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Department of the Treasury
Washington, DC 20224

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Date:

December 17, 2003

In Re:

Distributing =

Controlled 1 =

Controlled 2 =

Controlled 3 =

Controlled 4 =

Shareholder 1 =

Shareholder 2 =

Shareholder 3 =

Shareholder 4 =

Shareholder 5 =

Shareholder 6 =

Shareholder 7 =

Shareholder 8 =

Business A =

Year 1 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

State X =

Dear

This letter is in reply to your letter dated July 23, 2003, requesting rulings as to the federal income tax consequences of a proposed transaction. Additional information

was submitted in letters dated October 3, October 14, October 30, November 20, December 8, and December 10, 2003. The information submitted for consideration is summarized below.

Distributing is a cash basis State X corporation. Distributing elected to be taxed as an S corporation in Year 1. Distributing currently has 10,700 shares of voting common stock outstanding, which is owned by eight "Shareholders:" Shareholder 1 (a%); Shareholder 2 (b%); Shareholder 3 (c%); Shareholder 4 (d%); Shareholder 5 (e%); Shareholder 6 (f%); Shareholder 7 (g%); and Shareholder 8 (h%). Distributing has directly engaged in Business A for more than five years through its Shareholders and employees. The taxpayer has supplied financial information which indicates that Business A has had gross receipts and operating expenses representative of the active conduct of the business for each of the past five years.

Distributing has accumulated earning and profits of approximately \$i all of which is attributable to Distributing's predecessor (by virtue of a § 355 transaction in Year 1). Prior to Distributing's S election, Distriubuting's predecessor had accumulated these profits as a C corporation. Prior to the proposed transaction, Distributing intends to make a cash distribution ("Cash Distribution") proportionally to the Shareholders of its accumulated earnings and profits.

To resolve management issues relating to asset deployment and economic risk that are inherent in the current structure, Distributing has decided to separate Business A as follows (the "Proposed Transaction"):

- (i) Distributing will form Controlled 1, Controlled 2, Controlled 3, and Controlled 4 as cash basis corporations (together, the "Controlled Corporations") under the laws of State X. Distributing will contribute Business A assets to each of the newly formed Controlled Corporations in exchange for all of the outstanding stock of each of the Controlled Corporations.
- (ii) Distributing will distribute all of the stock of Controlled 1 to Shareholder 1 and Shareholder 2 in exchange for all of Shareholder 1's and Shareholder 2's stock in Distributing. Distributing will distribute all of the stock of Controlled 2 to Shareholder 4 in exchange for all of Shareholder 4's stock in Distributing. Distributing will distribute all of the stock of Controlled 3 to Shareholder 5 in exchange for all of Shareholders 5's stock in Distributing. Distributing will distribute all of the stock of Controlled 4 to Shareholder 6 in exchange for all of Shareholder 6's stock in Distributing (the "Distribution"). No fractional shares will be exchanged.

Section 1361(a)(1) provides that the term "S corporation" means, with respect to a taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(3)(A) provides that (i) a corporation which is a QSub shall not be treated as a separate corporation and (ii) all assets, liabilities, and items of income, deduction and credit of a QSub shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1361(b)(3)(B) provides that the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation if (i) 100 percent of the stock of such corporation is held by the S corporation, and (ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 1361(b)(3)(C) provides that if any corporation which was a QSub ceases to meet the requirements of § 1361(b)(3)(B), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock.

Section 1361(b)(3)(D) provides that if a corporation's status as a QSub terminates, such corporation (and any successor corporation) shall not be eligible to make (i) an election to be treated as a QSub or (ii) an election to be treated as an S corporation, before its 5th taxable year which begins after the first taxable year for which such termination was effective, unless the Secretary consents to such election.

Section 1.1361-5(b)(1)(i) of the Income Tax Regulations provides that if a QSub election terminates under § 1.1361-5(a), the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for the stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine.

