The Qualified Subchapter S Subsidiary Election—A Primer and Beyond

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QSubs offer tax and planning opportunities that make Subchapter S more flexible but also more complex.

In 1954, President Eisenhower recommended the passage of legislation to minimize the influence of federal income tax laws on entity selection by small businesses. It was not until 1958, however, that Congress acted on the President's recommendation. In that year, tucked-away in a technical corrections bill, the first version of Subchapter S was enacted into law.[1] Unfortunately, the original legislation contained so many flaws and intricate operational rules that most tax advisors avoided Subchapter S.

Subchapter S evolved over the next six decades. While its beginning was somewhat turbulent, lawmakers eventually smoothed out most of the rough edges. With significant legislative changes, including the creation of the Qualified Subchapter S Subsidiary (the QSub), Subchapter S is much more friendly today.[2]

THE QUALIFIED SUBCHAPTER S SUBSIDIARY

The Small Business Job Protection Act of 1996 (1996 Act) created the QSub.[3] To pave the way, lawmakers changed three longstanding provisions of Subchapter S, removing: (1) the prohibition against an S corporation being a part of an affiliated group of corporations;[4] (2) the prohibition against an S corporation having a corporate shareholder;[5] and (3) the rule providing that an S corporation, in its capacity as a shareholder of another corporation, is treated as an individual.[6]

Following the 1996 Act:

- An S corporation may own up to 100% of the shares of a subsidiary that is a C corporation.[7]
- A C corporation subsidiary may elect to join in the filing of a consolidated return with affiliated C corporations.[8]

- An S corporation parent is prohibited from joining in the filing of a consolidated return with its C corporation subsidiaries.[9]
- A subsidiary of a C corporation may not be an S corporation.[10]
- A subsidiary of an S corporation may, provided certain requirements are met, be an S corporation (i.e., QSub).[11]

The QSub is generally not treated as a separate entity for federal income tax purposes. Rather, all assets, liabilities, and items of income, deduction, and credit of a QSub, for income tax purposes, are treated as the assets, liabilities, and tax attributes of its S corporation parent.[12]

QSub/Planning Opportunities

The QSub offers tax and business planning opportunities.

Suspended Losses. In the situation in which a taxpayer owns shares of an S corporation with losses suspended due to insufficient shareholder basis, and the taxpayer also owns the shares of a profitable S corporation, a restructuring may allow the taxpayer to use the losses.

Example 1: Taxpayer owns 100% of two S corporations, X and Y. Corporation X is profitable. Corporation Y is generating losses and likely will continue in a loss mode for the immediate future. Taxpayer has $200,000 of stock basis in her stock of Corporation X. She has zero basis in her stock of Corporation Y and $100,000 of suspended losses from Corporation Y. For valid business reasons, Taxpayer transfers her stock of both Corporation X and Corporation Y to a newly formed S corporation, Holdco. Holdco immediately causes QSub elections to be made with respect to Corporation X and Corporation Y. This restructuring may enable Taxpayer to use the $100,000 of suspended losses attributable to Corporation Y.[13]

Example 2: The same facts apply as those set forth in Example 1 above, except, for valid business reasons, Taxpayer has Corporation Y acquire 100% of the stock of Corporation X in a tax-free merger, and Corporation Y immediately causes a QSub election to be made with respect to Corporation X. This restructuring may enable Taxpayer to utilize the $100,000 of suspended losses attributable to Corporation Y.[14]

Example 3: The same facts apply as those set forth in Example 1 above, except, for valid business reasons, Taxpayer contributes her stock of Corporation Y to the capital of Corporation X in a tax-free transaction under Section 351, and Corporation X immediately causes a QSub election to be made with respect to Corporation Y. This restructuring may enable Taxpayer to use the $100,000 of suspended losses attributable to Corporation Y.[15]

> **The non-passive income of one or more QSubs may help an S corporation parent avoid the application of Sections 1375 and 1362(d)(3).**

In each of these situations, it is important that valid business reasons exist for the restructuring. In addition, especially in Example 3, consideration should be given to the application of the step-transaction doctrine.

Another consideration, illustrated in Examples 2 and 3, is the question of which corporation should be the parent corporation. Having the profitable corporation (i.e., Corporation X) as the parent may be warranted if there exists the possibility that the creditors of the loss corporation could obtain (through legal process or otherwise) the stock of the profitable subsidiary (i.e., Corporation X) if it was owned by the loss corporation (i.e., Corporation Y). Consideration should be given, however, to risks of uninsured liability in either corporation. If a corporation is susceptible to such risks, avoiding having it as the parent may be warranted. When both corporations face liability, the transaction format of Example 1 may be preferable.

Potential Liability Protection/Segregation of Risk. Keeping activities in separate corporations may assist taxpayers in building protection against liabilities. Assuming corporate formalities are adhered to, the corporate veil should help taxpayers insulate themselves from liabilities associated with different business activities.[16]

Potential Planning Under Section 1374. Section 1374 imposes a corporate level tax on an S corporation's recognized net built-in gains that are recognized during the "recognition period."[17] Under current law, the term "recognition period" means the five-year period beginning with the first day of the first tax year for which the corporation was an S corporation.[18] Section 1374 does not apply to an S corporation that was never a C corporation and which has never acquired property from a C corporation in a carryover basis transaction.[19]

The net recognized built-in gains for the tax year is reduced by any net operating loss carryforwards arising from prior C corporation years.[20] The tax is reduced by any general business credit carryover arising from prior C corporation years.[21] Additionally, any recognized built-in gains can be reduced by built-in losses recognized during the tax year. [22]

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the built-in gains tax, the asset and any loss, deduction, loss carryforward, credit, or credit carryforward attributable to the asset is ignored.[23] The Service could use this anti-stuffing rule and other anti-abuse Code provisions to

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attack Section 1374 planning using QSubs.[24]

Section 1374 places limitations on the amount of net recognized built-in gains subject to the penalty tax in any tax year. First, only built-in gains recognized during the recognition period are taxed under Section 1374. Also, the net recognized built-in gains taken into account for any tax year cannot exceed the excess (if any) of the S corporation's net unrealized built-in gains over the net recognized built-in gains for prior tax years beginning in the recognition period.[25] Net unrealized built-in gains means the excess (if any) by which the fair market value of the corporation's assets at the beginning of its first tax year as an S corporation exceeds the aggregate adjusted basis of its assets at that time. The significance of this limitation is that it is only the *aggregate* net unrealized appreciation in a corporation's assets as of the beginning of its first S corporation year that will be subject to the tax. As soon as that appreciation is recognized and taxed, the penalty tax is no longer applicable.

The net recognized built-in gains cannot exceed an S corporation's taxable income for the year determined as if it were a C corporation.[26] Thus, if the excess of the corporation's recognized built-in gains over the recognized built-in losses for the year exceeds its taxable income, the amount subject to the penalty tax will be the taxable income of the corporation. The taxable income limitation places a premium on creating deductions in the year in which built-in gains are recognized by an S corporation. If the corporation's taxable income can be reduced to zero, no built-in gains tax will be imposed. Accelerating deductions in the years that built-in gains are recognized can eliminate or reduce taxable income upon which the calculation of the tax is based. Payments of compensation, as an alternative to distributions, create deductions and thereby reduce taxable income. The success of this strategy depends on compensation being "reasonable."[27] If the limitation applies, however, the excess of the corporation's net recognized built-in gains over its taxable income for the tax year is treated as recognized built-in gains in succeeding tax years (provided the succeeding years are within the recognition period).[28] If, of course, the S corporation's taxable income can be reduced to zero for each tax year remaining in the recognition period, the carryover penalty tax will be eliminated.

Anticipating that taxpayers may use QSubs to avoid or minimize the impact of the built-in gains tax under Section 1374, Treasury adopted anti-abuse regulations. To understand the impact of these regulations, a few rules need to be understood:

- All of a QSub's assets, liabilities, and items of income, deduction, and credit are treated as items of its S corporation parent.[29]
- A QSub election is treated as a deemed liquidation of the subsidiary into its parent which occurs the day before the QSub election.[30]
- If a C corporation elects to be treated as an S corporation and makes a QSub election for its wholly-owned subsidiary, effective the same date, the deemed liquidation occurs immediately before the S election, while the parent was still a C corporation.[31]

While these rules apply when a parent corporation acquires assets from an entity for which the corporation intends to make a QSub election, the application of Section 1374 may differ depending on the situation. If the corporation makes an S election for itself and a QSub election with respect to its subsidiary effective on the same date, the subsidiary's assets do *not* become subject to Section 1374(d)(8) as a result of the deemed liquidation of the subsidiary because the liquidation is deemed to have occurred immediately before the S election becomes effective (i.e., while the parent was a C Corporation).[32] However, the subsidiary's assets become subject to Section 1374(a) when the parent converts to an S corporation immediately after the deemed liquidation.[33]

If the parent corporation is an S corporation and makes a QSub election for its wholly-owned C corporation subsidiary, the deemed liquidation occurs the day before the effective date of the QSub election. Consequently, the assets of the subsidiary become subject to Section 1374 as a result of the parent acquiring the subsidiary's assets in a carryover-basis transaction described in Section 1374(d)(8) (rather than as a result of

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1 Section 64 of the Technical Amendments Act of 1958. P.L. 85-866, 9/2/58.

