Master Limited Partnerships: Paying Other People's Taxes

By David Cay Johnston

David Cay Johnston is a former tax reporter for *The New York Times*. He teaches at Syracuse University College of Law and is the author of two books about taxes, *Free Lunch* and *Perfectly Legal*.

In this column, Johnston reveals how the fine print of a federal regulation forces people to pay the individual income taxes of others and how this policy could easily be expanded to siphon billions of dollars per year from consumers.

Wouldn't it be fantastic if someone else paid your income taxes for you? Imagine all that extra money in your bank account. You could pay off your debts, save, and even splurge.

Of course, for the person who paid your income taxes it would be awful. They would have to pay their own income taxes and then, out of what was left, pay yours.

Congress would never enact such a law, right?

The good news is that Congress has not enacted such a law. The bad news is that buried deep in the fine print of the *Federal Register* is a regulatory rule that has the same effect.

The requirement that forces you to pay the personal income taxes of others applies — for now — only to owners of rate-regulated pipelines organized as master limited partnerships, or MLPs.

It is not surprising if you have never heard about this tax-shifting rule. Unless you dig into the inordinately arcane proceedings of the Federal Energy Regulatory Commission (FERC), a small government agency that wields enormous economic power, you would be in the dark. The commission gets almost no news coverage. The very few, and brief, news reports on the cases related to the MLP charge missed the tax issue.

You would never know from looking at your utility bills and gas station receipts that the federal government has let one type of big business drill a hole in your pocket to collect income taxes, just as when looking across the surface of the planet, you cannot see the rich deposits of oil and natural gas buried under miles of water, soil, and rock. The cost is embedded in the sums your local utility or gas station pays for the natural gas and petroleum delivered via pipeline.

While you may not have heard about MLPs, readers of *Barron's* and other publications for savvy investors have. In approving cover stories, *Barron's* and other investment journals tout MLPs as a way for investors to earn returns of 8 percent or more each year while paying little or no income tax.

In the shadows, business can use government to drill holes into consumer and producer pockets through inflated prices. Now one industry has applied this to taxes. This column casts a focused light on such activity to encourage disclosure, integrity, and fairness in taxation.

If this tax-shifting policy continues unchecked, you can expect one thing: well-funded and determined efforts to expand it to other rate-regulated monopolies. Given the complexity of the issue, hiding the tax shifting would be easy — or at least it would have been until now — by obscuring the issues in an era when few news organizations report on regulations. Pipelines are big, but small-time compared with electric, gas, cable, water utilities, and the railroads. Your interest is too small to put up a fight against this tax shift, but is big enough to encourage owners to ask the government to enable more such tax gouging. Get government to concentrate just a penny a day from every American and you collect a billion dollars annually year after year. You and I probably will not fight against being ripped off for a few bucks a year, but any enterprise will fight for a slice of a billion.

All that is needed to expand this tax shifting is a change in federal law — a change so minor it does not even require a sentence to be added to section 7704 (d)(1)(E), a list of industries that can be owned through publicly traded partnerships without being subject to the corporate income tax. As one lawyer deeply involved in the pipeline case told me: ''The electric utilities would be master limited partnerships now except that when the law was changed, the Edison Electric Institute was uncharacteristically asleep at the switch.''

At the core of the tax issue are two long-standing principles of rate regulation that are fundamental to fairness and integrity. The first is that owners of legal monopolies are entitled to recover all of their costs and earn the return on equity needed to attract capital for their level of risk. The second is that customers can only be charged actual expenses so that regulated prices, called rates, are just and reasonable.

The FERC pipeline policy, and the court decision upholding *FERC*, destroy both of these principles. They don't just harm them, they destroy them, something Judge David Sentelle and two other appeals court judges somehow failed to realize in the specious reasoning they used to justify this tax-shifting outrage in 2007. (For the case, see *ExxonMobil Oil Corp. v. FERC et al.*, 487 F.3d 945, 376 U.S. App. D.C. 259 (D.C. Cir. 2007).)

