The Secret of K-1 Dividends

How to Earn 15% a Year from an Obscure Tax Loophole

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In 1986, Tom Boyd and his wife moved to Oxnard, California, to be closer to the ocean.

Tom was 50 years old. He'd just quit his job at Chrysler in Indiana, where he'd spent 17 years working as a tooling engineer in a factory. His kids had moved away from home. Tom was ready for a new life.

That's when the million-dollar business idea struck him...

A friend had mentioned that Texas would soon be celebrating the 150-year anniversary of the Battle of the Alamo. Boyd's idea was a candy box in the shape of Texas, decorated with a map of the state and its major landmarks.

Boyd built a prototype, found a sales representative, and started selling his candy box in airport gift stores. The candy box generated strong sales.

There are 49 other states with airport gift shops. Boyd started producing candy boxes for the other states, starting with California. To make a candy box, you need a mould. Moulds are expensive – $1,500 each. That's an upfront cost. If customers decide they don't like the prototype, you've wasted $1,500.

Boyd needed financial help. The banks wouldn't lend him money... he had no track record. So Boyd looked for a partner. One day he went to the local community college to polish his Texas prototype. He met a welder there. The business idea impressed the welder. The welder invested $13,000 in the California box in exchange for 45% of the net earnings of the box.

Lawyers call this arrangement a "partnership." There's no corporation, no stock, no dividends, and no taxes. It's just two men in business together. The profits from the business flowed straight into their bank accounts. Then they paid tax on their annual incomes, like everyone else.

Today, we're investing in a basket of partnerships. *These partnerships do not pay any taxes, and their profits flow straight into our brokerage accounts*. I call the dividends these businesses produce "K-1 dividends." As I'll show you, the yields from K-1 dividends are much higher than yields on investments of similar risk...

How to Buy 45% of Snow White

Tom's California candy box turned out to be a hit. He started producing the candy boxes in his garage, then moved to occupy 1,200 square feet in the corner of a factory. Then, he got his own 3,000-square-foot space. And that's when he contacted Disney...

Tom sent a rep to Disney World with a picture of a candy box with Mickey Mouse's face on the lid. Disney loved it.

"That's when things got crazy," Tom recalls, "because they also wanted Daisy Duck, Bambi, Cinderella, Lady and the Tramp, and Roger Rabbit."

Boyd named his business States Plastics Inc. After Disney signed the contract, Boyd moved into his own 20,000-square-foot factory.

The Disney boxes had four-color art. Printing costs were $15,000 for the design. Boyd needed more money. He replicated the welder's partnership deal with other investors. He ended up raising $1.5 million with dozens of these partnership deals.

"It really turned investors on that they owned 45% of Snow White or Bambi," he says.

Partnerships Let You Avoid Tax

I found Tom Boyd's story in a 1989 issue of *Inc.* magazine. The column is about the benefits and drawbacks of limited partnerships. No taxes is the benefit of the limited partnership.

One of the secrets of income investing is avoiding tax. When you avoid tax, you generate higher returns without taking on more risk. Consider what an efficient income investment Tom's candy box was for the welder and the other partners. The profits from this business flowed straight through to their bank accounts as if they were working right alongside Tom Boyd in his factory. They paid no tax along the way.

If they'd made the same investments in a candy-box corporation, they wouldn't have received a penny until after the government had taken a 35% corporation tax from the profits. Then the government would tax their dividends again... at the 15% dividend rate... when they filed their income taxes.

As I said, this month we're investing in these high-yielding partnerships. I expect our overall returns from K-1 securities will trounce returns from the S&P 500, as well as other popular income investments, including real estate investment trusts (REITs) and utilities...

The Incredible Advantage of K-1 Dividends

In 1986, the U.S. government created a tax loophole for a handful of special businesses. (It's in Section 7704 of the Internal Revenue Code).

The government wanted to give these businesses a big incentive to expand the national infrastructure... so it let them structure themselves as partnerships instead of corporations even though they traded on the stock market.

In essence, it gave them an incredible advantage: *They don't have to pay tax*. These partnerships simply have to return all their earnings back to the partners every year, just like Boyd's candy-box business.

Today, 88 businesses qualify for this exemption under the government's rules. They are all publicly traded investments. The government calls these stocks "master limited partnerships" (MLPs) or "publicly traded partnerships" (PTPs) to distinguish them from private partnerships like States Plastic. MLPs call their owners "unit holders."

