Tortoise QuickTake Energy Podcast

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Ed Russell: Hello my name is Ed Russell, Senior Managing Director with Tortoise Capital Advisors. I am joined today by Brian Kessens, Portfolio Manager and Managing Director. We're doing today a special podcast: RIC or C-Corp – Understanding the Differences in Today's Environment. First let me start by saying that typically our podcasts discuss the current energy environment, and are not product specific. This special podcast will focus on product structure available for midstream investors. At Tortoise, we have both C-Corp and registered investment company products in closed-end funds and open-end funds. So we want to talk through the structures and I have a few prepared questions here that I am going to direct to Brian. So Brian, tell me what's the difference between the C-Corp or a RIC structure?

Brian Kessens: Sure, thanks Ed. Mutual funds are typically structured as regulated investment companies, or RICs. As such, they may invest up to 25 percent of their capital in MLPs. In contrast, a fund structured as a taxable C-corporation can invest up to 100 percent of its capital in MLPs.

Though RICs are limited to investing up to 25% in MLPs, the pipeline universe is much larger than just MLPs. Currently there are about 60 companies structured as C-Corps, with a market capitalization of about $500 billion. Some of these companies own or are related to MLPs. For example, some are a general partner to an MLP.

These C-Corps offer the same exposure that MLPs do: long-lived essential assets, fee-based long-term contracts and high barriers to entry. The nature of how they finance new projects is however, different. An MLP generally pays out all of its cash flow to unitholders in the form of a distribution, and finances projects with new equity and debt. Whereas, a C-Corp, while it commonly pays a dividend, typically retains a portion of its cash flow, relying much less on the equity markets for funding. Consequently, the returns of MLPs have a higher income component versus a C-Corp.

Yet while the way they finance projects is different, MLPs and C-Corps are subject to same business fundamentals and are diversified among natural gas, refined product and crude oil long-haul pipelines, and gathering and processing.

A fund structured as a RIC, will generally be 25% MLPs and 75% C-Corps versus a fund structured as a C-Corp that can invest up to 100% in MLPs. Both mutual funds and ETFs are commonly structured as RICs or C-Corps.

Ed Russell: Can you talk a little bit how RICs and C-Corps are taxed, or in some cases not taxed?

Brian Kessens: Sure. RICs are taxed as flow-through entities. They are not generally tax-paying corporations; the flow-through nature allows them to efficiently target both MLPs and the broader pipeline investment universe. The nature of their taxation is that only the investor is taxed. And the nature of taxation in the distribution that the RIC makes during the year could be ordinary income or long- or short-term capital gains.

C-Corps, on the other hand, incur double-taxation. The fund itself is taxed on the income it generates at the C-Corp tax rate, which following the recently passed tax reform, is 21% at the federal level. The investor then incurs additional tax as the nature of the distribution is ordinary income or return of capital. Another consideration is that as a C-Corp, the fund must calculate its NAV assuming the fund was liquidated today. If liquidated today, there is a tax impact. And this impact shows up as a deferred tax liability and the fund has a net capital gain or a deferred tax liability if the fund has a net capital loss. Yet while the deferred taxation calculation impacts the NAV, the actual taxes paid can be deferred for many years.

Ed Russell: Thanks Brian, but that was pretty complicated. Can you walk us through a simple example?

Brian Kessens: Sure, for example, a closed-end fund structured as a C-Corp may have a deferred tax liability that amounts to $5.00 per share. This means that if all the securities in the fund were sold today, the fund would owe $5.00 per share in taxes. The net asset value or the NAV of the fund is lower by this amount. If we never sold any securities, the fund would never pay this tax. How to value this deferred tax liability is subject to much subjectivity, yet it is fair to say it should impact valuation by somewhere between zero and $5.00 per share.

Ed Russell: Okay, thanks. So, investors have a lot of choices today to invest in the midstream space. You've got separately managed accounts, mutual funds, closed-end funds and then, or course, ETFs. Can you talk about the advantages and maybe even the disadvantages of each of those?

Brian Kessens: Sure. We think generally pipeline companies are great investments given how essential they are to our economy and way of life. Further, they benefit from long-term contracts and largely fee-based income. And with growing shale production, there is a need for more pipelines to transport increasing volumes.

We believe that the best way to get exposure to pipelines is through a separately managed account. An SMA provides direct exposure, at the market price. It is active management, you directly benefit from the tax-advantaged nature of MLPs. The downside is MLPs generate K1s which is a tax burden, especially for those that invest smaller sums and may not rely on an outside tax preparer.

For K1 sensitive investors, an open-end or closed-end fund makes sense. If you desire income, closed-end funds generally pay-out all of the cash distributed by its underlying holdings in the form of a dividend. Further, tax reporting is done on a 1099, and not a K1.

For investors that are in a C-Corp and are reinvesting the yield, this may not be the best for them. If an investor is focused on total return and more indifferent to income, open-end funds make sense. We think ones structured as RICs are better since you can buy them at NAV and they're flow-throughs from a tax perspective. And again, no K1, rather you receive a 1099.

If you desire a passive strategy, an ETF or ETN may make sense. Note, there is counterparty risk with an ETN.

Ed Russell: Okay, thanks. So in closing, last question. Why did Tortoise launch their closed-end fund structured as a C-Corp?

Brian Kessens: Prior to launching the first MLP fund in 2004, we evaluated various fund structure alternatives. We determined that a fund that is solely focused on MLPs, and hence a tax-paying entity, is best structured as a closed-end fund. Our conclusion was on several characteristics of a closed-end C-corporation fund:

One, it is a permanent capital vehicle, meaning that it does not have to fund redemptions of shareholder capital.

Secondly, the permanent nature of its capital provides multiple tax-related benefits, including the ability to manage a tax liability through detailed tax planning integrated into the portfolio management process and to take action to maximize tax efficiency without the risk of large inflows or outflows of capital.

And then lastly, it offers liquidity at a market price, as opposed to only net asset value, which will reflect, among other things, the present value of its deferred tax liability we talked about.

Ed Russell: Thank you Brian. And to summarize, we have always felt that the best way for investors to own master limited partnerships is to own them directly in a diversified portfolio. However we understand many clients do not want to own 25-30 MLPs and receive the associated K-1s. So when choosing a managed product that provides tax simplification, you should be aware that there are advantages and disadvantages to each solution. Thank you for joining us today on this special podcast. If you have additional questions you can call us by phone at 888-870-3088 or by email at info@tortoiseinvest.com.

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