



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR AREA COUNSEL SMALL BUSINESS - SELF EMPLOYED
(AREA 2), GREENSBORO, CC:SBSE:2:GBO

FROM: Mitchel S. Hyman, Assistant Branch Chief, Branch 2
(Collection, Bankruptcy and Summonses)

SUBJECT:

This responds to your memorandum dated June 26, 2001, in which you asked for our comments on the debtor's proposed Chapter 11 plan and disclosure statement with respect to the liquidating trust. We forwarded these documents to the office of Associate Chief Counsel (Passthroughs & Special Industries), and the following reflects their views.

BACKGROUND

The above named debtor and its 30 subsidiaries (together the "debtors") filed bankruptcy under Chapter 11, and subsequently filed their proposed plan and disclosure statement with the bankruptcy court. Section 7.1 of the plan provides that shortly after confirmation the debtors will transfer the trust assets, which are generally defined in section 1.74 as all property of the debtors and their consolidated estates of every type and nature, to a liquidating trust for the benefit of the holders of allowed claims. Upon confirmation, the subsidiaries will merge into the debtor. The trust is to be managed by a trust administrator who will also dissolve the debtors according to state law.

Section IV(A) of the disclosure statement provides that the debtors will transfer the trust assets to the trust free and clear of all liens, claims and encumbrances of any kind whatsoever except as otherwise provided in the plan and in certain documents relating to the settlement of claims. The documents include the Collateral Sharing Agreement, the Collateral Sharing Order, the APA, and the Approval Order. The settlement was previously approved by the bankruptcy court. Article XII of the plan and section IV(H) of the disclosure statement provide that upon the effective date the documents will be deemed ratified and reaffirmed in their entirety and incorporated into the plan and disclosure statement. Section 7.5 of the plan provides that the trust administrator, with the advice of a post confirmation committee to be formed under the plan, is authorized to enter into contracts and make all other arrangements necessary or

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appropriate to collect, sell, or otherwise dispose of all trust assets except for the claims.

Article III of the plan classifies the claims and interests in the plan. The allowed claims and interests, other than allowed administrative claims, are divided into the following five classes; (1) Class 1 consists of all allowed priority claims, (2) Class 2 consists of all allowed (secured) claims, (3) Class 3 consists of all allowed unsecured claims other than the certain claims in Class 4, (4) Class four consists of all allowed Subordinated Claims (subordinated per settlement), (5) Class 5 consists of all interests in the debtors.

Section 7.2 of the plan provides that it is intended that the trust shall be classified for federal income tax purposes as a liquidating trust. The transfer of the trust assets to the trust are to be treated for federal income tax purposes as a deemed transfer of the trust assets to certain holders of allowed claims (generally in proportion to the amount that each such allowed claim bears to the total of such allowed claims) followed by a deemed transfer of the trust assets by such holders of allowed claims to the trust.

Section VII(D)(1) of the disclosure statement provides that although the holders of allowed claims generally will be treated for federal income tax purposes as having received the trust assets from the debtors and then transferring them to the trust, because holders of allowed administrative claims and Class 1 claims will receive specified fixed amounts from the trust, the trust administrator intends to treat the actual payments made to holders of allowed administrative claims and Class 1 claims from the trust as being made in exchange for these claims on the date of payment thereof. Accordingly, a holder of an allowed administrative claim or a Class 1 claim should generally recognize gain or loss equal to the cash received (plus the fair market value of other property received, if any) with respect to its claim less its adjusted basis in its claim.

Section VII(D)(2) of the disclosure statement provides that although not free from doubt, holders of allowed claims in Classes 2 and 3 as of the effective date should be treated as receiving from the debtors their share of the trust assets remaining after distributions to holders of allowed administrative claims and Class 1 claims in satisfaction of their allowed claims, and simultaneously transferring such trust assets to the trust. Accordingly, a holder of a Class 2 or Class 3 allowed claim as of the effective date should initially recognize gain or loss in an amount equal to its share of the amount of cash and the fair market value of any other trust assets deemed received on the effective date (other than attributable to accrued and unpaid interest), less the adjusted tax basis of its claim. Additionally, such holder should recognize its allocable share of taxable income on the trust assets realized by the trust on an annual basis.