You likely know several MLPs already. We have AmeriGas Partners in our portfolio now. Kinder Morgan used to be part of Enron. And though you've probably heard of Blackstone Group and its private-equity operations, you may not know Blackstone is also structured as an MLP.

I call the distributions from these companies K-1 dividends because partnership investors must fill out a K-1 tax form to declare their partnership income. (Don't worry – with the investment I've found, you won't have to fill out the K-1 form.)

Pipelines Are Cash Cows

To qualify for MLP status, a business must generate 90% of its income from interest, dividends, real estate rents, or natural-resource activities. Eighty-five percent of MLPs are in the energy business. Two-thirds of these energy companies operate pipelines. The rest run miscellaneous "midstream" energy businesses – things like refining, compressing, pumping, and field gathering. Only 15% of MLPs are outside the energy sector.

Notice how pipeline businesses dominate the MLP sector. Did you know investment bankers value pipeline businesses as if they were bonds? That's because pipelines crank out such consistent earnings, they take on the characteristics of bond investments. It's why interest rates are the biggest factor in the price movements of pipeline investments. The consistent earnings profile of pipeline businesses puts them in competition with interest-rate products, such as bonds, money markets, and CDs.

Pipeline businesses are the perfect vehicle for partnership structure. They require little ongoing investment. They assume no commodity price risks, and they have no way to grow. They simply crank out earnings month after month for decades at a stretch. And because gas pipelines are so important to the economy, the government uses the huge tax break to make sure they receive plenty of investor money.

It's the exact same story with real estate rental businesses. They receive rent every month like clockwork... and apart from the occasional coat of paint or broken pipe, they require no major ongoing investment.

Timber fits, too. Trees grow at 5% a year. They don't worry about recessions, banking crises, elections, or bull markets. The timber companies harvest their trees using strict forest-management guidelines... and produce consistent dividends at the end of every season.

The MLP sector even includes a cemetery business.

All these "cash cow" businesses make perfect sense for the master limited partnership format. They are immune to recession. And because of their safety, high returns, high yields, and tax advantages, they are the perfect vehicles for generating retirement income.

Let's look at the returns of MLPs over the last 10 years... (As REITs and utilities compete with MLPs for investment dollars, I've included their returns with my analysis.)

Returns Over the Last 10 years (1998-2008)		
	Total Return	**Annualized**
*MLP Index	253%	13.5%
S&P 500	76%	6%
Russell 2000	96%	7%
S&P REIT Index	118%	8%
S&P Utility Index	130%	8.5%

Source: Bloomberg
** MLP return is based on Alerian MLP Index*

Not only do MLPs beat other asset classes in total returns, but they pay consistently higher dividend yields. According to Merrill Lynch's research, REIT dividends have averaged 6.6% over the last 10 years, utility dividends have averaged 4%, but MLP dividends have averaged 7.9%.

I'm always skeptical of investments that have done well in the past. It usually means they're about to turn into dogs. But I think MLPs will keep outperforming the other asset classes... Here's why:

Why MLPs Will Outperfom

MLPs have a huge tax advantage... The population of the United States grows every year. MLPs invest in infrastructure. I'm sure America will use more gas, timber, tombstones, and rental properties in the future.

But Canada's destruction of the income trust structure is the main reason I think MLPs will outperform the market over the next few years.

The income-trust market in Canada is almost identical to the MLP sector in the U.S. They pay no taxes, distribute all their earnings in dividends, and operate mostly in the commodity and energy sectors.

In other words, Canadian income trusts compete directly with MLPs for investment.

On October 31, 2006, the Canadian government changed the law. It ended the income-trust structure. Existing trusts have until 2011 to convert back to corporations and begin paying corporate taxes again.

MLPs are the perfect substitute. Millions of income investors, pension funds, retirees, and other dividend hogs have enjoyed the high trust dividends over the last 20 years. They will turn their attention to MLPs as the 2011 deadline approaches. (We have five Canadian royalty trusts in the portfolio. Even though they have to start paying tax in three years, they are all paying huge dividends right now and I'm happy to hold them in the meantime.)

