

## 14.0 QSUB/QSSS

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### 14.1 INTRODUCTION TO QSUB (ALSO KNOWN AS QSSS)

In 1996, the law which had prevented a subchapter S corporation from being a member of an affiliated group of corporations was repealed. House Report No. 104-586 Public Law No. 104-188 (also known as the Small Business Job Protection Act) allowed an S corporation to own all (or any lesser amount) of the stock of another corporation. As a result, an S corporation was allowed to have a separate business in a separate corporation.

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#### 14.1.1 Before the Qualified Subchapter S Subsidiary (QSub) Law

Prior to the Small Business Job Protection Act, a small business S corporation could not be a member of an affiliated group of corporations (other than by reason of ownership in certain inactive corporations). Therefore, an S corporation could not own 80 percent or more another corporation's stock and could not have as a shareholder another corporation (whether an S or C corporation). (Internal Revenue Code (IRC) Section 1362(b)(2)(A)) In addition, an S corporation was allowed a maximum of 35 shareholders under the pre-'96 Small Business Job Protection Act law (IRC Section 1361(b)(1)(A)).

#### 14.1.2 Reasons for Change

The House Ways and Means Committee understood that there are situations where taxpayers may wish to separate different trades or businesses in different corporate entities. The Committee believed that, in such situations, shareholders should be allowed to arrange these separate corporate entities under parent-subsidary arrangements, as well as, brother-sister arrangements.

## 14.2 BASIC FEDERAL LAW

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- 14.2.3 Election's Effect
- 14.2.4 Termination of QSub Election

### 14.2.1 What is a QSub?

QSub stands for qualified subchapter S subsidiary. It is also known as a QSSS. Because of possible confusion of QSSS with QSST (qualified subchapter S trust), QSub is the term of choice. The Internal Revenue Service procedures refer to the qualified subchapter S subsidiary as a QSub; therefore, this term is used in this discussion. QSub provisions are effective for income or taxable years beginning after December 31, 1996.

IRC Section 1361(b)(3)(B) defines a QSub as any domestic corporation which is not an "ineligible corporation" if the S corporation holds 100 percent of that corporation's stock and elects to treat that subsidiary as a QSub.

Ineligible corporations include:

- Financial institutions using the reserve method for bad debts described in IRC Section 585.
- Insurance companies subject to tax under Subchapter L.
- Corporations subject to an IRC Section 936 election (Puerto Rico and possession corporations).
- Domestic international sales corporations (DISCs) or former DISCs (IRC Section 1361(b)(2)).

Exceptions to the list of ineligible corporations include certain casualty insurance companies and qualified oil companies (Treasury Regulation (Treas. Reg.) Section 1.1361-1(d)(2)).

### 14.2.2 How to become a QSub?

#### a. Election

Currently, an S corporation owning 100 percent of the stock of a corporation that is eligible for QSub status makes the QSub election by completing federal Form 8869, *Qualified Subchapter S Subsidiary Election*. (IRC Section 1361(b)(3)(B))

The S corporation parent may make a QSub election at any time during the taxable year. The effective date of the QSub election cannot be more than one of the following:

1. Two months and 15 days prior to the date of filing the election.
2. Twelve months after the date of filing the election.

If the election specifies a date falling earlier than the date in item 1, it will be treated as being effective 2 months and 15 days prior to the date of filing the election. If the election

specifies a date falling later than the date in item 2, it will be treated as being effective 12 months after the date of filing the election. If no date is specified, the election is effective on the date Form 8869 is filed (Treas. Reg. Section 1.1361-3(a)(4)).

**Example A**

Big S has been a calendar year S corporation engaged in a trade or business for several years. Big S acquires the stock of Big C, a qualified calendar year C corporation, on March 1, 2015. On July 10, 2015, Big S files an election to treat Big C as a QSub.

Unless otherwise specified on the election form, the election will be effective as of July 10, 2015. If specified on the election form, the election may be effective on some other date that is not more than 2 months and 15 days prior to July 10, 2015 (April 25, 2015), and not more than 12 months after July 10, 2015 (July 10, 2016).

For federal purposes, an extension of time to make a QSub election may be available under the procedures applicable under Treas. Reg. Sections 301.9100-1 and 301.9100-3. Requests for extension will be granted when the taxpayer provides evidence to establish, to the satisfaction of the Commissioner, that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the Government (Treas. Reg. Section 301.9100-3(a)). Numerous letter rulings have been issued granting extension for filing the QSub election.

**b. Relief Provisions of Filing a Late Election**

Revenue Procedure (Rev. Proc.) 2013-30 (issued August 14, 2013, and effective for all requests pending and made as of September 3, 2013) facilitates the grant of relief to taxpayers that request relief by consolidating, modifying, and superseding the provisions of several previous revenue procedures into one revenue procedure and extending relief in certain circumstances. Rev. Proc. 2013-30 provides the exclusive simplified methods for taxpayers to request relief for late-filed S corporation elections, QSub elections, ESBT elections, QSST elections, and late corporate classification elections.

In general, relief may be granted by the Internal Revenue Service (IRS) if the request for relief is filed within 3 years and 75 days after the effective date. These provisions provide substantial additional protection for the all-too-common failure to comply with the due dates for filing the various S corporation related elections.

To request relief under Rev. Proc. 2013-30 (Section 4.02), the taxpayer must meet the following general requirements:

1. The entity intended to be classified as an S corporation, QSub, QSST, or ESBT as of the effective date.
2. The request for relief is less than 3 years and 75 days after the effective date.

3. The entity failed to qualify as an S corporation, QSub, QSST, or ESBT as of the effective date solely because of the failure to have filed the appropriate election by the required due date.
4. In the case of a late S corporation or a QSub election, the entity has reasonable cause for the failure to have timely filed the election and acted diligently to correct the mistake upon discovery. In the case of a late ESBT or QSST election, the failure to have timely filed the election was inadvertent.

Section 4.03 of Rev. Proc. 2013-30 provides the following procedural requirements regarding how the relief request is filed and what information and forms must be included.

