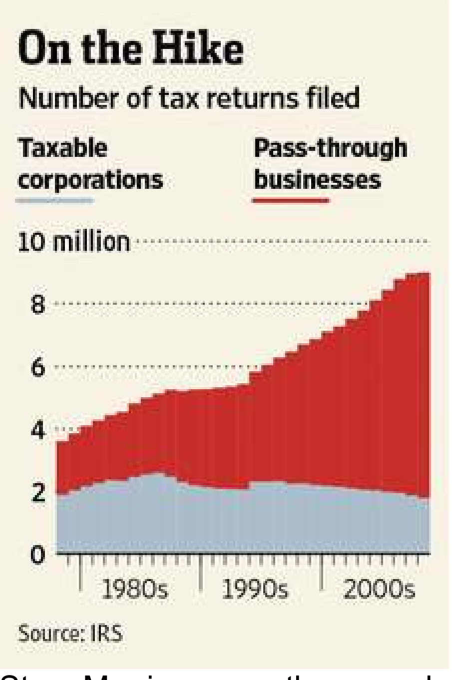
More Firms Enjoy Tax-Free Status

By JOHN D. MCKINNON
StoneMor Partners LP, the publicly traded firm that specializes in running cemeteries, expects to see handsome profits in coming years as baby boomers age and die. But unlike its largest rivals, its corporate tax bill from the federal government will be zero.



StoneMor is among the many businesses organized so they don't pay a penny in federal corporate income tax. And yet such firms don't employ an army of accountants to shield profits in complex tax shelters. Their enviable tax position is perfectly legal and has been encouraged by Congress and state governments. Known as pass-throughs, these firms pass along profits to investors who pay taxes on those sums through their individual returns.

This exception has been around for decades, and has been broadened repeatedly in recent years as a way to spur entrepreneurship. Millions of small businesses have organized this way, but so too have some behemoths like private-equity giant Blackstone Group LP, construction firm Bechtel Group Inc. and pipeline firm Kinder Morgan.

The percentage of U.S. corporations organized as nontaxable businesses has grown from about 24% in 1986 to about 69% as of 2008, according to the latest-available Internal Revenue Service data. The percentage of all firms is far higher when partnerships and sole proprietors are included.

Old-line U.S. public companies generally remain taxable, and many complain that they must pay higher effective rates than foreign competitors. They are eagerly seeking a cut in the 35% U.S. corporate-tax rate, now one of the highest in the world. But increasingly they find themselves at odds politically with the growing breed of nontaxable firms.

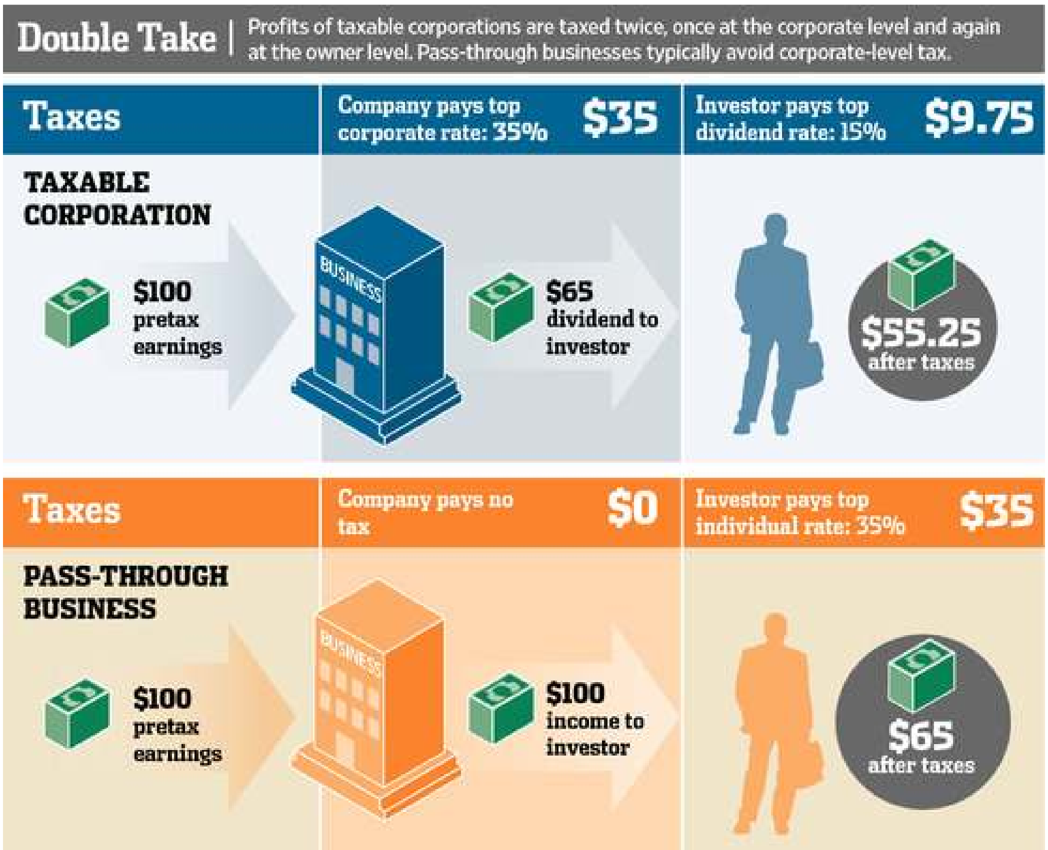
By some estimates, more than 60% of U.S. businesses with profits of $1 million are structured as pass-throughs, the highest rate among developed countries. Their popularity is one big reason why federal corporate tax collections amounted to just 1.3% of GDP in 2010, well below their mark of 2.7% in 2006 and far beneath their peak of 6.1% in 1952.

