3 High Yield Stocks for Tax Free Dividends

A Special Research Report from **30 Day Dividends**

Investors Alley

Introduction

By Tim Plaehn, editor, *30 Day Dividends*

The Tax Foundation has proclaimed today, April 24 as Tax Freedom Day. That means that, on average, every dollar you have earned in 2015 through today will go to Uncle Sam as your tax payments. For the high tax bracket investor, income taxes can take a huge bite out of realized gains and/or dividend income. There are very few tax advantaged investment products and most come with either severe restrictions on investment amounts or pay very low yields or returns. Master limited partnerships (MLPs) are one class of investment that will pay you a very attractive – 5% to 10% or more – yield that is non-taxable income. With a little bit of knowledge, you can add some MLPs to your investment portfolio, reduce you income tax bite, and move your personal tax freedom date up to an earlier day of the year.

The MLP Quick and Dirty

An MLP is organized as a partnership with limited partner units that trade on a stock exchange. You can buy and sell LP units just like you trade shares of a publicly traded corporation. The MLP business structure is primarily limited to companies operating in the energy and natural resources sectors.

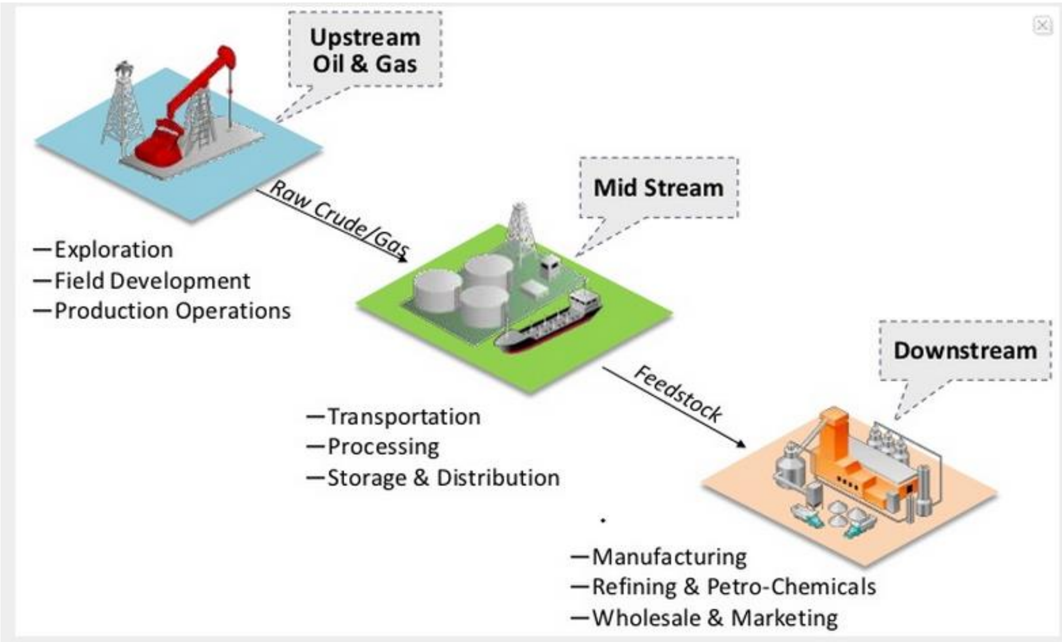
The business operations of an MLP are managed to generate free cash flow, which is paid out to LP unit holders as regular quarterly or monthly distributions, again similar to the dividends paid on corporate shares. The difference is that partnership distributions are classified as non-taxable return of capital. You pay no income tax on the distribution you earn from MLP investments. And many MLPs pay yields well above the typical corporate stock or fully taxable REIT. MLP distributions do reduce your cost basis in the units you purchase, and become ordinary taxable income when your basis reaches zero. This means you can earn 100% of your cost of investing in an MLP before you must pay any taxes on any of the distributions you earned.