1. The taxpayer may request relief by properly completing the election form(s) and attaching applicable supporting documentation. The completed election form must also include a statement (the "Reasonable Cause/Inadvertence Statement") establishing either reasonable cause for the failure to file the election under Subchapter S (in the case of the S corporation or QSub elections) or that the failure to file the election under Subchapter S in a timely manner was inadvertent (in the case of QSST or ESBT elections). The election form must state at the top of the document "FILED PURSUANT TO REV. PROC. 2013-30."
2. The entity requesting relief must file the applicable election form with the IRS Service Center by doing one of the following:
  - a. Attaching the election form to the current year tax return. If the entity seeking to make the election has already filed a tax return (or in the case of a QSub, the parent S Corporation has already filed a tax return) for the tax year between the effective date and the current year, the election form can be attached to the current year tax return. The current year tax return must be filed within 3 years and 75 days after the effective date. An extension of time to file the current year tax return does not extend the due date for relief. The tax return must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30."
  - b. Attaching the election form to the tax return for the tax year including the effective date. If the entity seeking to make the election has not yet filed a tax return (or in the case of a QSub, the parent S corporation has not yet filed a tax return) for the first year in which the election was intended to be effective or any tax year following the effective date, the election form can be attached to the tax return for the tax year including the effective date as long as the tax return including the effective date is filed within 3 years and 75 days after the effective date and all other delinquent tax returns are filed simultaneously and consistently with the relief request. The tax return must state at the top "INCLUDES LATE ELECTION(S) FILED PURSUANT TO REV. PROC. 2013-30."
  - c. Submitting the election form directly to the IRS Service Center within 3 years and 75 days after the effective date.
3. The "Reasonable Cause/Inadvertence Statement" and any other statements must contain a dated declaration stating "Under penalties of perjury I (we) declare that I (we) have examined this election, including accompany documents, and, to the best

of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." This declaration must be signed by an officer of the S corporation, the trustee of the ESBT, the current income beneficiary of the QSST or a shareholder, as applicable.

For California purposes, California has not conformed to IRC Section 7805(f), which authorizes the Commissioner to provide the procedures as outlined in Treas. Reg. Section 301.9100-1 and Treas. Reg. Section 301-9100-3. However, if an S corporation receives an extension for filing the QSub election by the Commissioner, California will honor the extension because California conforms to the S corporation election provisions and an independent election for QSub status is not allowed for California purposes (California Revenue & Taxation Code (R&TC) Section 23800.5(a)(3)).

#### **14.2.4 Election's Effect**

##### **a. Separate Existence Ignored**

Under the final regulations, the effect of a QSub election is that the existing subsidiary is not to be treated as a separate corporation. Generally, the QSub is deemed to be liquidated under IRC Section 332 and IRC Section 337 (Treas. Reg. Section 1.1361-4(a)(2)). All assets, liabilities, and items of income, deduction, and credit of a QSub are to be treated as those of the parent S corporation (IRC Section 1361(b)(3)). Items of the subsidiary, which become attributable to the parent S corporation, include accumulated earnings and profits, passive investment income, and built-in gains (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill)). Transactions between the parent S corporation and the QSub are not taken into account (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill)).

##### **Example B**

Quantum, an S corporation, is the single member of Little L, an LLC. Little L owns 100 percent of the stock in Quad, a corporation that could be an eligible QSub. The "check-the-box" regulations allow Little L to be a disregarded entity separate from Quantum, its owner. (Treas. Reg. Section 301.7701-2(c)) Quantum is considered as owning 100 percent of the stock of Quad and can elect QSub status for Quad.

##### **Example C**

Sophia & Co., an S corporation, wholly owns Quincy, a corporation, which has a valid QSub election in effect. Quincy owns all of Quality's stock. Quality is a corporation that could be an eligible QSub. Quincy is disregarded as an entity separate from Sophia & Co. Quincy's assets, including its stock in Quality, are deemed owned by Sophia & Co. Sophia & Co. can elect QSub status for Quality.

##### **Example D**

Assume same facts as Example C, except that Quincy owns 60 percent of Quality and Sophia & Co. owns the other 40 percent. Sophia & Co. is deemed the owner of 100 percent of the stock of Quality and can elect QSub status for Quality.

**Example E**

Assume same facts as Example C, except that Quincy is a C corporation. While Quincy is eligible for QSub status, no election for QSub status has been made. Quincy is considered the sole owner of Quality. Therefore, Sophia & Co. is unable to elect QSub status for Quality.

**Example F**

Jazz, an S corporation, owns 100 percent of Country, a corporation for which a QSub election is in effect. On April 12, 2015, the date on which the QSub election is in effect, Jazz loans Country \$10,000 by issuing a note with a market rate of interest that matures in ten years. Country is not treated as a separate corporation, and Jazz's issuance of the note to Country on April 12, 2015, is disregarded for federal tax purposes. The interest paid by Country is disregarded as an expense to Country and the interest income to Jazz is also disregarded for tax purposes. If Country defaults on the note, Jazz is not allowed a bad debt expense. Likewise, Country would not recognize any cancellation of debt income.

The QSub's debt issued to the shareholders of the parent S corporation is treated as the parent's debt for purposes of determining the amount of loss that can be deducted by the shareholders of the parent S corporation. (House Report No. 104-586 (PL 104-188), II.C.8 (sec. 1308 of the Bill))

**b. Deemed Liquidation**

Generally, 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 under IRC Section 332 and IRC Section 337. (Treas. Reg. Section 1.1361-4(a)(2)(i)) When the QSub election is filed, the making of the election is generally treated as the adoption of a plan of liquidation under IRC Section 332. (Treas. Reg. Section 1.1361-4(a)(2)(iii))

The tax treatment of the deemed liquidation or a larger transaction that includes the liquidation must take into consideration the IRC and the general principles of federal tax law, including the step transaction doctrine. The step transaction doctrine treats the steps of a corporate reorganization, if related, as one transaction. The tax consequences of the transaction (who is in control of the transferee/QSub) will be determined after all the steps are completed, not at each step of the transaction. 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, there will be no deemed liquidation of the new subsidiary. Instead, the corporation will be deemed to be a QSub from its inception. (Treas. Reg. Section 1.1361-4(a)(2))

A transitional rule exempts a QSub election from the step transaction doctrine if the S corporation and the QSub are related "persons" as defined in IRC Section 267(b) prior to the S corporation's partial or total acquisition of the QSub's stock. This exemption applies to QSub elections effective before January 1, 2001. (Treas. Reg. Section 1.1361-4(a)(5))

The examples below provide some of the most common situations we may encounter. The intent behind the law allowing QSubs is to allow some flexibility in the way small businesses

are allowed to separate different trades or businesses as different corporate entities, but at the same time not create situations where there is the potential for abuse.

