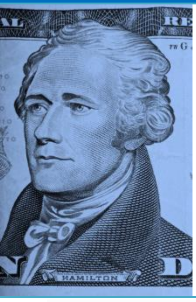

Guide to Investing in K-1 and IRS Form 1099 Reporting Stocks

Investors Alley

The Facts You Need to Know

Any stock market investor focused on dividend income will soon find him or herself looking at the yields and return prospects of master limited partnerships (MLPs) or other publicly traded partnership businesses. You can spot these stocks by the LP or LLC they have at the end of their name rather than the Inc. or Corp. of a corporation.

While MLPs often pay great dividends and have growing distributions, they come with different tax reporting requirements. There are many investors who did not realize there was a difference until they received the first IRS Schedule K-1 from a partnership investment instead of the IRS Forms 1099 sent out to report corporate share dividends on your taxes. The fact that a company sends out K-1's is not a reason to avoid an investment. However, there are some different consequences and rules that you need keep in mind.

Publicly traded partnerships – primarily MLPs – offer some tremendous return opportunities for investors with a dividend growth focused approach, which is the core of my newsletter investment strategies. However, since they are legally organized as partnerships, most MLPs send out what is called a Schedule K-1 for tax reporting. Most other investment products send a Form 1099. Including Schedules K-1 in your tax return requires some additional forms and, more importantly, a different understanding of how owning MLP units (partnership shares are officially limited partner units) may affect your tax situation.

While there is a lot of noise in the investment world about K-1's, below we'll cover the important points that will get you through tax season and let you make money from publicly traded partnerships.

Typically, in the early years of ownership in partnership units, an investor will have little or no taxable income from the units. This means that while you may have to do some extra paperwork at tax time, your MLP investments will not add much to your overall tax bill.

A partnership or limited liability company can choose to report and file taxes as either a partnership or as a corporation. Most go with the partnership option because the company is then not liable for any corporate income taxes. Profits, losses, and deductions pass through to the limited partners (us investors) and that is the information reported on a Schedule K-1.

Some publicly traded partnerships do elect to be corporations for tax purposes. These companies typically expect to actually owe little if any corporate income tax. A partnership that has taken the corporate tax election will send you a regular Form 1099 for tax reporting. The major financial and stock market information sources do not indicate whether a publicly traded partnership issues Forms 1099's or Schedule K-1's. To find this information, you need to access a specialty information service or dig into the Investor Relations pages of individual company web sites.

When I include a partnership type investment in one of my newsletter recommendations, I indicate whether the company sends out a K-1 or Form 1099.

Issues in IRA Accounts

Units of a K-1 reporting MLPs in an IRA-type (tax-qualified money) account can cause tax issues. The worst case is that the IRA will incur a corporate income tax obligation from the profits reported on the Schedules K-1. If an IRA earns what the tax code refers to as unrelated business income (UBI), that income is taxable if it exceeds $1,000 for the year. In that case, the IRA must file a corporate income tax return and pay the taxes – called UBIT – owed. However, an MLP will only break out UBI on the K-1 for units owned in an IRA type of account. As a result, there is no way to know or calculate in advance whether MLP investments will cause a tax issue for an IRA.

The selling of partnership units in an IRA where you have a large capital gain on the units can trigger additional UBI. Because of the unknown nature of owning K-1 reporting investments in an IRA or other tax advantaged account, I stick to a general recommendation of "Do Not Do It".

If a partnership reports taxes as a corporation and sends out Forms 1099 to investors, its units can be owned in an IRA with no tax issues. Packaged products such as ETFs and ETNs that cover the MLP sector absorb the K-1 reporting issues and pass through results on Forms 1099 to investors. An MLP focused fund is a very acceptable way to get MLP exposure in an IRA without the uncertainty of the tax reporting issues.

In my newsletters, I recommend some of what my research indicates as the better MLP funds to provide the yield and income growth that are the primary reasons to invest in the sector.

Final Considerations

A Schedule K-1 reporting MLP is a very tax-advantaged investment. Distributions are not taxable income and most MLPs will report little or no taxable income on the Schedule K-1, especially in the early years of an investment in one of these companies. As an investor, your tax basis in an MLP is unique to you and the company will track your individual share of profits or losses and deductions. **It is important to keep all of your K-1's from every year you own an MLP**.

When you sell, a realized gain can be offset by any losses reported on the Schedules K-1. To maximize the tax advantages of owning individual MLPs, you should own K-1 reporting MLP units in a regular, taxable brokerage account.

Including K-1's on your tax return is not as difficult as you may have heard. Modern tax software can easily handle the input of information and the completion of the required forms. And if you use someone as your tax preparer be sure to ask up front if that person has experience filing returns with K-1's. Again, it's not hard, but you want them doing it correctly.

The best companies that operate as publicly traded partnerships offer return potentials that are hard to match from stocks out of any other sector of the economy. For my newsletter recommendations and model portfolios, I search out the best partnership investments that report on both K-1's and Form 1099.

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