

# TAX DEFERRED HIGH INCOME & GROWTH



## HIGHLIGHTS

### FIVE Important Trends

- Demand for oil & gas in the US should continue to grow.
- Untapped sources and new discoveries of oil and gas in the US will require additional infrastructure.
- Opportunity to export natural gas requires new facilities.
- Midstream MLPs provide the storage, transportation and facilities to meet these requirements.
- Barriers to competitive entry are very high.

### SIX Ways You Benefit

- Higher yields.
- Tax-deferred income distributions.
- Growth in distributions leads to capital gains.
- Reduction of estate taxes.
- Reduction of portfolio risk.
- Less influenced by commodity price changes

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## WHAT YOU NEED TO KNOW

### What are MLPs

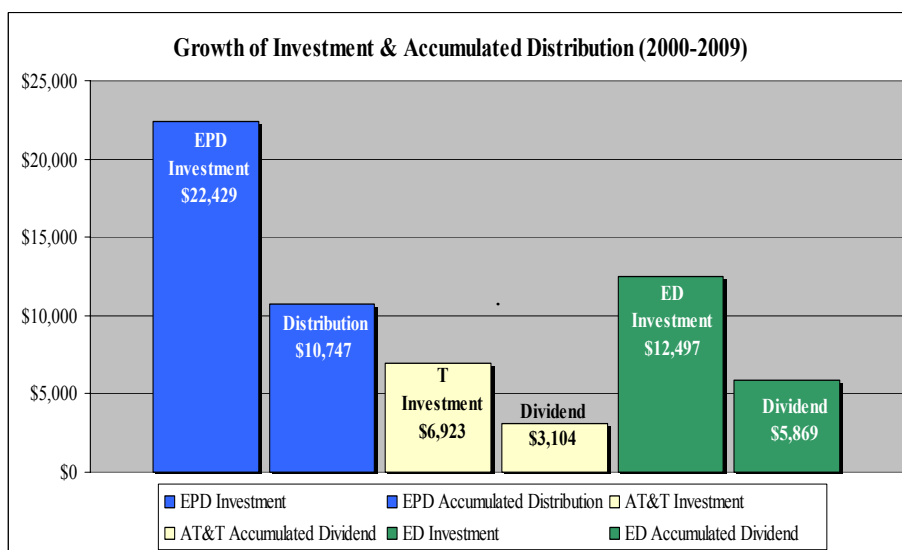
MLPs are Master Limited Partnerships that are publicly traded on the New York Stock Exchange, the American Stock Exchange and NASDAQ, the same exchanges where stocks are traded, and most are highly liquid. Most MLPs hold and operate assets related to the transportation and storage of oil and natural gas. There is little exposure to commodity prices for these mid-stream MLPs as revenues are derived primarily from the volume of products shipped or stored under long-term contracts.

### Why Choose Beacon Street Capital?

Beacon Street specializes in generating income solutions for its high-net-worth clients through separately managed accounts. Beacon Street managers put their own capital into the same strategies, thus sharing the same risks and rewards. As a result, Beacon Street managers stay highly focused on making their strategies successful.

### Why Choose MLPs

- **Tax Deferred High Income & Capital Gains:** MLPs provide a high level of tax-deferred current income and the growth potential of equities that in many cases are significantly greater than alternatives such as REITs, utilities and dividend oriented stocks. This makes MLPs an important part of the income-generating objectives of Beacon Street. MLPs have stable cash flows which are distributed to investors and which have the potential to grow each year. This growth in distributions over time has a positive impact on unit prices as the chart below shows.



*Note:* This compares the growth of a \$10,000 investment, and its accumulated distribution, in Enterprise Product Partners (“EPD”, an MLP) against AT&T (“T”) a typical blue-chip, high yielding stock and Consolidated Edison (“ED”) a premier utility stock.

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➤ **Excellent Alternative to REITs, Utilities and Fixed Income Investments:** MLPs act as a “toll road” between the exploration phase and the consumption of energy. In this manner they act as a utility, but unlike utilities their revenues are market-based and mostly unregulated. MLP cash flows grow as they build new projects or acquire infrastructure from oil producers who wish to divest themselves of these assets in order to raise capital for new exploration and development opportunities. In addition, MLPs pay no tax at the corporate level which increases their net cash flow available to shareholders. Consequently, MLPs as a group have recently been one of the best performing US equity segments. Cash distributions, fueled in many cases by annual increases in distributions, have also been among the highest for any group. Yields have been as much as 3% over 10-year Treasuries and on par with Baa/BBB Corporate bonds. *Bonds offer no prospects for increased coupons and little prospect for growth, whereas MLPs offer both with low volatility and tax advantages.*

➤ **Less Volatility:** MLPs may be less sensitive to rising interest rates than other high-yielding investments, like junk bonds and REITs. Their increasing distributions, which have been growing on average by about 4-6% per year, can offset weakness from rising interest rates.

➤ **Decreased Portfolio Risk:** MLPs provide good portfolio diversification due to their low correlation to most asset classes. The correlation between MLPs and the broader stock market, the U.S. Dollar, U.S. Treasuries and oil prices has been below 0.50 for the past 8 years.

