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Energy Investors: Behold the Miracle of the Tax Law

By Jason Zweig Dec 22, 2017

What a difference a rate makes.

With the signing of the new tax bill into law, the value of some funds investing in energy stocks will go haywire, shooting up by 10% or more.

More than 70 mutual, closed-end and exchange-traded funds, with a combined total of $54 billion in assets, specialize in master limited partnerships that handle oil and natural gas. Many of these MLP funds have long been riddled with tax complexities, turning every dollar of MLP income into 65 cents for their investors. As the tax law shifts, those complexities are changing too — and could take inattentive investors by surprise.

When master limited partnerships became popular about a decade ago for their high income and potential for some growth, marketers hit a roadblock: Rules from the Internal Revenue Service prevent most mutual funds from having more than 25% of net assets in MLPs.

Some clever firms did an end run by stashing MLPs inside funds organized as so-called C corporations. Unlike a "regulated investment company," the IRS term for a conventional mutual fund, a C corporation pays taxes instead of passing them through to its owners.

A fund run as a C corporation can put all its money into MLPs. It holds many energy partnerships in a single convenient package, along with less paperwork than the underlying MLPs spew out.

In return, a C-corp fund passes income through to investors only after it pays taxes on the income (and any capital gains) from its MLP holdings.

As a result, when such a fund holds MLPs worth more than it paid for them, it has to set aside what's called a deferred tax liability — a reserve to cover the taxes it will owe if it sells those assets someday. The higher the corporate tax rate, the more the fund has to designate as a deferred tax liability. That eats into returns.

On the other hand, when the tax rate drops, the fund doesn't need to set as much aside to cover its future IRS bill.

As the new law cuts the corporate rate to 21% from 35%, “that tax drag has been cut almost in half,” says Robert Gordon, a tax strategist and president of Twenty-First Securities in New York.

The lower rate will enable many funds to “look and act more in line with the underlying index they are seeking to track,” says Robert Velotta, a partner at Cohen & Co., an accounting firm in Cleveland, who specializes in fund taxation.

With a stroke of the president’s pen, these funds have become more valuable.

Most are closed-end funds, which generally don’t issue new shares or buy back old ones from investors who want to cash out. Instead, you have to buy or sell the shares on a stock exchange.

“There’s a measurable benefit to be had in these funds, on the order of 5% to 12%,” says Tyson Halsey, head of Income Growth Advisors, an investment-management firm in Charleston, S.C. that specializes in MLPs.

Based on the funds’ reports of their net assets as of Nov. 30, I estimate that the change in tax rates will increase the per-share value of Kayne Anderson Energy Development by 5.2%, ClearBridge Energy MLP Fund and Tortoise MLP Fund by 6.5% each, Kayne Anderson MLP Investment by 10.8% and Tortoise Energy Infrastructure by 11.6%.

With the changes wrought by the tax law making a material difference to the value of the funds, executives can’t comment on my estimates directly. Robert Thummel, a portfolio manager at Tortoise Capital Advisors in Leawood, Kan. tells me that “you are on the right track.” Chris Eades, a portfolio manager at ClearBridge Investments, says he does “not disagree with the math.” A person familiar with the industry says the Kayne Anderson estimates are also plausible.

It’s important to realize that the funds’ market prices have risen in the past few weeks, partly because the oil market has rebounded. New buyers won’t necessarily capture the full pop from the tax change, since the funds’ prices have already gone part-way up.

So far as I can tell, only one traditional mutual fund, Oppenheimer SteelPath MLP Select 40, has a sizeable deferred tax liability — about 3% of net assets as of its last report on May 31.

If you own any of these funds, don’t be fooled into thinking that the managers got an IQ transfusion or that every day will be as lucrative as the day the bill is signed into law.

If you want the income and growth potential MLPs can provide, you’re still better off owning the underlying partnerships or a bunch of them in a separate account rather than a C-corp fund.

Above all, the spike in the value of these funds is a reminder than behind every one-day wonder is an explanation that is anything but miraculous.