THE DEFINITIVE GUIDE TO MLP ETFs & ETNs

Overview & Description

February 2023

By: Ben McFadden, Paul Baiocchi, Dave Nadig

EXECUTIVE SUMMARY

Investors are always looking for ways to manage their tax situation, whether that's through tax-deferred accounts like a 401(k), or through tax-efficient vehicles like a traditional equity ETF. Any investor who looks hard enough for tax-advantaged investments will inevitably stumble across a unique type of vehicle known as the master limited partnership (MLP).

MLPs were designed as a kind of investment pooling vehicle with a specific goal in mind: to pass the income earned in some form of partnership directly to investors. By law, they can only be used for businesses where 90% or more of the revenue is being generated from certain qualifying activities, such as managing natural gas pipelines or storing crude oil—industries that generate steady income streams, but that also require large investments in infrastructure that need to be depreciated over long periods of time. In short, an MLP combines the pass-through tax treatment of a traditional partnership with the public tradability of a stock, much like a real estate investment trust does for the ownership of property.

MLPs therefore satisfy a wide range of investors, and can offer attractive yields (the indicative yield on the Alerian MLP index is 5.82% as of 1/29/2013) that are paid quarterly. Historically, these yields have made MLPs a favorite with investors living on fixed incomes, but the current zero-interest-rate environment in the U.S. has pushed pretty much any yield-seeking investor toward the asset class.

Like any individual investment, however, buying shares in one MLP exposes you to single-company risk. Further, MLP owners are required to pay income taxes in every state in which the MLP does business; will receive a K-1; and are subject to the rules surrounding unrelated business taxable income (UBTI). In a bid to diversify these risks, closed-end fund issuers were the first to create portfolios of MLPs structured as C-corporations. In the past few years, the advent of exchange-traded products (both exchange-traded funds and exchange-traded notes) has further enabled investors to get easy, diversified access to groups of MLPs. However, the tax benefits of MLPs, which are outlined in this paper, cannot be completely replicated in any of these structures. Each has pros and cons that necessitate careful consideration of personal tax issues, diversification requirements and other factors that complicate traditional index fund analysis. Some of the benefits of owning individual MLPs—particularly tax-deferred income—are significantly modified in all of these structures.

In choosing a pooled investment structure, investors are trading in the tax efficiency of holding individual MLPs for the diversification and liquidity benefits of the ETF and ETN structures. They are also swapping the complex taxation and difficult fit of individual MLPs in tax-deferred accounts for tax simplicity and universal eligibility. It's an imperfect trade-off, and investors willing to brave the vagaries of the tax code and single-firm risk may be better off holding individual MLPs rather than a pooled vehicle.

This paper reviews the investment case for MLPs and discusses how to compare, contrast and evaluate various exchange-traded approaches to accessing the MLP market. We pay particular attention to the impact of taxes and distributions on an investor's returns, as these are both the most important and most misreported aspects of MLP analysis. In the course of our analysis, we assume investors are at the highest marginal tax brackets, using the post-"fiscal cliff" tax environment as of Jan. 1, 2013.

Ultimately, the type of structure you choose is based on your own individual tax situation and your expectations for the MLP moving forward.

To summarize, you should own the ETN if:

- The investor expects the majority of total return to come from price appreciation.
- The investor is using a tax-deferred account and cannot benefit from the tax deferral of the ETF structure.
- The investor has a shorter time horizon.
- The investor places a high value on transparency and predictable returns.
- The investor is unconcerned about the credit risk of the note.
- The investor is more concerned with total return than after-tax yield.

An ETF/corporation makes most sense for MLP exposure if:

- The distribution yield of the MLP is greater than or equal to the MLP index total return. In this case, the tax deferral overwhelms the performance hit of the internal tax issues; however, paying out a higher distribution than total return is likely unsustainable in the long run.
- The investor has a very long time horizon, including potentially passing her position to an estate.
- The investor uses a high discount rate to value future cash flows.
- The investor has a low tolerance for credit risk.
- The investor is comfortable with complex tax accounting and its associated risks.
- The investor values tax efficiency over absolute returns or index tracking.