Generally, the deemed liquidation occurs the day before the QSub election. However, if an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSub election or the acquisition is in coordination with an IRC Section 338 election, then the deemed liquidation occurs the day after the S corporation acquires 100 percent of the subsidiary or the completion of the IRC Section 338 election. By making the deemed liquidation effective on the day after the acquisition or the completion of an IRC Section 338 election, the taxable event of the acquisition, if applicable, must be recognized before the effective date of the QSub. (Treas. Reg. Section 1.1361-4(b))

### Example G

Success, an S corporation, owns 100 percent of the stock of Jasmine, a C corporation. (The stock was acquired from an unrelated party on January 6, 2015.) On May 2, 2015, Success makes a valid QSub election for Jasmine, effective May 2, 2015. Assume that, under general principles of tax law, including the step transaction doctrine, Success' acquisition of the Jasmine stock and the subsequent QSub election would not be treated as related. The liquidation described in Treas. Reg. Section 1.1361-4(a)(2) occurs at the close of the day on May 1, 2015, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Jasmine's taxable year and separate existence for federal tax purposes end at the close of May 1, 2015.

#### Tax consequences:

Jasmine - The shareholder(s) of Jasmine recognize the applicable gain or loss on the sale of stock. Jasmine, a calendar year taxpayer, files a short period return for January 1, 2015, through May 1, 2015. No gain or loss is recognized by Jasmine under IRC Section 337.

Success - Success, a calendar year S corporation, files a full year tax return, which includes Jasmine as of May 2, 2015. No gain or loss is recognized on the deemed liquidation of Jasmine under IRC Section 332. Assuming there is no debt owed to Success by Jasmine on May 2, 2015 (Treas. Reg. Section 1.332-7), Success will carry over Jasmine's basis in the assets. (IRC Section 334(b)(1))

### Example H

Xavier owns 100 percent of the stock of Chess. Both companies are C corporations. On December 31, 2014, Xavier makes an election under IRC Section 1362 to be treated as an S corporation and a valid QSub election for Chess. Both are effective January 1, 2015. Assume that, under general principles of tax law, including the step transaction doctrine, Xavier's acquisition of the Chess stock and the subsequent QSub election would not be treated as related (IRC Section 267(b)). The liquidation occurs at the close of December 31, 2014, the day before the QSub election is effective. The QSub election for Chess is effective on the same day that Xavier's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when Xavier is still a C corporation. Chess' taxable year ends at the close of December 31, 2014. See Treas. Reg. Section 1.381(b)-1 for the operating rules applicable to carryovers in certain acquisitions.

**Tax consequences**

Keep in mind the ramifications of going from a C corporation to an S corporation. For example, built-in gains and distribution of C corporation earnings and profits. (See S Corporation Manual Section 14.2.4.d Carryover of Tax Attributes for a detailed discussion.) Assuming that these issues are not present here, the tax consequences of Xavier and Chess are as follows:

**Xavier**

- 2014 - Xavier files a C corporation income tax return. No gain or loss is recognized assuming no debt exists between Xavier and Chess.
- 2015 - All items of income and deduction of Chess become those of Xavier and are included in Xavier's income tax return.

**Chess**

- 2014 - Chess files a C corporation income tax return. No gain or loss is recognized assuming no debt exists between Xavier and Chess.
- 2015 - All items of income and deduction of Chess become those of Xavier and are included in Xavier's income tax return.

**Example I**

On January 1, 2015, Super S, an S corporation, acquires 100 percent of the stock of Duper S, an existing S corporation, for \$75,000 cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under IRC Section 338. Super S immediately makes a QSub election for Duper S effective January 2, 2015, and also makes a joint election under IRC Section 338(h)(10) with the shareholder of Duper S. Under IRC Section 338(a) and Treas. Reg. Section 1.338(h)(10)-1, Duper S is treated as having sold all of its assets with a basis of \$50,000 at the close of the acquisition date, January 1, 2015. (Duper S has no liabilities.) Duper S is treated as a new corporation, which purchased all of those assets as of the beginning of January 2, 2015, the day after the acquisition date. (IRC Section 338(a)(2)) The QSub election is effective on January 2, 2015, and the liquidation under Treas. Reg. Section 1.1361-4(a)(2) occurs immediately after the deemed asset purchase by the new corporation.

**Tax consequences**

Super S, a calendar year taxpayer, files an income tax return for 2015 including all items of income and deduction of Duper S beginning on January 2, 2015. However, on January 1, 2015, short year return, Duper S recognizes a gain of \$25,000 (Sales price of \$75,000 less Basis of assets of \$50,000). As a result of Duper S recognizing the gain of \$25,000, the assets of Duper S are given a stepped-up in basis to \$75,000. This basis amount of \$75,000 is carried into the parent Super S upon the QSub election of Duper S.



### 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, any loss or deduction disallowed under IRC Section 1366(d) with respect to a former shareholder of S2 is available to that shareholder as a shareholder of S1. (Treas. Reg. Section 1.1361-4(c)) Thus, a loss or deduction of a shareholder of S2 disallowed prior to or during the taxable year of the transaction is treated as incurred by S1 with respect to that shareholder if the shareholder is a shareholder of S1 after the transaction.

#### Example J

Embassy, an S corporation, acquires 100 percent of the stock of Ambassador, another S corporation. Embassy elects to treat Ambassador as a QSub effective on the day of the acquisition. Any loss or deduction disallowed under IRC Section 1366(d) with regard to a former shareholder of Ambassador remains available to that shareholder as a shareholder of Embassy. Therefore, a loss or deduction of a former Ambassador shareholder disallowed prior to or during the year of the transaction is treated as incurred by Embassy with respect to that shareholder provided the shareholder is a shareholder of Embassy after the transaction.

#### Example K

Same facts as Example J. The 100 percent shareholder of Ambassador (who is now a 100 percent shareholder of Embassy) had zero basis and carryover losses of (\$5,000 from Ambassador at the time of the QSub election. If Embassy has pass-through income items in the amount of \$10,000 that increase basis to the former shareholder of Ambassador, the shareholder may offset the carryover losses of (\$5,000) against the income from Embassy of \$10,000. (IRC Section 1367)

#### Example L

Same facts as Example J. Sharon, a former 50 percent shareholder of Ambassador (who is now a 30 percent shareholder of Embassy), had zero basis and carryover losses of (\$2,500) (50% X \$5,000) from Ambassador at the time of the QSub election. If Embassy has pass-through income items in the amount of \$3,000 (30% X \$10,000) to Sharon, which increase her basis, she may offset the carryover losses of (\$2,500) against the income from Embassy of \$3,000 (IRC Section 1367).

