

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

Effect of QSub election.

(a) Separate existence ignored -- (1) In general. Except as otherwise provided in paragraphs (a)(3), (a)(6), (a)(7), (a)(8), and (a)(9) of this section, for Federal tax purposes --

(i) A corporation that 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 items of income, deduction, and credit of the S corporation.

(2) Liquidation of subsidiary -- (i) In general. 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. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the transfer of assets to the subsidiary and the deemed liquidation are disregarded, and the corporation will be deemed to be a QSub from its inception.

(ii) Examples. The following examples illustrate the application of this paragraph (a)(2)(i) of this section:

Example 1. Corporation X acquires all of the outstanding stock of solvent corporation Y from an unrelated individual for cash and short-term notes. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. Because X acquired all of the stock of Y in a qualified stock purchase within the meaning of section 338(d)(3), the liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337.

Example 2. Corporation X, pursuant to a plan, acquires all of the outstanding stock of corporation Y from the shareholders of Y solely in exchange for 10 percent of the voting stock of X. Prior to the transaction, Y and its shareholders are unrelated to X. Thereafter, as part of the same plan, X immediately makes an S election and a QSub election for Y. The transaction is a reorganization described in section 368(a)(1)(C), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied.

Example 3. After the expiration of the transition period provided in paragraph (a)(5)(i) of this section, individual A, pursuant to a plan, contributes all of the outstanding stock of Y to his wholly owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction is a reorganization under section 368(a)(1)(D), assuming the other conditions for reorganization treatment (e.g., continuity of business enterprise) are satisfied. If the sum of the amount of liabilities of Y treated as assumed by X exceeds the total of the adjusted basis of the

property of Y, then section 357(c) applies and such excess is considered as gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

(iii) Adoption of plan of liquidation. For purposes of satisfying the requirement of adoption of a plan of liquidation under section 332, unless a formal plan of liquidation that contemplates the QSub election is adopted on an earlier date, the making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation described in paragraph (a)(2)(i) of this section.

(iv) Example. The following example illustrates the application of paragraph (a)(2)(iii) of this section:

Example. Corporation X owns 75 percent of a solvent corporation Y, and individual A owns the remaining 25 percent of Y. As part of a plan to make a QSub election for Y, X causes Y to redeem A's 25 percent interest on June 1 for cash and makes a QSub election for Y effective on June 3. The making of the QSub election is considered to be the adoption of a plan of liquidation immediately before the deemed liquidation. The deemed liquidation satisfies the requirements of section 332.

(v) Stock ownership requirements of section 332. The deemed exercise of an option under § 1.1504-4 and any instruments, obligations, or arrangements that are not considered stock under § 1.1361-2(b)(2) are disregarded in determining if the stock ownership requirements of section 332(b) are met with respect to the deemed liquidation provided in paragraph (a)(2)(i) of this section.

(3) Treatment of banks -- (i) In general. If an S corporation is a bank, or if an S corporation makes a valid QSub election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub under paragraph (a)(2) of this section had not occurred (except as other published guidance may apply section 265(b) and section 291(a)(3) and (e)(1)(B) not only to the bank parent or bank subsidiary but also to any QSub deemed to have liquidated under paragraph (a)(2) of this section). For any QSub that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSub, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. For purposes of this paragraph (a)(3)(i), the term bank has the same meaning as in section 581.

(ii) Examples. The following examples illustrate the application of this paragraph (a)(3):

Example 1. X, an S corporation, is a bank as defined in section 581. X owns 100 percent of Y and Z, corporations for which valid QSub elections are in effect. Y is a bank as defined in section 581, and Z is not a financial institution. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to X and Y and do not apply to Z. Thus, for example, section 265(b), which provides special rules for interest expense deductions of banks, applies separately to X and Y. That is, X and Y each must make a separate determination under section 265(b) of interest expense allocable to tax-exempt interest, and no deduction is allowed for that interest expense. Section 265(b) does not apply to Z except as published guidance may provide otherwise.

Example 2. X, an S corporation, is a bank holding company and thus is not a bank as defined in section 581. X owns 100 percent of Y, a corporation for which a valid QSub election is in effect. Y is a bank as defined in section 581. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply to Y and do not apply to X. However, all of Y's assets, liabilities, and items of income, deduction, and credit,

as determined in accordance with the special bank rules, are treated as those of X. Thus, for example, section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Y. However, any gain or loss on such a transaction by Y that is considered ordinary income or ordinary loss pursuant to section 582(c) is treated as ordinary income or ordinary loss of X.

(iii) Effective date. This paragraph (a)(3) applies to taxable years beginning after December 31, 1996.

(4) Treatment of stock of QSub. Except for purposes of section 1361(b)(3)(B)(i) and § 1.1361-2(a)(1), the stock of a QSub shall be disregarded for all Federal tax purposes.

(5) Transitional relief -- (i) General rule. If an S corporation and another corporation (the related corporation) are persons specified in section 267(b) prior to an acquisition by the S corporation of some or all of the stock of the related corporation followed by a QSub election for the related corporation, the step transaction doctrine will not apply to determine the tax consequences of the acquisition. This paragraph (a)(5) shall apply to QSub elections effective before January 1, 2001.