Section 1.1361-5(b)(3) Example 4 provides an example whereby an S corporation that distributes the stock of its QSub to its shareholders, terminating the QSub election, can qualify as a distribution to which §§ 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Section 1.1361-5(c)(1) provides that absent the Commissioner's consent, and except as provided in § 1.1361-5(c)(2), a corporation whose QSub election has terminated (or a successor corporation) may not make an S election or have a QSub election made with respect to it for five taxable years.

Section 1.1361-5(c)(2) provides that a corporation may make an S election or have a QSub election made with respect to it before the expiration of the five-year period described in § 1361(b)(3)(D) provided that (i) immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make

an S election or have a QSub election made for it; and (ii) the relevant election is made effective immediately following the termination of the QSub election.

The following representations have been made in connection with the Proposed Transaction:

- (a) The indebtedness, if any, owed by each of the Controlled Corporations to Distributing after the distribution of each Controlled Corporations' stock will not constitute stock or securities.
- (b) The fair market value of the stock of Controlled 1, Controlled 2, Controlled 3 and Controlled 4 to be received by Shareholders 1 and 2, Shareholder 4, Shareholder 5, and Shareholder 6, respectively, will be approximately equal to the fair market value of Distributing stock surrendered by such Shareholders in exchange.
- (c) No part of the consideration distributed by Distributing is being received by a Shareholder as a creditor, employee or in any capacity other than that as a shareholder of Distributing.
- (d) The five years of financial information submitted on behalf of Distributing is representative of the corporation's present operation and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.
- (e) Following the transaction, Distributing and each Controlled Corporation will each continue, independently and with its separate employees, the active conduct of all of the integrated activities of the business conducted by Distributing prior to the consummation of the transaction.
- (f) The distribution of stock of Controlled 1, Controlled 2, Controlled 3, and Controlled 4 is being carried out for the corporate business purpose of allowing divergent approaches to the appropriate asset deployment and economic risks with respect to Business A to avoid management and shareholder disagreements. The distribution of the stock of the Controlled Corporations is motivated in whole or in substantial part by this corporate business purpose.
- (g) Distributing is an S corporation (within the meaning of § 1361(a) of the Internal Revenue Code). Each of the Controlled Corporations will elect to be an S corporation pursuant to § 1362(a) of the Internal Revenue Code (the "Code") on the first available date after the distribution and there is no plan or intent to revoke or otherwise terminate the S corporation election of either Distributing or any of the Controlled Corporations.

- (h) There is no plan or intention by the Shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in either Distributing or any of the Controlled Corporations after the transaction.
- (i) There is no plan or intention by any of Distributing or any of the Controlled Corporations, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction.
- (j) There is no plan or intention to liquidate either Distributing or any of the Controlled Corporations, to merge any of the corporations with any corporation, or to sell or otherwise dispose of the assets of any of the corporations after the transaction except in the ordinary course of business.
- (k) The total adjusted basis and fair market value of the assets transferred to each of the Controlled Corporations by Distributing each equals or exceeds the sum of the liabilities assumed by each of the Controlled Corporations plus any liabilities to which the transferred assets are subject (as determined under § 357(d)). The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.
- (l) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (m) No intercorporate debt will exist between Distributing and any of the Controlled Corporations at the time of, or subsequent to the distribution of the stock of each of the Controlled Corporations.
- (n) Payments made in connection with all continuing transactions, if any, between Distributing and any of the Controlled Corporations will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (o) No parties to the transaction are investment companies as defined in § 368(a)(2)(F)(ii) and (iv).
- (p) The distribution is not part of a plan or series of related transactions (within the meaning of § 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50 percent or more of the total combined voting power of all classes of stock of Distributing and each of the Controlled Corporations or stock possessing 50% or more of the total value of all classes of stock of Distributing and each of the Controlled Corporations.

