Inside First Trust ETFs
July 2012 ■ Vol. 9

Does Your Energy Infrastructure Fund Suffer From (Tax) Leakage?

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Energy master limited partnerships (MLPs) offer a compelling long-term investment thesis, in my opinion, while providing attractive levels of income for investors, many of whom have become dissatisfied with the paltry yields offered by traditional fixed income investments. As a result, exchange-traded funds and mutual funds that invest in MLPs have seen strong inflows over the past few years. However, due to specific rules related to the use of MLPs in ETFs and mutual funds, many investors have also been saddled with a significant tax burden, even if the funds are held in tax-deferred retirement accounts. In this newsletter, we'll summarize why many MLP funds are subject to this additional layer of taxes, and discuss how the First Trust North American Energy Infrastructure ETF (EMLP) avoids this tax burden, while investing in MLPs and other energy infrastructure companies.

Why Energy Infrastructure?

Energy infrastructure plays an essential role in fueling economic growth and stability throughout the world. In recent years, technological breakthroughs related to the production of oil and natural gas have created substantial increases to the supply of these fossil fuels in North America. Oil and natural gas deposits found in shale formations, which were once thought to be economically unrecoverable, have been unlocked by new production techniques involving hydraulic fracturing and horizontal drilling.

With this new supply comes increased demand for transportation of oil and natural gas via energy pipelines. Companies that manage and operate pipeline assets collect "tolls" as fossil fuels flow through them, creating a recurring stream of cash flows tied more closely to levels of fossil fuel consumption than price fluctuations. For investors in MLPs and other energy infrastructure companies, this has resulted in a steadily growing stream of distributed income over the past decade.

The potential benefits of MLP ETFs and mutual funds

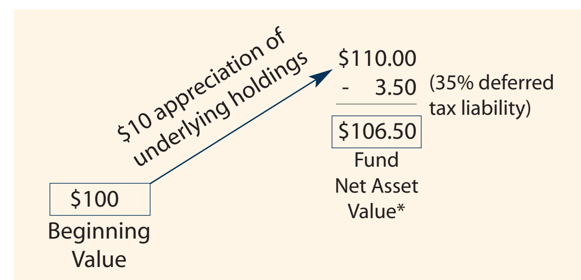
There are certain tax advantages enjoyed by companies that are structured as MLPs versus traditional "C" corporations that have contributed to their popularity in providing exposure to the assets described above. For example, unlike most corporations, MLP earnings are not subject to federal corporate income tax, currently at a maximum rate of 35% (assuming continuing compliance with applicable tax regulations). Additionally, a large portion of the distributions paid out by energy MLPs are classified as tax-deferred "returns of capital". These benefits have had a significant impact on the price investors are willing to pay for MLPs, which generally trade at premium valuations to "non-MLP" energy infrastructure companies.

However, with these benefits come additional administrative and tax considerations, which have discouraged many potential investors from allocating funds directly to MLPs. For example, rather than issuing a form 1099, MLPs must issue a schedule K-1 for each state in which income is earned, requiring more complicated personal income tax filings for investors. Also, a portion of MLP distributions may be classified as "unrelated business taxable income" (UBTI) for which there are limits if the MLP is held in retirement accounts.

For investors unwilling to accept the burden of these additional considerations, MLP ETFs and mutual funds have been a popular option. Instead of issuing multiple schedule K-1s, these funds simplify investors' tax filings by issuing a single form 1099. Additionally, investors in MLP ETFs and mutual funds are not subject to unrelated business income tax on mutual fund distributions, unlike investors in individual MLPs. However, there is a steep cost for the convenience of "pure play" MLP funds that must not be overlooked.

The hidden tax burden for MLP ETFs and mutual funds

Most mutual funds and ETFs are structured as "regulated investment companies" (RICs), which are exempt from corporate income tax. In order to qualify as a RIC, there are certain requirements that a fund must meet. One such rule limits ETFs and mutual funds from investing more than 25% of the fund's portfolio in MLPs. If an ETF or mutual fund exceeds that threshold as a "pure play" MLP fund, it does not qualify as a RIC, and is therefore subject to corporate income tax. Unlike most taxes paid by ETF and mutual fund investors, however, this tax liability often goes unnoticed because it is deducted in the daily calculation of a fund's daily net asset value.



*Excluding additional fees and expenses, which would further reduce the fund's NAV.
Past performance is not a guarantee of future results and there is no assurance that the above mentioned events or improvements will continue.
The information contained herein does not constitute tax advice. Please consult your tax advisor for specific information about your tax situation.