(ii) Examples. The following examples illustrate the application of this paragraph (a)(5):

Example 1. Individual A owns 100 percent of the stock of X, an S corporation. X owns 79 percent of the stock of Y, a solvent corporation, and A owns the remaining 21 percent. On May 4, 1998, A contributes its Y stock to X in exchange for X stock. X makes a QSub election with respect to Y effective immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock qualifies under section 351, and no gain or loss is recognized by A, X, or Y.

Example 2. Individual A owns 100 percent of the stock of two solvent S corporations, X and Y. On May 4, 1998, A contributes the stock of Y to X. X makes a QSub election with respect to Y immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by A of the Y stock to X qualifies under section 351, and no gain or loss is recognized by A, X, or Y. Y is not treated as a C corporation for any period solely because of the transfer of its stock to X, an ineligible shareholder. Compare Example 3 of § 1.1361-4(a)(2)(ii).

(6) Treatment of certain QSubs -- (i) In general. A QSub, even though it is generally not treated as a corporation separate from the S corporation, is treated as a separate corporation for purposes of:

(A) Federal tax liabilities of the QSub with respect to any taxable period for which the QSub was treated as a separate corporation.

(B) Federal tax liabilities of any other entity for which the QSub is liable.

(C) Refunds or credits of Federal tax.

(ii) Examples. The following examples illustrate the application of paragraph (a)(6)(i) of this section:


Example 1. X has owned all of the outstanding stock of Y, a domestic corporation that reports its taxes on a calendar year basis, since 2001. X and Y do not report their taxes on a consolidated basis. For 2003, X makes a timely S election and simultaneously makes a QSub

election for Y. In 2004, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for Y's 2001 taxable year. Because Y was treated as a separate corporation for its 2001 taxable year, Y is the proper party to sign the consent to extend the period of limitations.

Example 2. The facts are the same as in Example 1, except that in 2004, the IRS determines that Y miscalculated and underreported its income tax liability for 2001. Because Y was treated as a separate corporation for its 2001 taxable year, the deficiency for Y's 2001 taxable year may be assessed against Y and, in the event that Y fails to pay the liability after notice and demand, a general tax lien will arise against all of Y's property and rights to property.

Example 3. X is a QSub of Y. In 2001, Z, a domestic corporation that reports its taxes on a calendar year basis, merges into X in a state law merger. Z was not a member of a consolidated group at any time during its taxable year ending in December 2000. Under the applicable state law, X is the successor to Z and is liable for all of Z's debts. In 2003, the IRS seeks to extend the period of limitations on assessment for Z's 2000 taxable year. Because X is the successor to Z and is liable for Z's 2000 taxes that remain unpaid, X is the proper party to execute the consent to extend the period of limitations on assessment.

(iii) Effective date. This paragraph (a)(6) applies on or after April 1, 2004.

 (7) Treatment of QSubs for purposes of employment taxes-- (i) In general. A QSub is treated as a separate corporation for purposes of Subtitle C--Employment Taxes and Collection of Income Tax (Chapters 21, 22, 23, 23A, 24, and 25 of the Internal Revenue Code).

(ii) Effective/applicability date. This paragraph (a)(7) applies with respect to wages paid on or after January 1, 2009.

(8) Treatment of QSubs for purposes of certain excise taxes-- (i) In general. A QSub is treated as a separate corporation for purposes of--

(A) Federal tax liabilities imposed by Chapters 31, 32 (other than section 4181), 33, 34, 35, 36 (other than section 4461), and 38 of the *Internal Revenue Code*, or any floor stocks tax imposed on articles subject to any of these taxes;

(B) Collection of tax imposed by Chapter 33 of the Internal Revenue Code;

(C) Registration under sections 4101, 4222, and 4412; and

(D) Claims of a credit (other than a credit under section 34), refund, or payment related to a tax described in paragraph (a)(8)(i)(A) of this section or under section 6426 or 6427.

(ii) Effective/applicability date. This paragraph (a)(8) applies to liabilities imposed and actions first required or permitted in periods beginning on or after January 1, 2008.

(9) Information returns -- (i) In general. Except to the extent provided by the Secretary or Commissioner in guidance (including forms or instructions), paragraph (a)(1) of this section shall not apply to part III of subchapter A of chapter 61, relating to information returns.

(ii) Effective/applicability date. This paragraph (a)(9) is effective on August 14, 2008.

(b) Timing of the liquidation -- (1) In general. Except as otherwise provided in paragraph (b)(3) or (4) of this section, the liquidation described in paragraph (a)(2) of this section occurs at the close of the day before the QSub election is effective. Thus, for example, if a C corporation elects to be treated as an S corporation and makes a QSub election (effective the same date as the S election) with respect to a subsidiary, the liquidation occurs immediately before the S election becomes effective, while the S electing parent is still a C corporation.