ACCESSING MLPs: EVALUATING THE OPTIONS

Master limited partnerships are required to be in specific businesses to qualify for MLP status. They can engage in the production, processing or transportation of oil, natural gas and coal. They also produce, process or transport natural gas liquids, or are in the business of wholesale propane distribution. Many MLPs are unique in the energy space. Consider a pipeline company. It can often be shielded from changes in the price of energy, instead making money based on the quantity of material that travels through their pipelines, regardless of the actual price of that fuel. Some MLPs even earn revenues simply from keeping their transportation systems running, regardless of the amount of oil, natural gas or coal transported, further insulating them from changes in the demand for, or price of, energy. Investors often come to MLPs just for these insulating factors, as they help to ensure a steady and often high stream of income, without the variability that comes from traditional energy investments or alternative high-dividend-yielding equities.

MLPs tend to offer investors large dividends, and on an individual MLP level, they do so in a tax-efficient structure.

The reason is that an MLP, at its core, is a pass-through entity: Income generated from operations is passed through to shareholders directly, as if that shareholder had personally earned that income, with no corporate-level taxation. It is similar both to REITs and the now-extinct Canadian royalty trust structure. In fact, shareholders in an MLP are quite literally legally treated as "partners," and the MLP itself is structured as a limited partnership. The limited partnership passes income directly through to investors in the same form in which it was received by the partnership, allowing income to be taxed only once, on the individual investor's tax filing. In other words, MLP income is taxed as ordinary income on shareholders' tax returns; capital gains on equipment sold is taxed as capital gains; and so on.

Like any business, however, MLPs get to write off business expenses and depreciate capital expenditures, such as the cost of building a pipeline in the first place. These deductions offset the operating revenue of the MLP; thus, distributions of cash flow are often treated as nontaxable return of capital. The MLP owner gets a distribution, and lowers the cost basis of its investment, but pays no current taxes on that distribution. In recent years, it has been typical for between 70 and 100% of MLP distributions to be this kind of nontaxable return of capital, creating an extremely tax-efficient investment. While the investor must eventually pay taxes on the amount that this cost basis was reduced, they will do it at some time in the future, not now. It's important to note that those future taxes won't necessarily be at capital gains rates, due to "ordinary income recapture" rules, described later in this document; however, in general, a significant portion of those future taxes will be at the lower capital gains rate, except in cases where the cost basis has reached the zero bound.

Pooling MLPs to diversify from a single line of business, however, creates challenges. Under current tax laws, a traditional mutual fund (a 1940 Act regulated investment company) can't invest more than 25% of fund assets in publicly traded partnerships like MLPs. Indeed, a small industry of advisory shops has emerged that advise high-net-worth clients on which MLPs to buy in what proportions to create the diversification that funds hadn't been providing.

The first pooled investment vehicles to solve this problem were closed-end funds that structured themselves as C-corporations as opposed to traditional 1940 Act open-end funds. These closed-end funds chose not to be taxed as registered investment companies (RICs), but rather as corporations. These were the first-generation MLP products to launch, but the closed-end nature meant they were prone to big premium spikes, limiting their usefulness.

Enter ETFs. In recent years, the exchange-traded fund industry has launched a series of MLP-related offerings that attempt to deliver diversified exposure to multiple MLPs by getting around the 25% RIC rule. Investors can choose between two structures—exchange-traded notes or exchange-traded funds—both of which have unique issues.

MLP ETNs are exchange-traded debt instruments that are, fundamentally, a promise to pay a pattern of returns mirroring an index of MLPs. As debt instruments, any income they offer investors is treated just like a bond coupon, which means they pay ordinary income tax rates. This obviates the very reason many investors seek out MLPs in the first place—the chance to receive regular distributions with the favorable "return of capital" tax treatment. However, appreciation in the MLP index is deferred and taxed at capital gain rates when the MLP ETN is sold or matures. ETNs also expose the investor to the credit risk of the issuer—generally a small risk, but like any piece of corporate debt, a non-zero one.

MLP ETFs, on the other hand, actually invest directly in MLPs. They avoid the 25% RIC holding rule referenced above by structuring themselves as regular corporations, just like any other United States C-corporation (and like the enterprising closed-end funds before them) and forfeit the special tax treatment accorded traditional ETFs—tax treatment that allows a traditional ETF to pay out its income currently, take a deduction for its payment of dividends, and thereby reduce or eliminate corporate tax at the ETF level. C-corporations are entirely stand-alone entities as far as the tax code is concerned.