REITs also compete with MLPs for investment. REITs are pools of money that generate earnings from investments in real estate. They give the individual investor a way to invest in the United States commercial and residential property markets... through the stock market. As long as REIT companies pay out 90% of their income in the form of dividends to shareholders, the government doesn't tax them, either.

Income investors have had huge success in the REIT sector over the last decade. They earned high dividends from rent and made stock gains as the value of the real estate kept going up.

Now real estate looks like it's entered a bear market. As REIT investors give up on real estate, they may look at the MLP sector. (While the sector in general is poised to decline, I continue to recommend the three REITs in our model portfolio... Dividend Capital Trust, Dividend Capital Total Realty Trust, and Realty Income. I'll cover these positions in the portfolio review...)

The election could provide another boost to the MLP sector. What if Bush's dividend tax cut is not renewed again? It's set to expire in 2010. These tax-free companies will be much more attractive than regular dividend-paying companies if the dividend tax cut isn't renewed. MLP unit prices would jump.

In the past, institutional investors couldn't invest more than 10% of their funds in MLPs. But Congress passed the American Jobs Creation Act in 2004, allowing institutions (including the huge pension funds and mutual funds) to invest up to 25% of their assets in these tax-free companies. The new law is making a big difference...

As it stands, individual investors make up 67% of the shareholders of these special businesses... down from about 70% a year ago. Meanwhile, institutions are injecting cash into the MLP sector through private placements, and turning the ratio around. According to the National Association of Publicly Traded Partnerships, in the first quarter of 2006, these private placements were worth $151 million. They were worth $1.1 billion in the first quarter of 2007.

I expect institutions will continue investing in the MLP sector... and we'll see the split between retail and institutional invert in the coming years as institutions pile in. This will drive up MLP share prices.

If nothing changes, MLPs will keep generating 6.5% dividend yields over the next three years. Add that to 8% industry growth, and we'll make total annual returns of 15% – matching returns of the last 10 years.

But when you take into account the demise of the Canadian income trusts... the bust in the housing sector... and the potential for more tax on dividends if Bush's dividend tax cuts expire... I think there's a possibility we could easily see 25% annual returns.

The Right Way to Buy MLPs

You could invest directly in a series of high-quality MLPs right now and enjoy the healthy returns. But doing so comes with a few disadvantages, instead I've found a better way to invest in MLPs...

This month, I'm recommending Tortoise Energy Capital Corp. (NYSE: TYY).

TYY is a closed-end fund that exists to invest entirely in MLPs. Right now, TYY's portfolio contains 36 MLPs. Of the companies, 75% are either gas or oil pipelines. Here's the breakdown:

Crude/Refined Products Pipelines	50.4%
Natural Gas Pipelines	24.8%
Natural Gas Gathering and Processing	20.7%
Propane Distribution	2.2%
Shipping	1.9%

Right now, Tortoise Energy Capital Corp. pays a 6.5% dividend yield... but 6.5% is really understating things. The reality is, these dividends are constantly growing. TYY is only two and a half years old... but it has increased its dividend every quarter since inception. At its initial public offering, TYY shares sold for $25. The fund has already paid out $3.71 in dividends. But look how fast the dividend payment has risen:

YEAR 1	$1.31
YEAR 2	$1.58
YEAR 3*	82.5¢

** Represents only two fiscal quarters*

I expect the full Year 3 dividend will equal $1.67. That's a 6% increase over Year 2's payout. If the dividend keeps growing at 6%, the next three years will look like this:

	Estimated Dividend	Yield On Today's Share Price
YEAR 1	$1.73	6.9%
YEAR 2	$1.83	7.3%
YEAR 3	$1.94	7.8%

Tortoise Energy Capital Corp. is one of four closed-end funds managed by Tortoise Capital Advisors – which manages more than $2.9 billion in assets and opened for business in 2002.

The fund we're buying today – TYY – has total assets of $935 million. The managers of this fund have nearly 100 years combined of investment experience. According to its legal documents, TYY must invest at least 80% of its funds in MLPs. It may not sell short or put more than 15% of its funds in any one issue.

Why the Tortoise Fund Is Better than Individual MLPs

Like I said, you could invest in MLPs directly, but four factors make Tortoise Energy Capital Corp. a much better option.

The first reason is simplicity...

