

## **TGP PROBLEM #2**

Waterco is a publicly held corporation that, for more than fifty years, has been in the business of manufacturing vessels for purifying and storing fresh water. About 25 years ago, Waterco expanded its business to include the manufacture of certain component parts that went into the construction of swimming pools, including residential home pools. Over the course of the years, the latter business has gradually expanded such that it now includes, and has included for at least the past 10 years, the manufacture of all component parts needed to construct swimming pools. The customers of this latter business are a number of companies that are in the business of marketing and constructing residential swimming pools around the country. Until very recently, Waterco itself was not in the business of marketing or constructing residential swimming pools, but had limited its business to selling its products to customers who are in that business. About a year ago, the family that owned a competitor that was engaged in the manufacture of swimming pool components decided to put the business up for sale. At the conclusion of a bidding process, Waterco was the successful bidder and proceeded to purchase the competitor's business assets that were associated with swimming pools. Unlike Waterco, the competitor had a division that also marketed and constructed swimming pools for residential customers. Waterco did not want to purchase that division, but the competitor insisted that Waterco must purchase the swimming pool construction division or else the competitor would not sell the manufacturing division to Waterco. After some hesitation, Waterco acceded to the competitor's demand and purchased the construction division assets together with the manufacturing division assets for cash in a taxable transaction.

Initially, Waterco had intended to proceed to sell the construction division assets to a buyer shortly after closing the acquisition from the competitor. However, owing to normal business distractions, Waterco delayed the marketing of the construction division, which thus routinely went about its business of marketing, selling, and constructing residential swimming pools. A year has passed and the construction division has proved to be a highly effective competitor in its market and has been very profitable. As a result, Waterco estimates that the construction division has substantially appreciated in value since its purchase of that division. In fact, the construction division has been such an effective competitor in its business that it has begun to cause significant problems for Waterco's business of manufacturing swimming pool component parts because the construction division has been recognized as a very strong competitor of many of the companies that are customers of Waterco's manufacturing division. Upon becoming aware of this competition, many of the customers of Waterco's manufacturing business have been sending Waterco irate letters threatening to stop purchasing swimming pool components from Waterco unless it gets out of the business of constructing home swimming pools. The management of Waterco now estimates that its manufacturing division could suffer a 30-40 percent reduction in its sales unless it finds a way somehow to mollify the customers that are complaining about the fact that Waterco is now competing with them in the swimming pool construction business.

Waterco realizes that it could just proceed to sell the pool construction business to a third party. However, in light of the success that that business has enjoyed over the last year and its very good prospects for the future, such a sale would generate a substantial amount of taxable gain to Waterco. In addition, such a sale would generate substantial cash proceeds to Waterco, which would far exceed amounts that Waterco would need to invest in any of its other operations. Waterco could in fact use some internally generated capital for its other businesses, but not nearly as much as a sale of the construction division would be expected to generate. As a result, Waterco would be under some pressure to distribute the after-tax proceeds from such a sale to its shareholders. The result would be a substantial federal income tax liability both for Waterco and for its shareholders.

The management of Waterco has now called you to inquire about any ideas that you may have for divesting of the construction division that Waterco purchased about a year ago in a manner that will satisfy the complaining customers of the manufacturing division by taking Waterco out of the pool construction business, will generate some additional internal capital for Waterco, and will achieve both objectives with little or no federal income tax cost either to Waterco or to its shareholders. Are all of the objectives of Waterco's management reasonably achievable? What are some alternative transactions that you should consider as vehicles for attaining some or all of Waterco's objectives? What proposals should you ultimately recommend to management?