Master Limited Partnership Tax Rules

AAII Journal

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

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.

You pay tax on your share of the partnership's taxable income, as determined by all the items on the K-1. It is important to remember that you will owe tax on this income whether or not you receive a cash distribution.

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.

Read more »