Kinder Morgan’s Evolving Tax Strategy

By David Cay Johnston

In the middle of the nationwide rush to escape the corporate income tax by moving C corporation assets into master limited partnerships (MLPs), the company that pioneered the tax strategy is reversing course.

Kinder Morgan Inc. is paying a premium of up to 15.4 percent to holders of two types of MLP units so it can bring their assets into the C corp. entity. In doing so, it offers a textbook example of how government rules position some C corporations to shift their tax burdens onto their investors. (Related coverage: p. 770.)

The reversal is astonishing because the rush into MLPs was started by Richard Kinder, the Kinder Morgan CEO and former president of Enron. In just the last 10 years, Kinder, together with copycats, grew MLP assets tenfold to more than $400 billion. The MLP strategy made Kinder a personal fortune worth nearly $10 billion before he announced his reversal. He found a statutory and regulatory philosopher’s stone that transformed the burden of the corporate income tax. The scheme is worth about $1.4 billion a year to his enterprises, a gain to him that is a deadweight loss to the country.

Why would Kinder Morgan change course and bear the costly burden of double taxation of corporate profits, something economics textbooks rail against? The short answer is that our economics and tax textbooks are as out of date as the original 1771 Encyclopædia Britannica, which lacked entries for “economics” and “tax.”

The corporate income tax — born in 1909 and a robust producer of government revenue for decades — was infected with a host of policy parasites in 1986 and has been getting sicker ever since. For some companies these days, the tax is pretty much optional. Robert Willens, the savvy and independent Wall Street tax strategist, distilled the rationale for moving Kinder Morgan MLP assets into its C corp.: “I am sure they do not expect to pay taxes for 14 years.”

Collapsing the MLPs steps up Kinder Morgan’s basis in their assets, allowing re-depreciation and write-downs of upgrades financed with cheap new debt and equity. “Through a combination of deprecating the stepped-up assets and interest” expenses, the entities duplicate what they had when they were an MLP, which is freedom from taxation of their profits, Willens said.

A Genius Strategy

Kinder’s original insight was that pipelines, as monopolies whose prices are set by regulators, charge customers all reasonable expenses, including income taxes. But utility rates calculate the tax not at statutory rates, but at the grossed-up rates, which would be 54 percent for a 35 percent tax.

Kinder combined this with the 1986 Tax Reform Act, which added section 7704. “A publicly traded partnership shall be treated as a corporation,” it begins. Its real purpose is the opposite. Section 7704(d)(1)(E) exempts energy industry partnerships like pipelines.

That allowed MLPs to flourish, but it is not why they did. The why came during the George H. W. Bush administration when the Federal Energy Regulatory Commission (FERC) let SFPP, a Kinder pipeline, include a 75 percent grossed-up income tax in its rates. British Petroleum and ExxonMobil sued, saying that including a tax that is never remitted to the government violated the just and reasonable doctrine of utility rate setting.

Judge David B. Sentelle, a conservative jurist on the District of Columbia Court of Appeals, killed
the regulation (BP West Coast Products LLC v. FERC, 374 F.3d 1263, 362 U.S. App. D.C. 438 (D.C. Cir. 2004)). “The regulator cannot create a phantom tax to create an allowance to pass through to the rate payer,” he wrote. (Prior analysis: Tax Notes, June 21, 2010, p. 1393.)

By the time Sentelle’s decision came out, another Bush was in the White House and his FERC appointees set out to defeat the ruling. First they invented the “policy statement,” a procedure outside administrative law rules barring ex parte meetings during formal cases. This allowed pipeline lobbyists to meet privately with commissioners and staff, who drafted a new regulation. FERC then announced a formal proceeding, allowing only a few days to file a single 15-page brief with no rebuttals.

The same customers sued again, taking FERC before a three-judge panel headed by Sentelle. His decision made clear he loathed the new regulation. However, because FERC explained its rationale, the regulation was not arbitrary and would stand (ExxonMobil Oil Corp. v. FERC, 487 F.3d 945, 376 U.S. App. D.C. 259 (D.C. Cir. 2007)).

Now Kinder faced a new problem, an economic one stemming from the requirement to pay investors 90 percent of profits. “This company dividends out far more than it actually earns,” said Kevin Kaiser of Hedgeye Risk Management in Stamford, Connecticut, one of the few analysts to dig deeply into MLP finances.

As MLP general partner, Kinder Morgan sweeps tons of cash from the pipelines, including the tax money, according to an analysis of the very obtuse disclosure documents by Gordon Gooch, former general counsel to FERC’s predecessor agency. Stripped of cash, the only way to finance dividends is by raising funds from new investors or taking new loans. Gooch characterizes this as a legal Ponzi scheme — legal because while money from new investors pays dividends to old investors, in between stands an actual profit-making enterprise.

Kinder Morgan projects robust dividend growth and little if any tax bills for the parent C corp. over the next 10 to 14 years because of re-depreciation of the newly stepped-up assets plus interest charge deductions. The company says what drives the deal is not tax, but a much lower cost of capital. If that is true, however, then the deal should not work. Regulators should lower pipeline charges. Kinder Morgan is betting that will not happen.

By folding the MLPs into the C corp., Kinder Morgan will force the unit holders to pay hefty tax bills. For the company to get the stepped-up basis, tax must be paid on the spread between the old and new values. Investors will pay mostly at ordinary income tax rates. Many will pay 39.6 percent because MLPs dividends are largely characterized as tax-free return of capital. Loyal long-term unit holders will get hit hardest.

Kinder will not be so heavily burdened. He owns MLP units, but their value pales compared with his one-fifth stake in the parent C corporation that gets the benefit of the stepped-up basis on the pipeline assets. Kinder takes a salary of $1 per year.

However beneficial the reorganization may be in the long run, the deal strikes me as putting Kinder’s interests ahead of MLP investors, especially those who bought in expecting never to owe a tax on their units and to pass those units on to their heirs with a stepped-up basis.

Larry Pierce, a Kinder Morgan spokesman, said the company wants to focus on the whole deal and not just tax issues. “On average, we believe that [MLP investors] will be substantially better off on both a pretax and an after-tax basis” compared with maintaining the status quo, he said. For that to be true, it must be good for MLP investors to pay a tax bill now to collect larger dividends in the future. Time will tell.

Come 2029 or so, barring a change in the law, the new tax avoidance strategy will have run its course. Then Kinder Morgan shareholders will, at least according to tax textbooks, actually bear the burden of double taxation of corporate profits. As MLP investors understood, deferring a tax bill for life is a smart strategy, one cut short by Richard Kinder’s new tax strategy.