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CLOSELY HELD BUSINESSES: THE COMPLETE ANATOMY OF A QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTION – NOT JUST THE NUTS AND BOLTS

By:

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Chapter 1

Closely Held Businesses: The Complete Anatomy of a Qualified Subchapter S Subsidiary Election—Not Just the Nuts and Bolts

1.01 HISTORICAL OVERVIEW[1]

Subchapter S has evolved over the past six (6) decades.[2] While its beginning was somewhat turbulent, lawmakers eventually smoothed out many of the rough edges. With significant legislative changes, including the creation of the Qualified Subchapter S Subsidiary (the "QSub"), a large number of cases and rulings, and Treasury's adoption of numerous regulations, Subchapter S has become user friendly.

In 1954, President Eisenhower recommended the passage of legislation which would minimize the influence of federal income tax laws on the selection of a form of entity by small businesses. It was not until 1958, however, that Congress acted on the President's recommendation. In that year, tucked-away in the Technical Amendments Act of 1958, taxpayers saw the first version of Subchapter S enacted into law.[3]

The original legislation limited ownership of a Subchapter S corporation to ten (10) shareholders. Only individuals and estates were eligible shareholders. The legislation was burdened with numerous flaws and traps that often caught the unwary, resulting in unwanted consequences. Among these flaws and traps existed intricate eligibility, election, revocation and termination rules; complex operational priorities and restrictions on distributions; a rule whereby net operating losses in excess of a shareholder's stock basis were lost forever without any carry forward opportunity; and a rule whereby excessive passive investment income caused a retroactive termination of the S election.

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[1] The information contained herein is to be used solely for educational purposes. It is not intended and may not be relied upon as legal advice.
[2] Unless otherwise indicated, all references to the Internal Revenue Code are made to the Internal Revenue Code of 1986, as amended. The Internal Revenue Code is referred to herein as the "IRC" or the "Code."
[3] § 64 of the Technical Amendments Act of 1958. Public Law 85-866.

Intricate rules and hidden flaws contained in the original legislation led most accountants and tax attorneys to recommend use of Subchapter S only when absolutely necessary. Subchapter S avoidance planning continued for a long period of time.

Almost two and one-half (2½) decades after the birth of Subchapter S, Congress attempted the first major overhaul of Subchapter S with the enactment of the Subchapter S Revision Act of 1982.[4] As a result of this legislation, many principles of Subchapter K were extended to the Subchapter S corporation and its shareholders; many potential abuses which existed under prior law were eliminated; the risk of inadvertent termination was lessened; and entity audit procedures were established.

In 1986, Congress again enacted legislation which further refined Subchapter S.[5] The Tax Reform Act of 1986 served to redirect Subchapter S back toward its original goal of treating shareholders of electing small business corporations like partners and the corporation like a partnership for federal income tax purposes. Ironically, much of the impact of Tax Reform Act of 1986 on Subchapter S came from amendments to provisions outside of Subchapter S, including the inversion of the corporate-individual tax rate structure created by amendments to IRC § 1; the repeal of the capital gains deduction contained in IRC § 1202; the adoption of the passive loss rules set forth in IRC § 469; and the repeal of the "General Utilities Doctrine."

Historically, persons forming a new business automatically assumed it would take the form of a C corporation unless special circumstances made Subchapter S desirable. Following the enactment of the Tax Reform Act of 1986, which temporarily left us with an inversion of the corporate-individual tax-rate structure, the S corporation clearly became the entity of choice for closely-held businesses.

Today, with the highest individual income tax rate higher than the highest corporate income tax rate, however, the desirability of the S corporation may not be so vivid.[6] Making the desirability of the S corporation even less clear has been the creation of other business entities, namely the limited liability company and the limited liability partnership.

Some practitioners believe the S corporation will become a dinosaur. They are likely wrong! While it may be true that some newly created business entities will <u>not</u> take the form of an S

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[4] Subchapter S Revision Act of 1982. Public Law 97-354.

[5] Tax Reform Act of 1986. Public Law 99-514.

[6] In accordance with I.R.C. § 1(a), the highest individual income tax rate is currently thirty-nine and six tenths percent (39.6%). I.R.C. § 11(b)(1)(D) provides that the highest corporate income tax rate is currently thirty-five percent (35%), but it can reach slightly higher levels as the tax rate is increased by the lesser of five percent (5%) or $11,750 for corporate taxpayers to the extent of taxable income over $100,000; and is increased by the lesser of three percent (3%) or $100,000 to the extent of taxable income over $15,000,000.

corporation, a large percentage of businesses which exist today are, in fact, S corporations, and the majority of newly incorporated closely-held businesses will become S corporations.

Developments in the form of legislation, case law and rulings over the last decade or so in the world of S corporations support this conclusion. Further, if looking at recent legislation proposed by lawmakers during the past few decades (discussed below) serves as any insight, S corporations will continue to dominate the corporate landscape in the future.

[1] The Small Business Job Protection Act of 1996.

Several legislative revisions to Subchapter S, which enhance the viability of Subchapter S, were enacted as part of the Small Business Job Protection Act of 1996 ("1996 Act").[7] These legislative revisions include the following:

[a] Number of Shareholders.

IRC § 1361 (b)(1)(A) was amended so that the maximum number of permitted S corporation shareholders was increased from thirty-five (35) to seventy-five (75).[8]

[b] Tax-Exempt Organizations.

IRC § 1361(b)(1)(B) was amended so that tax-exempt organizations described in IRC §§ 401(a) and 501(c)(3) are eligible S corporation shareholders.[9]

[c] Affiliated Group Prohibition.

IRC § 1361(b)(2) was amended so that an S corporation is allowed to own eighty percent (80%) or more of the shares of a C corporation.[10] A wholly-owned subsidiary of an S corporation can, if the S corporation parent so elects, be treated as a QSub. The QSub was born!

[d] Electing Small Business Trust.

IRC § 1361(c)(2) was amended so that an additional type of trust, the Electing Small Business Trust ("ESBT"), is eligible to become an S corporation shareholder.[11]

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[7] Public Law 104-188.
[8] § 1301 of the 1996 Act. Public Law 104-188.
[9] § 1316(a)(1) of the 1996 Act. Public Law 104-188.
[10] § 1308 of the 1996 Act. Public Law 104-188.
[11] § 1302 of the 1996 Act. Public Law 104-188.

[e] Testamentary Trust Holding Period.

IRC § 1361(c)(2)(A)(ii) and (iii) were amended so that the allowable holding period of S corporation stock by testamentary trusts is now two (2) years rather than sixty (60) days.[12]

[f] Debt Safe Harbor.

The straight debt safe harbor was codified.[13] Consequently, debt is not treated as a second class of stock if four (4) requirements are met, namely:

- There is a written unconditional promise to pay on demand or on a specified date a sum certain in money;
- The interest rate and interest payment dates are not contingent upon profits, the borrower's discretion or like factors;
- The debt is not convertible into stock; and
- The creditor is an individual, estate or trust which is otherwise an eligible S corporation shareholder, or a person actively and regularly engaged in the lending business.

[g] Bank Eligibility.

IRC § 1361(b)(2) was amended to provide that a bank (as defined in IRC § 581) is an eligible small business corporation and may make an S corporation election, provided it does not use a reserve method of accounting for bad debts.[14]

[h] Untimely/Failure to File Relief.

The Service has authority under IRC § 1362(f) to waive the effect of an invalid S election created by an inadvertent failure to qualify as a small business corporation or to obtain the required shareholder consents (including QSST elections). Prior to the 1996 Act, the Service's legislative authority to waive untimely elections went no further. § 1305(b) of the 1996 Act added IRC § 1362(b)(5).[15] This provision permits the Secretary to treat an election as timely filed that, for reasonable cause, was filed late or was never actually filed. The legislative history to the 1996 Act indicates that the Secretary, in exercising this discretion, may consider any relevant information. It is intended that the Service be reasonable and apply standards similar to

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[12] § 1303 of the 1996 Act. Public Law 104-188.
[13] § 1304 of the 1996 Act. Public Law 104-188.
[14] § 1315 of the 1996 Act. Public Law 104-188.
[15] § 1305 of the 1996 Act. Public Law 104-188.

those applied to inadvertent S corporation terminations. Strangely enough, this provision was given a retroactive effective date back to the effective date of the Subchapter S Revision Act of 1982. Consequently, this provision was effective for taxable years beginning after 1982 (further discussion below).

[i] Termination Allocation Consent.

Under pre-1996 Act law, if any S corporation shareholder terminated his or her interest during a taxable year, the corporation (with the consent of all shareholders) was allowed to elect to allocate items of income, deduction, credit or loss by closing its books on the date of termination rather than applying the normal per-share/per-day allocation rules.[16] Congress believed that the election should not require the consent of any shareholder whose tax liability is unaffected by the election.[17] Consequently, in accordance with § 1306 of the 1996 Act, only the terminating shareholder and the shareholder(s) to whom the shares were transferred must consent to the election to close the books. If the shares are transferred to a corporation (including a redemption by the S corporation), however, all persons who were shareholders of the S corporation during the taxable year must consent to the election. This provision was effective for taxable years beginning after December 31, 1996.

[2] The American Jobs Creation Act of 2004 ("AJCA").

