

Reg. Section 1.1361-2

Definitions relating to S corporation subsidiaries.

(a) In general. The term qualified subchapter S subsidiary (QSub) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if –

- (1) 100 percent of the stock of such corporation is held by an S corporation; and
- (2) The S corporation properly elects to treat the subsidiary as a QSub under § 1.1361-3.

(b) Stock treated as held by S corporation. For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section --

- (1) Stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for Federal income tax purposes; and
- (2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) Straight debt safe harbor. Section 1.1361-1(l)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361-1(l)(5) if issued by the S corporation.

(d) Examples. The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of Y, a corporation for which a valid QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub under section 1361(b)(3)(B)(ii).

Example 2. Assume the same facts as in Example 1, except that Y is a business entity that is disregarded as an entity separate from its owner under § 301.7701-2(c)(2) of this chapter. X may elect to treat Z as a QSub.

Example 3. Assume the same facts as in Example 1, except that Y owns 50 percent of Z, and X owns the other 50 percent. X may elect to treat Z as a QSub.

Example 4. Assume the same facts as in Example 1, except that Y is a C corporation. Although Y is a domestic corporation that is otherwise eligible to be a QSub, no QSub election has been made for Y. Thus, X is not treated as holding the stock of Z. Consequently, X may not elect to treat Z as a QSub.

Example 5. Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361-1(l)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding

stock. In addition, under § 1.1361-1(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361-1(l)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.