Section VII(D)(3) provides that it is highly unlikely that holders of Class 4 claims will receive any distributions under the plan. Accordingly, although not free from doubt,

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on the effective date a holder of a Class 4 allowed claim should recognize gain or loss in an amount equal to the amount of cash and the fair market value of any other property that the holder actually receives with respect thereto (other than for accrued but unpaid interest).

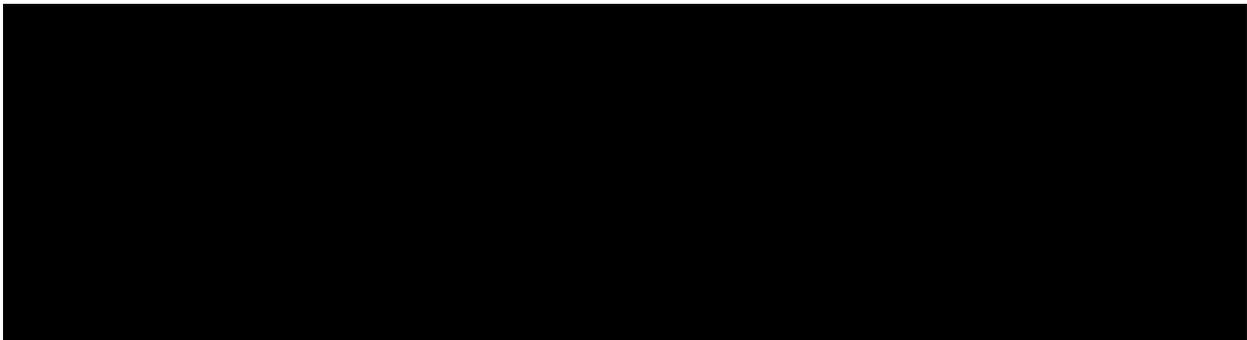
Section VII(D)(4) provides that equity holders will not receive any consideration under the plan. In general, if any security which is a capital asset (such as an interest) becomes worthless during a taxable year, the loss resulting therefrom (equal in amount to the holder's basis therein) shall be treated as a loss arising from the sale or exchange of such security on the last day of the taxable year.

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, 1994-2 C.B. 684, provides conditions under which the Service will consider issuing an advance ruling classifying an entity created pursuant to a bankruptcy plan under Chapter 11 of the Bankruptcy Code as a liquidating trust under section 301.7701-4(d) of the Procedure and Administration Regulations. We would like to bring the following issues to your attention.

1. Business Purpose



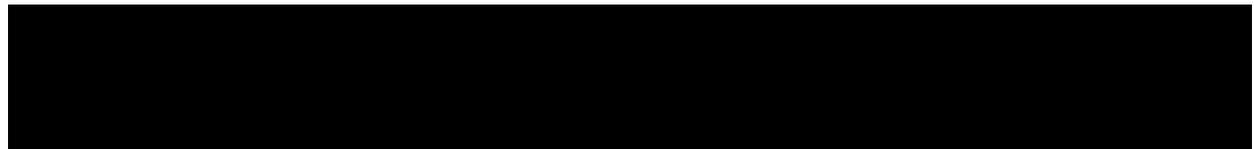


2. Taxation of the Transfer

The Transfer

The disclosure statement and the plan do not clearly explain the tax consequences of the transfer of the assets to the trust. Section 7.2 of the plan provides that the transfer of the trust assets to the trust shall be treated for federal income tax purposes as a deemed transfer of the trust assets to certain holders of allowed claims (generally in proportion to the amount that each such allowed claim bears to the total of such allowed claims) followed by a deemed transfer of the trust assets by such holders of allowed claims to the trust. While section VII(D)(1) of the disclosure statement provides that although the holders of allowed claims will generally be treated for federal income tax purposes as having received the trust assets from the debtors and then transferring them to the trust, because holders of allowed administrative claims and Class 1 claims will receive specified fixed amounts from the trust, the trust administrator intends to treat the actual payments made to holders of allowed administrative claims and Class 1 claims from the trust as being made in exchange for these claims on the date of payment thereof. Sections VII(D)(2) and (3) of the disclosure statement provide similar provisions with respect the holders of other classes of claims.