In case you missed the significance of this additional layer of taxes, a hypothetical example may help illustrate. Let's assume a "non-RIC" MLP mutual fund or ETF made an initial $100 investment in a portfolio of MLPs, which later appreciated to $110 (see diagram above). In the daily calculation of the fund's net asset value (NAV), the $10 unrealized gain is reduced by a deferred tax liability of 35% (or in this case, $3.50). This results in a $106.50 NAV, rather than the $110 NAV one would expect in a "RIC-eligible" mutual fund or ETF.* This tax hurdle must be overcome in order to simply match the performance of an MLP benchmark index, which explains why very few fund managers have been able to do so over the past several years.

Of course, corporate tax liability is a known element that is embedded in the price of most stocks, as taxes provide the same sort of drag on the earnings of individual companies. The difference when it comes to "non-RIC" MLP ETFs and mutual funds, however, is that the market value of the underlying MLPs does not generally reflect the embedded tax drag investors are saddled with as owners of the fund. Instead, fund investors effectively pay a premium for the tax-advantaged income generated by MLPs, without realizing the benefits, which are offset by the fund's tax liability as a corporation.

The First Trust North American Energy Infrastructure Fund (EMLP)

We believe that the First Trust North American Energy Infrastructure Fund (EMLP) offers a compelling option for investors seeking to gain exposure to MLPs and other high-payout energy infrastructure companies. Importantly, unlike "pure play" MLP funds, EMLP maintains RIC-eligibility, limiting direct MLP exposure to less than 25%. **As a result, the fund is exempt from corporate income tax, unlike "non-RIC" MLP funds, as discussed above.** In addition to direct exposure to MLPs, the fund's investments may include MLP affiliates, Canadian income trusts and their successor companies, pipeline companies, utilities, and other companies that derive at least 50% of their revenues from energy infrastructure assets. Additionally, unlike passive index-tracking approaches, EMLP is an actively-managed ETF that draws on the knowledge and expertise of the fund's portfolio manager, Energy Income Partners (EIP), a proven asset manager that specializes in MLPs and other high-payout energy infrastructure companies. As the demand to transport fossil fuels across North America remains strong for the foreseeable future, we believe energy infrastructure investors are well-positioned for long-term capital appreciation along with a growing stream of income for years to come.

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RISKS

The fund's shares will change in value, and you could lose money by investing in the fund. One of the principal risks of investing in the fund is market risk. Market risk is the risk that a particular stock owned by the fund, fund shares or stocks in general may fall in value.

The fund may not be fully invested at times. The fund may invest in foreign, small capitalization and mid capitalization companies. Such companies may experience greater price volatility than larger, more established companies.

Investors buying or selling fund shares on the secondary market may incur customary brokerage commissions. Investors who sell fund shares may receive less than the share's net asset value. Shares may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from the fund by authorized participants, in very large creation/redemption units.

You should be aware that an investment that is concentrated in stocks in the energy sector involves additional risks, including limited diversification. The companies engaged in the energy sector, which includes MLPs and utilities companies, are subject to certain risks, including price and supply fluctuations caused by international politics, energy conservation, taxes, price controls, and other regulatory policies of various governments.

Energy infrastructure companies may be directly affected by energy commodity prices, especially those companies which own the underlying energy commodity. Commodity prices fluctuate for several reasons, including changes in market conditions, demand, levels of production, energy conservation, governmental regulation and the availability of transportation systems. A decrease in the production or availability of commodities or a decrease in the volume of such commodities available for transportation, processing, storage or distribution may adversely impact the financial performance of energy infrastructure companies.

The fund may be subject to additional risks pertaining to currency, interest rates and derivatives.

The fund invests in securities of companies headquartered or incorporated in the United States and Canada. The portfolio may present more risks than a portfolio which is broadly diversified over several regions.

The fund is classified as "non-diversified." A non-diversified fund generally may invest a larger percentage of its assets in the securities of a smaller number of issuers. As a result, the fund may be more susceptible to the risks associated with these particular companies, or to a single economic, political or regulatory occurrence affecting these companies.

The fund is subject to management risk because it is an actively managed portfolio. In managing the fund's investment portfolio, the sub-advisor (EIP) will apply investment techniques and risk analyses that may not have the desired result. There can be no guarantee that the fund will meet its investment objective.

You should consider a fund's investment objectives, risks, and charges and expenses carefully before investing. Contact First Trust Portfolios L.P. at 1-800-621-1675 or visit www.ftportfolios.com to obtain a prospectus or summary prospectus which contains this and other information about a fund. The prospectus or summary prospectus should be read carefully before investing.

Not FDIC Insured • Not Bank Guaranteed • May Lose Value