



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

OFFICE OF
CHIEF COUNSEL

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MEMORANDUM FOR ASSOCIATE AREA COUNSEL, SB/SE:2 (RICHMOND)

FROM: Lawrence H. Schattner, Chief, Branch 2
(Collection, Bankruptcy and Summonses)

SUBJECT:

This responds to your memorandum dated December 27, 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.

LEGEND

AMOUNT A
AMOUNT B
DATE A
ENTITY A
ENTITY B
ENTITY C
IDENTIFIER A
IDENTIFIER B
NUMBER A
NUMBER B
NUMBER C
NUMBER D
NUMBER E
NUMBER F
NUMBER G
STATE
TAXPAYER

BACKGROUND

As of DATE A (the "Petition Date"), TAXPAYER, a Delaware corporation, and NUMBER A of its wholly-owned, direct, or indirect subsidiaries, (the "Debtors") were

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the IDENTIFIER A. The Debtors had been in operation for NUMBER B years and provided IDENTIFIER B related services to NUMBER G of customers each year. On the Petition Date, the Debtors filed for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of STATE.

Shortly before the commencement of the Chapter 11 cases, the Debtors and ENTITY A entered into an asset purchase agreement that provided, among other things, for ENTITY A's purchase of substantially all of the Debtor's assets

(the "ENTITY A sale transaction"). The Debtors also entered into a debtor in possession loan facility in the original principal amount of \$AMOUNT A (which was subsequently increased to \$AMOUNT B) with ENTITY B, an ENTITY A affiliate, to fund the Debtor's operations pending the ENTITY A sale transaction.

The plan and disclosure statement provide that on the effective date, the Debtors, on their own behalf and on behalf of the holders of allowed claims, shall execute the post-confirmation estate agreement and shall take all other steps necessary to establish the post-confirmation estate. Pursuant to the plan, the Debtors will transfer the post-confirmation estate assets to the post-confirmation estate, and the estate will become obligated to make distributions in accordance with the plan. The plan and disclosure statement provide that for all federal income tax purposes, all parties (including, without limitation, the Debtors, the plan administrator and the beneficiaries of the post-confirmation estate) shall treat the transfer of the assets to the post-confirmation estate in accordance with the plan, as a transfer by the Debtors to the holders of allowed claims entitled to a distribution under the plan followed by a transfer by such holders of the post-confirmation estate, and the beneficiaries of the post-confirmation estate shall be treated as the grantors and owners thereof.

The plan and disclosure statement anticipate that the Debtors will not incur any federal income tax liability from the transfer of the post-confirmation estate assets to the post-confirmation estate. The disclosure statement explains that under the plan, the Debtors are transferring substantially all of the proceeds from the Entity A sale transaction and their remaining assets to the post-confirmation estate. These transfers, other than the transfers of cash, may result in the recognition of taxable gain or loss by the Debtors. Nevertheless, due to available net operating loss and other loss carryforwards, the Debtors do not anticipate that a significant federal income tax liability, if any, will be incurred as a result of such transactions. The disclosure statement further provides that to the extent that any federal income tax liability results from the Entity A sale transaction or transfer of the assets to the post-confirmation estate, the Debtors will pay the resulting tax to the IRS. The plan also provides that the Debtors will be liquidated and dissolved. As a result, there

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will be no net operating loss or capital loss or capital loss carry forwards or other tax attributes available to the Debtors or to the post-confirmation estate following the effective date after giving effect to the transactions contemplated by the plan.

Pursuant to the disclosure statement and plan, the Debtors will transfer the post-confirmation estate assets to the post-confirmation estate, and the post-confirmation estate will become obligated to make distributions in accordance with the plan. The plan provides that the post-confirmation estate will be treated for federal income tax purposes as a "liquidating trust," as defined in § 301.7701-4(d), and will therefore be taxed as a grantor trust of which the beneficiaries will be treated as the owners and grantors. The plan further provides that because a grantor trust is treated as a pass-through entity for federal income tax purposes, no federal income tax should be imposed on the post-confirmation estate itself on the income earned or gain recognized by the post-confirmation estate. Instead the beneficiaries will be taxed on their allocable shares of such net income or gain in each taxable year (determined in accordance with the post-confirmation estate agreement or described in the plan), whether or not they receive any distributions from the post-confirmation estate in such taxable year.

