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QSSS Election—Proposed Regulations Regarding S Corporation Subsidiaries

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Proposed Treasury regulations were published on April 22 to address various matters relating to corporate subsidiaries of S corporations, including the election to treat a wholly-owned subsidiary of an S corporation as a "qualified subchapter S subsidiary" ("QSSS"), the revocation of such an election, and the effects of an election or termination of QSSS status. The proposed regulations under Subchapter S of the Internal Revenue Code (the "Code") are generally to apply to taxable years beginning after the date of publication of final regulations.

The proposed regulations will, when made final, supplant the temporary QSSS election procedure set forth in IRS Notice 97-4. The regulations also address many other issues, and reach some conclusions that may surprise many tax practitioners. Highlights of the proposed regulations are reviewed below.

Background

Under Subchapter S as amended by the Small Business Job Protection Act of 1996, an S corporation may own 80 percent or more of the stock of a C corporation, and may elect to treat as a QSSS a wholly owned subsidiary (other than certain financial institutions and other ineligible corporations). Except as otherwise provided in regulations, a corporation for which a QSSS election is made is not treated as a separate corporation for federal income tax purposes, and its assets, liabilities, and items of income, deduction and credit are treated as belonging to the parent S corporation.

The Code provisions that address the QSSS election leave open numerous questions relating to how the QSSS election is to be made or revoked, and regarding the tax consequences of a corporation becoming or ceasing to be a QSSS. IRS Notice 97-4 provided for a temporary procedure for the election of QSSS status through the filing of IRS Form 966; that procedure is to remain in effect until the proposed regulations are issued in final form.

QSSS Election

The election is to be made by filing a form to be prescribed by the IRS. The election will take effect on any effective date specified on the form that is not more than two months and fifteen days prior to, or twelve months after, the date of filing.

If no effective date is specified on the form, the election is effective when the form is filed. The subsidiary must be eligible for the QSSS election when the election is made and for all periods for which the election is to be effective.

A QSSS election may be revoked by filing a statement of revocation, which may specify an effective date at any time within the period beginning two months and fifteen days before the filing date and ending twelve months after the filing date. Both the election and any revocation thereof must be signed by a person authorized to sign the S corporation's return.

Effects of QSSS Election

Consistent with the discussion of the QSSS election in the 1996 House Committee Report, the proposed regulations provide that the election is deemed to cause a liquidation of the subsidiary into the S corporation. Except as provided in a transitional rule, however, "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."

The intended scope of the step transaction doctrine and other "general principles" is not made clear, and the thrust of the statement in the regulation is arguably inconsistent with Congressional intent as reflected in 1996 Congressional committee reports -- which may be read to state that Code sections 332 and 337 were intended to apply with respect to any QSSS election relating to an existing corporation.[1] The one example given in the proposed regulations of the consequences of the application of general principles of taxation is that, if an S corporation forms a subsidiary and makes a valid QSSS election for the subsidiary effective on the date of formation, there is no deemed liquidation and the subsidiary is treated as a QSSS from its inception.

The consequences of other possible applications of "general principles" may be more controversial. A transitional rule provides that the step transaction doctrine will not apply if an S corporation and another corporation are related (within the meaning of section 267(b) of the Code) before an acquisition of stock by the S corporation in the other corporation, and the acquisition of stock is followed by a QSSS election for the other corporation which is effective before the 60th day after the publication of final regulations. In such circumstances, the deemed liquidation is respected as an independent step and its consequences are determined under Code sections 332 and 337.

Attorneys with the IRS Office of Assistant Chief Counsel have asserted that if the transitional rule does not apply, the contribution of, say, 21% of the stock of a C corporation to an S corporation that owns the other 79%, coupled with a QSSS election, will be treated under *Bausch & Lomb*[2] and step transaction principles as a failed C reorganization and as a taxable exchange.

In general, the liquidation that results from a QSSS election is deemed to occur as of the close of the day before the effective date of the QSSS election. Special timing rules apply if a QSSS election is made effective on the date an S corporation first acquires 100% of the stock of another corporation (in which case the liquidation is deemed to occur immediately after the acquisition of 100% ownership), or in connection with a qualified stock purchase by an S corporation with respect to which a section 338 election is made.

Examples provide further insight into the new rules regarding QSSS elections and indicate, among other things, that, when a QSSS election is made, the taxable year of the corporation for which it is made ends on the date of the deemed liquidation.

