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# A New Limit on Monetizing Divisive Reorganizations

by Peter Richman

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In this article, Richman analyzes the proposed changes to section 361 in the Build Back Better Act.

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## I. Introduction

The Build Back Better Act (H.R. 5376) passed by the House would curtail the use of a common technique employed in divisive reorganizations to reallocate debt from the distributing corporation (Distributing) to the distributed corporation (Controlled). Specifically, the act would amend section 361 to impose a limit on Distributing's ability to transfer Controlled securities and nonqualified preferred stock (NQPS) to its creditors in connection with the divisive reorganization without the incurrence of corporate-level tax.[1] Prior legislative proposals introduced in 2007 and 2010 (the prior proposals) would have imposed a similar limit but with different mechanics that yield materially different results. This article provides relevant background and a technical analysis of the proposed change before evaluating the differences between the Build Back Better Act and the prior proposals.

## II. Background

A divisive reorganization under sections 368(a)(1)(D) and 355 generally involves a transfer of property by Distributing to Controlled in exchange for Controlled stock, followed by a distribution by Distributing of the Controlled stock to the Distributing shareholders. If various qualification requirements are satisfied, the divisive reorganization is tax free to both the Distributing shareholders (on receipt of the Controlled stock) and Distributing (on the distribution).

Congress recognized that this division of property between Distributing and Controlled may require a corresponding division of liabilities. The division of liabilities can take several forms: (1) Controlled may assume liabilities of Distributing (an assumption); (2) Controlled may borrow and distribute the proceeds to Distributing, which, in turn, may use the proceeds to satisfy its own debt (a leveraged distribution-funded repayment); or (3) Controlled may issue debt securities to Distributing, which, in turn, may use the Controlled securities to satisfy its own debt (a securities exchange). These different structures are economically similar: Each allows a reallocation of debt from Distributing to Controlled. However, the facts and circumstances of a particular transaction may create a preference for one of the three options. Subchapter C recognizes this need for flexibility and provides rules to accommodate each.

The impetus for the new provision in the Build Back Better Act is the inconsistent tax treatment under these three sets of rules. For an assumption or leveraged distribution-funded repayment, the amount of Distributing debt that can be shifted to Controlled tax free is limited to the adjusted basis in the property transferred by Distributing to

[1] *See* section 138143 of the Build Back Better Act.



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Controlled (the basis limitation).[2] However, for a securities exchange, no such limitation applies.[3]

Some practitioners have suggested that this inconsistency should be addressed by changing the rules that govern an assumption and leveraged distribution-funded repayment so that they, like a securities exchange, are subject to no limitation at all.[4] In the Build Back Better Act, the House endorsed a different approach by extending the basis limitation to securities exchanges. The Joint Committee on Taxation estimates that this change would raise approximately $17.8 billion from 2022 to 2031.[5] Before examining the proposal in detail, this article reviews some aspects of the current law.

## III. Current Law

### A. Section 361(a) and (b)

Section 361(a) provides that Distributing recognizes no gain or loss on the transfer of property to Controlled in pursuance of the plan of reorganization solely in exchange for Controlled stock or securities. Section 361(b)(1) provides that if Distributing receives money or other property (boot) in addition to the Controlled stock or securities, Distributing will recognize gain on the transfer of property unless it distributes the boot to shareholders in pursuance of the plan of reorganization.[6]

Before 1984, a transfer of boot to Distributing's creditors was not treated as a distribution in pursuance of the plan of reorganization under *Minnesota Tea*.[7] Thus, Distributing recognized gain (if any) on the transfer of property to Controlled if it used the boot received in the exchange to pay creditors.[8] From 1984 to 1988, Congress sought to change this result and ultimately enacted section 361(b)(3), which provides that if Distributing transfers the boot to creditors in connection with the divisive reorganization, the transfer is characterized as a distribution in pursuance of the plan of reorganization. With this favorable treatment, Distributing can use a leveraged distribution-funded repayment to allocate debt to Controlled without incurring additional tax.[9]

In the American Jobs Creation Act of 2004 (AJCA),[10] Congress added the basis limitation to section 361(b)(3), apparently based on the similar rule in section 357(c) that applies for an assumption.[11] Thus, under current law, the amount of boot that Distributing receives from Controlled and transfers to creditors that is eligible to be treated as a distribution in pursuance of the plan of reorganization is limited to the adjusted basis in the property transferred by Distributing to Controlled.