The AJCA[18] contained many provisions which directly impact Subchapter S corporations.

[a] Family Election.

Beginning in 2005, IRC § 1361(c)(1) was amended so that "family" members may "elect" to be treated as one (1) shareholder for purposes of determining the number of shareholders of an S corporation.[19] For this purpose, "family" includes a common ancestor and all lineal descendants of the common ancestor, and spouses and former spouses of these persons. A few limitations apply:

- "Family" is limited to six (6) generations; and
- A spouse and former spouse are treated as the same generation as the person to whom the person is or was married.

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[16] I.R.C. § 1377(a).
[17] § 1306 of the 1996 Act. Public Law 104-188.
[18] Public Law 108-357.
[19] § 231 of the AJCA. Public Law 108-357.

Generally, any family member may make the election and it will remain effective until expressly terminated. Shares owned by a "family" may be held directly or indirectly (as a beneficiary of an ESBT or QSST).

The impetus to this provision was primarily lobbying efforts on behalf of family-owned rural banks which were bumping up against the seventy-five (75) shareholder limitation rules. Other than in the case of family-owned rural banks, it is rare that the seventy-five (75) shareholder rule is really an issue for S corporations.

[b] Number of Shareholders.

Again, likely due to lobbying on behalf of family-owned rural banks, another revision was made to Subchapter S relative to the number of eligible shareholders.[20] The AJCA amended IRC § 1361(b)(1)(A) by increasing the maximum number of eligible shareholders of an S corporation from seventy-five (75) to one hundred (100). This change was effective for tax years beginning in 2005.

[c] Electing Small Business Trust Relief.

Under pre-AJCA law, an ESBT could hold stock of an S corporation. For the portion of an ESBT consisting of S corporation stock, the normal pass-through rules did not apply. Rather, the trust was taxed at a flat rate of thirty-five percent (35%) on its taxable ordinary income as specifically computed and its capital gains were taxed at the preferential rates that applied to individuals. For purposes of determining the maximum number of S corporation shareholders, each person who may have been entitled to receive a distribution from the trust (commonly referred to as a potential current beneficiary) was treated as a shareholder. To avoid disqualification after an ineligible shareholder became a potential current beneficiary of an ESBT, the ESBT had sixty (60) days to dispose of the S corporation stock.

The AJCA eliminated some of the tax traps for the unwary created by these rules.[21] Beginning in 2005, for purposes of determining who are the potential current beneficiaries of an ESBT, all unexercised powers of appointment are ignored and disregarded. The AJCA increased the period in which the ESBT can dispose of S corporation stock after an ineligible shareholder becomes a potential current beneficiary from sixty (60) days to one (1) year. Again, this provision is the result, at least in part, due to lobbying efforts on behalf of family-owned rural banks.

[d] Suspended Losses.

Under pre-AJCA law, any loss or deduction that is not allowed to a shareholder of an S

[20] § 232 of the AJCA. Public Law 108-357.
[21] § 234 of the AJCA. Public Law 108-357.

corporation because the loss exceeds the shareholder's basis in stock and debt of the corporation is treated as incurred by the S corporation with respect to that shareholder in subsequent tax years where adequate basis exists. Under pre-AJCA law, in accordance with IRC § 1366(d)(2), suspended losses are not transferred from a shareholder to a new shareholder upon a transfer of shares. The AJCA amended IRC § 1366(d)(2) so that such suspended losses are transferred with the shares provided the transfer is being made by a spouse or a former spouse incident to divorce.[22] This provision became effective in 2005.

[e] Qualified Subchapter S Trust ("QSST") Relief.

A QSST is a trust which may only have one (1) current income beneficiary and which makes a separate election to qualify the trust as an S corporation shareholder. In general, the S corporation income is passed through to the QSST and is taxed to the beneficiary. Under pre-AJCA law, the trust, rather than the beneficiary, was treated as the owner of S corporation stock for purposes of determining the tax consequences of the disposition of the S corporation stock by the trust. Consequently, since a disposition of the S corporation stock was treated as a disposition by the trust and not the beneficiary of the trust, any suspended losses under IRC § 465 (at-risk rules) or IRC § 469 (passive activity loss rules) were lost upon a disposition of shares by a QSST. The AJCA changed this outcome and provided that, upon the disposition of S corporation stock by a QSST, for purposes of only IRC §§ 465 and 469, the disposition will be treated as a disposition by the beneficiary.[23] This means that the QSST beneficiary may deduct losses which were suspended under the at-risk rules of IRC § 465 and the passive activity loss rules of IRC § 469 when the QSST disposes of the S corporation stock. This provision became effective in 2005.

Practice Alert: This provision applies only for purposes of the at-risk rules and the passive activity loss rules. The QSST, rather than the beneficiary, is treated as the owner of the S corporation stock for purposes of determining the tax consequences of the disposition of the stock by the trust and for all other purposes.

[f] Individual Retirement Accounts ("IRAs").

Under pre-AJCA law, only U.S. citizens and resident individuals, estates, tax-exempt charities and retirement plans, and certain types of trusts could be eligible S corporation shareholders. IRAs or Roth IRAs were not allowed as eligible S corporation shareholders. Under the AJCA, an IRA or Roth IRA may hold shares of an S corporation that is a bank, as defined in IRC § 581, but only to the extent of the shares held in the IRA or Roth IRA in the bank on the date of

[22] § 235 of the AJCA. Public Law 108-357.
[23] § 236 of the AJCA. Public Law 108-357.

enactment.[24] Where the shares are held by an IRA or Roth IRA, the individual beneficiary of the IRA or Roth IRA will be treated as the shareholder. Consequently, the individual beneficiary must be a U.S. citizen or resident.

Practice Alert: Because these rules are limited to shares held on the date of enactment (October 22, 2004), these rules only allow a limited number of banks, whose shareholders previously held their shares in IRAs, to elect S corporation status. This provision of the AJCA is likely another result of the lobbying efforts of family-owned rural banks.

[g] QSub Relief.

When an S corporation owns all the stock of a subsidiary, it may elect for the subsidiary to be treated as a QSub. In such case, the assets, liabilities and items of income, deduction, loss and credit of the subsidiary are treated as assets, liabilities, and items of income, deduction, loss and credit of the parent S corporation. Under pre-AJCA law, the Service had authority to waive inadvertently invalid S corporation elections and terminations, but it was given no specific authority to waive inadvertently invalid QSub elections and terminations.

The AJCA remedied this problem (discussed in more detail below). The Service was given authority to waive inadvertently invalid QSub elections or terminations.[25] In order to obtain such relief, the QSub and its shareholders (the S corporation parent) must:

- Within a reasonable period after discovering the circumstances causing the invalidity take steps so that the corporation qualifies as a QSub; and

- Agree to IRS prescribed adjustments consistent with the treatment of a corporation as a QSub during the relevant period.

In addition, this provision gives the Service authority to waive inadvertently invalid elections or terminations of elections to treat family members as one shareholder.

The AJCA also gave the Service additional authority relative to QSubs. It was given the specific authority to require a QSub to file informational tax returns.[26]

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[24] § 233 of the AJCA. Public Law 108-357.
[25] § 238 of the AJCA. Public Law 108-357.
[26] § 239 of the AJCA. Public Law 108-357.

[3] Other Interesting Not-So-Recent Developments.

[a] Single Member LLC Ruling.

On February 25, 2000, the IRS released Private Letter Ruling 200008015.[27] This is an important ruling, albeit not law, for single-member LLCs and S corporations. In this ruling, the Service determined that a single-member LLC, as long as it is disregarded for income tax purposes, may be a shareholder of an S corporation provided the sole member of the LLC is in fact an eligible S corporation shareholder.

[b] *Estate of Bean*.

The Eighth Circuit was presented with *The Estate of Bean v. Commissioner.*[28] In that case, the taxpayer, an S corporation shareholder, personally guaranteed a line of credit extended to the corporation. When the S corporation generated substantial losses, the taxpayer claimed his pro-rata share of the losses, claiming that the guarantee gave him basis in his S corporation stock. The taxpayer argued a ruling from the Eleventh Circuit (the *Selfe* case)[29] which allows an S corporation shareholder to obtain basis for personal guarantees where the lender truly intends to look to the shareholder primarily for repayment. The Eleventh Circuit is the only circuit to reach this conclusion. All other circuits which have decided this issue conclude no basis is given until the shareholder actually makes the payment pursuant to the guaranty. The Eighth Circuit joined the majority of other circuits on this issue, concluding the Estate of Bean was not entitled to any basis for simply executing a guaranty of the corporation's debt. A mere guaranty of the corporation's debt, without actual payment by the shareholder, does not create basis.

[c] *Gitlitz v. Commissioner.*

The *Gitlitz*[30] case represents a poorly-reasoned tax decision which was a good result for taxpayers. It was, however, short lived. In this case, the United States Supreme Court held that an S corporation shareholder may increase his or her basis in S corporation stock by the amount of the S corporation's discharge of indebtedness income which was totally excluded from gross income under IRC § 108 because the corporation was insolvent at the time of discharge. No income flows through to the shareholder, but the shareholder gets to increase his or her adjusted basis in the S corporation stock by the amount of the discharge. If the shareholder had suspended losses because of an inadequate basis, the shareholder could deduct these losses following the discharge of indebtedness to the extent of his or her new adjusted basis created by the discharge.

