Master Limited Partnership (MLP) Investment Primer

I'm looking for MLP exposure.
What investment vehicle should I use?

What type of account?

NON-TAXABLE

Tax Deferred (e.g. IRA, 401k) & Tax Exempt (e.g. foundations, charities)

Individual MLPs – Not recommended for tax deferred accounts because this can result in the account owing an "unrelated business taxable income" (UBTI) if the income designated as UBTI from the MLP exceeds $1,000.*

Exchange Traded Fund (ETF) / Mutual Fund (MF) / Closed End Fund (CEF) – Funds structured as Corporations ("C-Corps") allow for investment in tax-deferred accounts.

Exchange Traded Note (ETN) – May allow for investment in tax-deferred accounts. **

RIC-Structured MLP ETF/Mutual Fund – Funds structured as regulated investment Companies ("RICs") allow for investment in tax-deffered accounts.

TAXABLE

SEE TABLES:

Table 1: MLP investment vehicle comparison for taxable accounts

Table 2: Illustrative after-tax return of MLP ETF vs. ETN

* Not all income from an MLP is designated as UBTI. The UBTI from the MLP is typically found in the attached statements with the K-1. However, the tax deferred account needs to consider all UBTI income within the account, not just the potential UBTI from MLP investments.

** The IRS may assert that Section 1260 applies to ETNs, causing tax exempt and tax deferred investors to have UBTI as if it directly invested in MLPs.

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TABLE 1: MLP INVESTMENT VEHICLE COMPARISION FOR TAXABLE ACCOUNTS

As of 9/13/2016	Diversified MLP Exposure?	Credit Risk?	K-1 Reporting?	How are Dividends Taxed? [2]	Is the Fund itself Taxed?	Actively Managed?	Investment Options [3]	Expense Ratio[4]
Direct MLP Investment	No[1]	No	Yes, requires the issuance of both federal and state K-1s to investors	All distributions received are return of capital to the extent of tax basis in the MLP. Return of capital distributions reduce tax basis in the investment. The income, deductions, gains and losses on the K-1 are taxed at the applicable rate for such items based on their tax character - this will vary from preferential rates (e.g. long-term capital gains) of 15% up to ordinary income tax rates.	N/A	**N/A**	EPD ETP MMP	N/A
ETF	Yes	No	No, 1099 reporting only	Distributions that are return of capital are not taxable to the extent of basis; regular dividends are generally taxed at the ordinary federal tax rate (currently 43.4%). Dividends may be eligible for qualified dividend tax rates (currently up to 23.8%).	Yes. Taxed as a C-Corp	No[5]	AMLP MLPA YMLP	0.85% 0.45% 0.82%
Mutual Fund	Yes	No	No, 1099 reporting only	Distributions that are return of capital are not taxable to the extent of basis; regular dividends are generally taxed at the ordinary federal tax rate (currently 43.4%). Dividend may be eligible for qualified dividend tax rates (currently up to 23.8%).	Yes. Taxed as a C-Corp	**Yes**	MLPAX MLPDX MLPFX	1.52% 1.38% 1.12%
Closed End Fund	Yes	No	No, 1099 reporting only	Distributions that are return of capital are not taxable to the extent of basis; regular dividends are generally taxed at the ordinary federal tax rate (currently 43.4%). Dividend may be eligible for qualified dividend tax rates (currently up to 23.8%).	Yes. Taxed as a C-Corp	**Yes**	KYN TYG CEM	2.70% 1.99% 1.43%
ETN	Yes	Yes. An ETN is a promissory note which exposes investors to credit risk of the issuing institution	No, 1099 reporting only	Treated as ordinary income and taxed at marginal tax rate (top rate is currently 43.4%)	No	**No**	AMJ MLPI MLPN	0.85% 0.85% 0.85%
RIC-Structured Fund	Yes[6]	No	No, 1099 reporting only	Distributions that are return of capital are not taxable to the extent of basis; regular dividends are generally taxed at the ordinary federal tax rate (currently 43.4%). Dividends may be eligible for qualified dividend tax rates (currently up to 23.8%).	No	**Sometimes**	TORTX EMLP SMAPX	0.85% 0.95% 0.95%

Sources: Global X Funds, Morningstar, Bloomberg 2016.