As a limited partner in an MLP you will receive an IRS Schedule K-1 that reports your share of partnership profits or losses. The types of businesses engaged in by most MLPs generate large amounts of tax deductible depreciation and other write offs, so in practice it is unlikely you will have taxable K-1 income for years (if ever) after you first invest in an MLP. The bottom line is that MLP units can generate a high, tax-advantaged yield with the only cost is some extra tax reporting paperwork to add the K-1 information when you file your annual tax return.

The Investment Story

Here is a secret that few individual investors realize: Large corporations (like Royal Dutch Shell and Phillips 66), smaller energy companies and private equity firms use the MLP business structure as a way to turn energy sector assets into cash that can be reinvested into other ventures or projects. The owner of MLP qualifying assets organizes and IPO or spin-off of a new MLP to raise cash in the stock market. The sponsor of the MLP sets up the partnership so that it can pay steady and growing distributions to the general partner/sponsor and limited partner unit holders. The partnership agreement is written so that the sponsor benefits highly if the MLP pays a growing distribution stream on the LP units. This means that you as an individual investor can go along for the ride with rich investors and corporations that set up the MLPs to make themselves even richer.

The majority of MLPs provide energy midstream services. These are the gathering, processing, transporting and storage services that are necessary for oil and natural gas to get from the well to the end users. There are also MLPs that operate in the upstream, oil and gas oil well owning sector and the downstream refining and chemicals from natural gas sectors. This chart illustrates the energy sector and where MLPs do business.



Many midstream MLPs manage their operations to pay distributions that increase every quarter. The investment analysis task requires that you determine where an MLP plans to generate its cash flow growth and if that business model can sustain the cash flow growth rate into the future. The next step is to compare current yields with historic and expected distribution growth rate and rank MLPs using a combination of yield vs. growth. With a lower yield, you should expect a higher rate of distribution growth and vice versa.

Both MLP investment funds and individual investors focus their efforts on the large, stable steadily growing MLPs. These partnerships are great for a very steady, predictable combination of yield and growth. The poster child for these popular MLPs is $65 billion market cap Enterprise Products Partners LP (NYSE:EPD). EPD currently yields 4.4% and investors can be assured of realizing 5.5% to 6% distribution growth every year. Enterprise Product Partners is a machine and will never be a disappointment to long term investors. In my MLP research, I search out those MLPs with strong sponsorship where the market has severely undervalued the yield plus growth potential. I want to earn significantly more than the 10% to 12% annual total return that EPD will produce over time. I also want to earn a higher current tax free distribution yield.

On the following pages are three MLPs that my research has culled out from the MLP pack.

Enable Midstream Partners LP (NYSE: ENBL)

Enable Midstream Partners LP (NYSE:ENBL) came to market with an April 2014 IPO. Enable received its assets from two co-sponsor natural gas utility holding companies: OGE Energy (NYSE:OGE) with a $6.5 billion market cap and CenterPoint Energy (NYSE:CNP), $9.2 billion market cap firm. At the IPO the two sponsors retained about 75% ownership in ENBL and the MLP had an initial market cap of $9 billion. The partnership owns pipeline, processing and storage assets to provide midstream services to crude and natural gas well owning producers all the way through to the energy end users.

The initial assets transferred to the MLP included 7,880 miles of interstate gas pipelines and 2,304 miles of intrastate pipelines. Natural gas storage capacity is 86.5 billion cubic feet. The steep drop in the prices of crude oil and natural gas during second half of 2014 caused an across the board sell off in the MLP sector.

From a July 2014 high of $26.75 per unit, ENBL now trades in the low $17 range. Yet ENBL has the sponsor backing to live up to the MLP growth model and the distribution has increased for each of the three quarters since the IPO.

At $17.10 per unit ENBL yields 7.2% and distributions should grow at a 6% annual rate. If crude oil and natural gas prices rise, that growth rate could move up to 10%.

Recommendation: Buy up $17.50 for a 7% yield and growing distribution stream.

Midcoast Energy Partners LP (NYSE: MEP)

Midcoast Energy Partners LP (NYSE:MEP) is the rare story of a new MLP that did not work out as the sponsors initially planned. MEP was spun off in November 2013 to own the natural gas assets of crude oil pipeline focused, $13 billion market cap Enbridge Energy Partners LP (NYSE: EEP). Enbridge Energy Partners is controlled by $43 billion market value, Canadian pipeline company Enbridge Inc. (NYSE:ENB).