(2) Application to elections in tiered situations. When QSub elections for a tiered group of subsidiaries are effective on the same date, the S corporation may specify the order of the liquidations. If no order is specified, the liquidations that are deemed to occur as a result of the QSub elections will be treated as occurring first for the lowest tier entity and proceed successively upward until all of the liquidations under paragraph (a)(2) of this section have occurred. For example, S, an S corporation, owns 100 percent of C, the common parent of an affiliated group of corporations that includes X and Y. C owns all of the stock of X and X owns all of the stock of Y. S elects under § 1.1361-3 to treat C, X and Y as QSubs effective on the same date. If no order is specified for the elections, the following liquidations are deemed to occur as a result of the elections, with each successive liquidation occurring on the same day immediately after the preceding liquidation: Y is treated as liquidating into X, then X is treated as liquidating into C, and finally C is treated as liquidating into S.

(3) Acquisitions. (i) In general. If an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSub election is effective, the liquidation described in paragraph (a)(2) of this section occurs immediately after the time at which the S corporation first owns 100 percent of the stock.

(ii) Special rules for acquired S corporations. Except as provided in paragraph (b)(4) of this section, if a corporation (Y) for which an election under section 1362(a) was in effect is acquired, and a QSub election is made effective on the day Y is acquired, Y is deemed to liquidate into the S corporation at the beginning of the day the termination of its S election is effective. As a result, if corporation X acquires Y, an S corporation, and makes an S election for itself and a QSub election for Y effective on the day of acquisition, Y liquidates into X at the beginning of the day when X's S election is effective, and there is no period between the termination of Y's S election and the deemed liquidation of Y during which Y is a C corporation. Y's taxable year ends for all Federal income tax purposes at the close of the preceding day. Furthermore, if Y owns Z, a corporation for which a QSub election was in effect prior to the acquisition of Y by X, and X makes QSub elections for Y and Z, effective on the day of acquisition, the transfer of assets to Z and the deemed liquidation of Z are disregarded. See §§ 1.1361-4(a)(2) and 1.1361-5(b)(1)(i).

(4) Coordination with section 338 election. An S corporation that makes a qualified stock purchase of a target may make an election under section 338 with respect to the acquisition if it meets the requirements for the election, and may make a QSub election with respect to the target. If an S corporation makes an election under section 338 with respect to a subsidiary acquired in a qualified stock purchase, a QSub election made with respect to that subsidiary is not effective before the day after the acquisition date (within the meaning of section 338(h)(2)). If the QSub election is effective on the day after the acquisition date, the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new target corporation under section 338. If an S corporation makes an election under section 338 (without a section 338(h)(10) election) with respect to a target, the target must file a final return as a C corporation reflecting the deemed sale. See § 1.338-10(a). If the target was an S corporation on the day before the acquisition date, the final return as a C corporation must reflect the activities of the target for the acquisition date, including the deemed sale. See § 1.338-10(a)(3).

(c) Carryover of disallowed losses and deductions. If an S corporation (S1) acquires the stock of another S corporation (S2), and S1 makes a QSub election with respect to S2 effective on the day of the acquisition, see § 1.1366-2(c)(1) for provisions relating to the carryover of losses and deductions with respect to a former shareholder of S2 that may be available to that shareholder as a shareholder of S1.

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

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. On June 2, 2002, X makes a valid QSub election for Y, effective June 2, 2002. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of the day on June 1, 2002, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Y's taxable year and separate existence for Federal tax purposes end at the close of June 1, 2002.

Example 2. X, a C corporation, owns 100 percent of the stock of Y, another C corporation. On December 31, 2002, X makes an election under section 1362 to be treated as an S corporation and a valid QSub election for Y, both effective January 1, 2003. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of December 31, 2002, the day before the QSub election is effective. The QSub election for Y is effective on the same day that X's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when X is still a C corporation. Y's taxable year ends at the close of December 31, 2002. See § 1.381(b)-1.

Example 3. On June 1, 2002, X, an S corporation, acquires 100 percent of the stock of Y, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under section 338. X immediately makes a QSub election for Y effective June 2, 2002, and also makes a joint election under section 338(h)(10) with the shareholder of Y. Under section 338(a) and § 1.338(h)(10)-1(d)(3), Y is treated as having sold all of its assets at the close of the acquisition date, June 1, 2002. Y is treated as a new corporation which purchased all of those assets as of the beginning of June 2, 2002, the day after the acquisition date. Section 338(a)(2). The QSub election is effective on June 2, 2002, and the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new corporation.

Example 4. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. On May 12, 2002, a date on which the QSub election is in effect, X issues Y a \$ 10,000 note under state law that matures in ten years with a market rate of interest. Y is not treated as a separate corporation, and X's issuance of the note to Y on May 12, 2002, is disregarded for Federal tax purposes.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. At a time when Y is indebted to X in an amount that exceeds the fair market value of Y's assets, X makes a QSub election effective on the date it is filed with respect to Y. The liquidation described in paragraph (a)(2) of this section does not qualify under sections 332 and 337 and, thus, Y recognizes gain or loss on the assets distributed, subject to the limitations of section 267.