

Internal Revenue Service

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Legend

Distributing =

Controlled #1 =

Controlled #2 =

Controlled #3 =

A =

B =

C: =

Business X =

Business Y =

Date 1 =

a =

b =

Dear

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This is in response to a letter dated December 4, 2001, submitted on behalf of Distributing, requesting rulings under §§ 355 and 368 of the Internal Revenue Code (the "Code") with respect to a proposed transaction. Additional information was received in letters dated February 11, 2002, and March 8, 2002.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. The material information submitted is summarized below.

Prior to the formation of Distributing as described below, individuals A, B, and C together owned (in varying proportions) all of the stock of a S corporations (the "Former Corporations") which were engaged either in Business X or Business Y. Each of A, B, and C owned some stock in each of the Former Corporations.

Disputes arose among A, B, and C that made managing the day-to-day operations of the Former Corporations virtually impossible. A, B, and C attempted to end the gridlock by means of the following series of transactions: Pursuant to an agreement dated Date 1, each of A, B, and C contributed his or her stock in the Former Corporations to Distributing, a newly-organized S corporation, in exchange for Distributing stock. It is represented that no gain or loss was recognized in the formation of Distributing. Distributing immediately made qualified subchapter S corporation ("QSub") elections for each of the Former Corporations, causing for federal tax purposes a deemed liquidation of the Former Corporations into Distributing. Distributing formed Controlled #1, Controlled #2, and Controlled #3 (collectively, the "Controlled Subs") and immediately made a QSub election for each of them. For state law purposes, Distributing transferred approximately one-third of the assets of Business X and a portion of the assets and related liabilities of Business Y to each of the Controlled Subs in exchange for 100% of the stock of each. These transfers were disregarded for federal tax purposes. An agreement among A, B, and C provided that A would have management control over the Controlled #1 assets, B would have management control over the Controlled #2 assets, and C would have management control over the Controlled #3 assets.

Conflicts among A, B, and C continued after the formation of Distributing and have adversely affected day-to-day operations. In order to prevent further management gridlock and to prevent the disputes from further adversely affecting day-to-day operations, Distributing proposes the following transaction (the "Distribution"): Distributing will distribute all of its stock of Controlled #1 to A in exchange for 100% of A's Distributing stock, all of its stock of Controlled #2 to B in exchange for 100% of B's Distributing stock, and all of its stock of Controlled #3 to C in exchange for 100% of C's Distributing stock. As soon as practicable after the Distribution, Distributing will be dissolved under state law.

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Financial information has been received indicating that Business X has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

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 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

Section 1.1361-4(a)(2)(i) provides that if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation.

Section 1.1361-5(b)(1)(i) provides that if a QSub election terminates, 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 Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 1.1361-5(b)(1)(ii) provides if QSub elections terminate for tiered QSubs on the same day, the formation of any higher tier subsidiary precedes the formation of its lower tier subsidiary. See Example 6 in §1.1361-5(b)(3).

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Section 1.1361-5(c)(2) provides that the 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.

Section 1.1361-5(c)(3), Example 1 provides an example where QSub stock is distributed to the shareholders of the parent. The distribution terminates the QSub election because the QSub no longer satisfies the requirements of a QSub. Assuming the QSub is otherwise eligible to be treated as an S corporation, the QSub's shareholders may elect to treat the QSub as an S corporation effective on the date of the stock distribution without requesting the Commissioner's consent.

Section 1.1368-2(d)(2) provides that an S corporation acquiring the assets of another S corporation in a transaction to which § 381(a) applies will succeed to and merge its accumulated adjustments account ("AAA") (whether positive or negative) with the AAA (whether positive or negative) of the distributor or transferor S corporation as of the close of the date of distribution or transfer. Thus, the AAA of the acquiring corporation after the transaction is the sum of the AAAs of the corporations prior to the transaction.

Section 1.1368-2(d)(3) provides if an S corporation with accumulated earnings and profits transfers a part of its assets constituting an active trade or business to another corporation in a transaction to which section 368(a)(1)(D) applies, and immediately thereafter the stock and securities of the controlled corporation are distributed in a distribution to which §355 applies, the AAA of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation in a manner similar to the manner in which the earnings and profits of the distributing corporation are allocated under §312(h). See 1.312-10(a).

Distributing has made the following representations with respect to the Distribution:

- (a) The fair market value of the stock of each of the Controlled Subs to be received by each of the Shareholders will be approximately equal to the fair market value of the stock of Distributing surrendered by each of the Shareholders in the exchange.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder of Distributing as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

