Distributing, a State X corporation had elected to be an S corporation. Distributing owned all of the stock of a number of Qualified Subchapter S Subsidiaries ("QSubs"), including Subsidiary and Controlled. Distributing has voting and nonvoting common stock outstanding which is closely held. Subsidiary and Controlled have conducted Business A and Business B, respectively, as active trades or businesses for each of the past five years. Distributing wished to separate Controlled from Distributing to save Controlled a substantial amount of state income taxes without a reduction in federal income taxes.

Controlled created a second class of nonvoting common stock with identical rights as the Distributing nonvoting common stock. Distributing distributed all of the two classes of Controlled common stock pro rata to its shareholders (the "Distribution"). The Distribution caused a termination of Controlled’s QSub election because Controlled ceased to be a wholly-owned subsidiary of an S corporation. For federal tax purposes, Controlled was treated as a new corporation acquiring all of its assets and assuming all of its liabilities from Distributing immediately before the termination of Controlled’s QSub election in exchange for the stock of Controlled (the "Contribution"). Controlled elected to be treated as an S corporation.

The Contribution, followed by the Distribution, qualified as a reorganization within the meaning of Code §368(a)(1)(D). Distributing’s momentary ownership of the stock of Controlled, as part of the reorganization under §368(a)(1)(D), did not cause Controlled to have an ineligible shareholder for any portion of its first taxable year.

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