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[27] I.R.S. Priv. Ltr. Rul. 200008015 (February 25, 2000).
[28] 268 F.3d 553 (8th Cir. 2001).
[29] 778 F.2d 769 (11th Cir. 1985).
[30] 531 U.S. 206 (2001).

At the time *Gitlitz* was decided, most tax practitioners knew it was too good to be true. Popular belief was that Congress would surely fix this problem (eliminate this terrific taxpayer planning tool).

The tax bar was correct. Congress legislatively overruled *Gitlitz* when it amended IRC § 108(d)(7)(a) in 2002. Under IRC § 108(d)(7)(a), Congress expressly provided that discharge of indebtedness income is not considered an item of income under IRC § 1366 and therefore does not increase a shareholder's basis in his or her stock. It was good while it lasted!

[d] *St. Charles Investment Co. v. Commissioner*.

In *St. Charles Investment Co.,*[31] a C corporation which had suspended losses under IRC § 469, made a valid S corporation election. What happens to the suspended losses? S corporations are not subject to IRC § 469 because the losses flow through to the shareholders. C corporation losses, on the other hand, are usually suspended while a corporation is an S corporation. If, of course, a taxpayer is not careful, the suspended losses from C corporation years will expire and be lost forever during its S corporation years.

In *St. Charles Investment Co.*, the Tenth Circuit, reversing the Tax Court,[32] held the suspended losses from C corporation years may be deducted in the year the activity (property) is disposed of and the income and losses from the activity will flow through to the S corporation shareholders. *St. Charles Investment Co.* is an interesting decision given that the losses were incurred while the corporation was a C corporation and the taxpayer was attempting to use them while it was an S corporation. This decision is probably wrong! Be careful, other circuits likely will not follow this decision. The Tax Court certainly does not agree with this holding.[33]

[e] *Garwood Irrigation Company v. Commissioner*.

Garwood Irrigation Company[34] represents a final victory for Garwood Irrigation Company ("Garwood") and the end of its long battle with the Service over the computation of the built-in gains tax imposed under IRC § 1374. The taxpayer reported built-in gains of approximately $31,410,000 on its return and paid almost $10,000,000 in federal tax. On examination, the Service asserted the built-in gains at issue were actually $76,609,000, resulting in a tax deficiency of approximately $16,000,000. At trial, the taxpayer revisited its computation of the built-in gains. The taxpayer agreed with the Service on one issue at trial—that it miscalculated the built-in gains. But that was the only thing the parties agreed upon. The Service argued the built-in gains were actually greater than reported, while the taxpayer argued the built-in gains

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[31] 232 F.3d 773 (10th Cir. 2000), *rev'g* 110 T.C. 46 (1998).
[32] *Id*.
[33] *Id*.
[34] 126 T.C. 2333 (2006).

were really lower than reported. The stage was set and the parties' valuation experts went to battle.

In 2004, Garwood prevailed in Tax Court in its initial battle with the Service when the court ruled its reported built-in gains computation was approximately $10,000,000 higher than it should have been, resulting in a refund of more than $3,300,000. Unfortunately, the battle did not end there. Instead, a fight ensued over the computation of interest owed by the Service on the refund. Garwood filed a motion with the court seeking a determination of the applicable interest rate.[35]

The Service asserted that the applicable interest rate was the federal short-term rate plus one half percent (½%). Garwood, however, argued the proper interest rate was the federal short-term rate plus three percent (3%).

To understand the debate, a review of three provisions of the Code is needed:

- The interest rate on overpayments of tax by a corporation is the federal short-term rate plus two percent (2%).[36]
- The interest rate on "large" (over $10,000) overpayments of tax by a corporation is the federal short-term rate plus one half percent (½%).[37]
- The interest rate on overpayments of tax by non-corporate taxpayers is the federal short-term rate plus three percent (3%).[38]

The principal amount of refund at issue for Garwood was over $3,000,000. So, given the long length of the parties' battle, the interest computation was significant.

The Service argued the lower corporate taxpayer interest rate applied as the overpayment exceeded $10,000 and was computed using the highest corporate income tax rate as required by IRC § 1374. Garwood, however, asserted that the corporate taxpayer interest rate provisions only applied to C corporations, not S corporations. Thus, Garwood concluded the higher non-corporate taxpayer rate should apply.

Adopting the logic derived from Goldilocks and the Three Bears, the court concluded the non-corporate taxpayer interest rate was too high and the corporate taxpayer "large" overpayment

[35] *Garwood Irrigation Company v. Commissioner*, T.C.M. 2004-195 (2004).
[36] I.R.C. § 6121(a)(1).
[37] *Id.*
[38] *Id.*

interest rate was too low, but the regular corporate taxpayer overpayment interest rate was just right.[39]

[f] IRC § 1362(b)(5).

IRC § 1362(b)(5) was added to the Code by the 1996 Act.[40] This provision allows the Secretary to treat an S election as timely filed that, for reasonable cause, was filed late or never actually filed. This provision was retroactive all the way back to 1983.

Under pre-1996 Act law, no extension of time to file an S election could be granted.[41] Failure to file, even though Form 2553 was filled out and properly executed, or if taxpayer relied on counsel to file, did not create a valid election if the form was not in fact filed with the IRS.[42] As a result of the 1996 Act, however, the Secretary was given authority to ignore a late filing or allow an election where no election was actually filed if reasonable cause exists. Congress clearly desires to make this area of Subchapter S more taxpayer friendly.

Revenue Procedure 97-40[43] expanded late filing leniency. In accordance with this revenue procedure, if a corporation failed to qualify as an S corporation solely because its election was not timely, and the due date of the corporation's first S corporation income tax return, excluding extensions, had not passed, the procedure for fixing the error was rather painless. Within six (6) months of the original due date for the S election, a representative of the corporation was required to file IRS Form 2553, signed by all shareholders who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day of the taxable year for which the election was to be effective and ending on the day of the election, and an officer of the corporation.

In 1998, the Service issued Revenue Procedure 98-55.[44] In this revenue procedure, the Service broadened the late filing leniency created under Revenue Procedure 97-40 by extending the six (6) month period to twelve (12) months. Consequently, late filers were required to catch their

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[39] Treas. Reg. § 301.6121-3(b)(3) provides that after the year an S corporation election is made, the S corporation is not treated as a C corporation for applying the "large" **underpayment** rules of IRC § 6121(c)(3). The court extended this theory to the **overpayment** rules contained in IRC § 6121(a)(1) and concluded the "large" underpayment rule was inapplicable. Then, the court concluded the taxpayer was a corporation; thus, the regular corporate taxpayer rate of the federal short-term rate plus two percent applied as there was no distinction between S and C corporations (unlike the "large" underpayment or overpayment rules) in the provision itself or the corresponding Treasury Regulations.

[40] *Supra* note 15.

[41] Rev. Rul. 60-183, 1960-1 C.B. 625.

[42] *See e.g., Helen S. Leather*, 1991 T.C.M. (P.H.) ¶ 91,534. *See also, Taylor v. Commissioner*, 1988 T.C.M. (P.H.) ¶ 87,399.

[43] Rev. Proc. 97-40, 1997-2 C.B. 488.

[44] Rev. Proc. 98-55, 1998-2 C.B. 645.

error within twelve (12) months of the original due date for the S corporation election, but in no event later than the due date for the income tax return (excluding extensions) for the first year the corporation intended to be an S corporation.

Effective June 9, 2003, the Service even further broadened the leniency for late S corporation election filers when it issued Revenue Procedure 2003-43.[45] This revenue procedure applies to S elections, the elections of ESBTs, the elections of QSSTs, and the elections of QSubs. It supersedes Revenue Procedure 98-55.

The requirements for relief are fairly simple:

- Late filing must be the sole defect;

- A request for relief must occur within twenty-four (24) months of the original due date of the election under Subchapter S;

- The request must contain a statement indicating why reasonable cause exists for the election to be untimely;

- The application for relief must be filed within six (6) months after the due date (without extensions) of the corporation's income tax return for the first tax year in which the corporation intended to be an S corporation; and

- No shareholder may have taken a return position inconsistent with the election.

At the top of IRS Form 2553, it must state: **"FILED PURSUANT TO REV. PROC. 2003-43." In addition, attached to the IRS Form 2553 must be a statement explaining the reason for failure to file a timely S corporation election.** The Service is required to notify the corporation of the result of its reasonable cause determination. If the Service denies the entity relief or if the requirements above were not satisfied, the entity may still request relief from the Service through a private letter ruling. The procedures described in Revenue Procedure 2003-1[46] (or future like revenue procedures) must be followed in making the request.

Effective for taxable years ending on or after December 31, 2007, the Service further simplified the method to request relief for late S corporation elections when it issued Revenue Procedure 2007-62.[47] If the five (5) requirements from Revenue Procedure 2003-43 (mentioned above) are satisfied and the entity has not filed a tax return for the first taxable year in which the election was intended, the entity requesting relief simply needs to file a completed IRS Form 2553 with

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[45] Rev. Proc. 2003-43, 2003-1 C.B. 998.
[46] Rev. Proc. 2003-1, 2003-1 I.R.B. 1.
[47] Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

an IRS Form 1120S for the first taxable year it intends to be an S Corporation. The IRS Form 2553 must include a statement explaining the reason for failure to file a timely S corporation election.