Almost everyone in Washington appears to agree that the Byzantine corporate tax code needs a revamp. But on this point, the business community is split, presenting perhaps the biggest obstacle to any overhaul.

Many Democrats as well as some Republicans are willing to consider taxing the largest pass-throughs. It is a matter of fairness, they argue, and would also raise new revenue to help offset the cost of cutting tax rates.

On the other side, a Republican-backed coalition including building contractors, beer distributors, auto dealers and funeral directors argues that changing the rules will inhibit entrepreneurship, as well as hit their pocketbooks.

Various proposals for overhauling the tax code threaten to hit the untaxed entities to some degree, by curbing the business tax breaks they receive. And pass-throughs—unlike taxable corporations—would receive no benefit from a drop in the corporate rate.



Treasury Secretary Timothy Geithner has kicked the issue squarely back to lawmakers. "Congress has to revisit this basic question about whether it makes sense for us as a country to allow certain businesses to choose whether they're treated as corporations for tax purposes or not," Mr. Geithner said at a Senate Finance Committee hearing last year.

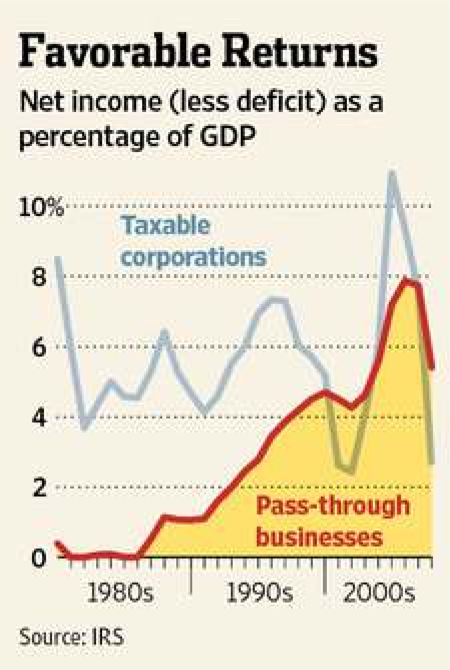
Pass-throughs are especially prevalent in industries such as agriculture, mining, construction, finance, real estate, professional services and entertainment. Businesses in these sectors often have relatively few owners and can rely on private financing to flourish. By contrast, public companies, with some exceptions, must organize as taxable entities.

Analysts noted the tax advantage of pass-throughs when pipeline giant Kinder Morgan announced in October that it would buy rival El Paso Corp. in one of 2011's biggest tie-ups. Kinder Morgan holds nearly all of its assets in Kinder Morgan Energy Partners LP, a so-called master limited partnership, a nontaxable entity. El Paso, though, for various business reasons, has kept a large percentage of its assets in the standard taxable corporate form. A Kinder Morgan spokesman said energy MLPs were authorized by Congress "to promote the development of energy infrastructure" in the U.S.

KKR, the big private-equity concern, reported that it earned a total of about $1.3 billion in 2010 through its pass-through ownership structure. KKR paid about $74 million in corporate tax, largely through a taxable subsidiary. If KKR were instead organized as a single taxable corporation, it would have paid about $523 million in corporate tax, counting both federal and state taxes, the company said. That means its pass-through structure saved it about $449 million.

Some but not all of that tax savings disappears when the individual taxes paid by the owners also are considered. Even so, KKR's current pass-through structure saves at least $277 million in taxes overall, compared to a taxable corporate structure, when all taxes are considered.

Many large pass-throughs are private, and few details have emerged about their tax status. Construction giant Bechtel Group, for instance, has become a frequent target for congressional critics who say it is inappropriately taking advantage of pass-through rules designed for smaller companies. The company declines to comment on how it is organized for tax purposes.