➤ **Estate Planning:** An MLP investment can be used as a vehicle for estate planning. When an MLP unit-holder dies and the ownership is transferred to an heir, the cost basis is reset to the market price on the transfer date, eliminating any accrued tax liability caused by return-of-capital nature of the cash distributions.

## CASH FLOW VS INCOME EARNED

With MLPs income is reduced by non-cash expenses, such as the depletion of natural resources and the depreciation associated with the cost of a long-term asset like a pipeline, over the asset’s useful life. However, these types of assets require little

maintenance and do not deteriorate rapidly; therefore an MLP can distribute a very high level of its cash flow to shareholders without diminishing the long-term basic earning power of the business. This makes MLPs unique from traditional corporations that must grow by replacing short-lived assets and improving technology, which leaves little cash flow left over for distribution to shareholders. For this reason MLPs are valued based on their available and distributable cash flow and not on the accounting calculation of earnings.

## TAXED DEFERRED INCOME

MLP investors enjoy a deferral of taxes on the majority of cash distribution paid to them (usually about 90%) due to the high depreciation expenses and special credits and deductions available to the energy industry. As a result the cash distributions are generally treated as a return-of-capital for tax purposes. The deferred amount is then subtracted from the LP unit-holder’s cost basis and is not realized as income until the unit is sold. When the unit is sold the difference between the original cost and the adjusted basis would be recovered as ordinary income and any market gain would be taxed as capital gains (see “Example of Tax Deferral” on page 3). The paper “losses” reported annually from each MLP may be carried forward to offset much of any potential ordinary income. This is reported to the unit-holder on a Schedule K-1 from the MLP.

Any annual reported losses are considered passive losses for tax purposes, and are not deductible from other ordinary income. These losses can only be used to offset any future income on the specific MLP which generated the losses. Losses may not be aggregated among a group of MLPs, and investors may be required to file state income tax returns in states where the MLPs do business if there is significant positive “ordinary income.” *It is important that investors seek the expertise of their personal tax advisors regarding the specific tax features and potential benefits from these types of investments.*

While MLPs may be held in IRAs and other non-taxable accounts they are typically not efficient for investments over \$5 million because if, in the aggregate, they generate over \$1,000 in unrelated business taxable income (UBTI), the amount above \$1,000 is subject to taxes. *Once again, investors should speak to their own personal tax advisors for any tax-related questions.*

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## EXAMPLE OF TAX DEFERRAL

If a unit-holder receives \$1 in distributions in a given year on a unit for which they paid \$20, generally only about \$0.10 would be considered regular taxable income. The remaining \$0.90 is return-of-capital and is subtracted from the original unit cost basis to get the adjusted basis. Taxes are not paid until the unit is actually sold, at which time tax is due on the difference between the original cost basis and adjusted basis. An example using a \$20 unit cost, an initial yield of 5% and assuming an 8% growth in cash distributions is shown below.

In addition, the taxable gain of \$8.87 when the unit is sold in Year 2 is taxed at 2 different rates. The gain on the difference between the sale price and the initial cost (\$27-\$20 = \$7.00) is taxed at the capital gains rate. However, the \$1.87 balance is taxed as ordinary income.

	Year 1	Year 2
<b>Cost Basis</b>	\$20.00	\$19.10
<b>Cash Distribution</b>	\$1.00	\$1.08
<b>Yield</b>	5%	5.4%
<b>10% Taxable Income</b>	\$0.10	\$0.11
<b>90% Tax-Deferred Income</b>	\$0.90	\$0.97
<b>Tax-Deferred Yield</b>	4.5%	4.85%
<b>Adjusted Basis</b>	\$19.10	\$18.13
<b>Sales Price</b>	-0-	\$27.00
<b>Taxable Gain</b>	-0-	\$8.87
<b>Amt. Taxed as Capital Gain</b>		\$7.00
<b>Amt. Taxed as Ordinary Income</b>		\$1.87

*Note: State taxes may apply and are not included in this example. The information and analysis contained herein are not intended as tax, legal or investment advice and may not be suitable for your specific circumstances; accordingly, you should consult your own tax, legal investment or other advisors, at both the outset of any transaction and on an on-going basis, to determine such suitability. Any investment returns, past, hypothetical or otherwise, is not indicative of future performance.*

## SUMMARY

### The Objective

Create a high yielding portfolio of best-of-breed MLPs with strong prospects for growth of tax-deferred income.

### The Strategy

Focus on the mid-stream portion of the energy sector which consists of transportation, processing and storage. These businesses do not pay corporate taxes so there is more cash flow available to distribute to investors. Revenues are more stable due to long-term contracts and costs are less influenced by energy price fluctuations. This provides investors with steady and predictable cash flows that can produce higher yields and greater growth in income and capital gains than alternative investments.

### The Future

The MLP sector market cap was over \$200 billion at the end of 2010 and is expected to grow significantly before the end of this decade. The MLP sector could be on a similar trajectory to REITs in the late 1980s due to the strong need for energy infrastructure investment. Currently fewer than 10% of institutional investors own MLP assets giving them plenty of room to grow.

## A PERSONAL APPROACH TO INVESTMENT MANAGEMENT & WEALTH ACCUMULATION

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