This means any income earned by the C-corporation must go through a round of tax treatment before anything is returned to investors (just as Microsoft must pay its own taxes before paying a dividend) and then net distributions to shareholders (after payment of the corporate tax) are taxed again in the hands of the shareholders. That means the distributions of MLPs, and any net appreciation in their value, are taxed at the corporate level before they are passed on to the shareholders, and then taxed again as dividend income once that pass-through takes place. Again, this compromises the very tax efficiency many MLP investors are seeking (as well as the tax efficiency of traditional ETFs), and makes any anticipated tax efficiency from the MLP ETF dependent upon extremely complex calculations.

When choosing an MLP ETF or ETN, understanding the pros and cons of each structure in detail is critical.

EQUITY AND FIXED-INCOME FUNDS

MLP ETFs are entirely unique in the world of exchange-traded funds, and require an entirely different approach to analysis because MLP ETFs forfeit the tax benefits accorded traditional ETFs by bringing into play the two levels of tax associated with U.S. C-corporations.

The core issue with MLP ETFs is that, while they were created in an attempt to pass through distributions in the same tax form as received from the MLP, they do so by adopting the double tax structure of a regular U.S. C-corporation and thereby interfere with the traditional pass-through mechanism that MLPs were designed to enable (as well as the single tax mechanism applicable to traditional ETFs). Rather than allowing income to pass directly through from the MLPs to shareholders, they insert a tollgate at the corporate level where MLP and appreciation are taxed and then a second "exit" tax is levied at the investor level.

A Primer on Partnerships

Each unit holder in a partnership such as an MLP is allocated a proportionate share of the partnership's income, gains, deductions, losses and credits. For individual investors holding individual MLPs, any income, gains, deductions, losses and credits are passed through directly and taxed at the individual investor's tax rate. With the MLP ETF, however, all income and gains are pooled and taxed at the same corporate rate inside the ETF, as a pure expense of the fund.

On the bright side, and unlike individual MLPs, neither MLP ETFs nor ETNs issue K-1 partnership statements at the end of the year, which can help investors avoid tax-deadline headaches. K-1s can be mailed to investors as late as March 15, forcing many investors to resubmit their taxes with last-minute changes. Furthermore, investors in individual MLPs are forced to file tax returns in every state where that MLP earned income, and any unrelated business income within an MLP could potentially change previously nontaxable income to taxable in the current year. Needless to say, this can cause enormous chaos for an individual's tax situation if things go badly.

Capital Gains and Losses

Because the corporation underlying an MLP ETF is the named owner of each MLP in its portfolio, the MLP ETF will accumulate capital gains and losses on any MLPs that are sold in the course of redemptions or any rebalancing of the portfolio. While traditional ETFs are widely seen as tax-efficient vehicles because they have "pass-through" characteristics and they can minimize capital gains by "passing out" low-basis shares of securities when redemptions occur, the C-corporation structure is a different animal entirely because it is not a "pass-through" and it cannot pass out low-basis property.

In fact, MLP ETFs will generate a capital gain or loss subject to immediate taxation every time a redemption takes place. That said, there have been very few redemptions in the Alerian MLP ETF (AMLP) to date, so the impact of this has been muted. In a corporate structure, capital losses have a five-year time span in which they can be carried forward to offset gains. In a perfect world, an MLP ETF would be managed so as to only generate realized capital losses to the extent of capital gains—essentially aiming for capital gains and losses to perfectly offset each other. While this is unlikely in the real world, the ETF manager does have some control over this in the right environment.

It is important to point out that these capital gains aren't passed on to the ETF investor, however. AMLP has never paid a capital gains distribution and likely never will. Because of the corporate structure, these capital gains from redemptions or rebalancing are recognized and taxed at the maximum corporate tax rate of 35%. Corporations do not enjoy the lower tax rate for long-term capital gains that individuals enjoy.

Because of this, the management of losses to offset gains by the ETF manager is critical, as the expiration of a capital loss carry-forward leads to an eventual recognition of a "phantom" gain and significant tax burden. Let's take a simple case: A fund sells some shares of an MLP today for a loss of $3. Six years from now, the fund sells shares in the same MLP for a gain of $2. The fund has a net economic loss in this particular position of $1 overall, but has recognized a taxable gain of $2 because of the timing. The fund lost the opportunity to use the $3 in losses, and now owes taxes where they might not have.

