

## Understanding Master Limited Partnerships and Relevant Value Issues

A master limited partnership ("MLP") by virtue of being a limited partnership differs from the more familiar corporate structure, and poses its own set of concerns regarding valuations. While interests in an MLP (commonly called "units") can be freely traded (on public exchanges), those units have characteristics that distinguish them from common stock of a corporation.

The units represent limited partner interests in the enterprise; that is, each unit owns a proportional part of the entity. The general partner, usually the sponsor of the MLP, manages the MLP's operation and is responsible for prompt and accurate reporting to each of the partners, commonly called "unitholders."

In a corporation, shareholders receive dividends (if declared), and a Form 1099 reporting those dividends for the year. The effect on a shareholder's current year taxable income usually relates only to the dollars received as a dividend. Undistributed earnings of a corporation, while often important in terms of the price of the corporation's stock, ordinarily have no direct impact on the shareholders. Generally, only cash distributions in the form of dividends have a current year tax effect. If no dividends are paid, no taxes are payable by the shareholder.

An MLP is different. Partners, or unitholders, receive a schedule K-1, after year-end, showing their share of the partnership's total income and deductions (for the period they owned the units) including depreciation and amortization of intangibles. Information derived from K-1s must be included on the unitholders' tax returns even if no distributions are made by the MLP. Most MLPs make periodic (usually quarterly) cash distributions. Depreciation and amortization, as calculated by the MLP, will often provide a 70% - 80% "shield," thus reducing the total amount of taxable income allocated by the MLP to the unitholders. The higher the depreciation and amortization, the greater the shield to the individual unitholders.

Technically, each time a unitholder sells units, a new valuation is needed. The old partner has relinquished his interests in the MLP in favor of a new partner. Thus the new partner acquires a basis in the MLP's assets based upon the price paid. In theory, each of the assets of the MLP has to be revalued so that the basis in the MLP's assets equals the basis in the MLP unit(s) acquired. In other words, a new allocation of the fair market value ("FMV") of the MLP to the MLP's assets should be made every time an ownership interest is transferred. Theoretically, an MLP with daily trading would warrant daily valuations.

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Both for financial and tax reporting, a proper allocation requires first determining the then current total FMV of the MLP. The next requirement is to allocate that FMV among working capital; property, plant and equipment ("PP & E"); and intangible assets. Because the value of working capital at any point is essentially fixed, fluctuations in an MLP's FMV usually have to be apportioned either to PP & E or intangibles. This allocation usually results in a tax impact.

In practice, most MLPs make a number of simplifying assumptions. First, only monthly valuations, not daily valuations, are ordinarily made. Second, detailed appraisals of PP & E are not usually performed; consequently, most changes in total FMV of the MLP have usually been assigned to intangibles. As a result of this approach, virtually all changes in the FMV of an MLP are debited or credited to goodwill.

Depending on the tax situation of the specific MLP, such changes in goodwill may or may not affect the taxable income of the unitholders. Assuming that goodwill resulting from changes in the MLPs assets is amortizable under IRC §197, arbitrarily assigning all changes in FMV of the MLP to goodwill may be a detriment to new partners.

In virtually every situation the total FMV of the MLP, and the allocation of any changes in value, will affect the taxable income allocated to new partners and the character of the gain to the selling partner.

How can the management of an MLP be certain that changes in the FMV of the MLP are 1) properly calculated and 2) correctly apportioned among the various assets? At one extreme, a new appraisal of the MLP's assets could be undertaken monthly, quarterly, or yearly. Our experience suggests that this approach has rarely been utilized, primarily because of the perceived cost involved. At the other extreme, the present method of valuing PP & E could be utilized even if the results may not be fully accurate.

The issue for management is how to obtain, for a reasonable cost, a valuation of assets that would maximize the tax benefits for all unitholders and withstand IRS scrutiny. Valuation Research Corporation has had substantial experience valuing assets for MLPs which have made IRC §754 elections. Our innovative techniques allow management of an MLP to develop accurate valuations internally. This can be done on a periodic basis, while outside support and substantiation can be provided as needed on an annual basis by independent appraisers. For more information regarding MLPs, please contact Robert Schulte at (617) 342-7366. **VR**

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