When you buy MLPs, you must file a K-1 form at tax time. Each MLP you buy comes with its own K-1. I don't want the hassle of dealing with these, and I doubt you do either (especially if you own more than a few).

With TYY, the fund owns the MLPs, so it deals with all the K-1s. It receives all the earnings from its partnerships and simply pays us a dividend every quarter. At tax time, it sends us the standard 1099 dividend form.

But you still keep most of the tax benefit. You see, the government only considers 40% of the payout as dividend income. The government deems the rest a *tax-free return of capital*.

The government taxes dividend income the year you receive it. It charges you 15%. But it treats return of capital as if you've received some of your investment back. And the government doesn't tax this. Therefore, *the government won't tax 60% of the income you receive from Tortoise*. There is one exception in cases where your dividend exceeds the cost of your initial investment.

If you have questions about the tax treatment of Tortoise's dividends, please ask your tax advisor.

The second reason I prefer TYY: It's the cheapest way to buy these MLPs...

I wrote about closed-end funds like TYY in last month's *12% Letter*.

In short, a closed-end fund is a collection of assets that trade on the stock market. When the assets held by the fund are attractive to investors, the stock price of the fund can trade at a premium to the value of the assets in the fund, the so-called net asset value (NAV). When investors lose interest, the opposite happens. The price of the fund trades at a discount to the value of the assets it holds.

This is the case with TYY. The NAV of the MLPs in Tortoise Energy Capital is $27.75 per share. We can buy a share for $25.25. In other words, **we can buy the MLPs in the fund at a 9% discount to their actual market values**.

Tortoise Energy Capital's third advantage: It can invest in deals that the average investor (you and I) can't. TYY can invest in IPOs, private deals, and with individuals or smaller companies that haven't gone public but still have pipelines or other assets that are bringing in royalties. These special deals often have higher payouts than publicly traded companies.

As individual investors, we'd never be able to invest in these situations. Tortoise Energy Capital may invest up to 50% of its capital in restricted securities and 5% of its capital in private company investments. Right now, 99% of the fund's capital is invested in MLPs.

Tortoise Energy Capital's fourth advantage is leverage. TYY can borrow money at 5.5% and increase our returns by investing this money in MLPs that pay 6.5% dividend yields. Right now, TYY uses 35% leverage.

Now Is the Time to Buy

Dividend yield is the best way to value TYY as it pays out almost all of its earnings as dividends. Since it began trading in 2005, the dividend yield has ranged between 4.75% and 6.5%.

Even though TYY's pipeline investments have low competition, are immune from oil and gas price fluctuations, transport an essential product around the country, and increase their dividends every quarter, investors see TYY as an income play. And over the past six months, investors have obliterated the income sector of the stock market. These declines have nothing to do with TYY's operations or business prospects. They are a function of indiscriminate investors.

TYY has fallen 22% in the last nine months from its all-time high... its yield has risen to 6.5%... and we can now buy in just above the 2005 IPO price of $25.

With the discount to NAV, the recent price decline, and the approaching exodus of capital from the Canadian income trust sector, TYY looks like a fantastic opportunity at these prices. I think we'll make 15% returns on our money if things stay the same. That's in line with returns from the MLP sector over the last decade. If institutional ownership of MLPs increases or if politicians increase the dividend taxes, we could see much higher returns, maybe 25% a year...

Action to take: Buy Tortoise Energy Capital Corp. (NYSE: TYY). Tax-free pipeline businesses are fantastic retirement investments. I'd like to hold this one forever. I expect TYY to remain a buy as long as it yields over 6%...

Where to Be Invested Now

I wouldn't be doing my job if I weren't looking at the financials right now...

Citigroup has a 4.7% yield, despite cutting its dividend by 40% this morning. Bank of America pays 6.5%. Wachovia pays 7%. These are the highest yields in a generation for the bank stocks. I expect we'll see more dividend cuts in the weeks ahead from banking stocks...

Citigroup is down more than 50%. The financial ETFs are down anywhere from 20% to 35%. The Fed will cut rates again. The politicians are calling for action. An election is approaching. They'll push billions of dollars into the markets and make sure the banks have unlimited access to money. Banks thrive in these conditions.

In my view, the correction has run its course. But I won't recommend financial stocks until I see the makings of a new uptrend. We must be disciplined here. When the time comes, I intend to fill our portfolio with these financial stocks. Until then... we have plenty of other income stocks to buy right now.