[1]Diversification can be achieved through investments in multiple MLPs. Diversification does not guarantee investment returns and does not eliminate risk of loss.
[2]All tax rates used are for federal income tax purposes only and do not include the 3.8% Medicare surcharge imposed under IRC Section 1411, as of 9/13/16.
[3]Top 3 investment options by assets under management as of 09/13/2016 (for individual MLPs, market capitalization is used). Only Funds with greater than 25% allocation to MLPs are included.
[4]Does not include front-end loads, distribution, interest, or income taxes, which are an additional cost that may apply to some Mutual Funds. Transactions in ETF shares may result in brokerage commissions.
[5]Generally, most ETFs are passively managed.
[6]RIC-structured funds limit MLP exposure to 25% of fund assets. The fund may hold other securities such as the general partners of MLPs, energy companies or utility companies.

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IMPACT OF TAXES ON ETFS AND ETNS

The net return for investors in a taxable account is the after-tax return. All examples below are illustrative and do not represent actual returns of any specific ETF or ETN.

TABLE 2: ILLUSTRATIVE AFTER-TAX RETURN OF MLP ETF VS. ETN

	MLP Yield	MLP Price Appreciation	Total Return	ETF After Tax Return	ETN After Tax Return
Example 1	6.0%	0.0%	6.0%	3.0%	3.6%
Example 2	6.0%	6.0%	12.0%	6.0%	8.4%
Example 3	6.0%	12.0%	18.0%	9.0%	13.2%
Example 4	6.0%	-6.0%	0.0%	0.0%	-1.2%

After Tax Return assumes position is sold after one year.

* Assumptions: maximum individual marginal tax rate of 39.6% (which applies to ETN distributions); an Effective Corporate Income Tax Rate of 37.4% (applicable to MLP ETFs); 100% of distributions are return of capital; Tax Rate of 20% on capital gains. The table above is a general illustration and may differ depending on your own marginal tax rate, the taxability of distributions from the ETF, and the ETF's effective income tax rate.

** Assumes the MLP ETF has a deferred tax liability to offset against price declines. Accounts may differ if the Fund has valuation allowances against Deferred Tax Assets (DTA).

Discussion

There are many factors to take into account when considering an MLP investment, but some of the most important for an investor are (1) after tax returns, (2) tax reporting (K-1 vs. 1099), (3) diversification, (4) credit risk, and (5) fees. An MLP investment decision may depend on the account type (taxable vs. tax deferred) and what priority or importance is given to these five categories. Each type of investment will have different characteristics in the context of these five categories, and understanding these differences will help investors make a more informed investment decision in the MLP space.

Taxation – In taxable accounts, the most efficient method for investing in MLPs may be to invest directly in the securities themselves. While this type of investment has other drawbacks (K-1s, multiple investments required to achieve diversification), from a tax perspective it is more efficient due to the favorable tax treatment of individual MLPs. When considering an MLP ETF/MF/CEF vs. an ETN, investors must consider the different tax effects on both distributions and capital appreciation. The ETF/MF/CEF category is more efficient for investors concerned with the taxation of distributions. Distributions from an ETF/MF/CEF investing in MLPs will typically be considered a return of capital and investors will reduce their cost in the investment by the amount of the return of capital. In contrast, because ETNs are debt instruments structured as notes, distributions from ETNs are taxed at the ordinary income rate. However, from a price appreciation perspective, ETNs can be a more efficient investment because they are not subject to corporate tax. ETFs/MFs/CEFs structured as C-Corps apply an effective tax rate to the Fund's price appreciation/depreciation. The effective federal and state tax rate is estimated to be 37.4% in this primer.

RIC-structured MLP funds – To avoid taxation at the fund level, RIC-Structured MLP funds limit MLP exposure to under 25% of the fund, the maximum allowed by the IRS to qualify as a RIC. These funds often seek to allocate the remaining 75% or so to General Partners of MLPs and other energy infrastructure companies with high correlations to MLPs.