It is important to note the ETF's net asset value (NAV). The NAV is calculated daily based on all gains or losses—whether or not realized—and deferred tax liabilities or assets. The taxes the corporation has to pay, however, come right out of the NAV as well, directly impacting performance.

Deferred Tax Liabilities and Deferred Tax Assets

To understand the performance of an MLP ETF with this corporate structure, investors should understand that the NAV of the ETF they see quoted online bakes in assets and liabilities not usually seen in an ETF, and those directly impact performance.

Unrealized gains are created inside an MLP ETF the same way they are in your own portfolio—when the value of an MLP increases but the fund has not yet sold the MLP. Unrealized losses are created when the value declines. Every single position in the ETF is by definition either in a state of unrealized gain or unrealized loss. From an accounting perspective, this means the fund always has an accrued deferred tax liability for all unrealized gains and a deferred tax asset for all unrealized losses accumulated in the fund. These deferred tax assets and liabilities represent hypothetical future tax payments and deductions, respectively, that may not be paid prior to termination of the ETF, but have real implications for the value of the fund on a daily basis nonetheless. Critically, deferred tax assets and liabilities are updated daily for the calculation of NAV—causing the fund to gain and lose value based on estimated future taxes owed.

Let's assume each share of an MLP ETF has a claim of $100 worth of MLPs—that's the proportional share of all the securities priced on the open market. But based on the above calculation of potential gains and losses on those MLPs, the fund will owe a theoretical $2 per share in future taxes because of an implied gain in those positions. A new investor would not pay $100 for a share of the ETF, because it wouldn't be fair for them to pay a tax that was created during the holding period of the previous investor. The deferred tax liability keeps track of potential future taxes, allowing the new investor to purchase the fund at the correct fair value of $98. Conversely, an investor would pay a "premium" for a fund that has accumulated deferred tax assets.

For an investor used to traditional ETF or mutual fund structures, this concept is entirely alien. In those cases, there's no concept of these future tax liabilities reducing current NAV, because the traditional ETF or fund itself will never pay any taxes—it will simply distribute any realized capital gains to shareholders, and those shareholders pay the tax.

(It's worth noting that the correct calculation of the deferred tax asset and deferred tax liability by the ETF is a subject of contention in some circles. MLP-structured products have received lawsuits in the past when funds improperly estimated their deferred tax assets and liabilities. Swank Capital, in 2010, had to settle a lawsuit regarding its Cushing MLP Total Return Fund's calculation of deferred tax asset.)

The existence of deferred tax assets and liabilities significantly alters the interpretation of tracking-error statistics for MLP ETFs. Because the assets and liabilities are incorporated into the fund's NAV—but not into its underlying index—tracking-error statistics do not indicate how close the underlying MLP investments track the relevant index, but instead may reflect a rough estimate of the tax cost associated with the MLP ETF's C-corporation structure. This "hit" to NAV may be a "tax" cost that detracts from the benefit of deferring tax on a portion of the distributions received from an MLP ETF. Similarly, premium and discount measures—which compare the share price of the ETF at the end of the day to its NAV—can be tricky.

Cash Distributions (vs. Income)

A second critical concept in understanding the impact of the ETF/corporation structure on the MLP investment thesis is the difference between distributions and income. In the case of MLPs, these are entirely different things.

When an MLP distributes cash back to its investors, that cash distribution is always treated as a "return of capital" for tax purposes. These distributions are not taxed when received, but instead lower the cost basis of the position (and thus will be taxed at some later date when the security is sold). Again, this tax deferral is one of the major benefits to investing in MLPs. Any distributions from the MLP always adjust downward the investor's (in this case, the ETF/corporation's) basis in that MLP.

However, that doesn't mean the MLP position is entirely tax deferred. Shareholders of a partnership are liable for taxes on the income of that partnership, regardless of whether any cash distributions are made. So when someone says that "80% of XYZ MLP's distributions are tax deferred," what they really mean is that the taxable income presented on the partnership's K-1 was equal to 20% of the nontaxable cash distributions. The investor's share (in this case, the corporation's share) of taxable partnership income each year adjusts its basis upward in that MLP.

Accelerated Depreciation and the 754 Election

There's one last thing that will impact the tax basis as well: depreciation.