### d. Carryover of Tax Attributes

Treas. Reg. Section 1.1361-4(b) provides that in general a QSub is treated as if it were liquidated into the S corporation. If this occurs, then generally, IRC Section 381 allows the acquiring corporation to succeed to and take into account the tax attributes of the subsidiary. These attributes include, among other things:

- NOL carryovers
- General business credits
- Method of accounting

- Depreciation methods
- Capital loss carryovers

Thus, in general if the acquiring corporation and the subsidiary are both S corporations, then the acquiring corporation will succeed to and take into account the tax attributes of the subsidiary. However, tax attributes generally will not carryover between C year and S year. (IRC Section 1371(b)) There are two instances that this could occur. First, both the acquiring corporation and subsidiary could have been C corporations prior to the acquiring corporation electing S status and QSub for the subsidiary. Second, the acquiring corporation is an S corporation that acquires a C corporation prior to electing QSub. In both these situations, the rules would be similar to a regular C corporation electing S corporation status. For example, the NOL carryovers and general business credits from C years can only be utilized if the S corporation had recognized built-in gains tax. (See S Corporation Manual Section 5.0 Built-In Gains Tax.)

### IRC Section 338 Election

If an S corporation acquires the stock of the subsidiary in a qualified stock purchase (IRC Section 338(h)(10)), then generally the tax attributes do not carryover to the acquiring corporation because, for tax purposes, the transaction is treated as an asset sale rather than a stock sale. Therefore, there are no tax attributes of the subsidiary subject to transfer. (See S Corporation Manual Section 16.0 Sale of Stock & Election of IRC Section 338(h)(10).)

**Note:** Despite the fact that an S corporation cannot have carryovers or carrybacks from tax years when it was not an S corporation, each year the corporation is an S corporation counts as a year for the purpose of figuring the year to which carryovers or carrybacks can be taken (IRC Section 1371(b)(3)).

### e. Built-In Gains Tax

There are several ways an S corporation with a QSub can be subject to built-in gains tax.

1. The S corporation could have been a C corporation prior to acquiring the subsidiary and electing S and QSub status.
2. The S corporation could have acquired a C corporation before electing QSub status.
3. There could have been a tax-free reorganization with a QSub election, involving an S and a C corporation where the S corporation acquired C corporation assets.

However, the transaction arose, an S corporation with a QSub will be subject to the built-in gains tax as long as the S corporation acquires an asset and the S corporation's basis in such asset is determined (in whole or in part) by reference to the basis of such asset (or any other property) in the hands of a C corporation (IRC Section 1374(d)(8)).

For example, if a C corporation elects to be treated as an S corporation and at the same time makes a QSub election for a subsidiary, the assets held by the QSub at the time of the election are treated as assets transferred from a C corporation which are taken into consideration for purposes of the built-in gains tax. This is in addition to the potential built-in gains tax on the assets of the S corporation itself. Keep in mind that the recognition period begins on the date of the S election or on the date of the assets acquisition (Treas. Reg. Section 1.1374-1(d)). Thus, if an S corporation acquires a C corporation subsidiary and

elects QSub status, the recognition period begins on the date of the acquisition and QSub election.

**Note:** For Federal purposes, the recognition period regarding the built-in gains tax was permanently reduced to 5 years with the passing of the PATH Act of 2015. For California purposes, the 10-year recognition period regarding the built-in gains tax remains in effect as California does not conform to the PATH Act of 2015 (R&TC Section 23051.5 and R&TC Section 23809). (See S Corporation Manual Section 5.0 - Built-In Gains Tax for additional discussion.)

### Example M

Oceana owns 100 percent of the following: Ship, Boat, and Yacht. The corporations are all C corporations. Oceana elects S status on January 1, 2015, and QSub status for Ship, Boat, and Yacht on January 2, 2015. The assets of Ship, Boat, and Yacht are not subject to built-in gains tax due to the deemed tax-free liquidation of the subsidiaries at the time of the QSub election. However, the built-in gains tax will become an issue if the assets of Oceana, Ship, Boat, and Yacht are sold within the recognition period.

### f. Gain on Liquidation

The QSub election may be tax free under IRC Section 332, IRC Section 337, and IRC Section 368. However, if the subsidiary is insolvent and is indebted to the parent S corporation, (Rev. Rul. 59-296, 1959-2 C.B. 87 and Treas. Reg. Section 1.332-7) or has liabilities in excess of the adjusted basis of its assets, (IRC Sections 368(a)(1)(D) and 357(c)(1)) the election may trigger a taxable event. (See S Corporation Manual Section 14.5 Audit Issue for additional discussion.)

### Example N

Stormy, an S corporation owns 100 percent of the stock of Cyclone, a C corporation. At the time when Cyclone is indebted to Stormy for an amount that exceeds the fair market value (FMV) of Cyclone's assets, Stormy makes a QSub election for Cyclone effective on the date it is filed. The liquidation described in Treas. Reg. Section 1.1361-4(a)(2) does not qualify under IRC Section 332 and IRC Section 337. Cyclone must recognize gain or loss on the assets distributed, subject to the limitations of IRC Section 267.

### Example O

Assume the same facts in Example N - Cyclone is indebted to Stormy. The balance on the note payable has a principal balance of \$375,000. Cyclone owns a single asset, land with a FMV of \$250,000. Cyclone will recognize a gain in the amount of \$125,000.

### g. Treatment of Banks

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 IRC and R&TC continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSub under Treas. Reg. Section 1.1361-4(a)(2) had not occurred. However, for any QSub that is a bank, 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 section, the term "bank" has the same meaning as in IRC Section 581. (Treas. Reg. Section 1.1361-4(a)(3))

Banks cannot elect S status if they use the reserve method. (IRC Section 1361(b)(2)(A)) However, there is one exception; S corporation status can be elected if the entity changes its accounting method from the bad debt reserve method to the specific write-off method. The corporation is required to recapture its bad debt reserve and pay built-in gains tax thereon. (FTB Notice 98-3 and Rev. Proc. 2002-9, 2002-3 I.R.B. 327)

#### Example P

Rocky, an S corporation is a bank holding company and accordingly is not a bank as defined in IRC Section 581. Rocky owns 100 percent of Shaky, a corporation for which a valid QSub election is in effect. Shaky is a bank as defined in IRC Section 581. According to Treas. Reg. Section 1.1361-4(a)(3)(i), any special rules applicable to banks under the IRC continue to apply to Shaky and do not apply to Rocky. However, all of Shaky's assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as those of Rocky. For example, IRC Section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Shaky. However, any gain or loss on such a transaction by Shaky that is considered ordinary income or ordinary loss according to IRC Section 582(c) is treated as ordinary income or ordinary loss of Rocky.