### B. Section 361(c)

Section 361(c)(1) provides that Distributing recognizes no gain or loss on the distribution to its shareholders of so-called qualified property in pursuance of the plan of reorganization. As relevant for our purposes, qualified property includes Controlled stock, securities, and non-security debt obligations received by Distributing in the transaction.[12]

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[2] *See* sections 357(c) and 361(b)(3).

[3] For this reason, the allocation of liabilities in a spinoff is a prominent area in which "altering the form for effectuating a transaction, without correspondingly varying its economic outcome, can produce dramatic changes in its tax results." *See generally* Robert Willens, "The Myth of Form and Substance in Subchapter C," *Tax Notes*, Aug. 2, 1999, p. 739.

[4] Critics of the basis limitation contend that Distributing and Controlled should not be subject to any tax friction in selecting the appropriate capital structures for the two companies going forward. *See* Amy S. Elliott, "Extenders Proposal Targets Debt Securities Issues in Spinoffs," *Tax Notes*, Oct. 11, 2010, p. 174. Proponents argue that it is an important safeguard against Distributing using the spinoff to effectuate a disguised sale of the Controlled stock. *See generally* Deborah L. Paul, "Spin-offs, Leverage and Value Extraction — A Spin by Any Other Name," 91 *Taxes* 99 (Mar. 2013). A full examination of this policy debate is beyond the scope of this article.

[5] *See* JCT, "Estimated Budget Effects of the Revenue Provisions of Title XIII — Committee on Ways and Means, of H.R. 5376, the 'Build Back Better Act,' as Passed by the House of Representatives," JCX-46-21 (2021).

[6] The application of section 361(b) is not limited to leveraged distribution-funded repayments. For example, the distribution may be funded by an initial public offering of Controlled or because Controlled is a preexisting entity.

[7] *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 (1938).

[8] Distributing would also recognize gain on the transfer of property to Controlled if it retained the boot received in the exchange.

[9] If Distributing and Controlled are members of a consolidated group, a distribution of boot by Controlled to Distributing may create or increase an excess loss account in the Controlled stock. If the Controlled stock is distributed to a nonmember, the excess loss account will be taken into account as income. *See* reg. section 1.1502-19(g), Example 3.

[10] AJCA (P.L. 108-357), section 898(a).

[11] For analysis of the basis limitation upon enactment of the AJCA, see Neil J. Barr, "Uncertainty Regarding the Tax Treatment of Liabilities in Divisive Reorgs Survives the AJCA," *Tax Notes*, Nov. 22, 2004, p. 1125.

[12] *See* section 361(c)(2)(B).



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As part of the legislation overruling *Minnesota Tea*, Congress also extended the nonrecognition treatment of section 361(c)(1) to transfers to creditors. Specifically, section 361(c)(3) provides that a transfer by Distributing of qualified property to its creditors in connection with the reorganization is treated as a distribution to shareholders pursuant to the plan of reorganization. Thus, Distributing does not recognize gain or loss on the use of Controlled securities as consideration in the securities exchange. Absent section 361(c)(3), the transaction would be governed by section 1001. That situation does not typically arise under current law because there is no tax limit on Distributing's ability to undertake a securities exchange. However, the House's proposal would change that.

## IV. Build Back Better Act

The Build Back Better Act would restructure section 361 so that a single basis limitation applies for purposes of both section 361(b)(3) and (c)(3) in a new section 361(d) (proposed section 361(d)).[13] Specifically, proposed section 361(d) would provide, in relevant part, that section 361(b)(3) and (c)(3) do not apply to a specified amount of the boot, Controlled NQPS, and principal amount of Controlled securities transferred to creditors. The amount to which section 361(b)(3) and (c)(3) would not apply is (1) the sum of the total amount of liabilities assumed by Controlled, the total amount of boot transferred to creditors, the fair market value of Controlled NQPS transferred to creditors, and the principal amount of Controlled securities transferred to creditors, reduced by (2) the adjusted basis in the property transferred from Distributing to Controlled.

In simpler terms, proposed section 361(d) would turn off section 361(b)(3) and (c)(3) to the extent that the total amount of debt reallocated from Distributing to Controlled exceeds the adjusted basis in the property transferred. As a result, section 361(b)(3) and (c)(3) would only apply to the extent of that adjusted basis.

[13]This restructuring would include the deletion of the last sentence of section 361(b)(3).