2 Unless otherwise indicated, all references to the Internal Revenue Code are made to the Internal Revenue Code of 1986, as amended. The Internal Revenue Code is referred to herein as the "Code."

3 P.L. 104-188, 8/20/96.

4 Prior to the 1996 Act, an S corporation could not have a C corporation as a 80% or more subsidiary (excepting only inactive subsidiaries) because an S corporation could not be a member of an affiliated group within the meaning of Section 1504.

5 Aside from the sole situation in which an S corporation owns 100% of the S corporation subsidiary (i.e., the QSub), an S corporation is still prohibited from having a corporation as a shareholder. Section 1361(b)(1).

6 *Id.*

7 The repeal of the affiliated group prohibition created this result. Section 1308 of the 1996 Act.

8 *Id.*

9 Section 1504(b)(8).

10 Section 1361(b)(1)(B). Other than in the case of a QSub, an S corporation may not have a corporation as a shareholder.

11 Section 1361(b)(3).

12 Sections 1361(b)(3)(A)(i) and (ii).

13 Reg. 1.1361-4(c).

14 *Id.*

15 *Id.*

16 For a good discussion of piercing the corporation veil, see Thompson, "Piercing the Corporate Veil: An Empirical Study," 76 Cornell L. Rev. 1036 (1991).

17 Section 1374(a).

18 Section 1374(d)(7).

19 See Sections 1374(c)(1) and (d)(8); Ann. 86-128.

20 Section 1374(b)(2).

21 Section 1374(b)(3)(B).

22 Section 1374(d)(2)(A).

23 Regs. 1.1374-9 and -10(b)(3).

24 See e.g., Sections 269, 382, 383, and 384.

25 Sections 1374(a)(2) and (d)(1).

26 Section 1374(d)(2).

27 See Section 162(a)(1).

28 See Section 1374(c)(2)(B).

29 Section 1361(b)(3).

30 Reg. 1.1361-4(b)(1).

31 *Id.*

32 See Reg. 1.1361-4(b)(1); see also TAM 200247002.

33 *Id.*

the parent's conversion to an S corporation). This treatment can be significant because, as discussed above, the Section 1374 attributes from the subsidiary's assets (e.g., a loss carryforward) cannot be used in determining the built-in gains tax with respect to the parent's other assets.[34]

The Treasury Regulations require separate pools be created and maintained for purposes of calculating the tax imposed by Section 1374 for each transaction under Section 1374(d)(8).[35] In connection with maintaining these separate pools, each entity's Section 1374 attributes, such as loss carryforwards and credit carryforwards, may be used only to reduce the Section 1374 tax imposed on the disposition of assets held by that entity. Further, Section 1374 attributes acquired in one transaction may be used only to reduce tax on the disposition of assets acquired in that transaction.[36] Last, the taxable income limitation of Section 1374(d)(2)(i) is allocated among the separate pools pursuant to a formula prescribed in the Treasury Regulations.[37] To prevent manipulation, the rules are rigid.

As discussed above, an S corporation's net recognized built-in gain for a tax year is the lesser of:

- Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and any built-in gain carryover (the "pre-limitation amount").[38]
- Its taxable income determined by using all rules applying to C corporations as modified by Section 1375(b)(1)(B)[39] (the "taxable income limitation amount").[40]
- The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior tax years (the "net unrealized built-in gain limitation").[41]

If Section 1374(d)(8) applies, the "taxable income limitation" is computed separately for the assets held by the S corporation when its S election became effective and the assets acquired in a Section 1374(d)(8) transaction.[42] Also, the "taxable income limitation" is specially allocated among the groups or pools of assets as prescribed in the Treasury Regulations.[43]

Example 4: X, a C corporation, elected to become an S corporation, effective 1/1/00. X has a net operating loss carryforward from 2014 of $200,000. On 1/1/15, Y, an unrelated C corporation, merges into X in a transaction under Section 368(a)(1)(A). Y has no loss carryforwards, credit, or credit carryforwards from C years. Y's assets are subject to Section 1374. Section 1374(d)(8) applies. The net unrealized built-in gain is $1,500,000.

In 2015, X disposes of some of the assets it received from Y. Its pre-limitation amount is $500,000 and its taxable income limitation amount is $1,000,000. Because there is only one pool of built-in gain assets, no allocation of the taxable income is needed. Consequently, X has net recognized built-in gain of $500,000, reducing the net unrealized built-in gain limitation for X to $1,000,000 ($1,500,000 – $500,000). X cannot use its loss carryforward to offset the gain because the tax is determined separately when the assets of Y were obtained in a basis carryover transaction under Section 1374(d)(8).[44]

Example 5: X, a C corporation, makes an S election, effective 1/1/15. At that time, it has $50,000 of net unrealized built-in gain in its assets. Y has no loss carryforwards, credits, or credit carryforwards. On 1/1/16, X merges with Y, an unrelated C corporation, in a transaction under Section 368(a)(1)(A). Y has no loss carryforwards, credits, or credit carryforwards. Y's assets have $800,000 of net unrealized built-in gain.

In 2016, X has a "pre-limitation amount" of $150,000 on its pre-S corporation assets and a pre-limitation amount of $150,000 on the assets acquired in the merger with Y. X's taxable income limitation amount is $100,000.

X's assets have a net unrealized built-in gain of $50,000; so, its net recognized built-in gain on those assets cannot exceed $50,000 before considering the "taxable income limitation." X's "taxable income limitation" of $100,000 gets allocated between the two pools: (1) the assets X has on the effective date of its S election, and (2) the assets X acquired in the merger with Y for purposes of computing the net recognized built-in gain from each pool.

Consequently, X's net recognized built-in gain from its assets held on the effective date of its S election is $25,000 ($100,000 × $50,000/$200,000). X's net recognized built-in gain on Y's assets is $75,000 ($100,000 × $150,000/$200,000).[45]

The Treasury Regulations provide, however, that a single Section 1374 pool may exist when the parent corporation's S election is made effective at the same time as its QSub's election.[46] In addition, a separate built-in gains tax exposure does *not* exist when an S corporation is deemed to acquire the assets of another S corporation under the step-transaction doctrine (or in an actual asset acquisition) if the acquired S corporation has no prior C corporation history.

If an S corporation has tiered subsidiaries for which it will make QSub elections effective on the same date, the general rule is that the subsidiaries liquidate in a bottom-up fashion in order to avoid multiple groups of Section 1374(d)(8) assets that cannot be netted for purposes of the built-in gains tax.[47] The S corporation parent, however, may specify the order of the liquidations.[48]

The overlap of the built-in gains tax and QSubs is complex. Careful

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34 Regs. 1.1374-1(c) and -8(b).

35 Reg. 1.1361-8(c).

36 Reg. 1.1361-4(b)(2).

37 Reg. 1.1361-8(d).

38 Reg. 1.1374-2(a)(1).

39 Pursuant to Section 1375(b)(1)(B), for this purpose, deductions allowed under Part VIII of Subchapter B of the Code (other than Section 248 deductions) and Section 172 are ignored.

40 Reg. 1.1374-2(a)(2).

41 Reg. 1.1374-2(a)(3).

42 Reg. 1.1374-8(c).

43 Reg. 1.1374-8(d).

44 Reg. 1.1374-8(e), Example 1.

45 Reg. 1.1374(8)(e), Example 2.

46 Reg. 1.1361-8(c).

47 Regs. 1.1361-4(b)(2) and 1.1374-8(b).

48 *Id.*

analysis of any transaction involving assets of a C corporation or an S corporation with C corporation history is warranted.

Potential Planning Under Section 1375. In accordance with Section 1375, S corporations with C corporation earnings and profits (E&P) at the *close* of the tax year and "passive investment income" totaling *over* 25% of gross receipts will be subject to a tax imposed at the highest corporate income tax rate under Section 11.[49] S corporations without any C corporation E&P, however, are excluded from the application of Section 1375.

The purpose of Section 1375 is to prevent C corporations with E&P from making S elections simply to avoid the application of the personal holding company tax rules. Absent Section 1375, shareholders of a C corporation could phase out the corporation's business, sell the corporation's assets, and continue to operate as an investment corporation. At a time when the highest corporate income tax rate is less than the highest individual income tax rate, gain on the sale would be taxed at the lower (corporate) tax rate. By not liquidating the corporation, the after-tax gain on the sale would avoid individual taxation. An S election made following the sale would avoid the personal holding company tax and permit passive investment of corporate assets. Section 1375 is designed to prohibit this type of manipulation.