Depreciation is an accounting measurement that matches the price paid for equipment to the year the equipment was actually used. Many capital expenditures are paid for up front, but the equipment is used over multiple years. Depreciation spreads this cost over the years of use—changing the yearly income recognized. Accelerated depreciation—which was implemented to encourage capital investments—allows for more charges to be recognized in the early years of equipment use, decreasing taxable income in the early years and increasing taxable income in the later years of the equipment's life. Most MLP equipment is depreciated using a 15-year accelerated depreciation schedule.

The partnership has its own way of handling these types of depreciation. Within the tax code, a Section 754 election allows purchasers of a partnership to use the amount paid for the basis in the partnership interest, and for accelerated depreciation to be calculated off the time the security was held by the investor—not how long the equipment has been held by the MLP. This is another flexibility afforded to owners of individual MLPs.

For the MLP ETF, however, this means the depreciation schedule is set every time the fund buys an MLP, and reset every time the fund sells and buys back the same MLP. If the fund is run properly, shares with longer time horizons can be sold for redemptions and bought back for creations. This simple act front-loads accelerated depreciation. Continuing to reset the depreciation will make it more likely the fund continues to pay return-of-capital distributions, aiding the fund's tax efficiency. In addition, most MLP general partners are aware that investors want tax-deferred income and make purchases to create more depreciation charges. To summarize: The investor's share (in this case, the corporation's share) of depreciation adjusts its basis downward in that MLP.

Actually Paying Capital Gains: Ordinary Income Recapture

When an individual MLP is sold, the entire difference between the share price of the MLP and the cost basis is not taxed at capital gains rates. Instead, the portion of the gain resulting from cost-basis reductions stemming from depreciation is taxed at ordinary income rates. This is termed "recapture." The 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. The IRS instituted this rule to keep investors from recognizing substantial depreciation charges in an attempt to minimize ordinary income and maximize capital gains. It is important to mention, however, that there is no income recapture at the fund level, so any difference between the reduced basis and the sale price is taxed as a capital gain (assuming it is held for more than a year).

Unlike owning individual MLPs, the ETF/corporation structure does not have to deal with ordinary income recapture. The main reason it isn't an issue is because the corporation requires both income and capital gains to be taxed at the same rate.

Passive Activity Losses and Credits

One advantage of an ETF/corporation over a mutual fund or owning individual MLPs is "passive activity losses." The IRS limits a taxpayer's ability to deduct losses from businesses in which he or she does not materially participate, also known as passive activity losses. This is to prevent taxpayers from effectively "buying deductions" through investment projects. Investing in an MLP activity is considered a "passive" activity.

With mutual funds or individual ownership of MLPs, the losses and tax credits an investor can claim from passive activity losses is limited. Neither a fund nor an investor is allowed to deduct losses from one MLP to offset gains of another MLP. In fact, the only way to deduct operational losses in an MLP is against gains from the same MLP. This inefficiency leads to losses going unused and more ordinary income recognized.

In contrast, an MLP ETF structured as a corporation avoids the rules regarding passive activity losses. Losses from one MLP can be deducted against any gains incurred by the corporation. This allows the MLP ETF to pool losses from all of the MLPs in the portfolio, and use them to offset gains in other parts of the portfolio, creating a significant potential tax advantage for the ETF.

The ETN Structure

In comparison with the blisteringly complex ETF/corporation structure, exchange-traded notes in the MLP space are phenomenally simple, and what issues they present for investors are quite easily understood.