As a general matter, proposed section 361(d) appears to be broadly aimed at harmonizing the tax treatment of the three debt-shifting techniques so that a securities exchange, like an assumption and a leveraged distribution-funded repayment, is subject to the basis limitation. Given that goal, one might think that the aggregate limitation would set the total amount of gain recognized by Distributing in the transaction to the excess of the total amount of debt shifted over the adjusted basis in the property transferred. Indeed, the committee explanations of the proposal suggest that this is its effect.[14] But, as discussed later, while that would have been the result under the prior proposals,[15] that is not the outcome under proposed section 361(d).

## V. Example

### A. Hypothetical Facts

Consider a simplified transaction involving a leveraged distribution-funded repayment and a securities exchange in which D transfers to C property with an FMV of $100 and an adjusted basis of $10 in exchange for C stock with an FMV of $40, C securities with a principal amount of $45,[16] and cash of $15. C funds the $15 of cash with a borrowing made in connection with the transaction. Pursuant to the plan of reorganization, D distributes the C stock to the D shareholders and transfers the cash and C securities to creditors in repayment of historic D debt. In total, D reallocates $60 of leverage to C. Assume that the transaction qualifies as a divisive reorganization.

[14]*See* JCT, "Description of the Chairman's Amendment," JCX-43-21 (Sept. 13, 2021); House Ways and Means Committee, "Section-by-Section Summary of Subtitle I of the Chairman's Amendment in the Nature of a Substitute to the Committee Print" (2021); House Budget Committee, "Section-by-Section Summary of Rules Committee Print 117-18" (2021).

[15]Tax Increase Prevention Act of 2007 (P.L. 110-166), section 3703 (2007); Small Business and Infrastructure Jobs Tax Act of 2010 (H.R. 4849), section 302; Job Creation and Tax Cuts Act of 2010 (S. 3793), section 411.

[16]Assume the C securities have an FMV equal to their principal amount.



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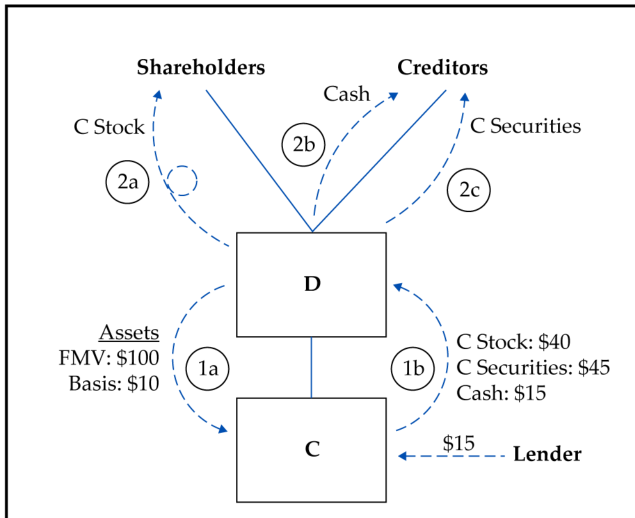


## B. Current Law

D realizes $90 of gain on the transfer of property to Controlled ($100 - $10) and will recognize the realized gain to the extent of boot received that is not distributed in pursuance of the plan of reorganization. Under current law, the basis limitation in section 361(b)(3) applies so that $10 of the cash boot is treated as distributed in pursuance of the plan of reorganization and $5 is not. Thus, D recognizes $5 of its $90 of realized gain.[17] Section 361(c)(3) applies to treat the entire $45 of C securities transferred to the D creditors as distributed to the D shareholders pursuant to the plan of reorganization; thus, D recognizes no gain or loss on the securities exchange.[18]

## C. Proposed Section 361(d)

Under the Build Back Better Act, the results are quite different. Again, D realizes $90 of gain on the transfer of property to C. Now, before analyzing the results under section 361(b)(3) or (c)(3), D first computes its limitation under proposed section 361(d). In this case, the limitation equals $50 (zero liabilities assumed + $15 cash transferred to creditors + $45 C securities transferred to creditors - $10 adjusted basis in property transferred). This $50 limitation is the amount of creditor repayments that section 361(b)(3) and (c)(3) will not characterize as distributions in pursuance of the plan of reorganization.

The remainder of the analysis depends on the resolution of at least two ambiguities in proposed section 361(d).[19] First, there may be a concern that the text requires the limitation amount to be applied separately, and without reduction, to each of section 361(b)(3) and (c)(3) (that is, that section 361(b)(3) does not apply to the extent of $50 and section 361(c)(3) also does not apply to the extent of $50). This interpretation would lead to unusual results,[20] and this article assumes that the limitation applies in the aggregate. Second, proposed section 361(d) does not provide an ordering rule for how the aggregate limitation is to be applied against section 361(b)(3) and (c)(3). For reasons that are explained in further detail later, this article assumes that the limitation amount should first be applied to section 361(b)(3) and then to section 361(c)(3). Thus, in our example, section 361(b)(3) does not apply to the extent of $50. Because there is only $15 of boot in the transaction, section 361(b)(3) does not apply to the entire $15 transferred by D to its creditors, and D recognizes $15 of gain.[21] A $35 ($50 - $15) limitation amount remains for section 361(c)(3).