The Secretary may waive the Section 1375 tax if:

- In good faith the corporation believed it had *no* C corporation E&P at the close of the tax year; and
- During a reasonable time after it determined that it actually had C corporation E&P, such was distributed to shareholders.[50]

Section 1362(d)(3) works in tandem with Section 1375. If "passive investment income" for an S corporation that has E&P from C years is *more than* 25% of gross receipts for three consecutive tax years, the S election is terminated at the beginning of the fourth tax year.[51]

The non-passive income of one or more QSubs may help an S corporation parent avoid the application of Sections 1375 and 1362(d)(3). Because the income of the S corporation parent and its QSubs are combined, if the aggregate net passive income of the entities is kept below the 25% threshold, the application of these provisions can be avoided.

Satisfaction of Lender Requirements. Often lenders require that debtors hold collateral for a loan in a bankruptcy remote entity, creating more lender protection. The separate entity is generally not subject to the liabilities of the borrower's other activities. A QSub, which constitutes a separate legal entity, can be used for this purpose.

State and Local Transfer Taxes. Many states and local governments impose a transfer or excise tax on the disposition of certain property. If property that an S corporation desires to sell or exchange is subject to such taxes, dropping the property into a QSub and transferring the stock of the QSub may avoid these taxes. A careful analysis of the applicable state and local law, however, is required. Many of these statutes provide that the tax is triggered upon the transfer of a controlling interest in the entity that holds the property.[52]

Other Planning Opportunities. Situations may arise where it is advantageous to have more than one activity under the same taxable roof, including where the at-risk limitations of Section 465 are in play or the passive activity loss limitations of Section 469 are being bumped up against by the shareholder(s). Adding business activities to an S corporation so that the shareholder(s) will meet the at-risk and/or active participation requirements may be a viable solution. At the same time, the corporation may not want the added risks or liabilities associated with having the additional business activities within the same entity. A potential solution may be for the shareholder(s) to contribute their stock of the corporation holding the additional business activity to the S corporation and have it make a QSub election, or by merging the entities, dropping the additional business activity into a newly formed subsidiary and making a QSub election. In either case, the shareholders participation in the combined activities may allow them to get over the Section 465 and/or 469 obstacles.

> Although the parent corporation may include more than one QSub on an IRS Form 8869, an election must be made by the parent corporation for each subsidiary it desires to be treated as a QSub.

Statutory Requirements

Section 1361(b)(3)(B) is the starting point for any discussion about QSubs. It defines a QSub as:

- A domestic corporation.[53]
- A corporation that is not an ineligible corporation (i.e., a corporation that is a bank that uses the

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49 The 1996 Act eliminates C corporation E&P existing before 1983 in certain circumstances.

50 Section 1375(d). A request for waiver is made in writing and filed with the district director. The request, which is filed in the same format as a ruling request, must contain all relevant facts to establish the aforementioned waiver criteria; a description of how and when it determined it originally had no C corporation E&P and how and when it discovered that it actually had C corporation E&P, steps taken to distribute the E&P, and the timetable for distributions if not made yet. On the date the waiver is approved, all E&P *must* be distributed.

51 Section 1362(d)(3)(A)(ii).

52 Washington State adopted legislation that brings a sale or exchange of a "controlling interest" within the purview of its real property transfer tax regime. See WAC 458-61A-101.

53 Section 1361b)(3)(B).

reserve method of accounting under Section 585, an insurance company subject to tax under Subchapter L, a corporation electing the possessions tax credit under Section 936, or a DISC or former DISC).[54]
- 100% of the stock is owned by an S corporation.[55]
- The S corporation parent makes a separate election to treat the subsidiary as a QSub.[56]

The key requirements are conceptually simple. The entity must be a domestic corporation that is otherwise an eligible corporation. Its stock must be solely owned by an S corporation. The parent must file a QSub election with the Service.

S corporations cannot have more than one class of stock.[57] Interestingly, QSubs are not expressly prohibited from having greater than one class of stock. So, as long as the parent owns 100% of a QSub's stock, the QSub could have more than one class of stock.

Practice Alert: Having a QSub with more than one class of stock may be imprudent. For example, if business reasons dictate spinning off the QSub, making the parent-subsidiary corporate structure a brother-sister corporate structure, the result is that the old QSub is now an ineligible corporation because it has more than one class of stock. Consequently, the former QSub is now a C corporation.

A Domestic Corporation Requirement. The Treasury Regulations provide that a domestic corporation is an entity classified as a corporation and which was created or organized in the United States or under the laws of the United States or any state therein.[58] An entity classified as a corporation existing under the laws of a foreign jurisdiction alone will not qualify, even though it owns property or does business in the United States. An entity classified as a corporation that is created or organized in both the United States and a foreign jurisdiction, however, will be treated as a domestic corporation.[59] The term "corporation" includes unincorporated entities that are otherwise treated as corporations under federal income tax laws.[60] A domestic entity that "checked the box" to be classified as a corporation will be treated as a corporation for federal tax purposes.[61]

Cannot Be An Ineligible Corporation Requirement. An ineligible corporation[62] is:
- A financial institution that uses the reserve method of accounting for bad debts as described in Section 585;
- An insurance company taxed under Subchapter L of the Code;
- A corporation with an election under Section 936 (the Puerto Rico and possessions tax credit); or
- A DISC or a former DISC.

100% Requirement. The 100% requirement seems straightforward, but it is not always simple in application. The proper inquiry is whether the S corporation parent owns all of the stock of the subsidiary, applying the principles of federal tax law.[63]

Disregarded Entities. When shares of a QSub are owned by a disregarded entity, the shares, for purposes of federal income tax, are owned by the owner of the disregarded entity.[64]

Example 6—Tiered QSubs: X, an S corporation, owns all of the outstanding stock of Y, a QSub. In turn, Y owns all of the outstanding stock of Z, a corporation meeting the QSub eligibility requirements. X may elect to treat Z as a QSub, as Y is ignored for federal income tax purposes.[65]

Example 7—Single-Member LLC: The same facts apply as in Example 6, except that Y is a limited liability company that is disregarded for federal income tax purposes under Reg. 301.7701-2(C)(2). X may elect to treat Z as a QSub.[66]

Example 8—S Corporation and Two QSubs: The same facts apply as in Example 6, except that X and Y own 50% of Z. Because Y is disregarded, Z is owned solely by X for income tax purposes. Consequently, X may elect to treat Z as a QSub.[67]

Nominal Ownership. Generally, a nominee with no beneficial ownership is ignored for purposes of determining the owner of the shares of a QSub. Instead, the person for whom the stock is held is the owner.[68] For example, if the stock of a subsidiary is held by a receiver of the parent corporation, the parent corporation would be the owner of the stock of the subsidiary. Likewise, the beneficiary of a voting trust is the owner of the stock held by the trust.[69]

Stock That Is Ignored. For purposes of the 100% ownership requirement, any outstanding instruments, obligations, or arrangements that constitute outstanding equity of the QSub must be owned by the S corporation parent. If any outstanding equity is owned by any person or entity other than the S corporation parent, the QSub election will be deemed invalid or otherwise terminated.[70] Instruments, obligations, and arrangements that are not considered outstanding equity are ignored.[71]

Example 9: X owns all of the outstanding stock of Y. X wants to incentivize its CEO to remain with X. So, it gives the CEO 10% of the stock of Y as a bonus. Except for the stock of Y owned by the CEO, all of the requirements of Section 1361(b)(3) are met. Provided the stock bonus is subject to a substantial risk of forfeiture and the CEO has not made an election in accordance with Section 83(b) with respect to the stock, the stock is not outstanding. X may elect to treat Y as a QSub.[72] If the

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54 Sections 1361(b)(3)(B) and (b)(2).

55 Section 1361(b)(3)(B)(i). For purposes of satisfying the 100% ownership requirement, stock of a corporation is treated as held by an S corporation if it is the owner of the stock for federal income tax purposes. Reg. 1.1361-2(b)(1). The straight debt safe harbor contained in Regs. 1.1361-1(l)(5)(iv) and (v) apply to the analysis. Reg. 1.1361-2(d).

56 Section 1361(b)(3)(B)(ii).

57 Section 1361(b)(1)(D).

58 Reg. 301.7701-5(a).

59 Reg. 301.7701-5; see also, Ltr. Rul. 9512001.

60 Reg. 301.7701.

61 *Id.*

62 Sections 1361(b)(2)(A), (B), (C), and (D).

63 Reg. 1361-2(b)(1).

64 Reg. 301.7701-2(a).

65 Reg. 1.1361-2(d).

66 *Id.*

67 *Id.*

68 Reg. 1.1361-1(e)(1).

69 Section 1361(c)(2)(iv).

70 Reg. 1.1361-2(b)(2).

71 Reg. 1.1361-2(b)(1).

72 Reg. 1.1361-1(l)(3).

risk of forfeiture expires or the CEO makes a Section 83(b) election, however, the 100% rule would be violated, preventing or terminating Y's QSub status.