The plan and disclosure statement provide that the plan administrator will file tax returns with the IRS for the post-confirmation estate as a grantor trust in accordance with § 1.671-4(a). The disclosure statement provides that the plan administrator will also send to each beneficiary of the post-confirmation estate a separate statement setting forth the beneficiary's allocable share of such items of income, gain, loss, deduction or credit and will instruct the beneficiary to report such items on such beneficiary's federal income tax return.

The plan provides that as soon as possible after the effective date, the plan administrator, to the extent that he deems necessary or appropriate in his sole discretion, may conduct a good faith valuation of the post-confirmation estate assets and may make such valuation available to the beneficiaries of the post-confirmation estate. Such valuation shall be used consistently by all parties (including the Debtors, the plan administrator and the beneficiaries of the post-confirmation estate) for all federal income tax purposes. Any dispute regarding the valuation of the post-confirmation estate assets shall be resolved by the bankruptcy court.

The plan provides that the plan administrator, in his sole discretion and based on available assets, shall periodically distribute to the beneficiaries of the post-confirmation estate net cash income and proceeds from the liquidation of assets pursuant to the plan. However, the post-confirmation estate shall retain such amounts as are necessary to meet contingent liabilities, and pay expenses of administration (including any taxes imposed on the post-confirmation estate or in respect of the post-confirmation estate or to which the post-confirmation estate

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assets are otherwise subject) in accordance with the plan and the post-confirmation estate agreement. The plan administrator shall also reserve such amounts as would be distributable with respect to disputed claims. The post-confirmation estate may withhold from amounts distributable to any entity any and all amounts, determined in the plan administrator's reasonable and sole discretion, to be required by any law, regulation, ruling, directive or other governmental requirement.

The plan provides that the post-confirmation estate will terminate no later than the NUMBER D anniversary of the effective date, provided, however, that, on or prior to the date NUMBER E months prior to such termination, the bankruptcy court, upon motion by a party in interest, may extend the term of the post-confirmation estate for a finite period, if such extension is necessary for the liquidation of the post-confirmation estate assets. Additionally, multiple extensions can be obtained so long as bankruptcy court approval is obtained at least NUMBER F months prior to the expiration of each extended term, and the plan administrator receives an opinion of counsel or a favorable ruling from the IRS that any further extension would not adversely affect the status of the post-confirmation estate as a grantor trust for federal income tax purposes.

The plan provides that after the transfer of the assets to the post-confirmation estate, such assets shall include the capital stock of ENTITY C, which, after payment of all obligations of ENTITY C,

, shall be voted by the plan administrator so as to dissolve and/or windup such ENTITY C and make available any net proceeds of such dissolution or winding up for distribution to the beneficiaries of the post-confirmation estate in accordance with the plan and the post-confirmation estate agreement.

The plan provides that the right and power of the plan administrator to invest assets transferred to the post-confirmation estate, the proceeds thereof, or any income earned by the post-confirmation estate, shall be limited to the right and power to invest in such assets (pending distributions in accordance with the plan) in cash equivalents. However, the scope of any such permissible investments shall be limited to include only those investments, or shall be expanded to include any additional investments, as the case may be, that a liquidating trust, within the meaning of § 301.7701-4(d) may be permitted to hold, pursuant to the Treasury Regulations, or any modifications to IRS guidelines, whether set forth in IRS rulings, other IRS pronouncements.

The plan provides that the plan administrator, in his sole discretion and based on available assets, shall periodically distribute to the beneficiaries of the post-confirmation estate net cash income and proceeds from the liquidation of assets

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pursuant to the plan. However, the post-confirmation estate shall retain such amounts as are necessary to: meet contingent liabilities; pay expenses of administration, including any taxes imposed on the post-confirmation estate or in respect of the post-confirmation estate assets; and satisfy other liabilities incurred or assembled by the post-confirmation estate, or to which the post-confirmation estate assets are otherwise subject, in accordance with the plan and the post-confirmation estate agreement. The plan administrator will also to reserve such amounts as would be distributable with respect to disputed claims. The post-confirmation estate may withhold from amounts distributable to any entity any and all amounts, determined in the plan administrator's reasonable and sole discretion, to be required by any law, regulation, rule, ruling, directive or other governmental requirement.

