



## What the Midterms Mean to Tax Managers

*Does it matter to corporate taxpayers which party takes Congress in the midterm elections? One tax expert thinks so.*

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If you are a corporate tax professional, duck! You could easily get caught in the crossfire of election-day mudslinging, as candidates and their parties square off about tax reform.

As the political rhetoric moves from election day into election night, Republicans will continue to insist that they can cut taxes and balance the budget simultaneously. That's fuzzy math to begin with, and since the budget deficit is swelling, the math may be just plain wrong. On the other side of the aisle rage Democrats, who are trotting out a tax reform plan called "Six for '06." It's a list of spending priorities that would use tax revenues to bolster homeland security, education, and healthcare, among other Democratic Party favorites. The problem with the math here, however, is that there is none. There is no price tag for plan, at least not yet, so it's hard to tell whether taxpayers should buy it.

But if tax managers are able to ignore the political posturing on economics for a moment, they may want to focus on two more salient issues that the midterm elections could affect. Those issues, says Robert Willens of Lehman Brothers, are the current 15 percent tax rates levied on long-term capital gains and potential changes to tax-free merger rules.

Willens posits that the relatively low 15 percent tax rate for net capital gains and qualified dividend income seem to be "emblematic in many people's minds of the 'income inequality' policies favored by the Bush Administration."

If that's the case, then raising the tax may be something Democrats may consider if they take control of the House or Senate, Willens told CFO.com. "I don't know how far they would get ... because the President would probably veto any legislation that rolled back his cherished tax cuts." Nevertheless, the impetus to undo tax cuts that benefit corporations would exist.

Another issue looming over the midterm elections is the possible rollback of the anti-Morris Trust rules. The rules, which are found in Section 355 of the Tax Code, make it hard for a corporation to accomplish a tax-free spin-off or merger by requiring that the merger partner be less valuable than the spun-off or distributing company.

Last year, Virginia Republican Rep. Eric Cantor introduced a bill to roll back the merger rules to the way they read before 1997, when tax-free mergers had less restrictions. The Cantor bill, which was never enacted, had the potential of sparking a flurry of deal-making, says Willens. Should the Democrats take the House, the bill would not likely surface again. If Republicans retain control, however, there's a chance that the bill would reemerge, especially if Cantor wins back his seat.

A change in control of Congress would also put other corporate tax breaks in danger, Willens thinks. For example, a Democratic Congress may want to do away with the tax advantages associated with contingent-payment debt instruments. Under current rules, companies can deduct interest expense at a rate known as the "comparable yield," that is well in excess of the stated yield on the securities. "It's been a great tax benefit for a lot of issuers," says Willens.

Further, with the Democrats in control, "you would expect to see an initiative towards a more general increase in tax rates—subject to a Presidential veto," he adds. Willens explains that the top rate is only 35 percent now, but under President Clinton, the top rate rose to 38.6 percent. "I would expect to see [Democrats] attempt to bring the rate-- maybe only temporarily, so the increase would function as a 'surcharge'--up to the level that existed under President Clinton," the tax expert says.

One thing that won't change regardless of which party wins control of Congress, is the way tax managers comply with the Sarbanes-Oxley Act's Section 404, the internal controls provision. "There's no relief in sight, whether it's Democrats or Republicans controlling Congress," says Jeff Westphal, president and chief executive officer of Vertex Inc., a tax software provider.

If there is a "big hiccup" in a tax process or procedure, the problem no longer stays at the vice president level to get solved, he says. Rather it moves up to the audit committee for review to determine whether the snag suggests a larger controls weakness.

If tax issues spawn a liability "because the proper controls are not in place, that's a bigger problem than ever before," says Westphal.