Debt Versus Equity. For purposes of the 100% ownership requirement, any arrangement that meets the straight debt safe harbor under Section 1361(c)(5) will not constitute outstanding equity.[73] For the straight debt safe harbor to apply:

- There is a written unconditional promise to pay on demand or on a specified date a sum certain in money.
- The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or like factors.
- The debt is not convertible into stock or other equity in the Qsub.
- The creditor is an eligible S corporation shareholder or a person actively and regularly engaged in the lending business.

If the safe harbor is not met, the debt of a subsidiary, if it is held by any person other than the parent, allows the Service to assert that it is equity, causing failure of the 100% ownership requirement. Consequently, the parent would be prohibited from making a QSub election for the subsidiary.[74]

Restricted Bank Director Stock. "Restricted bank director stock" is *not* considered outstanding equity.[75] Consequently, the issuance of "restricted bank director stock" of a subsidiary alone will not prevent a QSub election. Restricted bank director stock is stock in a bank (as defined in Section 581) or a depository institution holding company (as defined in section 3(w)(1) of 12 U.S.C. 1813(w)(1)), *provided:* (1) such stock is either required by federal or state law to be held by the holder in order to serve as a director of the bank or depository institution; *and* (2) such stock is subject to an agreement with the bank or depository institution (or a corporation that controls such entity) whereby the holder must sell the stock back (at the same price as the acquisition price) upon ceasing to be a director.

THE QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTION

As discussed above,[76] in addition to satisfying the QSub requirements,[77] the parent corporation must file an election with the Service on IRS Form 8869.[78] Although the parent corporation may include more than one QSub on an IRS Form 8869, an election must be made by the parent corporation for each subsidiary it desires to be treated as a QSub.

Practice Alert: State law cannot be ignored. New Hampshire, Tennessee, Texas, Louisiana, and the District of Columbia do not recognize S corporations. Also, Arkansas,[79] New Jersey,[80] New York,[81] and Pennsylvania[82] require a separate state law election for corporations desiring to be treated as S corporations. Relative to QSubs, Arkansas,[83] New Jersey,[84] and New York[85] require separate state law QSub elections. A careful review of state law relative to the recognition and treatment of S corporations and QSubs, and the election requirements for S corporations and QSubs is warranted.

Election Mechanics

The QSub requirements must be satisfied at the time the election is effective and for all periods thereafter.[86] The election form must be signed by a person authorized to sign the parent's IRS Form 1120S.[87] The IRS Form 8869 is filed:

- With the IRS Service Center where the parent corporation filed its most recent IRS Form 1120S when the parent corporation formed the subsidiary and is making the QSub election to be effective upon formation;[88] or
- With the IRS Service Center where the subsidiary filed its most recent tax return when the subsidiary was a pre-existing entity.[89]

Election Timing

A QSub election may be made by the parent corporation at any time during the tax year.[90] A QSub election will be effective on the specific date set forth in the election form, provided such date is no more than two months and fifteen days prior to the date of filing and no more than twelve months after the date of filing.[91]

If the specified effective date is more than two months and fifteen days prior to the date of filing, the election is effective two months and fifteen days prior to the date of filing.[92] Likewise, if the specified effective date is more than twelve months after the date of filing, the election is effective twelve months after the date of filing.[93] Last, if the election contains no specific effective date, the effective date is the date of filing.[94]

For a retroactive effective date, the eligibility requirements must be met on the date of filing and all periods for which the election is to apply (i.e., from the effective date forward). For a deferred effective date, the eligibility requirements must be met on the effective date of filing and all future periods for which the election is to apply (i.e., from the effective date forward).

Extension

The Treasury Regulations give the Service authority to grant the parent corporation, upon request, an extension.[95] The request, however, must be

NOTES

73 Reg. 1.1361-2(c).

74 Reg. 1.136-2(d), Example 5.

75 Section 1361(f)(1).

76 Note 54, *supra.*

77 The requirements under Section 1361(b)(3)(B) include: (1) the subsidiary is a domestic corporation; (2) the subsidiary is not an ineligible corporation; (3) 100% of the subsidiary is owned by the S corporation parent; and (4) an election is in effect for which the parent elects to treat the subsidiary as a QSub.

78 Section 1361(b)(3)(B)(ii).

79 Form AR 1103.

80 Form CBT-2553.

81 Form CT-6.

82 Form Rev-1640CT.

83 Note 80, *supra.*

84 Note 81 *supra.*

85 Form CT-60-QSSS.

86 Reg. 1.1361-3(a)(1).

87 Reg. 1.1361-3(a)(2).

88 *Id.*

89 *Id.*

90 Reg. 1.1361-3(a)(3).

91 Reg. 1.1361-3(a)(4).

92 *Id.*

93 *Id.*

94 *Id.*

95 Regs. 301.9100-1 and -3.

presented to the IRS as a formal private letter ruling request.

The Service routinely grants these extensions. Ltr. Rul. 201536015 is an example. In this ruling, the Service explained that an extension of not more than six months (except in the case of a taxpayer who is abroad) will be granted when the taxpayer presents evidence that it acted reasonably and in good faith, and that the grant of relief will not prejudice the government's interests.

The S corporation parent must demonstrate reasonable cause for its untimely QSub election. Historically, the IRS has placed a fairly low threshold on this requirement. Examples of situations in which the IRS has found reasonable cause include: the corporation's responsible person failed to file the election; the corporation's tax professional failed to file the election; and the corporation did not know it needed to affirmatively file an election. It appears that almost any explanation for a late filing will suffice.

Example 10: X, an S corporation, formed corporation Y at the beginning of Year One. X owns 100% of Y. All of the QSub requirements under Section 1361(b)(B)(3) were met at the beginning of Year One and continued to be met thereafter. X forgot to make

If an S corporation fails to prepare and file a QSub election for its wholly-owned subsidiary, or it cannot obtain relief from a late or invalid QSub filing, the subsidiary will be taxed under Subchapter C of the Code.

a QSub election. It filed its Year One IRS Form 1120S consistent with having made a QSub election. On March 15 of Year Three, as it was about to file its IRS Form 1120S for Year Two, it discovered the error. Including with the IRS Form 1120S a fully completed IRS Form 8869 clearly marked at the top *"FILED PURSUANT TO REV. PROC. 2013-30"* with the required statements attached is appropriate.

Simplified Late Filing Relief

Rev. Proc. 2013-30, 2013-36 IRB 173, offers a simplified method of obtaining relief without the need for a formal ruling. A parent S corporation that failed to make a timely QSub election may qualify for automatic relief if:

- The parent S corporation intended to treat the subsidiary as a QSub as of the intended effective date.
- Less than three years and seventy five days have passed since the intended effective date of the election.
- The only failure to qualify as a QSub as of the intended effective date is the late filing.
- The parent S corporation has reasonable cause for its failure to timely file the election and has acted with diligence to correct the error since discovery.
- The QSub satisfies the requirements of Section 1361(b)(3)(B), all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as attributes of the parent S corporation on all affected income tax returns consistent with the QSub election being in place from the intended effective date forward.

To apply for relief under Rev. Proc. 2013-30, the parent S corporation is required to file IRS Form 8869 with the Service Center where the election would have been filed if it had been filed on a timely basis. At the top of the form, it must state *"FILED PURSUANT TO REV. PROC. 2013-30."* The parent corporation must attach:

- A written statement of an officer of the parent corporation explaining that the subsidiary, during the period at issue, satisfied the requirements of Section 1361(b)(3)(B), and that all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as attributes of the parent S corporation on all affected income tax returns consistent with the QSub election being in place from the intended effective date forward.
- A written statement explaining why reasonable cause exists for the late filing and the diligence the parent corporation adopted to correct the error following discovery.

Depending on the circumstances, the IRS Form 8869 may be filed by the S corporation parent with its IRS Form 1120S for the current tax year; filed with its late IRS Form 1120S for the tax year in which the election was supposed to take effect; or filed standing alone.

Example 11: The same facts apply as in Example 10, except that the error was discovered when X was preparing its IRS Form 1120S for Year One, but the return was being filed with extension on September 15 of Year Two. Given the QSub election was to be effective on the first day of Year One, late filing relief is required. In this case, X can file the late IRS Form 8869 as described above with its IRS Form 1120S for Year One.

Example 12: The same facts apply as in Example 10, except that the error was discovered a month after X's IRS Form 1120S was filed with the Service. X can file the late IRS Form 8869 as described above (as a standalone document) with the IRS Service Center where it files its IRS Form 1120S.

If the requirements for simplified relief are not met, a formal ruling request is necessary.

Invalid QSub Election Relief

A QSub election may be filed on a timely basis, but otherwise be invalid for numerous reasons, including:

- 100% of the stock of the QSub was not owned by the S corporation parent;[96]

NOTES

[96] Note 55, *supra*.