#### Example Q

Same facts as in Example P - Shaky has ordinary income of \$50,000 from the sale of bonds. Shaky's ordinary income from the bond sales is treated as ordinary income of Rocky.

### h. Determination of Basis

- To Transferor Parent S corporation

The basis of stock received is equal to the basis of the property transferred less the value of boot received plus the amount of gain recognized. Liabilities assumed by the QSub are treated as boot for this purpose, unless such liabilities are excluded under IRC Section 357(c)(3) (IRC Section 358(d)).

- To QSub

The basis of property received is equal to the basis of the property in the hands of the transferor parent S corporation, plus gain recognized by the transferor in the exchange under IRC Section 362(a)(1). IRC Section 362 does not allow the QSub to increase basis to reflect liabilities it assumes unless the transferor is forced to recognize gain under IRC Section 357 and then only to the extent of the gain recognized.

**Example R**

On January 1, 2015, Veggie, an S corporation parent, acquires Squash, an S corporation, for \$75,000 and makes a valid QSub election for Squash effective January 2, 2015. At December 31, 2014, Squash is indebted to Moneybags for a note with a principal balance of \$100,000. As part of the contract for the acquisition of Squash, Veggie assumes Squash's liability to Moneybags. Squash has a single asset, land, with a basis and FMV of \$75,000. On Squash's income tax return for income year ending December 31, 2014, Squash recognizes income of \$25,000 (Principal balance of loan \$100,000 less FMV of land \$75,000). Veggie's basis in the Squash stock:

Basis of the property transferred	\$75,000
Value of boot received	0
Amount of gain recognized by Squash	25,000
Total basis in Squash stock	\$100,000

**Example S**

Assume the same facts as in Example R, except Squash is indebted to Veggie instead of Moneybags. Because Veggie would recognize a loss of \$25,000 (Principal balance note \$100,000 less FMV of land \$75,000) and Squash would recognize a gain of \$25,000; Squash stock would remain at \$75,000.

**Example T**

On June 1, 2015, Zippy, an S corporation parent, acquires Poky, an S corporation, for \$70,000 cash and makes a valid QSub election for Poky effective June 2, 2015. On May 31, 2015, Zippy is indebted to Big Bucks for a note with a principal balance of \$30,000. As part of the sales agreement, Poky agrees to assume Zippy's debt to Big Bucks and Zippy receives a parcel of land that includes a building with a basis and FMV of \$100,000. Poky recognizes no gain or loss (Basis of property and building \$100,000 less liability assumed \$30,000 less cash received \$70,000). Zippy's stock basis in Poky is:

Basis of the property transferred	\$100,000
Value of boot received	(30,000)
Amount of gain recognized by Poky	0
Total basis in Poky stock	\$70,000

### **i. Allocation of Accumulated Adjustments Account (AAA) and Earnings & Profits (E&P)**

AAA and E&P are accounts maintained by the corporations. Thus, when a parent S corporation acquires a subsidiary with AAA and/or E&P and elects QSub, these amounts carryover to the parent S corporation.

Under the rules similar to those governing a nonrecognized spin-off pursuant to IRC Section 368(a)(1)(D) and IRC Section 355, the AAA and E&P generally are allocated between the "distributing" (parent S) corporation and the "controlled" corporation (QSub) in proportion to the FMV of the business and assets retained by the parent S corporation and the business and assets transferred to the QSub. (Treas. Reg. Section 1.1368-2(d)(3))

## **14.2.5 Termination of QSub Election**

### **a. In General**

Once the QSub election is made, it remains in effect until terminated. The QSub election terminates if a QSub fails to meet the QSub criteria, if the parent's S election terminates or the election is voluntarily revoked. (Treas. Reg. Section 1.1361-5(a)) If the election is terminated, IRS consent is generally required for another QSub election with regard to the former QSub (or its successor) for any tax year before the fifth tax year after the first tax year in which the termination took effect. (Treas. Reg. Section 1.1361-5(c))

A QSub 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 15 days before the filing date and ending 12 months after the filing date. (Treas. Reg. Section 1.1361-3(b)) If the parent's S election terminates, the QSub election will terminate at the close of the last day on which an event occurs that renders the subsidiary ineligible for QSub status. A person authorized to sign the S corporation's tax return must sign the revocation. The notice of termination is to be included with the return for the taxable year in which the termination occurs. California follows the federal rules for termination.

If the QSub election terminates because an event renders the subsidiary ineligible for QSub status, the S corporation must attach to its tax return for the taxable year in which the termination occurs the following information:

- Notification of the QSub termination.
- The date of the termination.
- Names, addresses, and employer identification number of both the parent corporation and the QSub. (Treas. Reg. Section 1.1361-5(a)(2))

### **Example U**

#### **Termination because parent's S election terminates.**

Seesaw, an S corporation, owns 100 percent of So-So. A QSub election for So-So is in effect for 2014. Effective on January 1, 2015, Seesaw revokes its S election. Because Seesaw is no longer an S corporation, So-So no longer qualifies as a QSub at the close of December 31, 2014.

**Example V****Termination due to transfer of QSub stock.**

Prince, an S corporation owns 100 percent of the stock of Slippery. A QSub election is in effect for Slippery in 2015. On December 15, 2015, Prince sells one share of Slippery stock to Cindy, an individual. Because Prince no longer owns 100 percent of Slippery, Slippery no longer qualifies as a QSub. Accordingly, the QSub election made for Slippery terminates at the close of December 15, 2015.

**Example W****No termination on stock transfer between QSub and parent.**

Silly, an S corporation, owns 100 percent of Sassy. Sassy owns 100 percent of the stock of Sissy. QSub elections are in effect for Sassy and Sissy. Sassy transfers all of its Sissy stock to Silly. Because Silly is treated as owning the stock of Sissy both before and after the transfer of stock solely for purposes of determining whether the requirements of IRC Section 1361(b)(3)(B)(i) and Treas. Reg. Section 1.1361-2(a)(1) have been satisfied, the transfer of Sissy stock does not terminate Sissy's QSub election. Because the stock of Sissy is disregarded for all other federal tax purposes, no gain is recognized under IRC Section 311.