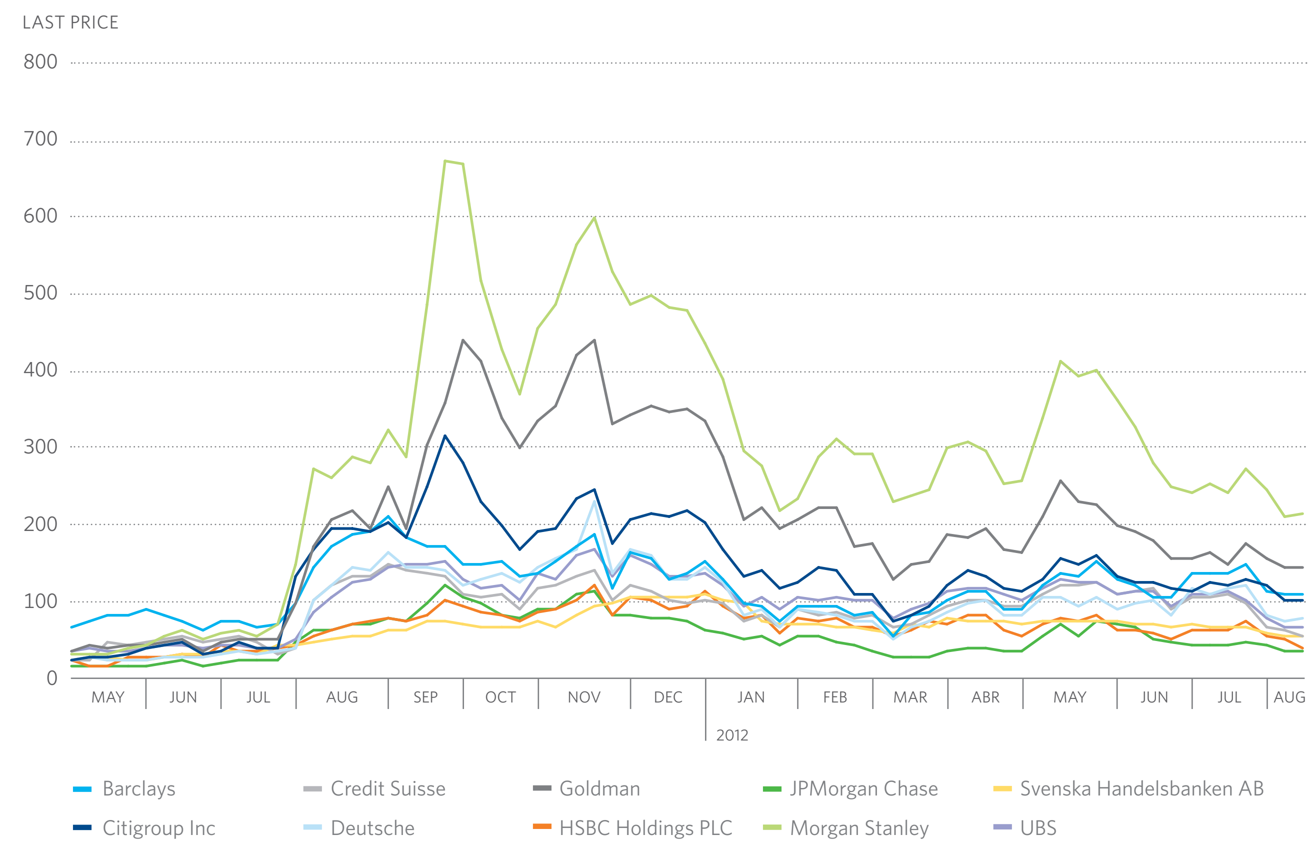
The MLP ETNs are simply debt instruments issued by a bank, such as J.P. Morgan. The notes promise to mature at a value consistent with a particular MLP index at some point in the future, and to make coupon payments along the way in proportion to the cash distributions of all the MLPs underlying that index.

We can assume that the bank offsets the liability of that promise by actually investing in those very same MLPs, but there's absolutely no connection between the ETN itself and how the bank chooses to offset that liability—there's no ownership stake in any MLP at all implied by owning shares of an MLP ETN.

This disconnection simplifies the tax issues surrounding MLP ETNs for good or ill. Investors will owe capital gains taxes on the change in value of the ETN shares when they sell, and they'll pay ordinary income taxes on whatever coupon payments the ETN makes along the way, just as if they had purchased a J.P. Morgan corporate bond.

While this provides extremely consistent exposure to the total-return characteristics of MLPs, it does so on a pretax basis, and introduces a new source of risk for investors: the risk that the bank issuing the ETN defaults. Because ETNs are just unsecured debt, in the event of bankruptcy, ETN holders could theoretically lose all of their money, just like any bondholder.

ETN Issuer CDS Rates



The good news is that this risk is relatively easy to analyze; in fact, there's an entire marketplace devoted to assessing the relative creditworthiness of major banks—the credit default swap (CDS) market.

When credit markets are stable and funding is readily available, this risk associated with daily-tradable unsecured debt from a global bank is generally slim. However, in times of credit stress or in the face of major credit events, this risk is elevated. The chart below shows the one-year CDS rates for all issuers of U.S.-listed ETNs. As you can clearly see, the credit crisis in Europe wreaked havoc on CDS rates for some ETN issuers in 2011.