The Service believes that a transfer to a liquidating trust for the benefit of creditors must be treated for all purposes of the Code as a transfer to the creditors (e.g., sections 61(a) (12), 483, 1001, 1012, and 1274) to the extent that the creditors are beneficiaries of the trust. The transfer will be treated as a deemed transfer to the beneficiary-creditors followed by a deemed transfer by the beneficiary-creditors to the trust. To the extent that the trust is being created for the benefit of equity interest holders in the debtor, the transfer to the trust should be treated as a transfer to the equity interest holders. See Rev. Rul. 94-45.



See also Rev. Rul. 85-13, 1985-1 C.B. 184, where the IRS considered whether, to the extent that a grantor is treated as the owner of a trust, the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.

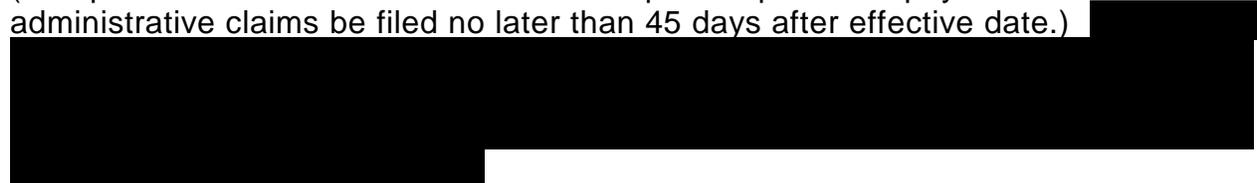
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Cancellation of Indebtedness Income

The property transfer from the debtors to the trust will be taxable to the debtors under section 1001 of the Code. The debtors are treated as having transferred their property to their 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 debtors will realize gain or loss on the difference between the debtor's basis in the property and its fair market value.

Because the debtors are 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 debtors will probably realize COD (cancellation of indebtedness) income under section 61(a)(12) 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 debtor's gross income and will reduce any of the debtor's tax attributes transferred to the estate. I.R.C. § 108(a)(1)(A) and (b).

It is unlikely that any tax will ultimately be payable upon the transfer from the debtors to the trust (as contended in section VII(B) of the disclosure statement). However, if there is a tax liability, the bankruptcy estate will be left without assets to satisfy this liability. Further, the bar date for the payment of administrative claims from the trust assets will have passed before any such liability could be determined. (See plan sections 2.11 and 10.3 which require requests for payment of administrative claims be filed no later than 45 days after effective date.)



3. Taxation of the Trust

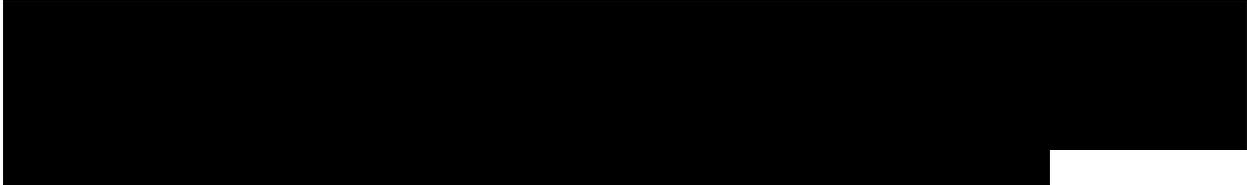
Generally, liquidating trusts are taxed as grantor trusts with the creditors treated as the grantors and deemed owners. The theory is that the debtor transferred its assets to the creditors in exchange for relief from its indebtedness to them, and that the creditors then transferred those assets to the 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.

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CONCLUSION



If you have any questions, please contact the attorney assigned to this matter in Passthroughs & Special Industries at (202) 622-3050.