**b. Effect of Termination of QSub Election**

When the QSub election terminates, the QSub is treated as a new corporation that acquires all of its assets and assumes all its liabilities immediately before the termination from the parent S corporation in exchange for stock of the new corporation. The tax treatment of this transaction will be determined under the IRC and general principles of tax law, including the step transaction doctrine. (Treas. Reg. Section 1.1361-5(b)) The deemed issuance of the subsidiary's stock for its assets will generally qualify as a tax-free IRC Section 351 transfer if the parent S corporation is still in control of the subsidiary by continuing to own at least 80 percent of the subsidiary's stock.

**Example X**

Season, an S corporation, owns 100 percent of the stock of Spring, a QSub. Season sells 21 percent of the Spring stock to Summer, an unrelated corporation, for cash. This transaction terminates the QSub election because Season no longer owns 100 percent of the Spring stock. Spring is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Spring stock immediately before the QSub termination. The deemed exchange by Season of assets for Spring stock does not qualify under IRC Section 351 because Season owns less than 80 percent of Spring's stock after the sale of stock to Summer. Season must recognize gain, if any, on the assets transferred to Spring in exchange for its stock. Season's losses, if any, on the assets transferred are subject to the limitations of IRC Section 267.

**Example Y**

Assume the same facts as in Example X, except that instead of purchasing Spring stock, Summer contributes a piece of land with a basis and FMV of \$60,000 to Spring in exchange for 21 percent of the Spring stock which had a basis of \$60,000 to Season. Spring is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Spring stock immediately before the termination. The transaction qualifies as an IRC Section 351 transfer because Season and Summer are co-transferors that control the transferee immediately after the transfer. Therefore, no gain or loss is recognized by Season or Spring.

**Example Z**

Spice, an S corporation, owns 100 percent of the stock of Mace, a QSub. Spice distributes all of the Mace stock pro rata to its shareholders, and the distribution terminates the QSub election. The transaction can qualify as a distribution to which IRC Section 368(a)(1)(D) and IRC Section 355 apply if the transaction otherwise satisfies the requirements of those sections. (Treas. Reg. Section 1.1361-5(b)(3))

**Example AA**

Sport, an S corporation, owns 100 percent of the stock of Baseball, a QSub. The valid QSub election was effective January 1, 2014. Sport revokes the QSub election on December 31, 2014. On January 1, 2015, Baseball is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in a deemed exchange for Baseball stock. On June 1, 2015, Sport sells 21 percent of the stock of Baseball to Ballet, an unrelated corporation, with a basis of \$50,000. Assume that under general principles of tax law including the step transaction doctrine, the sale on June 1, 2015 is not taken into account in determining whether Sport is in control of Baseball immediately after the deemed exchange of assets for stock on June 2, 2015. The deemed exchange by Sport of assets for Baseball stock and the deemed assumption by Baseball of its liabilities qualify under IRC Section 351 because Sport is in control of Baseball immediately after the transfer on January 1, 2015. Therefore, no gain or loss is recognized by Sport or Baseball on December 31, 2014.

If a QSub election terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in Type D reorganization or a spin-off distribution (IRC Sections 355 and 356), any loss or deduction disallowed under the basis limitation rules (IRC Section 1366(d)) is allocated between the S corporation and the former QSub with respect to the shareholder. The amount of the disallowed loss or deduction allocated to the shareholder of the S corporation can be an amount that carries the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the S corporation bears to the total value of the shareholder's stock in both the S corporation and the former QSub, determined immediately after the distribution. (Treas. Reg. Section 1.1361-5(b)(2))

Relief from the consequences of an unintentional termination of a QSub election may be available under the standards established by the Commissioner for the unintentional



termination of an S election under Treas. Reg. Section 1.1361-5(c)(1) and Rev. Proc. 2013-30.

**Example AB**

Forest, a parent S corporation, owns 100 percent of Tree. Forest has a valid QSub election in effect for Tree on January 1, 2014. On December 1, 2014, Forest terminates the QSub election as of January 1, 2015. The termination date was incorrectly specified as November 1, 2014. Forest submits a corrected termination election with explanation. The termination of the QSub election will take effect January 1, 2015.

**c. Election after QSub Termination**

Unless the IRS grants permission, following a QSub election termination, a subsequent S election or QSub election cannot be made for the former QSub corporation before its fifth tax year that begins after the first tax year for which the termination was effective. (IRC Section 1361(b)(3)(D)) If the QSub termination occurs as a result of a disposition of the subsidiary corporation's stock, then the corporation may, without requesting consent from the IRS, make an S election or have a QSub election made for it before the expiration of the 5-year waiting period, on the following conditions:

- Immediately following the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it.
- The S or QSub election is made effective immediately following the disposition of the corporation's stock. (Treas. Reg. Section 1.1361-5(c)(2))

**Example AC****Termination upon distribution of QSub stock to shareholders.**

Sky, an S corporation, owns Star, a QSub. Sky distributes all of its Star stock to Sky's shareholders. The distribution terminates the QSub election because Sky no longer owns 100 percent of Star. Assuming Star is otherwise eligible to be treated as an S corporation, Star's shareholders may elect to treat Star as an S corporation effective on the date of the stock distribution without requesting IRS consent.

**Example AD****Sale of 100 percent of QSub stock.**

Universe, an S corporation, owns Planet, a QSub. Universe sells 100 percent of the stock of Planet to Comet, an unrelated S corporation. Comet may elect to treat Planet as a QSub effective on the date of purchase without requesting IRS consent.

If the corporation is not eligible for any of the exceptions as described in Treas. Reg. Section 1.1361-5(c)(2), it can file a Private Letter Ruling (PLR) request for permission to reelect QSub status or make an S election before the end of the 5-year period.

**The information provided in this manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the last update.**

### 14.3 ANNUAL FRANCHISE TAX

A QSub is assessed the annual franchise tax if it meets **one** of the following conditions:

- Incorporated in California.
- Qualified to transact business in California.
- "Doing business" in California (R&TC Section 23800.5(a)(1)).

The activities of the QSub will be attributed to the S corporation parent for purposes of determining whether the S corporation is "doing business" in California. (R&TC Section 23800.5(a)(2)(B))

R&TC Section 23101 defines "doing business" as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." If the S corporation parent is not doing business in California and is not a qualified corporation in California, but the QSub is, then the S corporation parent is deemed to be qualified and/or doing business in California. This situation then subjects the S corporation parent to the annual minimum franchise tax.