By the third quarter of 2014 it became apparent that Midcoast Energy would fall well short of the cash flow forecasts Enbridge had included in the IPO prospectus. The MEP unit price dropped from around $25 to under $12.

Enbridge wasted little time firing the Midcoast CEO, bringing in a new leader, and establishing a new business plan that slashes expenses to get cash flow growth back on track. The market is just starting to see the MEP turn around and the unit price is up to almost $15. Yet the MLP still yields over 9%, distributions should grow by 10% per year this year and next. The goal is 15% annual distribution growth starting in 2017.

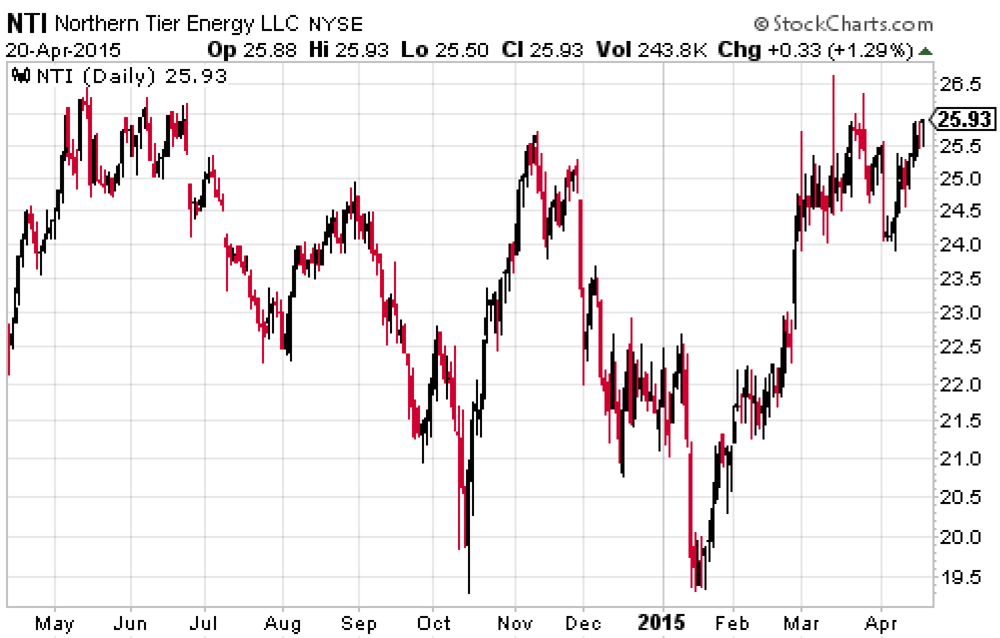
At the downstream end of the energy chain are the crude oil refining companies. Refiners are the sector of the energy companies that have benefited most from lower crude oil prices. Gasoline, diesel and other refined product prices have not declined as much as the price of a barrel of crude and refinery profits are exploding. The small group of refinery MLPs have variable distribution policies with 100% of free cash flow paid out each quarter as distributions to LP investors.

Recommendation: Buy up to $15.50 with a $25.00 target price

Northern Tier Energy LP (NYSE:NTI)

From my research, **Northern Tier Energy LP (NYSE:NTI)** is the best of the downstream MLP choices. The partnership owns a 89,500 bpd refinery located in St. Paul Park, Minnesota. The company also owns the SuperAmerica chain of convenience stores located in Minnesota and Wisconsin. 164 stores are company-owned, with another 79 as franchises. Northern Tier provides basically 100% of the gas and diesel sold by SuperAmerica stores. With its variable distribution policy, the NTI quarterly payments over the last three years have ranged from $0.31 to $1.48 per unit. In the current crude oil and fuels pricing environment, my analysis shows that NTI could easily pay over $4.00 per unit over the next four quarters. The unit price is about $25.

Recommendation: NTI can be accumulated as a long term position when the unit price drops below $23 or traded between the below $23 entry and sell above $28.



All data, including equity prices and yields current as of when this report was published.

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