- The QSub was not a domestic corporation;[97] or
- The QSub was an ineligible corporation.[98]

If a QSub election was not effective for the intended tax year due to a failure to meet the QSub requirements or obtain shareholder consent, relief may be obtained provided the following requirements are satisfied:

- The S corporation parent, within a reasonable time after discovery of the inadvertent failure, takes steps to remedy the failure.
- The Service determines the error was inadvertent.
- The S corporation parent agrees to make any adjustments the Secretary deems necessary and consistent with the treatment of the subsidiary as a QSub.[99]

Unfortunately, relief requires that the parent obtain a formal ruling from the Service. Relief of this nature, however, is routinely granted by the Service.[100]

Example 13: X, an S corporation, formed Y. X caused Y to issue some shares to its CEO. Years later, X decided to elect to have Y treated as a QSub. As part of its preparation for the election, X thought Y had completed a redemption of all stock owned by the CEO, leaving it owning all of the stock of Y. After filing a QSub election for Y on March 15 of Year Five, to be effective on January 1 of Year Five, X learned that the redemption had not been completed (despite the parties' intent that it was completed). Relief under Section 1362(f) is likely available. To obtain it, a private letter ruling is required.

Failure to Obtain Late Filing Relief or Inadvertent Invalid Election Relief

If an S corporation fails to prepare and file a QSub election for its wholly-owned subsidiary, or it cannot obtain relief from a late or invalid QSub filing, the subsidiary will be taxed under Subchapter C of the Code. As a result of the 1996 Act, an S corporation is allowed to own 80% or more of the shares of another corporation.[101] Consequently, the C corporation subsidiary will be taxed separately from its S corporation parent. The S corporation parent is prohibited from filing a consolidated return with its C corporation subsidiary.[102] Of course, if the C corporation subsidiary issues a dividend to its S corporation parent, it will be classified as a taxable dividend, thereby creating a double tax on the earnings of the subsidiary.[103]

Impact of a QSub Election

The result of a QSub election is generally two-fold:

1. The QSub is not treated as separate and apart from its S corporation parent.
2. All assets and liabilities, and items of income, deduction, and credit are treated as tax attributes of the S corporation parent.[104]

Like most general rules, exceptions exist:

Certain Income Tax Liabilities. A QSub is treated as a separate corporation from its S corporation parent with respect to:

- Federal tax liabilities of the QSub for any tax period when it was not a QSub of the S corporation parent.[105]
- Federal tax liabilities of another entity for which the QSub is otherwise liable.[106]
- Federal tax refunds and credits.[107]

Employment Taxes. A QSub is treated as a separate corporation from its S corporation parent with respect to employment taxes contained in Chapters 21, 22, 23, 23A, 24, and 25 of Subtitle C of the Code.[108] Consequently, a QSub is separately responsible for reporting, withholding, and paying employment taxes on the wages of its employees, and complying with the other employment tax related obligations, including making employment tax deposits, filing employment tax returns, issuing IRS Forms W-2 to its employees, and back up withholding.

Certain Excise Taxes. A QSub is treated as a separate corporation from its S corporation parent with respect to certain excise taxes imposed under the Code.

- Taxes imposed by Chapters 31 (retail), 32 (manufacturers), 33 (facilities and services), 34 foreign insurers), 35 (wagering), 36 (harbor maintenance), 38 (environmental), and 49 (indoor tanning) (other than Sections 4181 and 4461 and any floor stock taxes related thereto) or claims for credit, refund, and payment relating to these taxes or under Sections 6426 or 6427.[109]
- Collection of tax imposed by Chapters 33 and 49 of the Code.[110]

A QSub is separately responsible for reporting, withholding, and paying employment taxes on the wages of its employees, and complying with the other employment tax related obligations.

NOTES

97 Note 53, *supra*.

98 Note 55, *supra*.

99 P.L. 108-357, 10/22/04.

100 See e.g., Ltr. Rul. 201340001.

101 Section 1308 of the 1996 Act. P.L.104-188, 8/20/96.

102 Section 1504(b)(8).

103 Another possible consequence of an S corporation owning all of the stock of a C corporation is the application of Section 362(e)(2). If built-in loss property is contributed by the S corporation parent to the C corporation subsidiary, a basis adjustment in the loss property to fair market value may be required; alternatively, the S corporation may elect to reduce its stock basis in the subsidiary and the stock of the S corporation shareholders.

104 Reg. 1.1361-4(a)(1).

105 Reg. 1.1361-4(a)(6)(i)(A).

106 Reg. 1.1361-4(a)(6)(i)(B).

107 Reg. 1.1361-4(a)(1)(i)(C).

108 Reg. 1.1361-4(a)(7).

109 Reg. 1.1361-4(a)(8)(A) and (D).

110 Reg. 1.1361-4(a)(8)(B).

- Registration under Sections 4101, 4222, and 4412.[111]
- Assessment and collection of amounts under Section 4980H and reporting required under Section 6056.[112]

Employer Identification Number. A QSub must use its own employer identification number when (1) a QSub election is made for an existing corporation that has its own employer identification number[113] and (2) when a QSub has employees and reports payroll.[114]

In all instances, following termination of a QSub election, the subsidiary uses its own employer identification number. If it did not have its own employer identification number prior to termination of the QSub election, it will be required to obtain one.

Unless otherwise provided in the Treasury Regulations or other published guidance, and except as described above, a QSub must use the employer identification number of its S corporation parent for all federal tax purposes.[115]

THE TAX IMPLICATIONS OF THE QSUB ELECTION

The tax implications of making a QSub election appear, at first blush, to be straightforward. Several traps, however, exist. Accordingly, a thorough understanding of the QSub election and its implications are absolutely necessary.

General Rules

Generally, when a parent S corporation elects to treat its wholly-owned subsidiary as a QSub, a liquidation of the subsidiary into the S corporation parent is deemed to occur for income tax purposes under Section 332.[116] Except as provided in the applicable Treasury Regulations, assuming the requirements of Sections 332 and 337 are satisfied, the deemed liquidation should be tax-free. Consequently, the basis of the assets should carryover from the QSub to the parent S corporation under Section 334(b).

If the deemed liquidation of the QSub up into the S corporation parent is tax free and the carryover basis rules apply, the story is fairly mundane. Taxpayers have tried, however, to add drama to the story.

In *Ball*, TCM 2013-39, the taxpayers owned shares of an S corporation. The corporation owned 100% of the shares of a subsidiary for which it caused a QSub election to be timely made.

The taxpayers took the position on their individual income tax returns that the basis in their shares was increased by the amount of built-in gain on the shares of the QSub that went unrecognized pursuant to Section 332 as a result of the QSub election. This basis increase allowed the taxpayers to claim a loss passed through from the S corporation parent.

The Service denied the loss on the grounds that the taxpayers had inadequate basis in the S corporation. The taxpayers timely filed a petition in the Tax Court.

The taxpayers, asserting an argument that did *not* work in *Nathel*, 615 F.3d 83, 105 AFTR2d 2010-2699 (CA-2, 2010), *aff'g* 131 TC 262 (2008), *cert. denied*, 131 S. Ct. 2151 (2011), and only temporarily worked in *Gitlitz*, 531 U.S. 206, 87 AFTR2d 2001-417 (2001), argued that the unrecognized gain on the upstream liquidation into the S corporation parent was akin to tax-exempt income, which results in a basis increase under the Section 1367(a)(1)(A).

The argument sounded like magic. Unfortunately for the taxpayers, Judge Kerrigan was not too impressed with the razzle dazzle of the argument and was quick to dismiss it. The Tax Court held that unrecognized gain resulting from a QSub election does *not* create an item of income, nor does it create tax-exempt income. The non-recognition rules do *not* exempt income from taxation; they merely defer recognition through the substituted basis rules.

The Service's position was upheld. The taxpayers lost the battle. The carryover basis rules apply in a tax-free liquidation of the QSub up into its S corporation parent.

The taxpayers in *Ball* were not the first taxpayers to put forth this magical basis increase argument. In CCA 201114017, the shareholders of an S corporation contributed all their appreciated stock of a C corporation to their S corporation. They then caused the S corporation to make a QSub election for the C corporation, which was now wholly-owned by the S corporation parent. One day after the QSub election was made, the S corporation and the shareholders signed a letter of intent to sell the S corporation's stock. They proceeded and consummated the sale of stock.

Relying on *Gitlitz*, the shareholders took the position that the QSub election increased their basis in the S corporation under Section 1367(a)(1)(A) by the amount of the S corporation's built-in gain in the stock as a result of the QSub's deemed liquidation under Section 332. The shareholders argued that Sections 61(a)(3) and 331(a) applied to the QSub's deemed liquidation to produce an "item of income" within the meaning of Section 1366(a)(1)(A), and that the income (i.e. gain) was tax-exempt by application of Section 332. By taking this position, the shareholders were able to recognize a loss instead of a gain on the sale of their S corporation's stock.