The tax-shifting issue arises because Congress imposes two levels of taxes on corporate profits, but only one on partnerships. Historically pipelines were organized as corporations. To determine the rates charged to customers, a pipeline includes all of its costs and a rate of

Forcing You to Pay Other's Individual Income Taxes			
Corporate profits are taxed twice, partnership profits only once, yet the government lets pipelines owned by partnerships collect the same tax as corporations. The result: Partnership investors get a 75 percent larger return because you pay the partners' personal income taxes.			
This chart assumes a monopoly pipeline is allowed a 10 percent after-tax return of equity	**Corporation Under Actual Cost Rules at 42.7 Percent**	**Master Limited Partnership Under Actual Cost Rules**	**Master Limited Partnership Under New Fake Tax Rules**
Pre-tax profit Under Government Set Prices	$175	$100	$175
Less 42.7% Corporate Income Tax Paid on Profit	$(75)	$—	$—
Net Pipeline Profit After Taxes	$100	$100	$175
Less Owner's Personal Income Tax at 35 Percent	$(35)	$(35)	$(61)
Owner's After-tax Income	$65	$65	$114
Increase in after-tax income to owner by including fake tax			$49
Percent increase in after-tax income			75%
Source: Calculations by author from Federal District Court of Appeals decision in *BP West Coast Products v. FERC*.			

return set by FERC or, for intrastate pipelines, a state-level regulatory agency. For a traditional corporate-owned pipeline, these costs include the corporate income tax on company profits. However, the income taxes of individual investors have never before counted as a cost of providing service.

The 1986 Tax Reform Act allowed publicly traded partnerships in the pipeline business to escape double taxation even though their shares, called units, trade on the New York Stock Exchange and other bourses just like shares of a corporation. With an MLP, thanks to this law, pipeline profits and losses flow through to the partners, and so does any income tax obligation.

Even though the MLP does not pay the corporate income tax, FERC lets MLP pipelines include income tax in the rates charged to customers. FERC policy assumes the top marginal tax rate. Since the only income tax paid is by individual owners, this means that the rates include the individual income tax the MLP investors owe. In other words, you are forced to pay the income taxes of the MLP investors when you buy natural gas or petroleum products that were transported on such a pipeline.

Just how the income taxes you pay for others are assigned is another matter. But you must pay regardless of how the tax money is divvied up under the agreement between the general partner and the limited partners.

Actually, it is worse than that. The regulatory rule, upheld by the court of appeals, is that you must pay the income taxes of the pipeline partners even if they are only "potential" taxes. No actual income tax need be paid.

What exactly can be just or reasonable about forcing you to pay the income tax of another person who may not even pay tax?

Government regulation of monopolies like pipelines, electric utilities, and railroads is supposed to act as a proxy for the market. But just as a market requires buyers and sellers who are equally informed and are not coerced, regulated pricing requires treating both owners and customers equally. The introduction of MLPs into pipeline ownership created opportunities for the owner side to tilt the economic playing field, and FERC went along, going out of its way to rationalize this unfair tax policy.

Regulatory agencies often become captives of the industries they are supposed to regulate, seeing the world through the eyes of the regulated and blinding themselves to the concerns of customers. This is a natural human tendency, seen also in those journalists who identify with their sources rather than their audience, a now widely recognized problem in Washington coverage.

Judge Sentelle and his colleagues acted like they too have been captured by the pipeline industry, applying faulty reasoning that does not merely damage the just and reasonable standard but destroys it.

The first time the issue arose, in a 2004 case known as *BP West Coast Products*, Judge Sentelle and two other associates stood steadfast for fairness for only including actual taxes in rates (*BP West Coast Products LLC v. FERC et al.*, 374 F.3d 1263, 362 U.S. App. D.C. 438 (D.C. Cir. 2004)).

In *BP West Coast*, Judge Sentelle and his colleagues held that only actual taxes can be included in pipeline rates. FERC had included a 42.7 percent income tax allowance in rates for the SFPP Pipeline, an MLP pipeline whose creation traces back to the Santa Fe railroad rights of way.

"There is no question," Judge Sentelle held in *BP West Coast*, "that as a general proposition a pipeline that pays income taxes is entitled to recover the costs of the taxes paid from its ratepayers." (See *City of Charlottesville v. FERC*, 774 F.2d 1205, 249 U.S. App. D.C. 236. (D.C. Cir. 1985).)

Judge Sentelle walked through the history with nuanced clarity and then walloped FERC: "We cannot conclude that FERC's inclusion of the income tax allowance in SFPP's rates is the product of reasoned decision making."

After hitting FERC with a metaphorical two-by-four, Judge Sentelle made a crucial observation. He quoted FERC's own policy:

> Because the corporate tax is an extra layer of taxation, the Commission includes an element for the corporate taxes in the cost-of-service to ensure that the regulated entity has the opportunity to

earn its allowed return on equity. However, there is no allowance for the taxes paid by the owners of the corporation.