Effective September 2, 2013, pursuant to Revenue Procedure 2013-30,[48] the requirements for obtaining relief became even more lenient and the process was further clarified. The prior revenue procedures were superceded.

Under Revenue Procedure 2013-30, if an S corporation that failed to make a timely election files IRS Form 2553 within three (3) years and seventy-five (75) days of the date the election was to be effective, and the requirements of Revenue Procedure 2003-43 (mentioned above) are satisfied, it will be granted late filing relief. If a corporation has been filing IRS Forms 1120S for all years it intended to be an S corporation, the IRS Form 2553 is attached to the current year IRS Form 1120S.

If the three (3) years and seventy-five (75) days has passed, Revenue Procedure 2013-30 still may provide relief, provided:

- The corporation is not also seeking a late entity classification;
- At least six (6) months have passed since the corporation timely filed its return for the first year it was to be treated as an S corporation; and
- Neither the corporation or the shareholders received notice from the IRS of a problem with the corporation's S status within six (6) months of the timely filing of its first IRS Form 1120S.

So, today there essentially is no time limit on how far back a corporation can make a late S election effective, provided it has always filed as an S corporation, the shareholders have reported the income as S corporation shareholders, and the IRS has not issued a notice that the election was not filed.

Revenue Procedure 2013-30 offers similar relief for late ESBT, QSST, QSub and entity classification elections.

Revenue Procedure 2013-30 contains helpful flowcharts that will allow you to quickly determine if relief is available.

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[48] Rev. Proc. 2013-30, 2013-36 I.R.B. 173.

[g] IRC § 4975(d).

IRC § 4975 was amended by Congress in 2001 as part of the Economic Growth and Tax Relief Act of 2001.[49] Following the amendment, loans from qualified retirement plans to S corporation shareholders owning more than five percent (5%) of the corporation are no longer prohibited transactions and are no longer subject to the excise tax or potential plan disqualification.

[h] Health Insurance.

IRS Notice 2008-1[50] provides rules relating to an above-the-line deduction for health insurance premiums paid by or on behalf of more than two percent (2%) shareholder-employees of S corporations. The notice discusses two (2) basic rules:

- A self-employed individual can deduct, in accordance with IRC § 162(l)(1), as an above-the-line deduction, the amount paid for medical insurance (including spouse and dependent care). The Service has concluded this rule applies regardless of whether the insurance is actually purchased in the individual's name or in the business's name.[51]

- Amounts paid by an S corporation for medical insurance for its more than two percent (2%) shareholders (including spouse and dependent care) are considered compensation to the subject shareholders. As such, the amounts are deductible by the S corporation as compensation and includable on the subject shareholders' IRS Form W-2s. Nevertheless, a more than two percent (2%) S corporation shareholder is considered a self-employed person under IRC § 1372, and as such may deduct these amounts as an above-the-line deduction under IRC § 162(l)(5).

IRS Notice 2008-1 states that to be eligible for the above-the-line deduction, the more than two percent (2%) shareholder must be covered by a medical insurance policy *established by the S corporation.* A medical insurance plan is established by the S corporation if either of the following criteria is satisfied:

- The S corporation makes the premium payments for the accident and health insurance policy covering the two percent (2%) shareholder-employee (and his or her spouse or dependents, if applicable) in the current taxable year; or

- The two percent (2%) shareholder makes the premium payments and furnishes proof of the payments to the S corporation and then the S corporation reimburses the two percent (2%) shareholder-employee for the premium payments in the current taxable year.

[49] § 612 of the 2001 Act. Public Law 107-16.
[50] 2008-2 I.R.B. 251 (2007).
[51] I.R.S. C.C.A. 200524001 (2005).

If the premiums are not paid or reimbursed by the S corporation and included in the more than two percent (2%) shareholder's gross income, the medical insurance policy is not established by the S corporation and the more than two percent (2%) shareholder is not allowed an above-the-line deduction under IRC § 162(l). This situation occurs frequently in small, closely-held S corporations.

For many reasons, including having too few employees, small corporations find it difficult to find economically reasonable group health insurance. Therefore, as an alternative, the shareholder-employees end up purchasing individual medical insurance in their names independent of the corporation. In the past, this meant IRC § 1372 would not come into play and the shareholder was limited to taking an itemized deduction for premiums paid on the policy, subject to a seven and one half percent (7½%) adjusted gross income limitation.

This unfavorable result can now be avoided under the parameters of IRS Notice 2008-1. If the shareholder-employee is unable or does not wish to have the medical insurance policy placed in the name of the S corporation, the shareholder-employee can purchase the policy in his/her own name, make the premium payments, furnish proof of the payments to the S corporation, and have the S corporation reimburse him/her for the premium payments. So long as the S corporation reports the amount of the reimbursements as wages and the shareholder-employee reports that amount as gross income, the shareholder-employee may take the above-the-line deduction.

Alternatively, in the case of a business where the sole owner is the only employee of the company, the owner could consider the limited liability company alternative as the form of entity for the business rather than an S corporation. A single-member limited liability company is generally disregarded under the check-the-box regulations and the sole member would be treated as a sole proprietor. In accordance with advice issued by IRS Chief Counsel,[52] amounts paid for the insurance policy, regardless of whether the insurance is purchased in the name of the business, would generate an above-the-line deduction.

[i] Inadvertent Termination.

A corporation will continue to be treated as a Subchapter S corporation during a period of inadvertent termination, if:

- The election has been terminated, either because the corporation is disqualified as an electing small business corporation, or as a result of the passive investment income rule;

- The Service determines that the termination was inadvertent;

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[52] *Id.*

- The corporation promptly takes steps to correct the condition; and
- The corporation and the shareholders agree to treat the election as having been continuously in effect.[53]

Continuation of an S election following an inadvertent termination is ultimately within the Secretary's sole discretion. To obtain a determination of inadvertent termination, a ruling request must be filed with the IRS.[54] The Service routinely issues rulings in this area.

[4] Remaining Problems Plaguing Subchapter S.

Even with the impact of the AJCA on Subchapter S, unlike entities governed by Subchapter K, the allocation of income and losses of S corporations must be made in direct proportion to ownership, and no basis is generally obtained for debt of the entity. Also, several other negative rules continue to plague Subchapter S, including the following:

- Nonresident aliens are prohibited from owning shares of an S corporation;[55]
- Subchapter S corporations are prohibited from having more than one (1) class of stock;[56]
- An S corporation which has C corporation earnings and profits runs the risk of losing its S election if it derives more than twenty-five percent (25%) of gross receipts for three (3) consecutive tax years from passive sources[57] or may face being hit with the passive investment income tax;[58]
- Shareholders owning more than two percent (2%) of the shares of an S corporation are prohibited from excluding certain fringe benefits (i.e. medical insurance and limited group life insurance) from gross income.[59] Since these benefits are generally deductible from gross income, this limitation is not a problem for many taxpayers; and
- Non-virgin S corporations, or S corporations which have obtained assets from non-virgin S corporations in transactions such as a tax-free reorganization, may be subject to the built-in gains tax.[60]

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[53] I.R.C. § 1362(f).
[54] Treas. Reg. § 1.1362-4(c).
[55] I.R.C. § 1361(b)(1)(C).
[56] I.R.C. § 1361(b)(1)(D).
[57] I.R.C. § 1362(d)(3).
[58] I.R.C. § 1375.
[59] I.R.C. § 1372.
[60] I.R.C. § 1374.

Developments in the form of legislation, rulings and case law continue to impact Subchapter S. While these developments have not alleviated all of the negative rules plaguing Subchapter S, they generally provide further support for closely-held businesses to elect to be taxed under Subchapter S and offer good guidance for tax practitioners advising closely-held businesses.

[5] Additional Developments.

[a] IRS Audit Activity.

The Service's mission is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[61] In order to carry out this hefty mission, during the first several years of this decade, the IRS dedicated significant resources to a complete reorganization of its staff (de-emphasizing audit staff), technology upgrades and taxpayer outreach/public relations. As a result, the number of taxpayer field audits experienced by tax practitioners during that time period was nominal.

With the estimated annual "tax gap" (the difference between what taxpayers should have paid and what they actually paid on a timely basis) today exceeding $450 billion and our federal deficit growing, taxpayer compliance recently became a renewed priority for the IRS. While it appeared that the Service is back in the audit business, severe budgetary setbacks have plagued this effort. In fact, in its efforts to deal with expense reductions, IRS Commissioner Koskinen recently announced that, as a result of the budget cuts facing the IRS, in addition to several other expense cutting measures, (i) the IRS would not update and/or replace IT systems as previously scheduled; and (ii) the IRS would implement staff reductions and furloughs, resulting in 280,000 fewer collection matters being pursued and 46,000 fewer audits being conducted this fiscal year.

In a letter to Commissioner Koskinen dated September 2, 2015, Senator Ron Wyden (D-OR), Ranking Member of the United States Senate Committee on Finance, points out some interesting facts that call into question Commissioner Koskinen's expense cutting decisions. Foremost, Senator Wyden raises the fact that about $5.10 of taxes owed are collected for every dollar spent on enforcement efforts. Consequently, it is troubling that the Service is curtailing collection efforts, the very function that creates revenue.