The Chief Counsel's office disagreed with the shareholders' position. It reasoned that Section 332 generally results in no gain or loss recognition by a parent corporation on property distributed in complete liquidation of a wholly-owned subsidiary. When a parent corporation liquidates its subsidiary, the parent essentially switches from owning the subsidiary's stock to owning the subsidiary's assets. This mere change in form produces no accession to wealth–it does not produce an "item of income." Instead, Section 332 generates *unrecognized* gain, which is later triggered when the assets are disposed of by the parent outside the affiliated group.

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111 Reg. 1.1361-4(a)(8)(C).
112 Reg. 1.1361-4(a)(8)(E).
113 Regs. 301-6109-1(i)(1) and (3).
114 TD 9356, 8/15/07.
115 Reg. 301-6109-1(i)(2).
116 H. Rep't. No. 104-586, at 89 (1996).

The Chief Counsel's office noted that the shareholders' position would allow an S corporation to create phantom basis by forming a subsidiary and later liquidating it or making a QSub election. Consequently, a QSub election and the resulting deemed Section 332 liquidation do not give rise to an item of income under Section 1366(a)(1)(A), and, therefore, do not increase the electing S corporation shareholders' stock bases under Section 1367(a)(1)(A).

After *Ball* and CCA 201114017, the law seems quite clear. A QSub election, and the consequential liquidation up into the S corporation parent, in and of itself, do not create a step up in the basis of the QSub shares. Again, the carryover basis rules apply in a tax-free liquidation of the QSub up into its S corporation parent.

The Treasury Regulations provide that the tax consequences of the deemed liquidation that arises from a QSub election are to be determined under general tax principles.[117] These principles specifically include the step transaction doctrine.[118] Consequently, if an S corporation forms a wholly-owned subsidiary and thereafter makes a valid QSub election for its subsidiary, effective from the date the subsidiary was formed, the transfer of assets to the subsidiary and the deemed liquidation are ignored, and the subsidiary is deemed a QSub from inception.[119] The Treasury Regulations specifically provide that, unless a plan of liquidation is adopted on an earlier date, the QSub election is the adoption of a plan of liquidation for purposes of Section 332.[120]

Example 14: X, a C corporation acquires all of the stock of Y, a C corporation, from an unrelated individual for cash and a note. As part of a plan, X immediately makes a valid S corporation election and a QSub election for Y. Since X acquired all of the stock of Y in a qualified purchase under Section 338(d)(3), the deemed liquidation resulting from the QSub election is respected as an independent step separate from the stock acquisition and the liquidation under Sections 337 and 332.[121]

Example 15: X, pursuant to a plan, acquires all of the stock of Y from Y's shareholders (unrelated to X) in exchange for 10% of X's voting stock. Pursuant to the plan, X makes an S corporation election and a QSub election for Y. The transaction constitutes a reorganization under Section 368(a)(1)(C), provided the other requirements for a C reorganization (e.g. continuity of business enterprise) are met.[122]

Example 16: An individual, A, pursuant to a plan, contributes all of the stock of Y to his wholly-owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction constitutes a Section 368(a)(1)(D) reorganization, provided that the other requirements for a D reorganization (e.g. continuity of business enterprise) are met. If the liabilities of Y treated as assumed by X exceed the adjusted basis of the assets of Y, Section 357(c) would apply, causing the excess liabilities to be gain from the sale or exchange of property (capital gain or ordinary income).[123]

Even if the election and the deemed liquidation qualifies for tax-free treatment, other traps may exist, bringing unintended tax consequences.

Passive Activity. If a subsidiary was previously a C corporation with earnings and profits from its C corporation years, those earnings and profits could cause the application of the passive investment tax under Section 1375 to apply to the parent S corporation. Even worse, it could cause a revocation of the parent's S election under Section 1362(d)(3). If the parent's S election is terminated, under Section 1361(b)(3)(B)(i), the subsidiary can no longer be a QSub as the parent is not an S corporation.

Built-In Gains Tax. When a subsidiary preexisted the QSub election and has appreciated assets from its C corporation tax years (or appreciated assets it obtained from a C corporation in a tax-free or tax-deferred carryover-basis transaction) or has cash basis accounts receivable attributable to its C corporation years, a trap may exist. If the assets are disposed of within the recognition period, the S corporation parent is exposed to the built-in gains tax, a tax that the S corporation parent may have otherwise been immune from had it not made the QSub election.

LIFO Recapture. A trap exists when a subsidiary preexisted the QSub election, was a C corporation immediately preceding the election, and maintained its inventory under the LIFO method of accounting. The parent may be exposed to the LIFO recapture tax under Section 1363(d).

Disappearing Basis. A trap commonly called "disappearing basis" may result from a QSub election. A QSub election causes a deemed liquidation of the subsidiary up into the S corporation parent. As a consequence, any stock in the subsidiary, for income tax purposes, held by the S corporation parent is treated as if it was surrendered and cancelled in the liquidation. Hence, the S corporation's basis in its subsidiary's stock disappears.

Example 17: X, an S corporation, acquires from an unrelated seller, Z, all of the stock of Y, an S corporation. X paid Z $1,000,000 for the stock. X makes a QSub election for Y, effective on the date of acquisition. No election under Section 338 is made in the acquisition. Y's basis in its assets is $500,000. If X decides to sell the stock of Y a few years following the acquisition, it has no basis in its stock of Y. So, if X sells the Y stock for $1,200,000, it will recognize gain on the sale equal to $700,000 ($1,200,000 – $500,000).

Example 18: The same facts apply as in Example 17, except that X does not make a QSub election. In this scenario, there would have been no deemed liquidation. Consequently, on the sale, X would have gain on the sale equal to $200,000 ($1,200,000 – $1,000,000).

Example 19: The same facts apply as in Example 17, except that X joined

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117 Reg. 1.1361-4(a)(2)(i).

118 *Id.*

119 *Id.*

120 Reg. 1.1361-4(a)(2)(iii).

121 Reg. 1.1361-4(a)(2)(ii), Example 1.

122 Reg. 1.1361-4(a)(2)(ii), Example 2.

123 Reg. 1.1361-4(a)(2)(ii), Example 3.

Z in making an election under Section 338(h)(10) to treat its original acquisition as an asset acquisition. The result is the same as in Example 18 because the effect of the Section 338(h)(10) election is to give the target a fair market basis in its assets. The problem with the election is that there is an income tax cost to get the basis step-up, which either X paid in a negotiated increased purchase price to cover the tax cost (likely the case) or Z paid (all or part of) in order to consummate the sale.

Tiered Situations

When QSub elections are effective on the same date for a tiered group of corporations, the S corporation parent may specify the order of the deemed liquidations resulting from the QSub elections. If no order is specified, however, the liquidations are deemed to occur first for the lowest tier entity and then successively upward until all of the liquidations have occurred.[124] The deemed liquidations are made on the same date.[125]

Whether to allow the default rule (upward liquidations from lowest tier up) to occur should be carefully considered. There may be a non-tax business reason that dictates the order of the liquidations.

For example, in Ltr. Rul. 201007043, a valid business reason for avoiding the default ordering rule existed. X, an S corporation, had two wholly-owned QSubs, Y and Z. X and Y wished to combine their assets and operations into one corporation to take advantage of planned efficiencies and to reduce expenses and operational redundancies. Certain legal agreements under which Y was bound prohibited Y from merging upstream into X. The agreements did not, however, prohibit X from merging downstream into Y.

Consequently, X proposed to merge downstream into Y, with Y surviving the merger. The outstanding shares of X would be exchanged solely for common stock of Y, such that after the merger, the existing shareholders of X would have an identical ownership interest in Y. Y would end up owning 100% of Z.

The Service ruled that the downstream merger of X into Y constituted a valid "F" reorganization. Example 8 to Reg. 1.1361-5(b)(3) provides that where an S corporation, that owns 100% of a QSub, merges into said QSub under state law, causing the QSub election to terminate, and the QSub survives the merger, the formation of the new corporation (the merger of the S corporation into the QSub) can qualify as a "F" reorganization if the transaction otherwise satisfies the requirements of that section.

The Service also ruled that the "F" reorganization did not adversely affect X's status as an S corporation. Accordingly, X's S corporation election continued with respect to Y after the merger.[126] Moreover, Z's status as a QSub did not terminate as a result of the reorganization pursuant to Rev. Rul. 2004-85, 2004-2 CB 189 (an election to treat a wholly-owned subsidiary of an S corporation as a QSub does not terminate solely because the S corporation engaged in a transaction that qualifies as an "F" reorganization).

A tax purpose may exist, however, that dictates the order of the liquidations. One possible reason for desiring a top-down series of liquidations would be to ensure qualifying for tax-free treatment under Section 332.

A tiered group of corporations that file consolidated income tax returns may encounter adverse tax consequences from making QSub elections. Depending on the ordering of the liquidations, the excess loss account rules under Section 1509 and the corresponding Treasury Regulations may trigger unwanted taxable gain.