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- (c) The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operation and there have been no substantial operational changes since the date of the last financial statements submitted.
- (d) Following the Distribution, each of the Controlled Subs will continue independently the active conduct of its share of all of the integrated activities of Business X conducted by Distributing prior to the consummation of the Distribution. The services of b full-time and part-time employees will be shared among two or more of the Controlled Subs.
- (e) The Distribution is being carried out for the following corporate business purpose: to resolve disputes among A, B, and C that are adversely affecting the day-to-day operations of Distributing and Business A and Business B. The Distribution is motivated, in whole or substantial part, by this corporate business purpose.
- (f) Distributing is an S corporation within the meaning of § 1361(a) of the Code. Each of the Controlled Subs will elect to be an S corporation pursuant to § 1362(a) of the Code, and each of the Controlled Subs will make QSub elections for each of its eligible wholly-owned subsidiaries. There is no plan or intention to revoke or otherwise terminate the S corporation or QSub elections of any of the Controlled Subs, once made.
- (g) There is no plan or intention by any Shareholder to sell, exchange, transfer by gift, or otherwise dispose of any stock in, or securities of, any of the Controlled Subs after the Distribution.
- (h) There is no plan or intention by any of the Controlled Subs, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction, other than through purchases meeting the requirements of § 4.05(1)(b) of Rev. Proc. 96-30.
- (i) Distributing will distribute 100% of its assets in the Distribution and be liquidated as soon as practicable thereafter. There is no plan or intention to liquidate any of the Controlled Subs, to merge any of the Controlled Subs with any other corporation, or to sell or otherwise dispose of the assets of any of the Controlled Subs after the Distribution, except in the ordinary course of business.
- (j) The Distribution is not part of a plan or series of related transactions (within the meaning of Code § 355(e)) pursuant to which one or more persons will acquire directly or indirectly stock possessing 50% or more of the total combined voting power of all classes of stock of either Distributing or any of the Controlled Subs entitled to vote or stock

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possessing 50% or more of the total value of all classes of stock of either Distributing or any of the Controlled Subs.

- (k) The total adjusted basis and the fair market value of the assets transferred to each of the Controlled Subs by Distributing each equals or exceeds the sum of the liabilities assumed by each of the Controlled Subs plus any liabilities to which the transferred assets are subject. 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 Distribution.
- (m) No intercorporate debt will exist between Distributing and any of the Controlled Subs at the time of, or subsequent to, the Distribution.
- (n) Payments made in connection with all continuing transactions, if any, among the Controlled Subs will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (o) No two parties to the Distribution are investment companies as defined in Code § 368(a)(2)(F)(iii) and (iv).

Based solely on the information submitted and the representations made, we have concluded that:

- (1) The deemed exchange of Distributing's assets for the stock of the Controlled Subs resulting from the termination of Distributing's QSub elections with respect to the Controlled Subs, followed by the distribution by Distributing of all of the shares of the common stock of each of the Controlled Subs to the Shareholders, will be treated as a reorganization within the meaning of Code § 368(a)(1)(D). Distributing and Controlled will each be treated as a party to a reorganization within the meaning of Code § 368(b).
- (2) The distribution of the stock of the Controlled Subs to Distributing's shareholders will terminate the QSub elections of the Controlled Subs and any second-tier QSub. The Controlled Subs' shareholders may, without requesting the Commissioner's consent, make an S election for the Controlled Subs provided that (i) each is otherwise eligible to make an S election and (ii) the election is made effective immediately following the termination of the original QSub election.

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- (3) Distributing will not recognize any gain or loss upon the transfer of its assets to the Controlled Subs in exchange for 100% of the common stock of the Controlled Subs and the assumption of certain liabilities by the Controlled Subs. Code §§ 361(a) and 357(a).
- (4) No gain or loss will be recognized to the Controlled Subs upon the receipt of Distributing's assets in exchange for 100% of the stock of the Controlled Subs and the assumption of the liabilities of Distributing by the Controlled Subs. Code § 1032(a).
- (5) The basis of the assets received by the Controlled Subs from Distributing will be the same as the basis of such assets in the hands of Distributing immediately prior to the transfer. Code § 362(b).
- (6) The holding period of each asset received by the Controlled Subs from Distributing will include the period during which Distributing held such asset. Code § 1223(2).
- (7) No gain or loss will be recognized to Distributing upon the distribution to the Shareholders of 100% of the shares of the common stock of the Controlled Subs pursuant to the Distribution. Code § 361(c)(1).
- (8) No gain or loss will be recognized to, and no amount will be included in the income of, the Shareholders upon the exchange of their shares of Distributing common stock for shares of the common stock of the Controlled Subs pursuant to the Distribution. Code § 355(a)(1).
- (9) The basis of the shares of the common stock of each of the Controlled Subs in the hands of the Controlled Subs shareholders immediately after the Distribution will be the same as the basis of the Distributing common stock surrendered in exchange therefor. Code § 358(a)(1).
- (10) The holding period of the shares of the stock of the each of the Controlled Subs to be received by the Shareholders will include the period during which the Shareholders held the Distributing stock surrendered in exchange therefore, provided that such shareholder held the Distributing stock as a capital asset on the date of the Distribution. Code § 1223(1).
- (11) As provided in Code § 312(h), the earnings and profits of Distributing will be allocated among the Controlled Subs under Treas. Reg. § 1.312-10(a).
- (12) Distributing's accumulated adjustments account immediately before the transaction will be allocated among the Controlled Subs in a manner similar to the manner in which Distributing's earnings and profits will be allocated under section 312(h). Treas. Reg. § 1.1368-2(d)(3).

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No opinion is expressed as to the tax treatment of the transactions under other provisions of the Code or regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling. More specifically, no opinion is expressed as to whether the formation of Distributing qualified under § 351 of the Code or whether gain or loss was recognized in that transaction.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Gerald B. Fleming _____

Gerald B. Fleming
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