

Frequently Asked Questions: Qualified Subchapter S Subsidiaries (QSub)

Q What is a QSub?

A QSub stands for Qualified Subchapter S Subsidiary. QSub provisions are effective for income or taxable years beginning after December 31, 1996. A QSub is a domestic corporation that is a 100% owned subsidiary of an S corporation. It can not be an "ineligible corporation" (see below), and the S corporation parent must elect to treat it as a QSub.

Ineligible corporations include financial institutions using the reserve method of accounting for bad debts, insurance companies subject to tax under IRC Subchapter L, and domestic international sales corporations (DISCs).

Q How do I become a QSub?

A An S corporation owning 100 percent of the stock of a corporation that is eligible for QSub status may make the QSub election by following the temporary election procedure provided in IRS Notice 97-4. This notice states that a parent S corporation files Form 966, Corporate Dissolution and Liquidation (with modifications as described in Notice 97-4, 1997-1 C.B. 351). Under the proposed regulations, taxpayers will be able to make the election by filing a form to be developed by the IRS prior to the time the proposed treasury regulations become final. Until the proposed regulations are finalized, taxpayers should continue to use the temporary election procedure in Notice 97-4.

The election may be made by the S corporation parent at any time during the taxable year. It will take effect on any effective date specified on the form or on the date the election form is filed if no date is specified. The effective date specified on the form can not be more than two months and 15 days prior to the date of filing and can not be more than 12 months after the date of filing. The subsidiary must be eligible for the QSub election when the election is made and for all periods for which the election is to be effective.

An election made by the parent S corporation to treat the corporation as a QSub for federal purposes is treated as a binding election for California.

Q Does California conform to federal rules regarding QSubs?

A Yes. *Generally*, California conforms to federal rules unless otherwise specified in the California

law. A federal election made by the parent S corporation to treat the subsidiary corporation as a QSub for federal purposes is a binding election for California.

Q How does Franchise Tax Board know if my Form 100S includes a QSub?

A The Qualified Subchapter S Subsidiary Information Worksheet, Schedule QS, is used by the parent S corporation to inform us of any QSubs it owns. This notifies us that the QSub items of income, deductions, and credits will be included in the parent's return and the QSub will not be filing a separate California franchise or income tax return. The S corporation parent must complete Schedule QS and attach it to the Form 100S for each income year in which a QSub is acquired or a QSub election is made.

California also requires that an S corporation parent attach a copy of the Form 966 for each QSub doing business or qualified to do business in California to the return for the income year during which the QSub election was made.

Q The QSub is subject to an \$800 tax. Is this an annual tax or the minimum franchise tax?

A The QSub is subject to an annual tax that is paid by the S corporation parent. The S corporation parent is responsible for the annual tax for the QSub if the QSub is incorporated in California, is doing business in California, or is qualified to do business in California. Under California Revenue and Taxation Code (CR&TC) § 23800.5(b)(1)(B), the annual tax is equal to the minimum franchise tax. Currently, the minimum franchise tax is \$800.

Q When is the QSub annual tax due?

A The QSub annual tax is due and payable when the S corporation's first estimated tax payment is due. If the QSub is acquired, or a QSub election is made, during the year, the QSub annual tax is due with the S corporation's next estimated tax payment after the date of the QSub election or acquisition. The QSub annual tax is subject to the estimated tax rules and penalties.

Q Scoop, an S corporation parent does not do business in California. In 1999, Scoop purchased three QSubs, Vanilla, Chocolate and Strawberry. Only Vanilla and Chocolate are doing business in California. How do I file this return?

A For the 1999 income year, Scoop is deemed doing business in California because of Vanilla and Chocolate's business activities in the state, and subject to the franchise tax. Scoop is subject to California franchise tax in an amount at least equal to the minimum franchise tax. For income year 1999, Scoop is responsible for its own franchise tax (the greater of the minimum franchise tax or 1.5% of net income for tax purposes) plus two annual taxes for the QSubs, Vanilla and Chocolate.

Q Cement Inc, an S corporation, purchases Concrete Corp., which also is an S corporation; and immediately makes a QSub election for Concrete. At the time of the purchase, Concrete has S corporation NOLs and credits. Will Cement, the S corporation parent, be able to use Concrete's NOLs and credits?

A Yes. R&TC Section 23800.5(b)(2)(B) states, "All activities, assets, liabilities, including liability for the tax imposed under this subdivision, and all items of income, *deduction*, and *credit* of a qualified Subchapter S subsidiary shall be treated as activities [...], assets, liabilities, and those items, as the case may be, of the S corporation."

Q Brighten Music, an S corporation, purchased Sarah Corporation, a C corporation. Brighten immediately elected QSub status for Sarah. At the time of purchase, Sarah had \$50,000 NOL carryover and a \$60,000 Manufacturer's Investment Credit (MIC) carryover. Will Brighten, the S corporation parent, be able to use Sarah's NOL and credits?

A Sarah's NOL will be suspended until Brighten becomes a C corporation or the NOL expires, whichever comes first. Sarah's C corporation's credits will be reduced by two-thirds (\$40,000) and the remaining one-third of the credits (\$20,000) will be carried over to the parent S corporation. Although the S corporation may use these credits, they cannot be passed through to the S corporation's shareholders.

Q If the parent S corporation holds a note from the QSub, can the QSub claim interest expense paid on the note?

A For tax purposes, the QSub is not treated as a separate entity. Transactions between the parent S corporation and the QSub are disregarded. Therefore, the parent S corporation does not have an asset for the note receivable and will not have interest income received on the note. Conversely, the QSub does not have a liability for the note payable and will not have interest expense for the interest paid on the note.

Q If an S corporation and the QSub are not unitary, how do I file the return?

A If the QSub is not unitary with the S corporation parent, then it is treated as a separated division and computations must be made to compute the business income and apportionment factors for the QSub and the S corporation parent, and to apportion to California the business income of each.

RELATED FTB FORMS AND PUBLICATIONS

Form 100S Booklet

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From within the United States, call (800) 852-5711
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