Another example, flagging a trap for the unwary, concludes that, if a QSSS election is made for a subsidiary of an S corporation, and on the effective date of the election the subsidiary is indebted to the S corporation in an amount exceeding the fair market value of the subsidiary's assets, the resulting liquidation does not qualify under sections 332 and 337 (presumably because there are no assets available for distribution with respect to stock), and therefore gain is recognized. The example apparently assumes that the subsidiary's debt to the parent corporation is respected as debt for tax purposes.

Termination of QSSS Election

Generally, a termination of a QSSS election occurs (i) on the effective date stated in a revocation statement; (ii) at the end of the parent corporation's last taxable year as an S corporation, if the parent's S election terminates; or (iii) at the close of the day in which an event, such as a transfer of subsidiary stock, occurs that makes the subsidiary ineligible to be treated as a QSSS. If a termination occurs by reason of a subsidiary becoming ineligible to continue as a QSSS, the S corporation must attach a statement providing notice of the termination to its return for the taxable year in which the termination occurs.

Under the Code and the proposed regulations, when a corporation's status as a QSSS terminates by reason of an event causing the corporation to cease to be eligible for QSSS status, or otherwise under Proposed Reg. Search7RH1.1361-5(a), the former QSSS is treated as a corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation, immediately before the event terminating QSSS status, in exchange for its stock. As in the context of a QSSS election, the tax consequences will be determined under the Code and general principles of tax law, including the step transaction doctrine.

The first example illustrating the application of the "general principles" in this context appears destined to promote further controversy. The example concludes that if an S corporation sells 21% of the stock of its QSSS to an unrelated corporation, thereby terminating the QSSS election, the resulting deemed exchange by the parent corporation of assets for its subsidiary's stock does not qualify under Code section 351 because the parent is not in control of the subsidiary immediately after the sale of stock. Therefore, the S corporation must recognize gain, if any, that is realized on the deemed transfer of assets to the subsidiary.

The result in the example might be viewed as a logical consequence of the deemed contribution rule coupled with the 80% control rule of section 351. Other approaches could be justified as well, however, and the proposed regulations and IRS notice of proposed rulemaking do not cite any policy justification for the recognition of gain in this context.

On the (generally) more favorable side, another example concludes that, where the stock of a QSSS is distributed by a parent corporation to its shareholders, thereby terminating the QSSS election, the distribution may be nontaxable under sections 355 and 368(a)(1)(D) if the transaction otherwise satisfies the requirements of these sections. This appears to confirm that the separate existence of the subsidiary at the instant before the distribution is respected for purposes of applying the provisions of Subchapter C of the Code.

Election after QSSS Termination

The Code provides that, if a corporation's status as a QSSS terminates, that corporation (and any successor) is not eligible to make either a QSSS election or an election to be treated as an S corporation until the corporation's fifth taxable year beginning after the first taxable year for which the termination was effective, unless the Service consents to an earlier election.

The proposed regulations provide that such consent need not be requested where the QSSS election made for a subsidiary terminates by reason of a disposition of its stock, if (i) the subsidiary or its successor is otherwise eligible to make an S election, or to have a QSSS election made for it, immediately following the disposition of stock, and (ii) the relevant election is made effective immediately after the disposition of stock.

Stock Ownership in C Corporations

Although the Code now permits an S corporation to own up to 100% of the stock of a C corporation, dividends paid by the C corporation are generally includible in "passive investment income." This can be significant in some situations, because an S corporation will cease to qualify as such if its passive investment income exceeds 25% of its gross receipts for three consecutive taxable years and it has accumulated earnings and profits as of the close of each of those years.

If, however, an S corporation holds stock of a C corporation sufficient to meet the stock ownership requirements for filing consolidated income tax returns (in general, 80% by voting power and by value, excluding certain preferred stock), the dividends from the C corporation are not treated as passive investment income to the extent they are attributable to earnings and profits of the C corporation derived from the active conduct of a trade or business. The proposed regulations provide guidance as to the application of this special rule, including a safe harbor method for determining the portion of earnings and profits attributable to an active trade or business and ordering rules for determining the extent to which dividends are treated as made from "active" earnings and profits.

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1 The Congressional committee reports describing a technical correction made in 1997 to the QSSS provisions, however, state that regulations may provide exceptions to the general rule that a QSSS election is treated as a liquidation under section 332.

2 *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959).