



OFFICE OF  
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
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MEMORANDUM FOR ASSOCIATE AREA COUNSEL  
SMALL BUSINESS/SELF-EMPLOYED (AREA 2)

FROM: Kathryn A. Zuba, Chief  
Branch 2 (Collections, Bankruptcy & Summonses)

SUBJECT: In re

LEGEND:

- Taxpayer =
- SubA =
- SubB =
- x =
- Date1 =
- \_\_\_\_\_ =
- x+1 =
- Consultant =

By memorandum dated February 1, 2001, you asked us to review and comment on the debtor's proposed Chapter 11 plan. We read your request as covering the following specific issues: (1) the treatment of Class R5a on page 7 of the plan; (2) the Class R6 claims; (3) the Approval of the Stock Incentive Plan on page 48; (4) the treatment of the stock group of debtors on page 51; (5) the scheme outlined under Section VII on pages 51-58 to convert the Company's assets to a liquidating trust; (6) whether Section VII creates a need to obtain and review the Committee Settlement Agreement; (7) the consequences of issuing stock to satisfy claims as proposed in section X-F on page 66 and any attendant valuation problems; (8) the consequence of issuing debt to satisfy claims in section X-G on page 67; and (9) the propriety of the Tax Reporting provisions on page 74.

[REDACTED]. Accordingly, we forwarded the Plan and other documents to Passthroughs and Special Industries for their review and received their response on February 12, 2001. We have incorporated the gist of their response in this memorandum, as modified slightly by further conversations with them.

### **SUMMARY OF THE FACTS**

Taxpayer and its subsidiaries ("the Debtors") filed chapter 11 bankruptcy in the United States Bankruptcy Court for the District of \_\_\_\_\_ and its debtor subsidiaries have filed a plan of reorganization that consists of x+1 "sub-plans", one for each debtor.

At the time Taxpayer filed bankruptcy, it owned SubB Corporation ("SubB"), which manufactured and marketed \_\_\_\_\_.

During the course of the bankruptcy, the Debtors were divided into two groups – the Reorganizing Debtors and the Liquidating Debtors. The Liquidating Debtors are SubB and certain other subsidiaries. Through court approved transactions, the assets of the Liquidating Debtors have either been sold, or are in the process of being sold, and their businesses liquidated.

The Plan provides that shortly after confirmation of the Plan (the effective date), all of the capital stock of SubB issued before the effective date will be deemed canceled and SubB shall be deemed to transfer to a liquidating trust (the Trust) all of its right, title, and interest in all of its assets, and the Trust shall assume all of SubB's obligations under the Consultant Contract. The Plan defines the Trust as "the trust to be created on the Effective Date in accordance with ... the Plan ... for the benefit of the holders of Allowed Claims against the Liquidating Debtors." It should be noted that the assets of the other Liquidating Debtors are not transferred to the Trust under the terms of the Plan.

### **LAW AND ANALYSIS**

Section 301.7701-4(d) of the Procedure and Administration Regulations provides that certain organizations which are commonly known as liquidating trusts are treated as trusts for purposes of the Internal Revenue Code (the Code). An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Code

because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

Rev. Proc. 94-45 provides conditions under which the IRS will consider issuing an advance ruling classifying an entity created pursuant to a bankruptcy plan under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101, et seq. (1988), as a liquidating trust under § 301.7701-4(d). In the instant case, [REDACTED]

## 1. Business Purpose

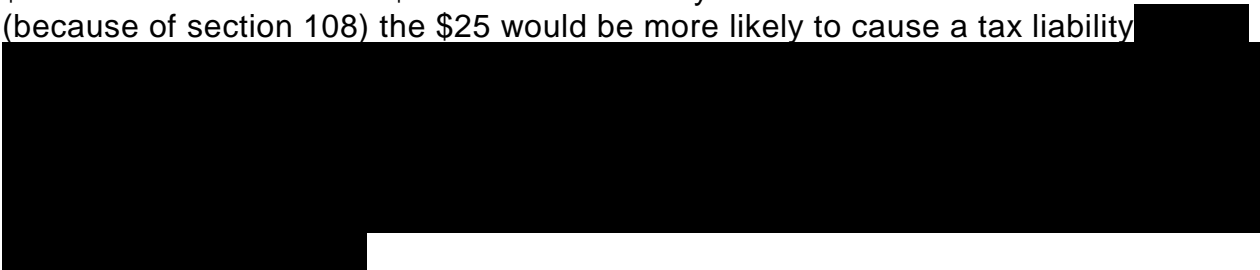
[REDACTED]. Section VII (A) provides that the Trust shall assume all of SubB's obligations under the Contract to the extent SubB and Consultant (Consultant) have entered into the Contract. The Plan defines the Contract as a contract between SubB and Consultant in which Consultant will provide services with respect to analysis and resolution of claims and avoidance actions under the Bankruptcy Code, sales and divestitures of assets, and other matters described in the Contract.

## 2. Taxation of the Transfer

The property transfer from the estate to the Trust will be taxable to the estate under § 1001 of the Code. The estate is treated as having transferred its property to its creditors in return for relief from an amount of debt equal to the fair market value of the property. See Danenberg v. Commissioner, 73 T.C 370 (1979). The estate will realize gain or loss on the difference between SubB's basis in the

property and its fair market value. This gain or loss will most likely be capital in nature.


Because SubB is in bankruptcy, the fair market value of any property to be transferred to the trust presumably will be less than the amount of debt being discharged. Therefore, the estate will probably realize COD income under § 61(a)(12) of the Code on the difference between the amount of debt discharged and the total of the cash and fair market value of the property transferred. However, due to the bankruptcy proceeding, the COD income will be excluded from the estate's gross income and will reduce any of SubB's tax attributes transferred to the estate. Sections 108(a)(1)(A) and (b). This will not affect, however, potential capital gains from the property transfer. For example, if SubB owes its creditors \$100 and transfers property into the Trust that has a fair market value of \$50 in which it has a basis of \$25, then SubB would realize \$50 of COD income and \$25 of capital gain. While the \$50 would be subject to the rules under I.R.C. § 108, the \$25 would not. While the \$50 would be unlikely to result in taxable income (because of section 108) the \$25 would be more likely to cause a tax liability



### 3. Taxation of the Trust

Generally, liquidating trusts are taxed as grantor trusts with the creditors treated as the grantors and deemed owners. The theory is that the debtor transferred its assets to the creditors in exchange for relief from its indebtedness to them, and that the creditors then transferred those assets to the trust for purposes of liquidation. The transfer to the creditors need not actually take place. It is deemed to have occurred.

The beneficiaries of the bankruptcy estate will be the grantors of the liquidating trust. They will be treated as the deemed owners of the trust because the property used to fund it came from them and all the income will be distributed to them or used to pay the expenses of their trusts. The beneficiaries must report each item of income or gain as it is earned by the trust.



**CONCLUSIONS**



We hope this adequately addresses your concerns. Please contact Bryan Camp at 202-622-3834 if you have any further questions.