Realty Income Corp. (NYSE: O) is probably the best long-term dividend stock I know. But its stock has fallen 25% since November on worries that its largest customer may go bankrupt... and general market anxiety toward finance and real estate stocks.

I'm not worried about this at all. If you haven't purchased Realty Income yet, you now have an excellent opportunity to get one of the world's great dividend payers at a bargain price.

Realty Income operates for the benefit of the small shareholder. Its managers run a simple business and pay out dividends every month.

In fact, dividends are so important to the corporate philosophy of this company, they now call themselves "the Monthly Dividend Company." This name is a registered trademark. Whenever this company makes a business decision, the first question it asks is, "Will this action improve our dividend payout." If the answer is "no," it doesn't do it.

Over the last 38 years, the Monthly Dividend Company has made 450 consecutive monthly dividend payments. It's raised this dividend for 41 consecutive quarters... including five dividend raises in 2007.

I covered the MDC's business model in the June 2007 *12% Letter*. Essentially, the MDC is a landlord company. It owns 2,250 properties in 48 states, leasing the properties to convenience stores, fast-food restaurants, day-care centers, and auto shops. These businesses are the last to suffer in a recession. Realty Income does not put more than 20% of its portfolio in any single industry or more than 10% of its portfolio in a single retail chain.

Buffet's is the parent company of Old Country Buffet and Ryan's restaurant chains – and MDC's largest customer. On January 4, Buffet's defaulted on its debt.

Realty Income purchased 144 of Buffet's restaurants in 2006. These locations represent about 6% of Realty Income's total real estate portfolio. They are Buffet's best restaurants... and will be the last restaurants to close down if the company goes bankrupt.

Realty Income looks at every location it buys as a separate investment... and it has the strictest underwriting codes in the industry. Since 1970, it has collected more than 98% of the original contractual rent obligations on its properties. So even if Buffet's does go bankrupt, I bet Realty Icome finds new tenants for these restaurants in no time.

In short, I don't think Buffet's problems will hurt Realty Income's cash flow... and I expect Realty Income will continue raising its dividend each quarter... just like it has for the past 38 years. Right now, Realty Income has a dividend yield of 7.2%. That's the highest it's been in years. **Realty Income is a terrific buy at these levels**.

Our publicly traded REIT – **Dividend Capital Industrial (NYSE: DCT)** – looks like a screaming buy below $9 a share. This is a well-run company with a fantastic collection of warehouse assets in the Midwest. The dividend yield is now 7.2%.

Midwest warehouses are valuable assets to the major retailers and logistics companies. The big retailers set up distribution hubs in the Midwest and use them as platforms for trading on the East Coast. It's why FedEx located in Tennessee, UPS went to Kentucky, and Wal-Mart is based in Arkansas.

With the election approaching, the Fed starting to pump cash into the economy, and short-term interest rates falling, I don't think Midwest warehouse real estate has any downside at these prices. If you buy DCT – our February 2007 pick – below $9, I suspect you'll probably make more than 20% in 2008.

The Canadian natural gas sector is still in a deep recession... and the natural gas plays in our portfolio have all fallen a long way in the past two years. With yields ranging from 8% for the safest play – **AltaGas (TSX: ALA.UN)** – to 15% for the riskiest play – **Trilogy (TSX: TET.UN)** – these natural gas stocks look like fantastic value to me. I expect natural gas to be one of the best-performing commodities of the next five years... and these stocks could rise hundreds of percent, paying out huge dividends all the way. I featured natural gas plays in the November, September, and July issues last year and just released a special report on them, titled *The Best 'Reserve Trust' for American Investors.* All four natural gas stocks remain strong buys.

Finally, **Norbord (TSX: NBD)** is a fantastic investment at these levels. Norbord, which I covered in the December 2007 issue, produces oriented strand board (OSB). OSB is a wood panel used by the housing and construction industry. It's like plywood, only it's about half the cost and much stronger. Supply for OSB is shrinking fast as uncompetitive Canadian producers go bankrupt. Prices for OSB are the lowest they've ever been... as a result of the housing bust.

You might think otherwise, but **we've never had a better time to buy OSB**. When demand comes back, it will create a supply crunch. Norbord is the lowest-cost producer in the world. It pays a 5% dividend yield.