Because D transfers $45 of C securities in the securities exchange and section 361(c)(3) is only turned off for $35, section 361(c)(3) applies to the extent of $10. Thus, section 361(c)(3) characterizes the transfer by D of $10 of C securities to D's creditors as a distribution pursuant to the plan of reorganization and, for that portion of the transfer, D recognizes no gain or loss.[22] The treatment of the other $35 of C securities is when things get interesting.

To the extent the transfer by D of C securities to D's creditors is not described in section 361(c)(3), it is a taxable exchange under section 1001 that requires D to compute its basis in the C securities. This is the reason for assuming the

[17] Section 361(b)(1)(B).

[18] Section 361(c)(1).

[19] If proposed section 361(d) is enacted in its current form, Treasury should exercise the grant of regulatory authority in proposed section 361(d)(3) to clarify these issues.

[20] Under this interpretation, an allocation of debt using a $100 leveraged distribution-funded repayment could enjoy significantly more favorable treatment than one involving a $50 leveraged distribution-funded repayment and a $50 securities exchange.

[21] Section 361(b)(1)(B).

[22] Section 361(c)(1).



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proposed section 361(d) limitation amount is first applied against section 361(b)(3) — in order for D to determine its basis in the C securities under section 358, it must know if any gain is recognized on the initial transfer of property by D to C (that is, under section 361(b)(1)(B)).[23] Under section 358, D's aggregate basis to be allocated among the nonrecognition property received in the exchange is $10 ($10 adjusted basis in transferred property + $15 gain recognized - $15 cash received). This $10 of basis is allocated between the $40 of C stock and $45 of C securities. Thus, $5.29 of basis is allocated to the C securities ($10 * $45/$85), with $4.11 of basis attaching to the $35 of C securities that are subject to section 1001 ($5.29 * $35/$45). As a result, D recognizes $30.89 of gain on the securities exchange ($35 - $4.11).[24]

## VI. Discussion

This analysis illustrates the significant effect the Build Back Better Act would have on the tax treatment of some divisive reorganizations. Under current law, D would recognize $5 of gain in our example. Under proposed section 361(d), D would recognize $45.89 of gain ($15 + $30.89). A higher amount of gain should come as no surprise, but is $45.89 the right higher amount of gain?

As indicated, various committee documents suggest that proposed section 361(d) requires Distributing to recognize gain equal to the excess of the total amount of debt shifted from Distributing to Controlled over the adjusted basis in the property transferred.[25] In our example, that amount would be $50. There are two ways to understand the disconnect between this theoretical $50 and our actual $45.89 — mechanically and conceptually.

As a mechanical matter, the disconnect arises because proposed section 361(d) does not prescribe an amount of gain to be recognized by Distributing on the securities exchange. Rather, proposed section 361(d) removes an amount of securities from the divisive reorganization altogether, rendering it an amount realized under section 1001. Distributing then offsets that amount realized by its adjusted basis in the securities, which, in our example, explains the $4.11 difference between $50 and $45.89.

As a conceptual matter, the disconnect stems from the more fundamental decision in proposed section 361(d) about which realization event should be targeted for recognition. One way to understand this decision is by contrast to the prior proposals, which would treat Controlled securities and NQPS in a divisive reorganization as boot for purposes of section 361(a) and (b)(1). As a result, a securities exchange would be analyzed under the same rules as a leveraged distribution-funded repayment and would trigger recognition of the gain realized by Distributing on the transfer of property to Controlled.[26] In our example, the prior proposals would result in $50 of recognized gain.

The Build Back Better Act, however, adopts a different approach. While the prior proposals fold the analysis of a securities exchange into the existing rules that govern a leveraged distribution-funded repayment, proposed section 361(d) simply extends the basis limitation to section 361(c)(3). Thus, instead of focusing on the gain realized by Distributing on the transfer of property to Controlled, proposed section 361(d) focuses on the gain realized by Distributing on the securities exchange itself. This pivot to a different realization event is the underlying choice that leads to $45.89 of recognized gain in our example instead of $50.

