Levin's Jobs Bill Would Limit Tax-Free Receipt of Securities in a Spinoff

by Amy S. Elliott

The discussion draft of the jobs bill introduced March 15 by acting House Ways and Means Committee Chair Sander M. Levin, D-Mich., includes a provision to amend section 361. Under the provision, debt securities issued by the controlled subsidiary in a divisive D reorganization would generally be taxable boot even if the distributing parent uses the securities to pay its own debt or distributes the securities to shareholders.

Ways and Means is scheduled to mark up the bill, the Small Business and Infrastructure Jobs Tax Act of 2010, on March 17. If it becomes law, the ability of a distributing parent to shift indebtedness to its controlled subsidiary in connection with a reverse Morris Trust transaction will be severely curtailed, Robert Willens of Robert Willens LLC told Tax Analysts. (For the discussion draft of the bill, see *Doc 2010-5573* or *2010 TNT 50-17*. For a Ways and Means release, see *Doc 2010-5571* or *2010 TNT 50-24*. For a Ways and Means summary of the bill, see *Doc 2010-5572* or *2010 TNT 50-25*. For prior coverage, see *Doc 2010-5568* or *2010 TNT 50-4*.)

But the impact goes far beyond just reverse Morris Trust transactions. This "will affect every distributing company's ability to split debt between itself and its spin-co by way of exchanging spin-co debt for its own, whether or not the spinoff is followed by an acquisition," said Candace Ridgway, a partner at Jones Day.

While the proposal is significant, it isn't surprising. Robert H. Wellen, a partner at Ivins, Phillips & Barker, noted that Congress in recent years has sought to limit a parent company's ability to pull out cash or dump debt and liabilities on its subsidiary before spinning it off tax free.

Wellen noted that in 2004, Congress amended section 361 to limit a parent's ability to receive cash tax free in a spinoff. After the change, parent companies were less able to settle their debts by getting cash out of a spin, but they could still exchange securities in a tax-free spinoff to pay down their debt.

The scenario the legislation seeks to target goes something like this: A distributing parent company spins its controlled subsidiary off in a tax-free reorganization; as part of the transaction, the parent gets a batch of debt securities from its subsidiary and gives them to its creditors, who in exchange agree to retire the parent's debt.

Under current law, the securities received by the parent are treated as nonrecognition property. But this bill would treat them as boot so that the parent would have to recognize gain on the amount of securities received in excess of the net basis of the assets transferred.

But five New England House Members recently wrote a letter to then-Ways and Means Chair Charles B. Rangel, D-N.Y., asking for his "renewed support" in limiting the use of reverse Morris Trust transactions. In the letter, Democratic representatives Michael H. Michaud, Maine, Chellie Pingree, Maine, Rep. Peter Welch, Vt., Rep. Paul W. Hodes, N.H., and Rep. Carol Shea-Porter, N.H., said the transactions result in "disastrous consequences" to service and employment, citing in particular the spinoff of some of Verizon's land lines to FairPoint Communications Inc.

On January 21 Hodes introduced H.R. 4486, which also would amend section 361 to change the classification of securities and nonqualified preferred stock to boot but in a way that differs slightly from the jobs bill. Hodes has said Verizon's use of reverse Morris Trust transactions to dump its debt on smaller companies is bad for consumers. (For H.R. 4486, see *Doc 2010-1787* or *2010 TNT 16-31*.)

Willens said the jobs bill as it stands would do away with the only provision that remains in Part III Subchapter C of the code that allows a transferor of property to receive securities on a tax-free basis. While not an advocate of the proposal, Willens said purists will view it as a change to make section 361 conform with the treatment provided in companion sections 351, 354, and 355.

Wellen added that while the treatment provided in section 361 regarding debt securities is an artifact from a prior, more liberal period, the proposed change isn't especially satisfying. "It's making things rational but in the wrong way."

The provision is one of a handful of revenue raisers in the Levin jobs bill. The Joint Committee on Taxation estimated that that provision alone would raise $260 million from 2010 to 2020 or about $25 million per year. (For the JCT score, see *Doc 2010-5737* and Doc 2010-5740. For the JCT description, see Doc 2010-5738 and Doc 2010-5739.)

Willens pointed out that the revenue impact of the provision is questionable. "In their crazy scoring system, if a provision prevents a transaction that is currently tax free -- and perhaps ought not to be -- from occurring, they somehow get to score that as a revenue raiser."