Currently, the most popular MLP ETN is the JPMorgan Alerian MLP Index ETN (AMJ). Investors in this fund are subject to the risk of a J.P. Morgan default. One-year CDS rates can be volatile. If we look at the one- and five-year CDS rates on J.P. Morgan, we can see the likelihood of default on its debt spiked in the fall of 2011.

Clearly, the risk of J.P. Morgan's default has normalized in the view of the market, and its CDS rates have fallen accordingly. Still, credit risk is real, and it is unique to the ETN structure. Any risk of default should be viewed as an embedded cost of the ETN, and CDS rates of the issuer's debt are generally the best way to measure it.

COMPARING THE STRUCTURES

The difficulty in comparing the two available structures for ETP MLP exposure comes from setting an appropriate framework for analysis. In general, most investors care about their after-tax returns. However, traditionally, securities analysis is done on a pretax basis. If one were to compare, for instance, three traditional ETFs covering the U.S. stock market, taxes likely wouldn't be a major consideration.

With MLPs, however, taxes are incredibly important, because the very reason many investors seek them out is for preferential tax treatment. And in this case, since neither structure can fully replicate direct MLP ownership, the two structures have dramatically different tax approaches.

On the one hand, MLP ETFs are taxed mostly at the corporate level and then again at the shareholder level. All income distributed to investors has already been taxed, and distributed earnings will be taxed again in the hands of the shareholders. The fund accumulates a deferred tax liability for the amount of unrealized gains it currently holds, which is adjusted into NAV. As mentioned, this often results in the deferred tax liability and taxes paid by the fund being incorrectly considered as traditional tracking error. By comparison, the MLP ETN does not have these inherent tax issues—it simply accumulated capital gains and pays coupons, like any bond subject to special tax risks associated with synthetic exposure to MLPs.

To run a fair comparison of the two and engage in accurate tracking analysis, both funds would have to be converted to either a pre- or after-tax basis. To convert to a pretax basis, you would need to know the daily deferred tax liability/asset. This is virtually impossible without the fund company providing daily data, and such data is currently only published twice a year, in the annual and semiannual report. Converting to an after-tax rate is the theoretically correct route for a fair analysis, but it involves too many leaps of faith, including an assumption of an individual investor's tax rate, which, given the recent "fiscal cliff" compromise, is more complex than it has been in many decades.

Looking purely at the top-line numbers, however, does at least highlight the major differences between the ETF/corporation approach, and the ETN approach.

MLP Beta and Tracking Error As of 3/1/2013

	AMLP ETF	AMZI/AMZX INDEX*	MLPI ETN
Beta to Index	0.65	N/A	0.99
Mean Performance Deviation	0.03%	N/A	0.02%
Standard Deviation	0.36%	N/A	0.15%
Price Return**	13.68%	36.00%	35.68%
Total Return**	32.56%	57.79%	54.24%

**AMZI is the price-return version of the Alerian MLP Infrastructure Index and AMZX is the total-return version*
***Since 8/25/10 launch of AMLP*

As you can see, AMLP is currently the only ETF/corporation that has been able to track its index tightly, but it suffers from a low beta to its targeted index. The lower beta figure is easy to understand when you assume that the fund assumes a maximum corporate tax rate of 35% on its unrealized gains; has to pay actual taxes on its realized income and gains; and also pays state taxes. The fund is essentially underleveraged to its index.

On the other hand, AMJ and the UBS ETRACS Alerian MLP Infrastructure Index ETN (MLPI) achieve a beta close to 1 because taxes are not taken out at the fund level.

However, despite the many caveats of the ETF/corporation structure, so far the majority of dividends paid by AMLP have been eligible to be treated as return-of-capital distributions, much like the underlying MLPs themselves (85% in 2011, 99.7% in 2012). While the ETF investors don't have the basis changes that a direct MLP investor would have from depreciation or income, they do benefit from the tax-deferral effects of these return-of-capital distributions. However, this benefit may come at a price, including (1) the future cost of higher aggregate double tax on the amount of such distributions, (2) the tax cost of subjecting any current distributions that do not qualify as return of capital to a higher double tax, and (3) the tax cost of subjecting any net economic appreciation, being accounted for no later than the investor's disposition of his or her ETF units, to a potentially higher aggregate double tax.

