A Less Taxing Approach To MLPs

June 27, 2013 • Debbie Carlson

Yield-seeking investors are piling into master limited partnerships, but adding these energy infrastructure investments to a portfolio can add tax complications.

The Eagle MLP Strategy Fund (EGLAX) strives to ease the process for the average person in this niche field by avoiding the complicated tax filings involved in these types of partnerships.

MLPs have features of limited partnerships, but trade like a stock. Many are focused in the energy sector because MLPs must receive 90 percent of their income from “qualifying” activities that are generally focused on natural resources, including energy.
Many energy-focused MLPs are engaged in managing pipelines and/or storing oil and gas. These businesses create steady income, but also have big infrastructure investments that need to be depreciated over a long time.

Income is distributed as a return of capital, so MLPs avoid federal and state corporate income tax. However, MLP owners are required to pay income tax in each state the MLP does business via a Schedule K-1 form, and owners face rules regarding unrelated business taxable income.

To make MLPs easier for retail investors, the providers of closed-end funds, exchange-traded products and mutual funds have created offerings that hold shares (known as units in MLPs) in multiple MLPs to offer both diversity in a pooled fund and to issue only 1099 dividend forms at tax time.

In the process, many have stripped away one of the benefits of MLPs––tax efficiency. If a regulated investment companies (RIC) wants to keep their tax pass-through status, their holdings in securities that issue a Schedule K-1 form are capped at 25 percent. The rest could be in other energy securities, which makes these RICs more like an MLP-focused investment than purely an MLP fund.

If the fund invests more than 25 percent in companies that issue Schedule K-1 forms, they lose the pass-through tax status and the fund is structured as a C corporation. Many of these opt to invest 100 percent in MLPs. However, C corporations are taxed on the income they receive from the investments, and they pass on the reduced income to investors, who then pay their own taxes, so the same income stream is taxed twice.

Fly Like An Eagle

The Eagle MLP Strategy Fund sought to keep the tax advantage of a RIC, but to include other investments in energy infrastructure. The fund retains the complete tax pass-through by limiting its investments in Schedule K-1 issuing firms to 25 percent of its holdings.

The other 75 percent is invested in general partnerships, shipping MLPs, MLP-tracking stocks and exchange-traded notes––all entities that issue 1099s. This allows Eagle to keep the pass-through status at the fund level and is the source of their tax efficiency, says David Chiaro, managing director at Houston-based Eagle Global Advisors.

Other RICs also retain the complete tax pass-through at the fund level by keeping the 25 percent in MLPs, but these other RICs mainly invest the other 75 percent in energy utilities, energy debt or royalty trusts, Chiaro says.

"Things like that aren't related to the infrastructure play," Chiaro says. "They can call themselves energy income funds or something similar, but it's not a true MLP investment. If an investor wanted a dedicated MLP fund, we are the only option available, as far as I'm aware."

To differentiate itself, Eagle sought out investments that are "roughly securities of MLPs, mirror MLPs, or something that you'd consider an MLP in everything but name," Chiaro says.

The fund's recent top holdings were Kinder Morgan Management, Linn Co and Williams Companies Inc.
For compliane reasons, Chiaro says, he couldn't give performance information about yield and returns. But Morningstar's website shows EGLAX has a dividend yield of 3.89%, based on forward-looking data. Morningstar says the category average is 3.77%

Limited Number Of Investment Opportunities

As a whole, there are limited investment opportunities in the field. Lipper tracks 25 closed-end MLP funds and 17 exchange-traded products. There are only 19 unique open-end actively managed MLP funds, says Tom Roseen, head of research services at Lipper.

Of those 19 open-end funds, 11 are C corporations and eight are mutual funds. As this area grows, more firms will likely enter the space.

When it comes to returns and tax efficiency, Roseen says nothing beats the performance of an actual MLP, but MLP-related funds can be more convenient and give buyers diversification and make tax-filing easier. A RIC structure also allows groups such as pension funds to invest in MLPs, and it can be part of an individual retirement account.

EGLAX launched in September 2012 and has more than $232 million in assets.

The fund has a load of 5.75 percent. The year-to-date return for the fund (as of June 21) was 15.66 percent (and 15.76 percent for the fund's institutional shares, ticker EGLIX), far above the 2.43 percent collective loss for Lipper's global natural resources category.

Chiaro says because the fund is new they have received mostly inflows, allowing them to buy the securities they want without having to sell to raise money. "Because we have a lower turnover, we are incurring less taxable gains than we would normally because we have a constant inflow of capital," he says, and fees are paid from cash received from dividends.

Chiaro says he believes the fund's structure of blending MLPs, MLP securities, general partnerships and ETNs is unique, but acknowledges it's unlikely to stay unique for an extended period. He's not worried, though. "We believe our core competency is not the structure, but the management of the fund," he says, adding that Eagle Global has managed MLP investments for about 10 years. "We know the business of MLPs; we focus on securities selection."

Because the fund is less than a year old, research firms such as Morningstar and Lipper haven't analyzed it yet. Speaking generally about MLP funds, Mike Taggert, head of Morningstar's U.S. closed-end fund research, says he wasn't sure if the tax issue between RICs and C corporations is that drastic. C corporations do pay taxes, but the odds of them triggering a taxable event are "pretty low," unless they sell one of the MLPs.

Roseen says without knowing Eagle's general practice for income distributions and portfolio turnover, he can't comment specifically about the fund. But he says having ETNs in the portfolio are positive for returns.

In separate research he did about MLPs funds, the double taxation has impacted C corporations' returns in the ETF space, Roseen says. For the year through April 19, the timeframe studied, C corporation ETFs saw returns of 11.5 percent, while RIC-structured ETFs returned 13.4 percent and ETNs returned 19.6 percent.

On the mutual fund side, C corporation funds returned 12.2 percent on average versus 10.84 percent for RIC-structured, which he says isn't surprising given the strong showing of individual MLPs lately.

Even though MLPs are a relatively complex and niche investment, Taggert says people who know these funds love them. "I can tell you, at Morningstar people love these things," he says. "People want yield. MLPs are for people who are risk tolerant, but want income."