#### Example AE

Scoop, an S corporation parent, owns three QSubs (Vanilla, Chocolate, and Strawberry). Scoop began business as an S corporation in 2014. It made valid QSub elections for Vanilla, Chocolate, and Strawberry in 2015. Vanilla and Chocolate are qualified and doing business in California, Scoop and Strawberry are not. For income year 2015, Scoop is deemed to be doing business in California because of Vanilla's and Chocolate's business activities in California and is subject to California franchise tax, in an amount at least equal to the minimum franchise tax. For income year 2015, Scoop is responsible for its own franchise tax (the greater of the minimum franchise tax or 1.5 percent of net income for tax purposes) plus two annual taxes for the QSubs, Vanilla and Chocolate.

The S corporation parent must pay estimated taxes that include the annual minimum tax for each of its QSubs (R&TC Section 23800.5(a)(1), R&TC Section 19023, R&TC Section 19025, R&TC Section 19147, and R&TC Section 19149). The QSub annual tax is subject to the estimated tax rules and penalties, and is the liability of the S corporation parent. An S corporation's first estimated tax installment payment may not be less than its minimum tax and the annual minimum tax for each of its QSubs. An S corporation's QSub first becomes subject to the annual tax after the last day of the third month of the parent S corporation's income year. However, the parent S corporation is not liable for the QSub annual taxes until the due date for the next estimated tax installment. (R&TC Section 19025(c))

For example, if the QSub is acquired during the income year, the QSub annual tax is due with the S corporation's next estimated tax installment. An amount equal to the greater of the minimum franchise tax or 1.5 percent of net income for tax purposes for the parent S corporation plus the QSub(s) annual tax or taxes are to be reflected on Form 100S.

### 14.4 LLC VS. QSUB (FOR CALIFORNIA PURPOSES)

The following is a summary of the some of the items that an S corporation needs to consider when determining the classification of a wholly owned subsidiary.

- **Subsidiary classification:** An S corporation can classify a wholly owned subsidiary as a single member Limited Liability Company (LLCs) or single member QSub.
- **Liability:** Corporate veil is difficult to pierce. The law is less settled whether 100 percent ownership of an LLC justifies relaxation of the standards under which the owner can be treated as the alter ego of the business entity.
- **Type of business:** Corporations are pretty much unrestricted in the type of business they can conduct. However, as discussed above, a QSub cannot be a foreign corporation, financial institution using the reserve method for bad debts, insurance company, corporation subject to an IRC Section 936 election, or domestic international sales corporation (DISCs) or former DISCs. California imposes the following restriction on an LLC: an LLC cannot engage in the banking business, the business of issuing policies of insurance and assuming risks, or the trust company business, regardless of whether the business is for profit. (California Corporation Code (Cal. Corp. Cd.) Section 17701.4 through Cal. Corp. Cd. Section 17713.13) However, effective January 1, 1997, insurance agents and brokers may form an LLC. (California Insurance Code (Cal. Ins. Cd.) Section 1628 and Cal. Ins. Cd. Section 1647.5). Additionally, a domestic or foreign LLC cannot act as a professional corporation or render professional services (Cal. Corp Cd. Section 17701.4(e)). "Professional services" mean any type of professional service that may be lawfully rendered pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, or the Osteopathic Act, as well as services that may be lawfully rendered under the Yacht and Ship Brokers Act. (Cal. Corp. Cd. Section 13401(a) and Cal. Corp. Cd. Section 13401.3)
- **Secretary of State (SOS) requirements:** The LLC is required to register and file articles of organization with the California SOS; the QSub as a corporation (whether C to S to QSub or S to QSub) is required to register and file articles of incorporation.
- **Taxation:** Both the LLC and the QSub are subject to the annual franchise tax. In addition to the annual tax, the LLC is also subject to a Limited Liability Company Fee based on total annual income. (R&TC Section 17941, R&TC Section 17942, and R&TC Section 17942(b)(1)) The fee is applicable to total annual income greater than or equal to \$250,000 and the fee range is from \$900 to \$11,790 for 2015. The QSub's income becomes the income of the parent S corporation that is currently subject to a 1.5 percent income tax.

Let's compare an LLC with total annual income and a QSub with taxable income of \$750,000 for tax year 2015. The LLC fee would be \$2,500 (total income between \$500,000 and \$1,000,000); the QSub tax liability of the parent S corporation would be \$11,250 ( $\$750,000 \times 1.5$  percent) assuming the parent S corporation and any other QSub's have no offsetting losses. When considering the QSub income on its own, the LLC fee is the better bargain when compared with the QSub's S corporation tax. The entities are comparable when the LLC has total annual income less than \$250,000 and the QSub has zero or less taxable income because both the LLC and the QSub have an annual franchise tax. (**Note:** the computation of the LLC's total income for purposes of the LLC fee is different in that it is gross receipts without any deductions.)

- Ownership: The QSub having one owner is allowed only one class of stock; the LLC faces no restrictions on separate classes of ownership interests. Therefore, the LLC can transfer control and ownership from generation to generation easier than an S corporation and/or a QSub.

**14.5 AUDIT ISSUES**

When examining assets and liabilities, the auditor should review California Form 100S, Schedule L – Balance Sheet. Assets can sometimes be viewed in Business Entity Tax System (BETS) \*\*\*\*\*.

The following information can be found in the BETS application and Taxpayer Folder (TPF) application.

	BETS *****	TPF List
Details of Financial Adjustment Transactions	****	Accounting
Details of Line Items on a return	****	Returns
Recent Changes to a return	****	Returns
Totals of Tax, Penalty, Interest and Assessment for a Specific Period	****	Accounting
Business Start Date	****	Demographics
Business End Date and Reason	****	Overview
Date of Incorporation	****	Overview & Demographics
Entity Type	****	Overview

Questions regarding BETS screens/\*\*\*\*\* can be directed to the \*\*\*\*\*, \*\*\*\*\*, \*\*\*\*\*. Additional support regarding TPF lists can be found in the \*\*\*\*\* link located in the \*\*\*\*\* or the \*\*\*\*\* icon located in the \*\*\*\*\* of each application page.

- 14.5.1 Deemed Liquidation May Be Taxable
- 14.5.2 Accumulated Adjustments Account (AAA) / C corporation Earnings & Profits (E&P)
- 14.5.3 Built-In Gains
- 14.5.4 Excess Net Passive Income (ENPI) Tax

**14.5.1 Deemed Liquidation May Be Taxable**

If the deemed liquidation of a subsidiary does not qualify under IRC Sections 332 and 337 as a tax-free liquidation, the subsidiary and/or the parent S corporation must recognize the gain and/or loss on the transaction.

## Potentially Taxable Events

### a. Liabilities Exceed Tax Basis of Assets at Time of Contribution

For various reasons, liabilities can exceed the tax basis of property at the time of QSub election. Some of these reasons can include:

- Fully depreciated property used to collateralize a loan.
- IRC Section 179 deduction.

