Making Sense of Master Limited Partnership Tax Rules

The unique structure of MLPs gives them tax advantages, but also makes them more complex. Find out how distributions and gains are taxed.

So you've finally bought some shares in a master limited partnership (MLP) after hearing everyone rave about this equity investment that gives you a high yield, pays out cash every quarter and has tax advantages.

A couple of quarters go by, your investment pays off as promised, and you're a happy camper. Then tax season rolls around and instead of the familiar Form 1099, a new form called a Schedule K-1 (Form 1065) shows up in the mail, with numerous boxes labeled with different types of income and deductions. What's going on? What are you supposed to do with this?

For those who are new to them, the first thing to understand is that an MLP is simply a publicly traded partnership (PTP). (Not all PTPs are MLPs, however; a number of PTPs are simply commodity pools.) By buying shares, technically referred to as "units," in an MLP, you become a partner (or a "unitholder") in this very large partnership. As a partner rather than a corporate shareholder, you enter a whole new world of taxation. Partnership taxation is what makes MLPs a tax-advantaged investment, but it also makes them more complex than many other investments.

As a partnership, an MLP is not considered to be a separate entity for tax purposes the way a corporation is, but rather is a pass-through entity—sort of an agglomeration of all its partners. An MLP does not pay corporate tax; instead, all the things that go into calculating tax—income, deductions, gain, losses and credits—are divided up among the unitholders as if they had earned the income themselves. Part III of the K-1 tells you your total share of each of these items.

What about the distributions? Do you pay tax on them as well? You might think so, since the quarterly cash distributions look a lot like dividends; however, MLP distributions are not dividends, but quite a different creature. When you fill out your tax return, the only thing you have to worry about paying tax on is your share of net partnership income. The portion of the distribution that is equal to net income is covered by that tax payment.

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