Senator Wyden predicts that as a result of Commissioner Koskinen's expense cuts, in addition to reduced tax collections, the number of tax cheats will rise. This is especially true if the IRS does not use its available resources to improve IT systems.

[61] I.R.B. 2004-20 (May 17, 2004).

It is difficult to disagree with Senator Wyden's predictions or his criticism of the cost cutting measures being implemented within the IRS. In fact, Senator Wyden concludes the combination of reduced enforcement activity and funding cuts for IT systems is a "dangerous cycle" that will likely lead to increased tax fraud in this country. He states: "Shouldn't the American public view diminished enforcement and reduced IT spending for what they really are: tax cuts for tax cheats and kickbacks to crime syndicates?"

The facts are the facts. The budget cuts facing the IRS are significant. Commissioner Koskinen is presented with a very difficult dilemma. One thing is clear – cutting the funding for collection, enforcement, and IT systems will not serve our tax system well. That said, where should the cuts be made?

Former IRS Commissioner Mark W. Everson stated, in support of increasing the Service's compliance activity, that "[t]he magnitude of the tax gap highlights the critical role of enforcement in keeping our system of tax administration healthy."[62] As a step to improve taxpayer compliance, the IRS has undertaken to update its audit selection system with statistical information gathered from various studies.

S corporations are currently the most common choice of business entity. They represent nearly two-thirds of all corporate entities. According to the Service's latest data, 3.9 million businesses were S corporations in 2006, representing an increase of thirty-five percent (35%) from tax year 2000, and the number of S corporation shareholders is 6.7 million.[63] In 2006, according to a report issued by the U.S. Government Accountability Office ("GAO"), S corporations accounted for $413 billion in total net income and $3.3 trillion in assets, an increase of $166 billion in net income and $1 trillion in net assets from tax year 2000.[64] Consequently, it is not surprising the Service desires to focus significant efforts on S corporations.

[i] Unreasonably Low Compensation Studies.

In 2002, U.S. Treasury Inspector General for Tax Administration issued a detailed report focusing on low compensation in S corporations.[65] The report was the result of a study on compensation paid by S corporations to shareholders/employees. The report reveals that five percent (5%) of 2,600,000 IRS Forms 1120S filed in 1998 reported S corporation shareholder/employee compensation under $10,000. In fact, in eighty-four (84) S corporation cases under examination by the Service, the study revealed that the average wages for S corporation shareholders/employees was approximately $5,300, while the average distribution

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[62] I.R. 2006-28 (February 14, 2006).
[63] I.R. 2009-77 (August 25, 2009).
[64] U.S. Government Accountability Office Report to the Committee on Finance, U.S. Senate, **"Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules"** (December 2009).
[65] U.S. Treasury Inspector General for Tax Administration Report No. 2002-30-125 (July 5, 2002).

to these same shareholders/employees was approximately $350,000. The report recommended that the Service aggressively review S corporation shareholder/employee compensation to ensure reasonable compensation is reported and appropriate FICA/Medicare tax is collected. The result of this study is simple -- shareholder compensation will be carefully scrutinized by the Service in its audits of S corporations.

[ii] National Research Program Extended to S Corporations.

In 2005, the Service launched a study to assess the reporting compliance of S corporations. The study, carried out under the National Research Program ("NRP"), involved the examination of roughly 4,800 randomly selected S corporation returns from tax years 2003-2004. While the Service has not revealed the full, detailed results of the study, the tax community believes there will be a significant increase in S corporation audits and they will focus on at least six (6) areas:

- Unreasonably low compensation;
- Insufficient S corporation stock basis to deduct losses passed through from S corporations;
- Noncompliance with qualification rules;
- Failure of shareholders to report income passed through from S corporations;
- Improper tax-free treatment of fringe benefits provided to S corporation shareholder/employees and their families; and
- Conversion of nondeductible personal expenses into deductible business expenses.

Unreasonably low compensation is likely at the top of the Service's S corporation audit list. It is low-hanging fruit. Tax practitioners need to take action to prevent the Service from asserting that S corporation distributions should be treated as shareholder/employee compensation.

Tax practitioners should carefully consider advising S corporation clients to develop a compensation methodology for shareholder/employees which establishes compensation based upon at least the following factors:

- Personal qualifications;
- Nature, extent and scope of work **actually** performed;
- Compensation required to be deferred in prior years due to lack of cash;

- Compensation paid for similar work by the corporation to its non-shareholder employees; and

- Compensation paid for similar work by comparable businesses.

Tax practitioners need to look to the laws of the applicable jurisdiction to determine if additional factors should be considered. Application of the factors, and the actual compensation derived therefrom, should be documented in written corporate minutes each year.

[b] GAO Report on the S Corporation NRP.

The GAO submitted a report to the Senate Finance Committee in December 2009. The report was the result of a study on long-standing S corporation income and employment tax noncompliance issues. The Senate Finance Committee asked the GAO to analyze the types of S corporation noncompliance, what the IRS has done to address noncompliance, and options to improve compliance. It also asked the GAO to analyze the extent of shareholder/employee compensation noncompliance, and to identify options for improving compliance. Although the report was based primarily on the data from the NRP, it also reflects the GAO's interviews of accountants, legal professionals, small business representatives, and IRS officials and examiners, as well as representatives of several of the companies selected for audit during the NRP.

[i] Income Tax Noncompliance.

According to the GAO report, an estimated sixty-eight percent (68%) of all S corporation returns filed for tax years 2003 and 2004 misreported at least one (1) item affecting net income. The net misreported amount (taking into consideration both under-reported and over-reported amounts) for those years was estimated at $85 billion. Assuming a ten percent (10%) tax rate, that is $8.5 billion in lost tax revenues for tax years 2003 and 2004. The major items misreported were:

- Distributions;

- Gross sales;

- "Other" deductions (e.g., amortization, professional fees, insurance premiums, certain business costs, supplies, travel, meal, entertainment and utilities);

- Shareholder compensation;

- Cost of goods sold; and

- Depreciation.

Misreporting of net income was more prevalent with S corporations having three or fewer shareholders. It was also more prevalent with S corporations having fewer than $250,000 of net assets. In some cases, S corporations had deducted personal expenses of the shareholder(s) (e.g., payments for personal taxes, personal tax return preparation, personal insurance, or personal vehicles). In other cases, the S corporations were unable to substantiate the deducted expenses. Interestingly, the misreporting statistics were generally the same among S corporations which used a paid tax return preparer and those which did not.

The GAO made a number of recommendations to the Senate Finance Committee to improve S corporation compliance, but it heavily stressed the importance of stricter regulation on tax return preparers. For instance, federal tax returns filed by taxpayers in Oregon (a state with rigorous preparer licensing requirements) for tax year 2008 were shown to be more accurate compared to those filed by taxpayers in the rest of the country. Alternatively, the GAO recommended the possibility of levying penalties on tax return preparers who understate a taxpayer's tax liability. Statistics, however, do not show penalties will necessarily improve tax compliance.

[ii] Losses in Excess of Basis.

Another major area of noncompliance was shareholder use of S corporation losses in excess of basis. Upon analyzing IRS annual examinations of individual tax returns that closed for fiscal years 2006 through 2008, the GAO determined the amount of misreported losses that exceeded basis limitations was over $10 million, or about $21,600 per taxpayer. The GAO suggests this type of noncompliance is a consequence of shareholder, not S corporation, responsibility to calculate and track basis.

To improve this type of noncompliance, the GAO recommended Congress pass a law requiring S corporations to calculate each shareholder's basis and report that basis on the shareholder's Schedule K-1.[66] Although such a requirement may be burdensome on S corporations, it would likely reduce noncompliance because basis calculations would be reported both to the shareholders and the Service. Moreover, it would parallel the partnership requirement to report partner capital accounts.

[66] This was only one of the many recommendations made by the GAO. Other recommendations included having the IRS send information on basis calculations to newly elected S corporations and providing guidance sheets to taxpayers for calculating basis.

[iii] Employment Tax Noncompliance.

The final major issue the GAO addressed was avoidance of employment taxes (FICA/Medicare) vis-à-vis large distributions to shareholders. Because distributions to S corporation shareholders are not subject to employment taxes, S corporations sometimes improperly pay their shareholder/employees low wages while making large distributions to them during the year. According to NRP data, about thirteen percent (13%) of S corporations paid inadequate wages, resulting in just over $23.6 billion in net underpaid wages. Nearly all underpayments of wages occurred in S corporations with one to three shareholders.

Determining what a shareholder's wages should have been during a year is based on the facts and circumstances. Consequently, the IRS often has difficulty determining when too few wages have been reported and/or arriving at justifiable conclusions on the appropriate amount of wages a shareholder should have received. IRS examiners reported they typically only pursue the issue in cases in which a shareholder reported little to no wages, but had large distributions from an S corporation during the year.

The GAO recommended disposing of the facts and circumstances test in determining employment tax liability. Instead, the GAO proposed the following options:

- Make net business income reported by S corporations subject to employment taxes;
- Make net business income for service sector businesses subject to employment taxes;
- Make net business income for majority shareholders subject to employment taxes;
- Make payments to active shareholders subject to employment tax;
- Make payments to active shareholders up to a dollar tolerance subject to employment tax; or
- Retain character of income between entities.