The consolidated group rules are complex. The excess loss account is just one of many tax traps that exist when considering making QSub elections. Careful review and analysis of each situation is necessary.

Acquisitions

Several rules apply in acquisitions involving QSubs. For example, if the S corporation parent does not own 100% of the subsidiary on the day before the QSub election is effective, the deemed liquidation will occur immediately after the S corporation parent acquires 100% of the QSub's stock.[127]

Except when an election exists under Section 338, if an S corporation acquires the stock of another S corporation, and a QSub election is made, effective on the day the target S corporation is acquired, the target S corporation is deemed to liquidate up into the acquiring S corporation at the beginning of the day that the termination of the target corporation's S election is effective.[128] Likewise, if a C corporation acquires the stock of an S corporation, and makes an S election for itself and a QSub election for the target corporation effective on the day of the acquisition, the target corporation is deemed to have liquidated up into the acquiring corporation at the beginning of the day in which the acquiring corporation's S election is effective.[129]

Example 20: X, an S corporation, acquires 100% of the stock of Y, an S corporation. X makes a QSub election for Y effective on the date of acquisition. Y is deemed to liquidate up into X at the beginning of the day when the termination of its S election is effective. Consequently, there is no period between the termination of Y's S election and the deemed liquidation of Y during which Y was a C corporation.

Example 21: X, a C corporation, acquires 100% of the stock of Y, an S corporation. X makes an S election for itself and a QSub election for Y effective on the date of acquisition. Y is deemed to liquidate up into X at the beginning of the day when X's S election is effective. Consequently, there is no period between the termination of Y's S election and the deemed liquidation of Y during which Y was a C corporation.

Section 338 Elections. The Treasury Regulations specifically consider the impact of an election under Section 338 in an acquisition where it is con-

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124 Reg. 1.1361-4(b)(2).
125 *Id.*
126 See Rev. Rul. 64-250, 1964-2 CB 333.
127 Reg. 1.1361-4(b)(3)(i).
128 Reg. 1.1361-4(b)(3)(ii).
129 *Id.*

templated that a QSub election will be made for the target corporation.[130] In an acquisition of the stock of a target corporation, provided the requirements of Sections 338 and 1361(b)(3)(B) are satisfied: (1) The acquiring corporation may make an election under Section 338 to treat the acquisition as an asset purchase; and (2) The acquiring corporation may make a QSub election with respect to the target corporation.

If a Section 338 election is made, a QSub election made with respect to the target corporation will not be treated as effective prior to the day after the acquisition is made (within the meaning set forth in Section 338(h)(2)).[131]

If the QSub election is effective on the day after the acquisition date, the deemed liquidation up into the S corporation parent (the acquiring corporation) occurs immediately after the deemed asset purchase by the new target corporation under Section 338.[132]

If an S corporation makes a Section 338 election (rather than a Section 338(h)(10) election) with respect to its target, the target must file a final income tax return as a C corporation reflecting the deemed sale.[133]

If the target corporation was an S corporation on the day before the acquisition date, the final income tax return as a C corporation must reflect the activities of the target for the acquisition date, including the deemed sale.[134]

If an S corporation acquires all of the stock of another S corporation, the acquiring corporation may join in an election under Section 338(h)(10), and have the target corporation treated as a QSub.

Example 22: X, an S corporation, buys 100% of the stock of Y, an existing S corporation on day one. X joins the former shareholder of Y in making an election under Section 338(h)(10). X elects to treat Y as a QSub. In accordance with Section 338, the transaction is treated for income tax purposes as if Y sold its assets to X at the close of the acquisition date (day one), and Y became a new corporation that purchased the assets at the beginning of day two. Because of the QSub election, the new Y is deemed to have liquidated up into X immediately after the fictitious asset acquisition on day two.

Carryover of Suspended Losses. If an S corporation acquires the stock of another S corporation and makes a QSub election for the new subsidiary, effective on the date of acquisition, Reg. 1.1366-2(c)(1) governs the availability of existing suspended losses from the target corporation at the time of the acquisition.[135] In accordance with these regulations, when an S corporation is acquired by another S corporation that makes a QSub election for the target S corporation effective on the date of acquisition, provided the basis of the stock of the target is determined in whole or part by reference to the transferor's basis, any suspended losses under Section 1366(d) with respect to the former shareholder of the target will be available to that shareholder as a shareholder of the acquiror. In other words, a loss or deduction of a shareholder of the target corporation disallowed prior to the acquisition will be available to the shareholder provided he or she is a shareholder of the acquiror after the transaction.

Example 23: A owns 100% of the shares of X and Y, both of which are S corporations. X is a very profitable automobile repair business. Y is an automobile dealership. A is actively involved in the operations of both X and Y. While Y has been historically extremely profitable, it started experiencing some financial setbacks in recent years, resulting from product quality issues. A has significant losses in Y that are suspended in accordance with Section 1366(d) due to lack of basis in her Y stock. Y has no debt owing to A. A is confident that Y will become profitable again, but it will take a few more years. A contributes her stock of both Y and X to a newly formed corporation, Holdco. Holdco immediately makes an S election and makes QSub elections for X and Y. A's suspended losses from Y will be available to her to offset income flowing through to her from Holdco, provided she has adequate basis in her Holdco stock (which will be the combination of her basis in X and Y, plus any additional capital contributions or amounts she lends to Holdco).

Example 24: The same facts apply as in Example 23, except that A contributes her stock of Y to X and X immediately makes a QSub election for Y. The result should be the same. To the extent A has basis in her stock of X (which should be the combination of her basis in X and Y), she will be able to use the suspended losses that arose from pre-QSub operations of Y.

Section 355 Distributions. A parent S corporation should be able to distribute the stock of its QSub to its shareholders in a transaction that qualifies for tax-free treatment under Section 355, provided the requirements of Section 355 and the corresponding Treasury Regulations are satisfied. In the context of Section 355, a pivotal issue is whether a QSub will be treated as a separate corporation from its S corporation parent at the time of the distribution of its stock.

Neither the Code nor the provisions contained in the applicable Treasury Regulations directly address this issue. Interestingly, Reg. 1.1361-5(b)(3) indicates that the QSub will be treated as a separate corporation for purposes of a distribution of the stock of the QSub under Section 355. The fact that the S corporation parent is distributing the stock of a QSub should not prevent Section 355 from applying.

Example 25: X, an S corporation, owns 100% of the stock of Y, a corporation for which a QSub election is in effect. X distributes all of the Y stock on a pro rata basis to its shareholders. The distribution, in and of itself, terminates Y's QSub election because X no longer owns 100% of its stock as required under Section 1361(b)(3)(B)(i). The transaction can

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130 Reg. 1.1361-4(b)(4).

131 *Id.*

132 *Id.*

133 *Id.*

134 *Id.* See also Reg. 1.338-10(a)(3).

135 Reg. 1.1361-4(c).

qualify as a distribution to which Sections 368(a)(1)(D) and 355 apply, provided the requirements of these sections are satisfied.[136]

Sale or Transfer of QSub Stock

As discussed above, in order to qualify as a QSub, 100% of the subsidiary's stock must be owned by the S corporation parent.[137] If the S corporation parent disposes of any of the stock of the QSub, the QSub election will terminate because the wholly-owned requirement will be violated.[138] In accordance with Section 1361(b)(3)(C), the result is a termination of the QSub election; it will be treated for income tax purposes as a deemed transfer of assets to the former QSub in a transaction to which Section 351 applies.

Practice Alert: If the aggregate basis of the assets is less than the liabilities, the termination may result in a taxable event under Section 357. Caution is advised.

Example 26: A owns 100% of X, an S corporation. X in turn owns 100% of Y for which a valid QSub election is in place. For good business reasons, X caused Y to give 20% of Y's stock to Y's CEO as a bonus. The rationale for the bonus was to share the profits of Y with the CEO and to create golden handcuffs to keep the CEO working for Y. The stock is subject to a ten-year cliff vesting. Consequently, if the CEO leaves Y's employment for any reason within ten years of the bonus, the stock will be forfeited. C considered adopting a phantom plan, but the CEO would not accept it; he wanted real stock of Y. After conferring with his tax advisors, the CEO made an election under Section 83(b). As a consequence, despite the substantial risk of forfeiture, the stock owned by the CEO is outstanding. The QSub election is terminated upon the transfer of the Y stock to the CEO. Immediately before that point, a deemed transfer of assets and assumption of liabilities from X to a new Y occurred to which Section 351 applies. In accordance with Section 1361(b)(3)(C)(i) and Reg. 1.1361-5(b), immediately before the termination caused by a transfer of the QSub's stock, a deemed transfer of its assets and liabilities from the S corporation parent to a newly formed Y in exchange for the stock of the newly formed Y occurred to which the general principles of federal tax law apply, including Section 351. For this purpose, instruments, obligations, and other arrangements that are not considered as stock under Reg. 1.1361-2(b) are ignored. If the adjusted basis of the assets (in X's hands) exceeds the liabilities deemed to be transferred to Y, the termination should be tax free.