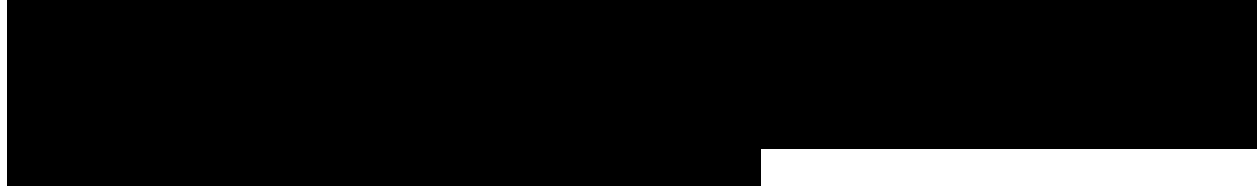
The plan provides that the post-confirmation estate shall be established for the primary purpose of liquidating its assets, in accordance with § 301.7701-4(d), with no objective to continue or engage in the conduct of a trade or business, except to the extent reasonably necessary to, and consistent with, the liquidating purpose of the post-confirmation estate.

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 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 section 301.7701-4(d) of the Procedure and Administration Regulations. In addition, we would like to bring the following issues to your attention.

1. Business Purpose



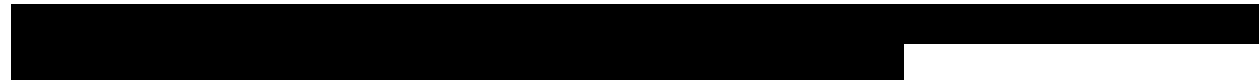
2. Taxation of the Transfer

The Transfer

The plan and the disclosure statement provide that the Debtors will transfer the post-confirmation estate assets to the post-confirmation estate, and the post-confirmation estate will become obligated to make distributions in accordance with the plan. The plan provides that for all federal income tax purposes, all parties (including, the Debtors, plan administrator and the beneficiaries of the post-confirmation estate) shall treat the transfer of the assets to the post-confirmation estate in accordance with the plan, as a transfer by the Debtors to the holders of allowed claims entitled to a distribution under the plan followed by a transfer by such holders of the post-confirmation estate, and the beneficiaries of the post-confirmation estate shall be treated as the grantors and owners thereof.

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. Proc. 94-45.

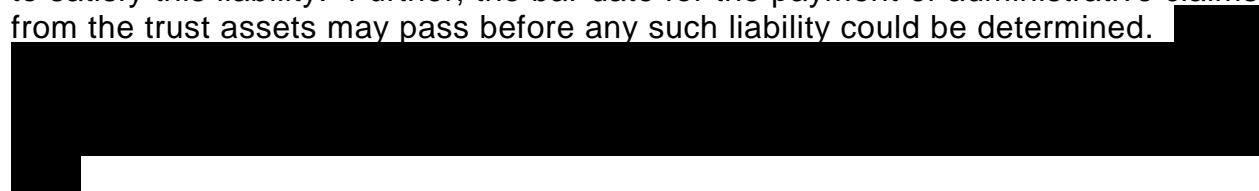



Cancellation of Indebtedness Income

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 income under section 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 Debtor's gross income and will reduce any of the Debtor's tax attributes transferred to the estate. Sections 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 the plan and the disclosure statement). However, if there is a tax liability, the bankruptcy estate could be left without assets to satisfy this liability. Further, the bar date for the payment of administrative claims from the trust assets may pass before any such liability could be determined.



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.

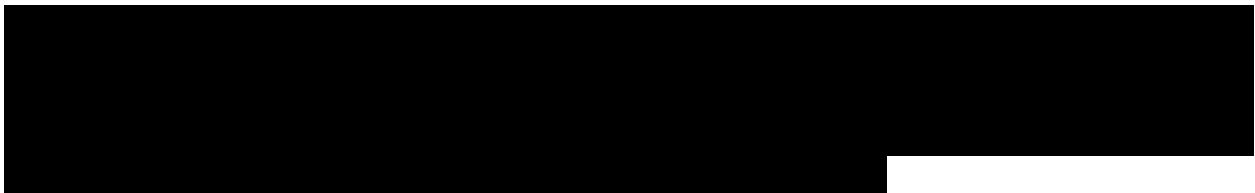
The beneficiaries of the bankruptcy estate will be the grantors of the liquidating trust. They will be treated as the deemed owners of the trust because the property used to fund it came from them and all the income will be distributed to them or

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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.



CONCLUSION



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