In tax deferred accounts (e.g. IRA, 401k), the tax benefit of individual MLPs may disappear because this can result in the account owing an "unrelated business taxable income" (UBTI) if the income designated as UBTI in the K-1 exceeds $1,000. As a result of these considerations, the ETN structure is typically more efficient for these types of accounts than an investment in an ETF/MF/CEF or individual MLP.

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After tax return - Taxable accounts

More Efficient
Individual MLPs, RIC-structured MLP funds

Less Efficient
ETF/MF/CEF and ETN (preference depends on importance of taxes on distributions vs. taxes on price appreciation).

Tax Deferred Accounts

More Efficient
ETN, RIC-structured MLP funds

Less Efficient
Individual MLPs

Tax Reporting

Tax reporting for individual MLPs is the cause of much investor frustration. MLPs designate taxable income on a K-1 form rather than the typical 1099 form. For non-professionals, the K-1 forms can be complex and may require the hiring of a tax professional in order to complete their federal, state and local taxes accurately. If this is the case, investors should factor this cost in to the total cost (both time and money) of their investment.[1] Tax reporting is one area where the ETF/MF/CEF and the ETN structures provide a clear benefit – the ETF/MF/CEF and ETN securities report their distributions on the simpler 1099 form.

More Efficient: ETF/MF/CEF, ETN, RIC-structured MLP funds

Less Efficient: Individual MLPs

Diversification[2]

The most efficient investments from a diversification perspective are the ETF/MF/CEF and the ETN, which all invest in a basket of different MLP securities. Some Funds may be actively managed while others passively track an Index, but all provide some form of diversification (company, geographic, business segment) that cannot be achieved with an individual MLP investment. An investor could achieve diversification by investing directly in several different MLPs, but this would create additional trading costs and result in individual K-1s for each security.

More Efficient: ETF/MF/CEF, ETN, RIC-structured MLP funds

Less Efficient: Individual MLPs

Credit Risk

Credit risk refers to the risk that a lender will default on any type of debt by failing to make a payment. In the context of MLP investing, credit risk only applies to investments through the ETN structure, because ETNs are structured as notes (debt instruments) and are essentially an obligation of the issuing institution. Unlike ETF/MF/CEF where individual MLP investments are segregated, an ETN investment exposes investors to the credit risk of the issuing institution, which could become problematic if the issuer's credit rating is downgraded or, in a more extreme case, if the issuer goes bankrupt. If the latter were to occur, investors in the ETN from that issuer could lose all or most of their investment.

More Efficient: ETF/MF/CEF Individual MLPs[3], RIC-structured MLP funds

Less Efficient: ETN (has credit risk)

[1] Investors who already use a tax professional may not incur additional costs through direct MLP investment.
[2] Diversification does not guarantee investment returns and does not eliminate risk of loss.
[3] Only the indirect credit risk inherent in equity securities.

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Fees

All else being equal, investors tend to prefer investment options with the lowest fees. However, due to the unique tax structure and reporting requirements of MLPs, investors need to consider all the various costs of their investment. To make this clear we will define two types of costs: (1) management fees and (2) other costs. With regard to management fees, the clear winner is an individual MLP investment, because this is simply a security and there are no management fees associated with a direct investment in a MLP security. For investors considering various MLP Fund structures, management fees are typically higher for actively managed MFs and CEFs, while ETFs and ETNs that are passively managed and track an Index typically have lower management fees. This tends to hold true across asset classes other than MLPs as well, and is really a distinction between active and passive management. When considering additional costs (other than management fees and taxes), investors should factor in the costs of their tax return preparation if it includes a K-1. Investors in individual MLPs that hire a tax professional to complete their tax return should consider this an additional cost of investment. Other costs to consider are trading costs, commissions, and the cost of maintaining a brokerage account to trade securities. These costs may depend on several variables including the broker used and the size of the investment.

More Efficient: Individual MLPs (if K-1 reporting costs are low) or low-cost passively managed ETFs, ETNs, or RIC-structured MLP funds

Less Efficient: Individual MLPs (if K-1 reporting costs are high) or high-cost actively managed MF/CEF

Please note: the discussion above does not constitute tax advice; please consult a tax professional before making an investment decision.