REVOCATION AND TERMINATION OF QSUB ELECTIONS

A QSub election may be intentionally revoked by the S corporation parent. Also, it may be terminated, intentionally or unintentionally, for failing to continue to satisfy the requirements of Section 1361(b)(3)(B).

Revocation

The revocation procedure is straightforward.[139] The S corporation parent is required to file a statement with the IRS Service Center where its most recent IRS Form 1120S was properly filed.[140] The statement must be signed by a person authorized under Section 6037[141] to sign the parent S corporation's return. It must contain (1) the name, address, and taxpayer identification number of the S corporation parent and (2) the name, address, and taxpayer identification number, if any, of the QSub.

While not required, the statement should clearly state the effective date of the intended revocation. If no effective date is stated, the effective date of the revocation will be the date of filing (e.g., the date it is hand delivered to the Service, placed in the U.S. mail, or placed in the hands of one of the private delivery services approved in IRS Notice 2004-83, 2004-2 CB 1030).[142]

The statement should indicate the intent to revoke the QSub election of the subsidiary corporation. In addition, four rules should be considered:

- If an effective date is specified in the statement, it cannot be more than 12 months after the date of filing.[143]
- If an effective date is specified in the statement, it cannot be more than two months and 15 days prior to the date of filing.[144]
- If the specified effective date in the statement is more than 12 months after the date of filing, the actual effective date will be 12 months after the date of filing.[145]
- If the specified effective date in the statement is more than two months and 15 days prior to the date of filing, the actual effective date will be two months and 15 days prior to the date of filing.[146]

Practice Alert: A revocation cannot be made after the occurrence of a QSub disqualifying event (i.e., an event that causes the QSub to fail one or more of the requirements set forth in Section 1361(b)(3)(B)).[147]

An extension of time to file a revocation statement may be obtained when the necessary approval of the S corporation parent's shareholders is delayed because:

- One or more of the shareholders is serving in the armed forces in a combat zone or in a contingency operation as defined under Section 7508; or
- The S corporation parent or one or more of the shareholders is affected by a presidentially declared disaster or a terrorist or military action as defined under Section 7508A.[148]

If a taxpayer makes a prospective revocation of a QSub election but changes its mind prior to the effective date, can it rescind the revocation? Neither the Code nor the Treasury

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136 Reg. 1.1361-5(b)(3), Example 4.
137 Section 1361(b)(3)(b)(i).
138 An exception to this consequence may occur if the stock of the QSub is transferred to a disregarded entity owned by the S corporation parent.
139 Reg. 1.1361-3(b)(1).
140 *Id.*
141 *Id.*
142 Section 1305 of the 1996 Act. P.L. 104-188, 8/20/96.
143 Reg. 1.1361-3(b)(2).
144 *Id.*
145 *Id.*
146 *Id.*
147 Reg. 1.1361-3(b)(3).
148 Rev. Proc. 2005-27, 2005-1 CB 1050.

Regulations address the rescission of a prospective QSub revocation, but by analogy to the regulations dealing with S corporation elections, a good argument exists that a prospective revocation of a QSub election can be rescinded, provided:

- The effective date of the revocation has not yet occurred.
- A statement is filed with the IRS Service Center where the revocation was filed prior to the effective date of the revocation, clearly advising the Service that the S corporation parent is rescinding the prior filed QSub revocation and is doing so prior to its effective date.
- The statement is signed by a person authorized to sign the parent S corporation's return under Section 6037.[149]

Termination

A QSub election will terminate if:

- The S corporation parent's S election is revoked or otherwise terminated;[150]
- 100% of the subsidiary is no longer owned by the S corporation parent;[151]
- The subsidiary is no longer a domestic corporation;[152] or
- The subsidiary becomes a corporation described in Section 1361(b)(2) (a financial institution that uses the reserve method of accounting for bad debts, an insurance company taxed under Subchapter L of the Code, a corporation to which a Section 936 election is in effect, or a current or former DISC).[153]

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149 Reg. 1.1362-6(a)(4) addresses the procedures for rescinding an S election revocation prior to its effective date. Arguably, this regulation applies by analogy to the rescission of a QSub revocation prior to its effective date.

150 Section 1361(b)(3)(B)(i).

151 *Id.*

152 *Id.*

153 *Id.*

A termination is effective:

- If the termination is due to the S corporation parent's S election being terminated or revoked, the termination of the QSub election occurs on the last day of the S corporation parent's last year as an S corporation;[154]
- If the termination is due to the occurrence of an event that causes the QSub to fail any of the requirements set forth in Section1361(b)(3)(B) (discussed above), the termination of the QSub election occurs at the close of the day in which any of such requirements failed to be met;[155] or
- If the termination is due to the S corporation's parent becoming a member of a consolidated group of corporations (and no Section 338(g) election is made), Reg. 1.1502-76(b)(1)(ii)(A)(2) (special rules for S corporations that join a consolidated group) applies to the S corporation parent's QSub that also joins the group at the same time, [156] and the S corporation parent's S election terminates at the close of the day before it joined the consolidated group, and the QSub election is terminated effective that same date.[157]

If the termination of the QSub election is due to the failure to satisfy any of the requirements set forth in Section 1361(b)(3)(B), the S corporation parent has the additional responsibility of attaching to its income tax return for the tax year in which the termination of the QSub election occurred a statement that clearly indicates:

- The QSub election terminated.
- The date of the termination.
- The name, address, and employer identification number of the S corporation parent.
- The name, address, and employer identification number of the subsidiary.

Practice Alert: A transfer of stock of a QSub by another QSub to the S corporation parent will not cause a termination of a QSub election.[158]

Re-election After Termination or Revocation

Generally, if a corporation's QSub election was terminated or revoked, it is not eligible to be treated as a QSub or make an S election for five years.[159] Exceptions exist:

- If a QSub election was revoked before it was effective, the revocation will be ignored and the S corporation parent will not be required to wait five years to make another QSub election on behalf of its subsidiary.[160]
- With the consent of the Secretary, provided the requesting corporation establishes that, under the facts and circumstances, the Service should allow a reelection before the five years has expired. Assuming the same standards are applied by the Service as it applies to S corporation re-elections, the key is to show no tax abuse or tax avoidance motives exist. A formal ruling is required. These rulings are commonly granted.[161]
- If the QSub election terminated by reason of the disposition of the subsidiary's stock by the S corporation parent, it will not be required to wait five years to make another QSub election on behalf of its subsidiary nor will the subsidiary have to wait the five years to make an S election, provided that: (1) immediately following the disposition of the QSub's stock, the subsidiary or its successor is otherwise eligible to make an S election or have a QSub election made on its behalf; and (2) the relevant election is made effective immediately following the stock transfer.[162]

Waiver of Inadvertent Terminations

As part of the AJCA, Congress specifically gave the Service authority to waive inadvertent QSub terminations.[163] Like inadvertent S election terminations, a QSub will continue to be treated as a QSub during a period of inadvertent termination, if:

- The termination results from failure to meet the requirements of Section 1361(b)(3)(B).
- The termination was inadvertent.
- The corporation promptly takes corrective steps.
- The QSub and the parent (and its shareholders) agree to treat the QSub election as having been continuously in effect.[164]

Continuation of a QSub election following an inadvertent termination is ultimately within the Secretary's sole discretion. To obtain a determination of inadvertent termination, a formal ruling request is required.[165] The Service routinely issues rulings.

CONCLUSION

The birth of the QSub has made the Subchapter S terrain more challenging. The amendments to Subchapter S to accommodate the QSub have added significant complexity to the world of S corporations. The abolishment of the affiliated group prohibition and the creation of the QSub have, however, redirected Subchapter S back toward President Eisenhower's original goal—that legislation be passed to minimize the influence federal tax laws have on entity selection by small businesses. By eliminating the affiliated group prohibition and allowing Subchapter S corporations to have wholly-owned subsidiaries, Subchapter S is more flexible. With that flexibility comes much more complexity and tax traps. When working with QSubs, a good understanding of the applicable provisions of the Code and Treasury Regulations, as well as the cases and rulings, is vital. ●

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154 Reg. 1.1361-5(a)(1)(ii).
155 Reg. 1.1361-5(a)(1)(iii).
156 Reg. 1.1361-5(a)(3).
157 Reg. 1.1361-5(a)(3), Example 4.
158 Reg. 1.1361-5(a)(3), Example 3.
159 Section 1361(b)(3)(D).
160 Reg. 1.1361-3(b)(4).
161 See e.g. Ltr. Ruls. 8842007, 8844005, 8831048, 8828050, and 200004028.
162 Reg. 1.1361-5(c)(2).
163 Section 238 of the AJCA, P.L. 108-357, 10/22/04.
164 Reg. 1.1362-4(a).
165 Reg. 1.1362-4(c).