Nontaxed companies go by a smorgasbord of appellations, from Subchapter S corporations to limited liability companies and master limited partnerships, to even more specialized forms. A common example would be a limited liability partnership, such as a law or accounting firm, which distributes profits to its partners. The firm itself typically doesn't pay taxes. Instead, the federal government gets its cut by taxing partners' income. The late Donald Alexander, an IRS commissioner in the 1970s, called this "tax nirvana."

The concept gained momentum in the 1950s when Congress created the Subchapter S corporation, a relatively strictly defined designation aimed at encouraging start-ups and diluting the influence of corporate giants. It got a boost in the 1970s, when Hamilton Brothers Oil Co. persuaded Wyoming's legislature to approve a new form called the Limited Liability Company or LLC.

Starting in the late eighties, when the IRS recognized LLCs as partnerships for tax purposes, other states quickly followed suit. By 2008, about 1.9 million LLCs were filing tax returns with the IRS. "I tell friends my biggest business error was not getting a royalty" on the idea, said A.J. Miller, the former Hamilton executive who led the effort.

Reagan-era tax cuts made the structures more attractive because corporate rates suddenly were significantly higher than individual rates. Top individual rates have since risen and now are at 35%, the same as top corporate rates.

But organizing as a pass-through for tax purposes is still attractive for most businesses, because it eliminates one layer of taxation. Corporate profits are typically taxed twice, first at the corporate level and secondly when they are paid out to individuals as dividends and capital gains. Investors in pass-throughs, therefore, often benefit from larger sums being distributed.

Congressional officials knew they were encouraging businesses to become pass-throughs. Even so, "there were a hell of a lot more pass-throughs created than I think we expected," says J. Roger Mentz, a former Reagan Treasury official who helped guide the 1986 Act through Congress.

In 1987, amid a rush by businesses to convert to the pass-through form, Congress declared that publicly traded companies should also be taxable corporations. But it carved out a few exceptions that seemed narrow at the time. One was for companies in the energy and natural resources field. Another was for real estate. Still another was for certain financial firms.

Despite occasional recent threats by some lawmakers to try to block private-equity firms from using the pass-through technique, Blackstone Group and KKR took advantage of the rules for publicly traded partnerships a few years ago. In 2011, two more well-known financial firms, Carlyle Group LP and Oaktree Capital Management LP, filed to go public in the same manner.

Todd Molz, general counsel of Oaktree, said the industry's moves are appropriate, because they prevent another layer of taxation on earnings. Businesses owned by private-equity firms often pay corporate taxes. Shareholders of the private-equity firms pay tax on their payouts. So imposing a levy on the investment firm itself would create a third layer of tax on the same activity, he said.

Since 2004, StoneMor, based in Levittown, Pa., has been organized as a master limited partnership. That means it doesn't pay corporate-level taxes even though it is publicly traded and has grown to become one of the industry's larger firms. StoneMor filings indicate that the firm is structured to take advantage of the real-estate and financial exceptions.

The firm's chief aim in converting to an MLP was to encourage investors to look at its cash flow and yield, the way MLP's usually are valued, rather than by typical corporate measures of profitability, said Tim Yost, a company vice president. "This isn't a tax-avoidance" maneuver, he said. StoneMor's market capitalization recently hovered around $450 million, up from $120 million at the end of 2006.

Company materials tout StoneMor's "predominantly tax free" structure, and tax benefits for investors. But StoneMor has to pay some corporate tax through subsidiaries, for income such as casket sales that doesn't qualify for one of the MLP exceptions. And company officials note their investors pay taxes on their share of the profits.

The structure is so potentially valuable that one of StoneMor's directors has sought to replicate it with other companies, and has obtained a patent on an investment-fund strategy that involves converting corporations to master limited partnerships.

StoneMor's largest rivals in the death-care industry, as the firms dub themselves, are organized as traditional taxable corporations. Industry analysts say too much of their income comes from funeral services, which doesn't fit into any of the exceptions for publicly traded partnerships. Two of them, Service Corporation International and Carriage Services Inc., paid total tax rates of more than 40% each on their 2010 profits, counting federal and state corporate levies, according to their financial filings. They both declined to comment.

The administration has been working for months on a business-tax overhaul, but has yet to release it.

White House and Treasury spokesmen declined to comment. Some lawmakers have called for curtailing business tax deductions, with the additional revenue redeployed to help lower corporate tax rates. A few lawmakers—mostly Democrats—have floated the idea of imposing a tax on the largest pass-throughs.

But small-business groups and their allies in Congress, particularly Republicans, have pushed back on the idea of raising taxes on pass-throughs, warning that such a move could slow job creation. And the larger pass-through companies retain significant lobbying and political clout.

Most Republicans say they favor reducing both corporate and individual tax rates. "I don't know how you deal with the [corporate] rate without dealing with also the pass-through entities," Rep. Vern Buchanan (R., Fla.), whose own businesses are organized as pass-throughs, said at a House hearing in June. "It all has to be looked at."