Based solely on the information submitted and on the representations set forth above, we rule as follows:

- (1) The transfers by Distributing to Controlled 1, Controlled 2, Controlled 3, and Controlled 4 of a portion of the assets of Business A, in exchange for all of the stock of each of the Controlled Corporations and the assumption of liabilities by each of the Controlled Corporations, as described above, followed by the distribution of stock of Controlled 1, Controlled 2, Controlled 3, and Controlled 4 to Shareholders 1 and 2, Shareholder 4, Shareholder 5, and Shareholder 6, respectively, will each be a reorganization within the meaning of § 368(a)(1)(D). Distributing and each of the Controlled Corporations will be a "party to the reorganization" within the meaning of § 368(b).
- (2) No gain or loss will be recognized by Distributing upon the transfer of assets, subject to liabilities, to each of the Controlled Corporations solely in exchange for stock in each of the Controlled Corporations, as described above (§ 361(a) and 357(a)).
- (2) No gain or loss will be recognized by Controlled 1, Controlled 2, Controlled 3, and Controlled 4 upon the receipt of the assets from Distributing in exchange for shares of stock of each such Controlled Corporation (§ 1032(a)).
- (3) The basis of the assets received by Controlled 1, Controlled 2, Controlled 3, and Controlled 4 will be the same as the basis of such assets in the hands of Distributing immediately prior to their transfer to Controlled 1, Controlled 2, Controlled 3, and Controlled 4 (§ 362(b)).
- (4) The holding period of the Distributing assets received by Controlled 1, Controlled 2, Controlled 3, and Controlled 4 will include the period during which such assets were held by Distributing (§ 1223(2)).
- (5) Except for the Cash Distribution, no gain or loss will be recognized by (and no amount will be included in the income of) Shareholders 1 and 2, Shareholder 4, Shareholder 5, or Shareholder 6, upon their receipt of shares of Controlled 1, Controlled 2, Controlled 3, and Controlled 4, respectively, in exchange for all of their Distributing shares, as described above (§§ 355(a)(1) and 356). The cash contribution will be treated as a distribution of property to which § 301 applies (§§ 356(b) and 1.356-2(a)).
- (6) No gain or loss will be recognized by Distributing upon the distribution of the stock of Controlled 1, Controlled 2, Controlled 3, and Controlled 4 to Shareholders 1

and 2, Shareholder 4, Shareholder 5, and Shareholder 6, respectively, as described above (§ 361(c)).

- (7) The basis of the stock of Controlled 1, Controlled 2, Controlled 3, and Controlled 4 in the hands of Shareholders 1 and 2, Shareholder 4, Shareholder 5, and Shareholder 6, respectively, will be the same as the basis of the Distributing stock surrendered by such Shareholders in exchange therefor, decreased by the amount of cash received by such Shareholders in the Cash Distribution, and increased by the amount of such cash that is treated as a dividend to such Shareholders (§§ 358(a)(1) and 358(c)).
- (8) The holding period of the stock of Controlled 1, Controlled 2, Controlled 3, and Controlled 4 received by Shareholders 1 and 2, Shareholder 4, Shareholder 5, and Shareholder 6, respectively, will include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the distribution (§ 1223(1)).
- (9) As provided in § 312(h), proper allocation of earnings and profits between Distributing and each of the Controlled Corporations will be made under § 1.312-10(a) of the Income Tax Regulations.
- (10) Distributing's momentary ownership of the stock of each of the Controlled Corporations as part of the divisive reorganization under § 368(a)(1)(D) will not cause any of the Controlled Corporations to have an ineligible shareholder for any portion of its first taxable year under § 1361(b)(1)(B).
- (11) The election of each of the Controlled Corporations to be an S corporation under § 1362(a), if timely made under § 1362(b)(1) and without requiring Distributing's consent, will be effective during such corporation's first taxable year notwithstanding the momentary ownership of the stock of such controlled corporation by Distributing immediately prior to the distribution.

No opinion is expressed about the tax treatment of the Proposed Transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the Proposed Transaction that are not directly covered by the above rulings.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transaction covered by this ruling letter is consummated.

The rulings contained in this letter are predicated upon the facts and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as part of the audit process.

Pursuant to the power of attorney on file in this office, a copy of this letter has been sent to your authorized representative.

Sincerely yours,
Associate Chief Counsel (Corporate)

By Mark S. Jennings
Mark S. Jennings
Chief, Branch 1