Closed-end fund update: understanding taxes

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Q: Why are TYG and NTG subject to taxes?

A: TYG and NTG are organized as corporations. As such, they must pay federal and state corporate level taxes on their net taxable income each year. The federal corporate tax rate is 21% and the average state tax rate is approximately 5%.

Q: What are deferred taxes and what do they represent?

A: Deferred taxes are either future tax liabilities or future tax benefits that the fund expects to pay or receive because of timing differences related to the recognition of income and deductions. These timing differences are primarily related to how GAAP and tax regulations require the fund to account for the MLP investments and the fund's ability to deduct net capital losses in the current year. A deferred tax liability (DTL) represents a future tax liability that the fund will owe and a deferred tax asset (DTA) represents a future tax benefit that the fund will receive.

Q: What is a valuation allowance and when is it required?

A: A valuation allowance is a reserve that is used to offset a deferred tax asset (either partially or wholly) if the fund does not reasonably expect it can realize the tax benefit during the carryback/carryforward period. If the fund has a net deferred tax asset, then it must evaluate the reasonableness for which it will be able to recognize the tax benefit in a prior or future period. If it does not believe it can recognize the tax benefit then a valuation allowance must be recorded. The fund must frequently evaluate the ongoing need for a valuation allowance and make adjustments as needed.

Q: Why don't TYG and NTG both have deferred tax assets?

A: TYG and NTG must each independently analyze the reasonableness of being able to use a tax benefit (DTA). If it is not reasonable that a tax benefit can be used, then a full or partial valuation allowance (reserve) must be recorded against the DTA. DTA's and DTL's shown on the balance sheet are net DTA's and DTL's. This means that there are multiple timing differences that each result in a DTA or DTL that are netted together to arrive at an overall DTA or DTL. The largest component of the DTA for both funds is capital losses. These are capital losses recognized in the current period as a result of sale transactions. Capital losses may be carried back 3 years and/or forward 5 years to offset capital gains recognized in other tax periods. TYG has an ability to carryback capital losses because it recognized and paid tax on capital gains during the last 3 tax periods. NTG did not pay tax during the last 3 tax periods because it utilized net operating losses (NOLs) and therefore cannot carry back losses. As such, TYG reasonably expects to realize a future benefit from a portion of its DTA and is not required to reserve against it. At the current time, neither fund expects to use the remaining capital loss carryforwards during the next 5 tax years and has recorded a valuation allowance accordingly.

Q: What is the current tax liability and what does it represent?

A: The current tax liability is the amount of taxes the fund is expecting to owe for the current fiscal year to date. This amount is calculated based on the current estimated taxable income which is a result of all activities (income/loss from investments, fund expenses, sales of securities, etc.) and transactions that have taken place fiscal year-to-date.

Q: When TYG and NTG sell securities does that create a tax liability?

A: When the fund sells securities the transactions result in a gain or loss. All of the capital gains and losses recognized are netted to arrive at a net gain or net loss for the year. Capital losses can only be used to the extent of capital gains. If capital losses exceed capital gains, then the net capital losses may be carried back 3 years or carried forward 5 years to offset capital gains. If the fund sells MLP securities then it must further evaluate the character of the gain or loss. When an MLP is sold, ordinary gain is recognized due to ordinary losses taken in prior periods. The ordinary gain recognized on a sale transaction is not allowed to be netted against capital losses. Ordinary gains may be offset with other ordinary type deductions such as fund expenses and MLP K-1 losses. As corporations, TYG and NTG are subject to federal tax at a flat 21% rate regardless of the character of the income/gain.

Q: If you sell an MLP for less than the purchase price, is there still an ordinary gain on the sale?

A: When an MLP is sold the resulting gain or loss must be broken out into two components – ordinary gain and capital gain or loss. If an MLP is sold for less than the purchase price there will still be an ordinary gain recognized on the sale transaction. Ordinary gain is recognized even when the MLP security is sold at a loss because it is recapturing ordinary losses (primarily related to depreciation) taken in prior periods. Given the market volatility earlier this year, TYG and NTG were selling MLP securities in a depressed market and recognizing ordinary gain and capital losses. Given the level of selling that took place, both funds have net capital losses for the year and are unable to deduct the excess losses and must look to prior or future tax periods to utilize those losses against other capital gains.

Q: What are estimated tax payments and are TYG and NTG required to make them?

A: Estimated tax payments are quarterly payments required by the IRS and the state governments for corporate taxpayers, such as TYG and NTG. Every quarter, each of TYG and NTG must calculate its estimated taxable income for the year and pay in a pro-rata share of the total tax due. Quarterly payments are required to help facilitate tax collection throughout the year and not just after the completion of the tax year.

For a more detailed explanation on the tax treatment of MLP's please read "The ABCs of MLPs: making sense of taxes".