The first three (3) options would eliminate the need to determine an adequate wage payment for each shareholder. Instead, the basis for employment tax liability would be shifted to the S corporation's net business income, similar to sole proprietors and partnerships. Under the fourth and fifth options, employment tax liability would be shifted to all payments to active shareholders, including wages, personal payments, distributions, or loans. Under the final option, the current facts and circumstances test would not change. However, it would eliminate the ability of taxpayer to use an S corporation to shelter business income from a partnership—i.e., the shareholder could not insert an S corporation between the partnership and individual and shelter the partnership income from employment taxes. Any income flowing from the

partnership to the S corporation would retain its self-employment tax character to the individual shareholder.

[c] Proposed Legislation on S Distributions – Halted, But May Return.

One of the provisions of the American Jobs and Closing Tax Loopholes Act of 2010 passed by the House, (the "tax extenders bill")[67] would have required shareholders of a professional service S corporation to take into account for self-employment tax purposes all of their pro rata share of S corporation income attributable to the service business. This change would make it more difficult for the shareholders to avoid employment taxes by paying themselves nominal salaries for services rendered to the corporation. The proposed employment tax rules would have applied to: (i) any S corporation which is a partner in a professional service business, if substantially all the S corporations' activities are performed in connection with such partnership; or (ii) any other S corporation engaged in a professional service business if the principal asset of such business is the reputation and skill of three or fewer employees. The term "professional service business" was defined as any trade or business, substantially all of the activities of which involve providing services in the fields of health, law, lobbying, engineering, architecture, accounting, actuarial services, performing arts, consulting, athletics, investment advice, or brokerage services. These changes were set to go into effect for all taxable years beginning after December 31, 2010.

The proposed employment tax changes were not received particularly well in the Senate. Initially, the then acting Senate Finance Committee Chairman, Max Baucus (D-Montana), indicated the language of the rules would need to be modified. He proposed to change the bill to target S corporations engaged in a professional service business if *80% or more of the gross income* of such business is *attributable* to the service of *three or fewer shareholders*, thereby removing the concepts of *principal asset*, *reputation and skill*, and *employees*.

On September 17, 2010, however, Senator Baucus completely removed the new employment tax rules from the tax extenders bill, much to the jubilation of S corporation allies. This was not the end of the story or the last time we would see a legislative attempt to eradicate this perceived abuse of S corporations.

In 2012, as part of the Stop Student Loan Interest Rate Hike Act of 2012,[68] Senator Harry Reid (D-Nevada) introduced yet another legislative attempt to limit personal service providers' ability to avoid employment taxes by routing income through S corporations. This legislation would have treated S corporation pass through items as income or loss from self-employment.[69] Specifically, the "net earnings from a professional service business" would include a

[67] H.R. 4213 111th Cong. § 413 (2010).
[68] S 2343, 112th Cong. § 3 (2012).
[69] *Id.*

shareholder's pro rata share of S corporation income or loss.[70] Again, fortunately for S corporation allies, the proposed legislation failed. Although all is currently quiet on the legislative front, most commentators expect attempts to legislatively curb S corporation avoidance of employment taxes will resurface in the future.

[d] Legislative and Regulatory Changes.

[i] IRC § 1374(d)(7) – Built-in Gains Tax Relief.

Section 1251(a) of the American Recovery and Reinvestment Tax Act of 2009 amended IRC § 1374(d)(7) to exempt an S corporation from the built-in gains tax for taxable years beginning in 2009 and 2010, if the *seventh* taxable year in the recognition period preceded such taxable year.[71] This rule applies separately with respect to any asset acquired from a C corporation in a carryover basis transaction.[72]

Section 2014(a) of the Small Business Jobs Act of 2010 further amended IRC § 1374(d)(7) to exempt an S corporation from the built-in gains tax for taxable years beginning in 2011 if the *fifth* taxable year in the recognition period preceded the 2011 tax year.[73]

Section 326(a)(2) of the 2012 Taxpayer Relief Act even further amended IRC § 1374(d)(7) to exempt an S corporation from the built-in gains tax for taxable years beginning in 2012 if the *fifth* faxable year in the recognition period preceded the 2014 tax year.[74] So, this provision applies to tax years 2012 and 2013.

For tax years beyond 2013, we went back to a ten (10) year recognition period. Most commentators predict we will soon see a permanent reduction in the recognition period to five (5) or seven (7) years. Time will tell.

[ii] Final Treas. Reg. § 1.108-7(d) – COD Income Excluded from Gross Income under IRC § 108.

In October 2009, Treasury issued a final Treasury Regulation effective October 30, 2009.[75] The regulation provides special rules for S corporations which exclude cancellation of debt ("COD") income from gross income pursuant to IRC § 108 because the S corporation is bankrupt or insolvent, or the debt discharged was qualified farm debt.

[70] *Id.*
[71] Public Law 111-5.
[72] *See* I.R.C. § 1374(d)(8).
[73] Public Law 111-240.
[74] Public Law 112-240.
[75] Treas. Reg. § 1.108-7(d).

IRC § 108(d)(7)(A) states the amount of COD income excluded from gross income must be applied to reduce the S corporation's tax attributes under IRC § 108(b)(2). The reduction of tax attributes occurs after determining the S corporation's tax liability for the taxable year of the discharge.[76]

The S corporation's tax attributes must be reduced in the order specified by IRC § 108(b)(2). Net operating losses (NOLs) are first on the list. Although S corporations do not have NOLs (the S corporation's losses pass through to the shareholders under IRC § 1366(d)(1)), Treasury Regulation § 1.108-7(d) treats any loss or deduction disallowed under IRC § 1366(d)(1) and any carryover losses from prior years under IRC § 1366(d)(3) as a "deemed NOL" which is reduced under IRC § 108(b)(2).

If the S corporation's deemed NOL exceeds the amount of the S corporation's COD income excluded under IRC § 108, the excess deemed NOL is allocated to the shareholder(s) of the S corporation as a loss or deduction that is disallowed under IRC § 1366(d) for the taxable year of the discharge. This may seem simple enough, but for S corporations with more than one shareholder, application of this rule involves the following tricky, two-step calculation:

- The S corporation must first calculate each shareholder's "excess amount"—the amount (if any) by which the shareholder's losses or deductions disallowed under IRC § 1366(d)(1) (before any reduction of attributes) exceed the amount of COD income that would have been taken into account by that shareholder under IRC § 1366(a) had the COD income not been excluded under IRC § 108(a); and

- Any shareholder with an "excess amount" must be allocated an amount equal to the S corporation's excess deemed NOL multiplied by a fraction, the numerator of which is the shareholder's excess amount and the denominator of which is the sum of all shareholders' excess amounts. For any shareholder who does not have an excess amount, none of the S corporation's excess deemed NOL is allocated to that shareholder.

Treasury Regulation § 1.108-7(d) also provides the character of the S corporation's excess deemed NOL allocated to a shareholder consists of a proportionate amount of each item of the shareholder's loss or deduction that was disallowed under IRC § 1366(d)(1) in the year of discharge.

[76] I.R.C. § 108(b)(4)(A).

[iii] IRC § 6699 – Increased Penalty for Failure to File S Corporation Return.

The Worker, Homeownership, and Business Assistance Act of 2009 (November 6, 2009)[77] increased the penalty for failure to file an S corporation return to $195 per shareholder per month, up to a maximum of twelve (12) months. The beefed-up penalty was made effective for tax years beginning after December 31, 2009.

[iv] New 3.8% Medicare Tax on Net Investment Income.

The Patient Protection and Affordable Care Act,[78] as modified by the Health Care and Education Reconciliation Act of 2010,[79] imposes a new three and eight-tenths percent (3.8%) Medicare tax on the lesser of the taxpayer's "net investment income" or the excess of modified adjusted gross income over a "threshold amount" (generally $250,000 for taxpayers filing a joint return, $125,000 for married taxpayers filing a separate return, and $200,000 in all other cases). Net investment income generally means the excess of (i) interest, dividends, capital gains, annuities, royalties, rents, income from passive activities, and income from trading financial instruments, over (ii) allowable deductions properly allocable to such income. Some types of income are exempt from the tax, including income from the disposition of the shares of an S corporation.

One interesting provision in the new legislation provides that non-passive income from a taxpayer's active participation in an S corporation is not subject to the tax. The tax applies to passive income and income from a trade or business of trading financial instruments or commodities. By contrast, investment income from C corporations is subject to the tax, and self-employment income on wages and dividends from a partnership is subject to a nine tenths of one percent (0.9%) Medicare tax increase. This slight tax advantage will be a potential planning opportunity for taxpayers considering making an S corporation election.

These changes went into effect on January 1, 2013.

[v] New Credit for Small-Business Employee Health Coverage.