This list is by no means all-inclusive and is for illustrative purposes only.

### b. QSub Indebted to Parent's S corporation

If the QSub is indebted to the parent S corporation for an amount greater than the FMV of the QSub's assets when the QSub election is made, then the transaction does not qualify under IRC Sections 332 and 337. Gain or loss, subject to the limitations of IRC Section 267, is recognized by the subsidiary for the difference between the subsidiary's indebtedness to the parent S corporation and the FMV of the subsidiary's assets.

#### Example AF

Mozart, an S corporation, owns 100 percent of the stock of Beethoven, a C corporation. At a time when Beethoven is indebted to Mozart in an amount that exceeds the fair market value of Beethoven's assets, Mozart makes a QSub election effective on the date it is filed with respect to Beethoven. The liquidation described does not qualify under IRC Section 332 and IRC Section 337. Therefore, Beethoven recognizes gain or loss on the assets distributed, subject to the limitations of IRC Section 267. Because the liquidation is not tax-free, Beethoven's tax attributes generally will not carry over to Mozart. (IRC Section 381) However, Mozart may be able to deduct a loss under the worthless security rules. (IRC Section 165(g))

### c. Termination of QSub Election

When the QSub election terminates, the QSub is treated as a new corporation that acquires all of its assets and assumes all its liabilities immediately before the termination from the parent S corporation in exchange for stock of the new corporation. The tax treatment of this transaction will be determined under the IRC and general principles of tax law, including the step transaction doctrine. (Treas. Reg. Section 1.1361-5(b)) The deemed issuance of the subsidiary's stock for its assets will generally qualify as a tax-free IRC Section 351 transfer if the parent S corporation is still in control of the subsidiary by continuing to own at least 80 percent of the subsidiary's stock.

The step transaction doctrine applies when the QSub election terminates. (Treas. Reg. Section 1.1361-5(b)(1)) If the termination occurs because the subsidiary no longer qualifies as a QSub, it normally takes place on a disposition of a portion of the parent S corporation's equity ownership in the QSub.

Under the step transaction doctrine, when an S corporation's equity ownership in the QSub is below 100 percent, a new corporation has deemed to be formed. (Treas. Reg. Section 1.1361-5(b)(1)) If the parent retains at least an 80 percent interest in the subsidiary, the formation of the subsidiary by the parent S corporation would be tax-free, as long as the liabilities deemed contributed to the newly formed corporation do not exceed the tax basis of the assets contributed. (See item "b" above.) If the parent does not control (at least 80 percent) the subsidiary immediately following the formation, the necessary control requirement for acquisitive related party (IRC Section 267) reorganizations and tax-free contributions to capital would not be met. Therefore, the parent would be deemed to have sold its assets to the subsidiary at FMV.

#### **14.5.2 Accumulated Adjustments Account (AAA) / C corporation Earnings and Profits**

Treas. Reg. Section 1.1368-2(a) states, "On the first day of the first year for which the corporation is an S corporation, the balance of the AAA is zero." An issue may arise when the QSub was a C corporation prior to the valid QSub election and has undistributed C corporation earnings and profits. Distributions are taxable as follows:

- Nontaxable to the extent that AAA and stock basis is not exceeded.
- Capital gain to the extent that AAA is not exceeded, but stock basis is exceeded.
- Dividend to the extent of C corporation earnings & profits.
- Nontaxable return of capital to extent of the remaining stock basis. and
- Capital gain to the extent stock basis exceeded.

(See S Corporation Manual Section 8.0 Distributions/Accumulated Adjustments Account (AAA) for a detailed discussion.)

#### **14.5.3 Built-In Gains**

Under IRC Section 1374 an S corporation's gain from disposition of an asset may be subject to a higher tax rate, if the gain associated with the appreciation occurred prior to the corporation making an S corporation election and if the asset is disposed of within the recognition period. For California purposes (R&TC Section 23809), IRC Section 1374 is modified to apply the California corporate tax rate to these "built-in gains," instead of the federal tax rate. (See S Corporation Manual Section 5.0 Built-In Gains Tax for a detailed discussion.)

Built-in gains may become an issue when the QSub was a C corporation prior to the QSub election and has substantially appreciated assets that are sold after the valid QSub election.

#### **14.5.4 Excess Net Passive Income (ENPI) Tax**

The purpose of the tax on excess net passive income (ENPI) is to discourage a C corporation with accumulated earnings and profits from becoming (or functioning as) a holding company in order to obtain favorable tax treatment under Subchapter S. ENPI may become an issue when the QSub was a C corporation prior to the QSub election and had accumulated

earnings and profits. When reviewing a tax return, the auditor should look for investment income such as interest, dividends and royalties.

See S Corporation Manual Section 7.0 Excess Net Passive Income Tax for a detailed discussion.

## 14.6 ADDITIONAL RESOURCES

<b>IRS:</b> LTR 9801015	S corporation defined; Tax imposed on built-in gains
<b>AICPA:</b> The Tax Adviser	QSSS prop. regs; IRS proposed regulations concerning qualified Subchapter S February 1, 1999 subsidiary corporations
<b>FTC 2d:</b>	
¶ D-1531	Qualified subchapter S subsidiaries (QSub) not treated as separate corporation.
¶ D-1533	Qualified subchapter S subsidiaries (QSubs) treated as separate corporations.
¶ D-1534	Treatment of qualified subchapter S subsidiary (QSub) election as liquidation.
¶ D-1535	Timing of deemed liquidation upon a qualified subchapter S subsidiary (QSub) election.
¶ D-1535.1	What events cause a termination of qualified subchapter S subsidiary (QSub) status?
¶ D-1536	Effects of termination of qualified subchapter S subsidiary (QSub) status.
¶ D-1537	Tax treatment of corporation formation resulting from termination of qualified subchapter S subsidiary (QSub) status.
¶ D-1538	Reelection after loss of qualified subchapter S subsidiary (QSub) status.
¶ D-1539	Qualified subchapter S subsidiaries (QSubs) defined.
¶ D-1540	How to make the qualified subchapter S subsidiary (QSub) election.
¶ D-1542	How to revoke the qualified subchapter S subsidiary (QSub) election.

**14.7 EXHIBIT**

Exhibit 14.7.1 Federal Tax Form 966 – Corporate Dissolution or Liquidation

**NOTE:** (( \* \* \* )) = Indicates confidential and/or proprietary information that has been deleted.

Revised Date: December 2018