GLOSSARY OF TERMS

C Corporation (C-Corp) – refers to any corporation that, under United States federal income tax law, is taxed separately from its owners. Typically, ETFs are classified as Regulated Investment Companies (“RICs”) and are exempt from this additional taxation. However, as a result of regulatory requirements surrounding MLP investing, in order for an ETF to hold more than 25% of its assets in MLPs, the ETF must be structured as a C-Corp rather than a RIC. This C-Corp structure reduces some of the tax efficiencies for the ETF and its investors.

Credit Risk – refers to the risk that a borrower will default on any type of debt by failing to make the required payments. In the context of ETN investing, credit risk is applicable because ETNs are structured as unsecured debt instruments issued by an institution. Therefore, an investor in an ETN is exposed to the credit risk of the institution (e.g. a bank) issuing the ETN. This could become problematic if the institution has its credit rating downgraded or in a more extreme case if the institution goes bankrupt. Credit risk is also sometimes referred to as “counterparty risk.”

Effective Tax Rate – the rate at which an individual or corporation is taxed. For an MLP ETF, the effective tax rate is used to describe the federal and state income tax rate (taking into account each MLP’s state apportionment) of the ETF that invests directly in MLPs (and therefore is structured as a C-Corp and subject to taxation). The effective tax rate can change over time as it reflects both the state and federal tax treatment of the underlying holdings.

Form 1099 – a tax document used to report different types of taxable income other than wages, salaries and tips. Most investors who purchase stocks are familiar with this form as a means to report taxable income generated from dividends, interest, selling stocks, etc. on their tax return.

K-1 – a tax document used to report the income, deductions, gains and losses, credits, etc. to a business’s partners or S corporation’s shareholders. Because they are structured as partnerships, individual MLPs provide a K-1 rather than a Form 1099 to each shareholder. The K-1 is typically more complex, and for the average investor may require the assistance of a tax adviser.

Marginal Tax Rate – the amount of tax paid on an additional dollar of income, which increases along with an individual’s income. An investor’s marginal tax rate is an important consideration for MLP investing because distributions from ETNs (including MLP ETNs) are considered to be interest and are taxed at the individual’s marginal tax rate.

Return of Capital – a return of the shareholder’s cost to purchase the investment. It is not taxable until the accumulated return of capital exceeds the original investment cost. Most MLP partnership distributions are classified as return of capital and are tax deferred to the extent of the owner’s basis.

GLOBAL X

Beyond Ordinary ETFs

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Investing involves risk, including the possible loss of principal. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Investments in securities of MLPs involve risk that differ from investments in common stock including risks related to limited control and limited rights to vote on matters affecting the MLP. MLP common units and other equity securities can be affected by macro-economic and other factors affecting the stock market in general, expectations of interest rates, investor sentiment towards MLPs or the energy sector, changes in a particular issuer's financial condition, or unfavorable or unanticipated poor performance of a particular issuer (in the case of MLPs, generally measured in terms of distributable cash flow). The Global X MLP ETF (NYSE Arca: MLPA) and the Global X Junior MLP ETF (NYSE Arca: MLPJ) invest in the energy industry, which entails significant risk and volatility. The Funds are non-diversified which represents a heightened risk to investors. Furthermore, the Funds invest in small and mid-capitalization companies, which pose greater risks than large companies. MLPA and MLPJ pay distributions, which are generally treated as a return of capital for tax purposes rather than from net profits and shareholders should not assume that the source of distributions is from the net profits of the Fund.

Due to the nature of the Fund's investments, the Fund will be subject to taxation on its taxable income. The NAV of Shares will also be reduced by the accrual of any deferred tax liabilities. The Underlying Index however is calculated without any deductions for taxes. As a result, the Fund's after tax performance could differ significantly from the Underlying Index even if the pretax performance of the Fund and the performance of the Underlying Index are closely correlated.

The potential tax benefits from the Fund's investment in MLPs depend largely on the MLPs being treated as partnerships for federal income tax purposes. As a partnership, an MLP has no federal income tax liability at the entity level. Therefore, treatment of one or more MLPs as a corporation for federal income tax purposes could affect the Fund's ability to meet its investment objective and would reduce the amount of cash available to pay or distribute to you. There is no guarantee distributions will be made and dividends may be reduced or eliminated at any time.

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