The Patient Protection and Affordable Care Act,[80] as modified by the Health Care and Education Reconciliation Act,[81] also provides, effective January 1, 2010, employers with no more than twenty-five (25) full-time equivalent employees (see below) and whose annual wages are no more than $50,000 may receive a tax credit of up to thirty-five percent (35%) of the employer's

[77] Public Law 111-92.
[78] Public Law 111-148.
[79] Public Law 111-152.
[80] *Supra* note 78.
[81] *Supra* note 79.

cost to provide group health insurance. The credit is based on a sliding scale calibrated to the number of employees and their average annual wages. For tax years beginning in 2014 or later, the maximum credit increases to fifty percent (50%) of the employer's cost to provide group health insurance.

This credit is available to pass-through entities, such as S corporations and partnerships. However, S corporations are not eligible to use the credit for more than two percent (2%) shareholders because such shareholders are treated as self-employed for health insurance purposes (*see* earlier discussion regarding the health insurance deduction available to more than two percent (2%) shareholders).

Although simple in theory, this credit contains extremely complex definitions and rules. For example, for purposes of determining the number of full-time equivalent employees, all members of an employer's control group are included, and part-time employees are converted to full-time equivalents based on 2,080 hours of service per year. Consequently, S corporations which may potentially qualify for this credit should carefully review these rules with their tax advisors. Application of the rules governing the credit are complex.[82]

[vi] Extension of IRC § 1367(a)(2).

Section 325 of the American Taxpayer Relief Act of 2012 extends the life of the IRC § 1367(a)(2).[83] This provision, originally added to the Code in 2006, allows shareholders of an S corporation reduce share basis by the adjusted basis of property contributed to a charity, even though the full fair market value of the property passes through to the shareholder as a charitable contribution. The statute is extended to contributions made in tax years beginning before January 1, 2014. The prior law only applied to contributions made in tax years beginning before January 1, 2012. So, IRC § 1367(a)(2) was given two more years of life. Unless Congress extends it, IRC § 1367(a)(2) is no longer viable today.

[e] ABA Tax Section Proposals.

On April 10, 2013, the Tax Section of the American Bar Association ("ABA") asked Congress to consider certain items of Subchapter S reform,[84] including:

- The ABA asked Congress to repeal IRC § 1375 (passive income tax);

[82] I.R.C. § 45R.
[83] Public Law 112-240.
[84] Letter dated April 10, 2013 from ABA Tax Section addressed to Max S. Baucus, Chairman, Senate Committee on Finance; David Camp, Chairman, House Committee on Ways and Means; Orrin G. Hatch, Ranking Member, Senate Committee on Finance; and Sander Levin, Ranking Member, House Committee on Ways and Means.

- The ABA asked Congress to repeal IRC § 1362(d) (passive income termination risk);
- The ABA asked Congress to legislatively expand S election timing leniency by eliminating the separate election requirement and making it a matter of checking a box on the corporate return (whenever filed); and
- The ABA asked Congress to adopt legislation that provides a shareholder obtains basis from back-to-back loans despite lack of economic outlay.

To date, Congress has not acted on any of these specific proposals. Nevertheless, lobbying efforts continue for tax reform along these lines.

[f] Congressional Tax Reform Proposals Impacting Subchapter S.

Our lawmakers keep talking about tax simplification. On February 21, 2014, then House Ways and Means Committee Chairman Dave Camp (R-Michigan) issued a discussion draft of the "Tax Reform Act of 2014."[85] The proposed legislation spans almost 1,000 pages and contains some interesting provisions, including at least four (4) provisions that directly impact Subchapter S.

[i] Recognition Period.

Chairman Camp proposed to permanently set the built-in gains tax recognition period under IRC § 1374 at five (5) years. This change, if ever enacted into law, would likely have significant impact on corporate tax planning.

[ii] Passive Income Threshold.

Chairman Camp proposed to increase the passive income threshold for purposes of IRC §§ 1362(d)(3) and 1375 from twenty-five percent (25%) to sixty percent (60%). This change, if ever enacted into law, would be a significant help for corporate taxpayers that are at the end of their business life and have C corporation earnings and profits.

[iii] Non-Resident Aliens.

Chairman Camp proposed to allow non-resident aliens to be beneficiaries of ESBTs. Even if this proposal ever becomes law, non-resident aliens would still be prohibited from being shareholders of S corporations.

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85 H.R. ___, 113th Cong. (Discussion Draft).

[iv] S Election Timing.

Chairman Camp proposed to make the deadline for making a timely S election the due date (with extensions) of the corporation's IRS Form 1120S. This proposal, if ever enacted into law, would remove any confusion as to the due date of the election and would eliminate an extra filing deadline.

Upon circulating this tax reform proposal, Chairman Camp pronounced that the draft legislation will "fix America's broken tax code by lowering tax rates while making the code simpler and fairer for families and job creators." He further stated that he would work to gain support for the first comprehensive overhaul of the Code since the Tax Reform Act of 1986 -- "I am hopeful that lawmakers on both sides of the aisle – and partners at both ends of Pennsylvania Avenue – take a close look at this plan and share their thoughts and ideas, and those of their constituents,…just saying no is not a solution."

Significant election-year challenges currently loom in Washington, likely inhibiting our lawmakers from enacting tax reform legislation anytime soon. Nevertheless, Chairman Camp's proposal has attracted interest from policymakers and stakeholders, and stimulated movement toward tax reform.

Most commentators believe we will not see any tax reform proposals enacted into law until 2017 or later. Keep an eye out. It is likely any reform bills proposed by lawmakers will touch Subchapter S.

[g] Indebtedness Basis Final Regulations.

As discussed below, in 2014, Treasury published final regulations dealing with basis obtained by shareholders of S corporations from debt.[86]

Subchapter S continues to evolve. Undoubtedly, one of the most significant changes to Subchapter S was the repeal of the affiliated group prohibition and the birth of QSubs as a result of the 1996 Act.[87] The creation of the QSub opened up planning opportunities that were not available to Subchapter S corporations and their shareholders prior to the 1996 Act. A good understanding of the QSub rules and the opportunities that may arise from its existence are important to tax practitioners.

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[86] *Infra* note 154.
[87] *Supra* note 10.

1.02 THE QUALIFIED SUBCHAPTER S SUBSIDIARY

Born in 1997, as a result of the 1996 Act,[88] the QSub is now almost two (2) decades old. Lawmakers, in order to create the QSub, had to change three (3) ironclad provisions of Subchapter S that had existed for almost forty (40) years, by removing: (i) the prohibition against an S corporation being a part of an affiliated group of corporations;[89] (ii) the absolute prohibition against an S corporation having a corporate shareholder;[90] and (iii) the rule providing that an S corporation, in its capacity as a shareholder of another corporation, is treated as an individual.[91]

The legislative history of the 1996 Act sheds some light into why lawmakers chose to make these changes to the law and enable the creation of the QSub. In the committee reports accompanying the 1996 Act, the following appears:

> The Committee understands that there are situations where taxpayers may wish to separate different trades or businesses in different corporate entities. The Committee believes that, in such situations, shareholders should be allowed to arrange these separate corporate entities under parent-subsidiary arrangements as well as brother-sister arrangements.[92]

This revision to Subchapter S is clearly within the parameters of President Eisenhower's original vision of Subchapter S – the creation of legislation that would minimize the influence of federal income tax laws on the selection of a form of entity by small businesses. Allowing S corporations, like other business entities, to have subsidiaries is consistent with that vision.

Following the 1996 Act, the rules of the road regarding entity affiliation are fairly clear:

- An S corporation may own up to and including 100% of the shares of a subsidiary that is a C corporation;[93]

- A corporate subsidiary that is a C corporation may elect to join in the filing of a consolidated return with its affiliated C corporation(s) (i.e., a chain of controlled

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[88] *Id.*

[89] Prior to the 1996 Act, an S corporation could not have a C corporation as a 80% or more subsidiary (excepting only inactive subsidiaries) because an S corporation could not be a member of an affiliated group within the meaning of I.R.C. § 1504.

[90] Aside from the sole situation where an S corporation owns 100% of the S corporation subsidiary (i.e., the QSub), an S corporation is still prohibited from having a corporation as a shareholder. I.R.C. § 1361(b)(1).

[91] *Id.*

[92] H.R. Rep. No. 104-586, at 88; S. Rep. No. 104-281, at 52 (1996).

[93] The repeal of the affiliated group prohibition created this result. § 1308 of the 1996 Act.

corporations having a common parent);[94]

- A corporate parent that is an S corporation is prohibited from joining in the filing of a consolidated return with its C corporation subsidiaries;[95]
- A subsidiary of a C corporation may not be an S corporation;[96] and
- A subsidiary of an S corporation may, provided certain requirements are met, be an S corporation (i.e., QSub).[97]

The QSub is not treated as a separate entity for federal income tax purposes. Rather, all assets, liabilities and items of income, deduction and credit of a QSub, for income tax purposes, are treated as the assets, liabilities and tax attributes of its S corporation parent.[98] Consequently, a QSub is a disregarded entity for federal income tax purposes.

[1] Benefits of the QSub/Planning Opportunities.

Use of the QSub can result in both tax and business benefits, including:

- Utilization of suspended losses;
- Liability protection/segregation of risk;
- Potential IRC § 1374 tax planning;
- Potential IRC § 1375 tax planning;
- Minimize issues surrounding intercompany loans and transactions;
- Satisfaction of lender requirements;
- Possible avoidance of state and local transfer taxes; and
- Other tax planning.