The ETN issues all distributions at an ordinary income tax rate, in the year in which those distributions are made. Clearly, $1 paid tomorrow is worth less than $1 paid today, tilting the scales, seemingly, in favor of the ETF/corporation structure. However, the comparison is not so simple, as the future taxes paid in the ETF structure will likely be determined at a higher aggregate tax rate due to the double tax created by the ETF. Consequently, comparing the ultimate tax efficiency of the structures requires assumptions regarding the length of the deferral as well as the appropriate discount rate. Further, assumptions must be made regarding whether some part of the ETF double tax could be minimized by using estate planning that allows a step-up cost basis in inheritances, essentially negating the capital gains tax that would be paid on the ETF units if the unit holder dies and the units pass to her heirs.

In conclusion, the choice of ETF/corporation versus ETN for MLP exposure involves assumptions about the time horizon, tax position and risk tolerance of the individual investor, combined with certain assumptions about the future returns of the MLP market.

But broadly speaking, an ETN makes most sense for MLP exposure if:

- The investor expects the majority of total return to come from price appreciation.
- The investor is using a tax-deferred account and cannot benefit from the tax deferral of the ETF structure.
- The investor has a shorter time horizon.
- The investor places a high value on transparency and predictable returns.
- The investor is unconcerned about the credit risk of the note.
- The investor is more concerned with total return than after-tax yield.

An ETF/corporation makes most sense for MLP exposure if:

- The distribution yield of the MLP is greater than or equal to the MLP index total return. In this case, the tax-deferral overwhelms the performance hit of the internal tax issues; however, paying out a higher distribution than total return is likely unsustainable in the long run.
- The investor has a very long time horizon, including potentially passing her position to an estate.
- The investor uses a high discount rate to value future cash flows.
- The investor has a low tolerance for credit risk.
- The investor is comfortable with complex tax accounting and its associated risks.
- The investor values tax efficiency over absolute returns or index tracking.

In either case, however, it's important to understand that these exchange-traded products are not simple roll-ups of the value proposition from holding individual MLPs, and perhaps more than any other corner of the ETF market, a deep understanding of both the underlying asset class and the ETF structures is not just prudent, but necessary.

There are now 13 different MLP ETPs on the market, with more than $13 billion in AUM between them. Although there are some redundancies in underlying indexes, there are many distinct choices for those looking to fine-tune their exposure. These exposure differences, while important, should be the second step in your investment decision, with the first step being the choice of structure. It is this first step that will allow you to properly match your investment profile, objectives and expectations to the correct product.

NOTE ON BASIS EXHAUSTION

When a return-of-capital distribution is issued to an MLP ETF, the entire amount can theoretically be passed on to shareholders of the ETF. The individual investor's cost basis in the ETF drops by the amount of that distribution. With a long enough time horizon, the cost basis will eventually drop to zero. When that happens, any future distributions from the ETF will have to be treated as current-year capital gains distributions. While better than being treated as ordinary income—as is the case with the ETN—it still represents an increase in current-year taxes from tax-deferred return-of-capital distributions.

How early the cost basis in the ETF is exhausted is dependent on the amount of the distribution yield; the percent of distributions labeled return of capital; and the yearly MLP return performance.

To show how quickly this can occur, we built the following table assuming distributions to be 85% return of capital:

Years to Basis Exhaustion

	DISTRIBUTION YIELD				
MLP INDEX PRICE APPRECIATION	2%	4%	6%	8%	10%
2%	59	39	31	26	22
4%	39	30	26	24	23
8%	26	20	17	15	14
12%	20	16	13	12	11
16%	17	13	11	10	9

It is not far-fetched to assume that cost basis will be exhausted within 20 years. A bigger risk to short-term holders could be the possibility of the ETF/corporation's cost basis in the MLPs running to zero. The onus is on the fund manager to prevent low-cost-basis MLPs from reaching that point and incurring internal capital gains taxes.

The good news is the portfolio manager does have some control over this. The fund, like most ETFs, reserves the right to execute creations and redemptions either in cash or in-kind. The standard procedure is in-kind, but the fund manager reserves the right to execute redemption in cash to the extent that it will help her effectively manage his tax liability. Otherwise, both the fund and investors will be paying capital gains taxes on distributions that are normally distributed as return of capital.