Tortoise

Tortoise QuickTake Podcast

August 29, 2017

Welcome to the Tortoise QuickTake podcast. Thank you for joining us. Today, a senior member of Tortoise provides a timely update on trending topics in the market.

Hello, I'm Brad Adams, CEO of the Tortoise closed end funds. Thank you for joining us for our next in a series of QuickTake podcast focused on the closed end fund space. In this podcast, we are going to discuss how tax reform could impact the midstream energy space and our midstream energy closed end funds.

Tax reform appears to be a top priority for some in the Administration and the area where most Administration officials seem to agree, is in a lower corporate tax rate.

So let's consider the implications across the energy sector if corporate rates do decline:

Exploration and production companies have large amounts of deprecation to offset taxable income. Their effective tax rate is low, so, everything else being equal, the impact of lower rates on their value would likely be marginal.

Refiners generally have little depreciation to offset taxable income, and consequently pay near the full corporate rate. They stand to benefit in value by the capitalized amount of the difference between the two rates.

MLPs do not pay taxes at the corporate level, so a change in the corporate tax rate would have no impact.

C-Corp pipelines vary in level of depreciable assets, so effective tax rates paid varies. To the extent a C-Corp pipeline pays a lower amount in taxes due to tax reform, the company benefits in value by the capitalized amount of tax 'savings'.

In the midstream sector, we would not be surprised if MLPs sell off modestly in the short-run following the introduction of tax reforms as investors buy C-Corp pipelines that have more relative value in a lower corporate tax environment. Yet over the long run, the value of MLPs should not change in our view.

Now let's shift to consider the impact to closed end funds that are structured as C-Corps and own MLPs. Closed-end funds structured as C-Corps with deferred tax liabilities would see a lower DTL value in a lower corporate tax environment. The amount of the DTL is reduced by the percentage change in the tax rate.

For example, in TYG, assuming a scenario of a 25% corporate tax (versus the current 35%), the tax rate is reduced by ~29%. The amount of the DTL is also reduced by approximately 29%.

Continuing with our example, if the amount of the DTL is $9.00 per share at a 35% tax rate, the amount at a 25% tax rate is approximately $ 6.43, calculated by taking the 25% new tax rate divided by the 35% old tax rate * $9.00). Everything else being equal, this results in a reduced liability and therefore higher NAV by $2.57 per share which is the new DTL per share of $6.43 compared to the old DTL per share of $9.00.

Closed-end funds structured as regulated investment companies or RICs don't have deferred tax liability, so they're not affected in the same manner as C-Corp funds

Of course, this is a hypothetical example to illustrate the impact of DTL to NAV and we are not making a representation of potential tax rate changes until we get further direction from the administration… which the market eagerly awaits!

That concludes our discussion. We hope this has been helpful. We look forward to speaking with you again soon.

Thank you for joining us. And stay tuned for our next cast. Have topics you want covered or other feedback to share? Write us at info@tortoiseinvest.com.

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