The difference between the committee explanations of proposed section 361(d) and the mechanics of the text invites a closer examination of whether the proposal achieves its goals. The results suggested by the committees would implement a policy objective of creating parity between the different methods for shifting debt in a divisive reorganization. Recall that, in our example, Distributing shifts a total of $60 of debt

[23] Theoretically, the aggregate limitation could also be allocated (1) pro rata between section 361(b)(3) and (c)(3) in proportion to the total amount of boot relative to Controlled securities and NQPS transferred to creditors or (2) first to section 361(c)(3) with the remainder, if any, to section 361(b)(3).

[24] Section 1001.

[25] *See supra* note 14.

[26] The prior proposals' reclassification of Controlled securities and NQPS as boot would apply only for purposes of section 361(a) and (b)(1). Thus, Controlled securities and NQPS would continue to be treated as qualified property, within the meaning of section 361(c)(2)(B), for purposes of section 361(c).



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to Controlled. If the facts are modified so that Controlled directly assumes $60 of Distributing debt, Distributing would recognize $50 of gain.[27] Similarly, if the debt is shifted by a $60 leveraged distribution-funded repayment, Distributing would recognize $50 of gain.[28] These alternatives illuminate why an amendment to section 361 that results in $50 of gain in our example might be appealing — it would harmonize the tax consequences of a securities exchange with that of an assumption and a leveraged distribution-funded repayment. Such a change would also align with the AJCA.

However, because the committee documents do not explicitly offer a policy rationale for proposed section 361(d), the purpose of the provision — which triggers more gain on a securities exchange but does not create parity between the three debt-shifting techniques — is unclear. This lack of clarity raises the question of why the House adopted proposed section 361(d) instead of the prior proposals, which, irrespective of the issue of parity, would also trigger more gain. Perhaps there was hesitation that the prior proposals' redesignation of Controlled securities and NQPS as boot for purposes of section 361(a) and (b)(1) might adversely affect other aspects of a divisive reorganization.[29] Also, there may have been apprehension that treating securities as boot could be inconsistent with broader principles of subchapter C.[30] Whatever the reason, the decision to develop a new rule in the Build Back Better Act to address securities exchanges suggests some material concern with the framework or consequences of the prior proposals.

## VII. Conclusion

Under current law, securities exchanges receive significantly more favorable tax treatment than assumptions and leveraged distribution-funded repayments. There are sound policy reasons for harmonizing the tax consequences of these economically similar transactions. However, while proposed section 361(d) would substantially reduce the preferential treatment afforded to securities exchanges, it would still maintain some of the distortions under current law.[31]

The reasons for the Build Back Better Act's departure from the prior proposals, which would have equalized the tax treatment of the three debt-shifting techniques, are unclear. Also, the prior proposals are somewhat simpler than proposed section 361(d), which introduces a new recognition event that requires an additional basis computation. Finally, the prior proposals would likely be estimated to raise slightly more revenue than proposed section 361(d),[32] which may be a relevant factor in the broader legislative context.

As a practical matter, if proposed section 361(d) is enacted in its current form, spinoff practitioners will need to pay much closer attention to Distributing's basis in the Controlled securities while planning for a securities exchange. These basis computations should not be technically difficult but may present a trap for the unwary. What will be more interesting to observe is which practitioners ultimately find their way to section 1001 — and which restructure their transactions to avoid proposed section 361(d) altogether. ■

[27] *See* section 357(c).

[28] *See* section 361(b)(1) and (3).

[29] For example, there may be a concern that the prior proposals would limit Distributing's ability to distribute Controlled securities or NQPS to its shareholders. However, even if the Controlled securities and NQPS are reclassified as boot, that distribution would not require Distributing to recognize any additional gain on the transfer of property to Controlled. *See* section 361(b)(1)(A). Separately, there may be a concern that the prior proposals would require additional gain recognition when Distributing retains the Controlled securities or NQPS. *See* section 361(b)(1)(B). However, that transaction would also need to satisfy the requirements of section 355(a)(1)(D) and does not appear to be sympathetic.

[30] *But see* section 351, which has treated securities as boot since 1989.

[31] Depending on the interpretation of technical ambiguities in the text, proposed section 361(d) could also introduce new distortions. *See supra* note 20.

[32] As illustrated, the adjusted basis offset under section 1001 ensures that the application of proposed section 361(d) results in an amount of gain recognition lower than the amount resulting from the prior proposals. In some instances (*e.g.*, when Distributing has zero adjusted basis in the property transferred to Controlled), the prior proposals and proposed section 361(d) can result in the same amount of gain recognition.



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