The court held that regulators ''cannot create a phantom tax in order to create an allowance to pass through to the ratepayer'' and that a regulated limited partnership pipeline company cannot be allowed to collect ''for the phantom income taxes it did not pay.''

You would think that would be the end of it. But not when vast sums are at stake.

The math here is stunning. When rates include a tax that does not exist, the investors make out like, well, bandits. Investors in an MLP pocket 75 percent more in after-tax profits than they would if they invested in a traditional corporation owning a pipeline.

You will not find this math in Judge Sentelle's 2007 decision. Had he done the math, would the outcome have been different?

The broad issues here have continued through five administrations, so the makeup of the commissioners is bipartisan. The commissions have always issued decisions that tended to favor owners over consumers, but during the George W. Bush administration things went further.

FERC responded to the 2004 decision not by reopening the formal rate-making process, but by inventing something outside regulatory law. The commission in 2005 called this extraordinary procedure a ''statement of policy.''

Because that statement was not a formal case, it meant that there was no prohibition against lobbyists meeting privately with commissioners. That is, the ex parte rules did not apply. The commission considered four options after *BP West Coast*, including ignoring taxes and what it ultimately did, which was to find that if any tax might be owed by some owner, the maximum tax rate should be included in the authorized rates charged customers.

Judge Sentelle made clear that his panel could have found grounds to reject the new policy, but then he approved it, resting his decision on the thinnest of reeds by finding that FERC ''justified its new policy with reasoning sufficient to survive our review.''

''We hold that the Commission's income tax allowance policy was not arbitrary or capricious or contrary to law,'' the decision stated.

The tax shifted to consumers looks to be as much as $1.6 billion a year for gas pipelines and $1.3 billion more for petroleum pipelines. Industry data show oil pipeline profits are an eye-popping 42 percent of revenues, more than four times the margin for the 12,000 largest corporations.

This estimate has to be heavily hedged because, amazingly, FERC does not issue any statistical reports on either the cost of this tax transfer or of the underlying data from which a solid estimate could easily be calculated. A new law requiring either truth, or at least transparency, in regulations that shift tax burdens would help here, but the Wall Street-friendly Obama administration seems unlikely to take up such a cause.

The commission, at this writing, is conducting an inquiry into the gaps in its natural gas pipeline financial reporting systems, which mix incompatible accounting theories and fail to ask for some basic data. The oil pipeline data reporting is so loosely administered that 1 in 4 pipeline companies evidently does not even file the required annual reports, known by the bizarre name of ''Page 700.'' Maybe someday we can determine just how much is being taken from you to pay the income taxes of individual pipeline investors.

The tax shifting is also inflated by a curious FERC practice. FERC has acknowledged that there is some over-collection by oil pipelines and yet it continues to grant rate hikes based not on costs, but on an index. This only worsens the over-collection from customers. Because there are virtually no added costs, the over-collection is pure profit except for the income tax burden, which is shifted to customers. This forces consumers to pay even more to cover assumed income tax costs even though no taxes may be going to the government. This is neither just nor reasonable and that two branches of government, the executive and the courts, allow this should be investigated by the third branch of our government, Congress.

Whatever the tax-shifting cost, it could easily balloon to much more — well north of a billion dollars per month for customers of utilities and railroads. Adding them to the list of industries eligible to have publicly traded MLPs that are subject to just one tier of tax would force anyone who boils water or drives a car to pay the individual income taxes of a thin slice of wealthy investors. Given the stakes, it is more than reasonable to expect those who want you to pay their income taxes to exploit FERC's ridiculous policy and Judge Sentelle's faulty reasoning to form the basis for expanding the new rules.

The one ray of hope is that the California Public Utilities Commission had a recent case involving the portion of the SFPP that operates within the Golden State. A proposed decision would flatly reject the idea that an untaxed entity can collect income taxes in its rates.

Taxes should not be hidden, as David Ricardo and Adam Smith taught. They should also not be shifted from those who gain to those who are captive customers of monopolies. But the trend in America under both parties is away from markets and toward a subtle expansion of corporate socialism, under which profits are concentrated through government action and losses are socialized through bailouts. Now we have income tax burdens forcibly shifted from the wealthy few to the many through regulation.