Investors face unexpected taxes in Kinder Morgan deal

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Investors who thought death would get them before taxes are facing a grim reality in Kinder Morgan's $44 billion deal to combine the pieces of its pipeline empire.

If it goes through - and at least three lawsuits are trying to stop the deal - thousands of individuals and institutions will pay taxes now on gains they thought would be deferred under the company's corporate structure.

For years, investors have piped billions of dollars into Kinder Morgan and other energy transportation companies structured as master limited partnerships - the cash-machine darlings of investors looking for yields higher than on typical bonds in an era of low interest rates.

Master limited partnerships, developed in the 1980s, pay out all of the income that isn't needed for operations to investors called unit-holders. Taxes on the quarterly distributions are deferred until the holder dies or sells the securities - unlike taxes on typical corporate dividends, which are due on each year's tax return.

Kinder Morgan's proposed reorganization will dismantle the MLPs under its corporate umbrella, giving investors in those partnerships a choice of cash payments, shares in the publicly traded corporate parent Kinder Morgan Inc., or a combination. Kinder Morgan Inc. pays taxable dividends.

Four investors have filed separate proposed class action lawsuits in Delaware against Kinder Morgan or one of its affiliates, seeking to include hundreds or thousands of other investors scattered across the United States in an effort to kill the transactions before they close next year. Two of the suits have been consolidated.

Kinder Morgan says it will fight the lawsuits, and that their focus on taxes misses the opportunities for investors to profit in the consolidated company.

Only 8.3 percent of Kinder Morgan's 461.7 million master limited partnership units are held by insiders, including company leaders who assembled the consolidation deal. More than 740,000 individual and institutional investors hold Kinder Morgan MLP units.

When the proposed deal closes, many longtime holders who had counted on tax-fee quarterly cash infusions in retirement instead will face an income tax bill containing accumulated tax levies that otherwise might have been deferred for years.

People who had planned to pass Kinder Morgan securities to their spouses or children tax-free after their deaths are suddenly anticipating taxes they never planned to pay.

"That creates a problem for people," said Gil Baumgarten, president of Houston financial advisory firm Segment Wealth Management. "You can imagine how someone who made decisions 10 to 20 years ago is upset because the rug was pulled out from under them."

The Kinder Morgan transaction, rolling its 50,000 miles of U.S. pipelines and 180 storage terminals into one balance sheet, would be the second-largest energy deal in U.S. history after Exxon Corp.'s $74.5 billion acquisition of Mobil Corp. in 1999, The pipeline firm has about 2,800 employees in Houston and more than 11,000 across the United States.

Kinder Morgan investor Irwin Berlin filed the most recent proposed class action lawsuit against the company on Oct. 3, claiming its leaders overlooked potentially "crippling tax losses" for investors.

With taxes considered, Berlin's lawsuit said, investors in Kinder Morgan Energy Partners, the master limited partnership that operates the bulk of the company's pipeline network, will effectively see a 4 percent loss on the deal.

Kinder Morgan has said in filings related to its proposed consolidation that the exchange of MLP units for Kinder Morgan Inc. shares or cash will be taxed as ordinary income, which carries a tax rate as high as 40.5 percent.

Kinder Morgan estimated that taxes could average $12.39 per unit if Kinder Morgan Inc. shares were priced at $36.12. The shares closed at $36.47 on Friday.

Berlin's petition notes that if the MLP stayed in place, investors who sold units they had held for at least a year would incur capital gains, which carry lower tax rates. Capital gains are the difference between the cost of an asset and the price at which it sells.

The lawsuit also alleges that the subsequent dividends from Kinder Morgan Inc. would be less than the cash distributions from the MLP, and would lack the income tax deferment.

But it will probably take more than an argument about tax liabilities to convince a court to stop the deal, said Praveen Kumar, a University of Houston finance professor and executive director of the UH Global Energy Management Institute.

"They have to prove there was something improper about the sale of the asset," Kumar said. Investors losing money because of taxes "isn't managerial malfeasance. The tax risk in the event of a sale is something they should have been anticipating."

Investor lawsuits often lead to out-of-court settlements because it is difficult for plaintiffs to prove that a deal is unfair, but companies want to avoid the "very significant" cost of litigating cases and the delays of a trial, said Trey Branham, a Dallas attorney who specializes in class action lawsuits and commercial litigation but who isn't involved in the cases.

Kinder Morgan spokesman Larry Pierce said the firm believes the allegations in the lawsuit are factually and legally incorrect, and it intends to defend the case vigorously. On average, he said in an email, the unit-holders "will be substantially better off on both a pre-tax and an after-tax basis."

Pierce said it's incorrect to focus only on the potential taxes and ignore investors' prospects for future gains, which they could see by trading their units for shares in Kinder Morgan Inc.

The deal offers unit holders in Kinder Morgan Energy Partners three options for each unit they hold in the master limited partnership: They can take 2.48 shares of Kinder Morgan Inc., 2.2 shares plus $10.77 in cash, or $91.72 in cash.

Units of Kinder Morgan Energy Partners surged after the company announced the deal in August, and the firm said the reorganization will allow it to accelerate its growth in North America. Units closed Friday at ***$***89.62.

"Any deal like this is going to attract lawsuits," said Jason Stevens, an analyst with Morningstar, adding Kinder Morgan isn't obligated to follow a script for every investor's retirement plan.

Kinder Morgan's mega deal comes at a time when more retirement-age investors are shopping around for investments that could bring them a viable source of income and enable them to defer taxes.

But the deal also demonstrates that amid the rush to finance new public offerings of pipeline firms, average investors should be aware of the pitfalls of betting on any "sure thing," said Curtis Holden, a financial adviser with Tanglewood Wealth Management.

"I think there may be some investors that don't realize the full ramifications of holding MLPs," Holden said. "It's sort of a double-edged sword."

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