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Some in Congress want to redo tax advantages linked to ESOP

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There are at least two ways to structure a company to avoid paying taxes — each with a distinct reaction from lawmakers.

A cash-hungry Congress may chastise companies such as Apple Inc. for seeking what it called the "holy grail" of tax avoidance by using Irish subsidiaries — a charge the iPhone-maker's CEO disputed on Capitol Hill last month.

But that same Congress will provide what a local attorney called "unparalleled tax incentives" if a boss sells a business to its workers through a somewhat complex transaction known as an employee stock ownership plan, or ESOP.

"The company's pretax earnings are its after-tax earnings," said David Ackerman, a Morgan, Lewis & Bockius LLP partner, describing the tax-free structure of a particular type of ESOP.

"Basically what Congress is saying is, 'We will help you if you set up a plan that results in sharing ownership with all your employees.'"

ESOPs — used by almost 11,000 companies ranging from the smallest of businesses to the 159,000-employee supermarket chain Publix — have been seen by politicians on both sides of the aisle as a way to promote local jobs, foster economic growth and help employees plan for retirement. Those perks have resulted in a slew of tax benefits.

Fiscal concerns in Washington, D.C., though, have led some in the ESOP industry to fear their tax breaks — and the reasons they exist — may get lost in an ongoing debate surrounding an overhaul of the corporate tax code.

The debate comes at a time when ESOPs are expected to become more common as retirement-age business owners look for tax-efficient ways to sell their companies or transition to the next generation.

"Tax reform means we've got to be on our toes," said Michael Keeling, president of The ESOP Association, which lobbies Congress.

"It has opened up a considerable concern on the part of the ESOP community."

Such concerns did not exist when Ackerman and his Morgan, Lewis partner Elizabeth S. Perdue began offering ESOPs as a tax-efficient way for corporate clients to sell or continue to control their businesses in the 1980s.

Congress at the time passed tax incentives for owners to sell their businesses to employees. The sale usually involves a trust taking out a loan for the purchase on behalf of employees, who receive stock in the company. The loan, which the employees are not liable for, is paid off using the business' profits.

The tax incentives offered for some ESOP transactions include the ability to deduct the principal of the loan in addition to its interest, Ackerman said. Most states operate the same way and the end result can be a $10 million loan that after tax deductions costs more like $6.5 million.

"It's a very effective technique for arranging succession in ownership, which is a perennial problem that owners of businesses face and that we in the legal community are regularly advising our clients about," Ackerman said.

One of the more intriguing ESOP transactions involves the sale of an "S" corporation, a structure where the owners of a business assume its tax liabilities, Ackerman said.

First allowed in 1998, the sale of an "S" corporation to an ESOP can result in zero taxes at both the corporate and individual levels, said Loren Rodgers, executive director of the National Center on Employee Ownership.

"If a nontaxpaying entity is the only shareholder, then there's no tax due. And an ESOP is not a taxpaying entity," Rodgers said.

While it can take up to an hour to explain some ESOP concepts to clients, Perdue and Ackerman said the tax benefits usually garner interest.

"We have seen a large number of transactions over the last 10 years where a company goes to 100 percent ESOP ownership, because that carries with it some extremely advantageous tax benefits," Perdue said.

David Ackerman

Elizabeth S. Perdue

Ackerman said: "People say, 'Why aren't there more ESOPs if these are so great?' The primary answer is that ... no one brings the ESOP concept to (business owners') attention."

The concept has been brought to the attention of lawmakers.

The Treasury Department's 2013 federal budget proposal included a section that would repeal one ESOP-related tax incentive.

Such proposals aren't adopted without Congress' input and the specific tax incentive at issue is relatively modest — it would save about $8 billion over 10 years. Still, The ESOP Association's Keeling said he is concerned because of the administration's reasoning for the suggested change.

The proposal says ESOPs used by companies that gross more than $5 million in revenue a year pose a risk to employees' retirement accounts.

That is because the ESOP concentrates retirement assets in one place — an employer's stock. And the larger the company, the less impact one employee will have on its success, the proposal says. If the company went under, not only would an employee be out of a job, but their retirement accounts could be wiped out as well.

Keeling said he has two problems with that line of thinking.

For one, the proposal takes aim at "99.9" percent of ESOPs by setting a risk threshold at less than $5 million in annual revenue. In addition, he said employee-owners are motivated to see their companies succeed no matter how big their business.

"If your attitude or policy is that (ESOPs) don't benefit employees because employees can't understand what being an owner means ... yeah, you ought to get rid of all the damn ESOPs," Keeling said.

"But I think it's an insult to say to average-paid employees that they don't understand what they do or where they work."

Greg Klein, chairman of Employee-Owned S Corporations of America, said Congress continues to offer broad support for ESOPs despite the budget proposal.

"We go to Washington and we get an awful lot of good feelings and good feedback from the members of Congress," Klein said.

"They really like this structure and what it does for employees. They come visit our stores and see it in action. And they notice a difference when they come into our places of business."

Morgan, Lewis' Ackerman also said he expects continued bipartisan support for ESOPs.

"I think ESOPS are here to stay. They've been around for over 30 years, (and) there's a strong lobby for this," Ackerman said.

"It's the only thing I ever knew (former U.S. senator) Ted Kennedy and (former U.S. representative) Jack Kemp to agree on."