MLP Investors Face Tax Hit On Top of Big Losses

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For some energy investors, there are worse things than going to zero.

A wave of expected bankruptcy filings and debt restructurings could trigger taxes for investors at a number of energy firms, a doubly unpleasant outcome that has companies searching for a fix.

Linn Energy LLC, a Houston-based oil-and-gas producer, is exploring a change to its corporate structure that could shield investors from a tax hit triggered by a likely debt restructuring, according to people familiar with the matter. Distressed peers are watching closely, hoping Linn can provide a blueprint to follow as low oil prices continue to spread pain through their ranks.

The issue stems from the fact that Linn is taxed as a master limited partnership, or MLP, rather than a corporation, a popular arrangement among energy companies when oil prices were soaring.

In good times, that status allowed income to flow straight through to investors without the Internal Revenue Service taking a cut at the corporate level. Linn distributed some billions of dollars of cash to investors as U.S. energy production boomed.

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But the collapse in oil and gas prices has exposed the structure’s double-sided risk: Investors with potentially worthless shares—or units, as they are known—may nonetheless owe taxes on debt that is forgiven in a bankruptcy or an out-of-court restructuring.

That is because MLPs pay no corporate taxes and instead pass certain tax burdens, along with a share of their income, to investors. Debt forgiven in a restructuring counts as noncash income, or "cancellation of debt income," which creates a tax liability for investors without an associated cash distribution.

The roughly 60% plunge in oil prices since the summer of 2014 already has sent a number of energy companies into bankruptcy court, and more are expected to follow. Fitch Ratings expects the default rate for U.S. high-yield energy bonds to rise to 11% by the end of the year, compared with 1.5% for bonds outside the battered energy and metals-and-mining sectors.

A gusher of bankruptcies and debt restructurings could be especially painful for MLP investors, most of whom are individual investors. Big institutions like BlackRock Inc., as well as many endowments and foreign institutions, can't legally own partnership units or don't want to, given their complexity.

Lee Hiller, a retired retail executive in Boca Raton, Fla., invested in four energy MLPs and was happy with the payouts for several years. "The sales literature and much of the press coverage compared them to toll roads and made them seem pretty safe," he said. "Rarely, if ever, was there a discussion of the effect of a major oil-price decline."

Joseph Alfonso, a financial adviser and tax preparer in Portland, Ore., said he has several clients who were sold MLPs by brokers who didn't explain the pitfalls. "They weren't told they were buying a high-risk product with potential tax traps," he said.

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Linn suspended its investor distribution in October as losses mounted, and the company in February said that it tapped Kirkland & Ellis LLP and Lazard Ltd. to help fix its capital structure. It is weighing debt-restructuring options, including a potential bankruptcy filing, according to people familiar with the matter. Equity holders are typically wiped out in bankruptcy.

Investors, meanwhile, are betting the company will repay significantly less than the $10 billion it owes; some of its bonds recently traded for less than five cents on the dollar. Linn's units, trading at $30 apiece two years ago, closed at $1.60 on Wednesday.

Linn advisers are exploring workarounds that could spare investors a big tax bill that would follow a debt reduction, the people said. Among the options being debated is merging Linn with a publicly traded corporate affiliate, LinnCo LLC, or letting investors swap Linn units for LinnCo shares ahead of any restructuring, some of the people said. The corporate entity could shield investors from the tax hit.

The exact mechanics are unclear and are complicated by legal rules around taxes and corporate governance. And there is little precedent; MLPs are a relatively young group of companies, most launched in the past decade, and this crop hasn't weathered a sustained downturn in oil prices.

Linn hopes helping investors sidestep a tax hit could reduce the chance that they will band together and complicate a potential bankruptcy, according to people familiar with the matter.

MLPs proliferated in the latter part of the last decade, driven by two intersecting trends: a surge in U.S. energy production and investor hunger for yield in an era of ultralow interest rates. MLPs sometimes yielded more than 10% a year at a time when Treasury bonds were yielding pennies on the dollar.

Investors have soured on the structure. The Alerian MLP Index, which tracks about 50 large energy partnerships, has lost nearly half its value over the past 18 months. A number of energy MLPs, including Linn, Breitburn Energy Partners LP and Atlas Resource Partners LP, have debt trading at distressed levels.

In an era of low energy prices, the structure may no longer make sense for many companies using it, some advisers said.

The downside extends beyond surprise tax bills. Shunned by institutional investors, MLPs have shallower investor bases, which makes it harder to raise money. Share issuance by oil-exploration partnerships fell 84% last year to a seven-year low, according to data provider Dealogic, compared with a 13% decline for all energy exploration-and-production companies.

And in hard times, there is less upside. Many MLPs have cut or halted cash distributions, the main draw for many investors.

“For some of the more distressed companies, being an MLP just doesn’t make sense anymore,” said Ryan Carney, a lawyer at Vinson & Elkins LLP who focuses on energy partnerships.

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