basis is:	\$30,000
Investor receives total cash distributions of \$2.50/unit	- \$2,500
Investor is allocated and pays tax on net taxable income of \$.50/unit, including \$2.00 of income and \$1.50 of depreciation	+ \$ 500
Adjusted Basis	\$28,000
Year 2: All units sold @ \$32.00	\$32,000
Gain per unit: \$32.00 - \$28.00 = \$4.00	\$ 4,000
Depreciation recapture-taxed at ordinary income rates	\$1,500
Taxed at capital gain rates*	\$2,500
*Assumes MLP has no “ordinary income” assets	

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