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94 *Id*.
95 I.R.C. § 1504(b)(8).
96 I.R.C. § 1361(b)(1)(B). Other than in the case of a QSub, an S corporation may not have a corporation as a shareholder.
97 I.R.C. § 1361(b)(3).
98 I.R.C. § 1361(b)(3)(A)(i) & (ii).

[a] Suspended Losses.

In situations where a taxpayer owns the shares of a loss S corporation, but such losses are suspended because the taxpayer has insufficient shareholder basis to utilize the losses, and the taxpayer also owns the shares of a profitable S corporation, a restructuring of the brother-sister arrangement may allow the taxpayer to use the suspended.

Example 1: Taxpayer owns one hundred percent (100%) of two (2) S corporations, X and Y. Corporation X is profitable. Corporation Y is generating losses and likely will continue in a loss mode for the immediate future. Taxpayer has $200,000 of stock basis in her stock of Corporation X. She has zero (0) basis in her stock of Corporation Y and $100,000 of suspended losses from Corporation Y. For valid business reasons, Taxpayer transfers her stock of both Corporation X and Corporation Y to a newly formed S corporation, Holdco. Holdco immediately causes QSub elections to be made with respect to Corporation X and Corporation Y. This restructuring should enable Taxpayer to utilize the $100,000 of suspended losses attributable to Corporation Y.[99]

Example 2: Assume the same facts as those set forth in Example 1 above, except, for valid business reasons, Taxpayer has Corporation Y acquire one hundred percent (100%) of the stock of Corporation X in a tax-free merger, and Corporation Y immediately causes a QSub election to be made with respect to Corporation X. This restructuring should enable Taxpayer to utilize the $100,000 of suspended losses attributable to Corporation Y.[100]

Example 3: Assume the same facts as those set forth in Example 1 above, except, for valid business reasons, Taxpayer contributes her stock of Corporation Y to the capital of Corporation X in a tax-free transaction under IRC § 351, and Corporation X immediately causes a QSub election to be made with respect to Corporation Y. This restructuring should enable Taxpayer to utilize the $100,000 of suspended losses attributable to Corporation Y.[101]

For obvious reasons, in each of these situations, it is important that valid business reasons exist for the restructuring exercise. In addition, especially in Example 3, consideration should be given to the application of the step-transaction doctrine.

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[99] Treas. Reg. § 1.1361-4(c).
[100] *Id.*
[101] *Id.*

Another consideration in both Examples 2 and 3 is which corporation should be the parent corporation. On one hand, having the profitable corporation (i.e., Corporation X) as the parent may be warranted if there exists the possibility that the creditors of the loss corporation could obtain (through legal process or otherwise) the stock of the profitable subsidiary (i.e., Corporation X) if it was owned by the loss corporation (i.e., Corporation Y). Also, consideration needs to be given to risks of uninsured liability in either corporation. If a corporation is susceptible to such risks, avoiding having it as the parent may be warranted. In situations where both corporations face such liability, the transaction format of Example 1 should be carefully considered.

[b] Potential Liability Protection / Segregation of Risk.

As discussed above, keeping activities in separate corporations may assist taxpayers in building some protection against liabilities. Assuming the corporate formalities are adhered to, the corporate veil should help taxpayers insulate themselves from liabilities associated with different business activities.[102]

[c] Potential Planning under IRC § 1374.

IRC § 1374 imposes a corporate level tax on an S corporation's recognized net built-in gains that are recognized during the "recognition period."[103] Under current law, the term "recognition period" means the ten-year period beginning with the first day of the first taxable year for which the corporation was an S corporation.[104] IRC § 1374 does not apply to S corporations that were not formerly C corporations and which do not acquire property from a C corporation in a carry-over basis transaction.[105] If an S corporation, however, acquires an asset, the basis of which in the hands of the S corporation is determined in whole or part by reference to the basis of the asset in the hands of a C corporation, IRC § 1374 could apply to any built-in gains attributable to such asset. Transactions of this nature are commonly referred to as "IRC § 1374(d)(8)" transactions.

The net recognized built-in gain for any tax year is reduced by any net operating loss carryforwards arising from a prior C corporation year.[106] The built-in gains tax can be reduced by any general business credit carry-over arising from a prior C corporation year.[107]

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[102] For a good discussion of piercing the corporation veil, *see* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 Cornell L. Rev. 1036 (1991).
[103] I.R.C. § 1374(a).
[104] I.R.C. § 1374(d)(7).
[105] *See* I.R.C. § 1374(c)(1); I.R.C. § 1374(d)(8); and I.R.S. Announcement 86-128.
[106] I.R.C. § 1374(b)(2).
[107] I.R.C. § 1374(b)(3)(B).

Any recognized built-in gains can be reduced by built-in losses recognized during the same taxable year. [108]

If a corporation acquires an asset before or during the recognition period with a principal purpose of avoiding the built-in gains tax, the asset and any loss, deduction, loss carryforward, credit or credit carryforward attributable to the asset is ignored.[109] This is known as the anti-stuffing rule. The Service could use the anti-stuffing rule and well as other anti-abuse provisions of the Code to attack any IRC § 1374 planning using QSubs.[110]

IRC § 1374 places limitations on the amount of net recognized built-in gains which may be subject to tax in any taxable year. For one, only built-in gains recognized during the recognition period are taxed under § 1374. Any built-in gains recognized after the recognition period are not subject to the penalty tax of IRC § 1374. Also, the net recognized built-in gains taken into account for any taxable year cannot exceed the excess (if any) of the S corporation's net unrealized built-in gains over the net recognized built-in gains for prior taxable years beginning in the recognition period.[111] Net unrealized built-in gains means the excess (if any) by which the fair market value of the corporation's assets at the beginning of its first taxable year as an S corporation exceeds the aggregate adjusted basis of its assets at that time. The significance of this limitation is that it is only the aggregate net unrealized appreciation in a corporation's assets as of the beginning of its first S corporation year which will be subject to the tax. As soon as that appreciation is recognized and taxed, the penalty tax is no longer applicable.

The net recognized built-in gains cannot exceed the S corporation's taxable income for the year determined as if it were a C corporation.[112] Thus, if the excess of the corporation's recognized built-in gains over the recognized built-in losses for the year exceeds its taxable income, the amount subject to the penalty tax will be the taxable income of the corporation. The taxable income limitation places a premium on creating deductions in the year in which built-in gains are recognized by the S corporation. If the corporation's taxable income can be reduced to zero, no built-in gains tax will be imposed. Accelerating deductions in the years that built-in gains are recognized can eliminate or reduce taxable income upon which the calculation of the tax is based. Payments of compensation, as an alternative to distributions, create deductions and thereby reduce taxable income. However, the success of this strategy depends upon compensation payments being "reasonable."[113] The usefulness of the taxable income limitation for S corporations is limited.[114] If the taxable income limitation applies in any taxable year, then

[108] I.R.C. § 1374(d)(2)(A).
[109] Treas. Reg. §§ 1.1374-9 and 1.1374-10(b)(3).
[110] See e.g., I.R.C. §§ 269, 382, 383 and 384.
[111] I.R.C. § 1374(a)(2) and I.R.C. § 1374(d)(1).
[112] I.R.C. § 1374(d)(2).
[113] *See* I.R.C. § 162(a)(1).
[114] *See* I.R.C. § 1374(c)(2)(B).

the excess of the corporation's net recognized built-in gains over its taxable income is treated as recognized built-in gains in the succeeding taxable year (provided the succeeding year is within the recognition period).[115] If the S corporation's taxable income can be reduced to zero for each taxable year remaining during the recognition period, the carry-over penalty tax will be forever eliminated.

Treasury anticipated taxpayers using QSubs creatively to avoid or minimize the impact of the built-in gains tax under Code § 1374. To understand the impact of Treasury's anti-abuse provisions, a few rules need to be understood:

- A QSub is not treated as a corporation separate and apart from its S corporation parent. Consequently, all of its assets, liabilities and items of income, deduction, and credit are treated as items of its S corporation parent.[116]

- A QSub election is treated as a deemed liquidation of the subsidiary into its parent which occurs the day before the QSub election.[117]

- If a C corporation elects to be treated as an S corporation and makes a QSub election for its wholly-owned subsidiary, effective the same date, the deemed liquidation occurs immediately before the S election, while the parent was still a C corporation.[118]

Accordingly, if an S corporation made a QSub election for its wholly-owned C corporation subsidiary, the deemed liquidation occurred the day before the QSub election was effective, while the subsidiary was a C corporation. Since the parent acquired assets from a C corporation in a carryover basis transaction, it will potentially be subject to the built-in gains tax on any unrecognized built-in gain under Code § 1374(d)(8).

If a C corporation made an S election and a QSub election for its wholly-owned C corporation subsidiary, however, the deemed liquidation occurred the day before the S election effective date, while the parent was a C corporation. The result is that the parent S corporation is subject to the built in tax provisions of Code § 1374(a); not Code § 1374(d)(8).[119]

The application of these special rules creates different results, depending upon the circumstances. While the rules apply when a parent corporation acquires assets from an entity for which the corporation intends to make a QSub election, the application of Code § 1374 may differ depending upon the situation. If the corporation makes an S election for itself and a QSub

[115] *Id.*
[116] I.R.C. §1361(b)(3).
[117] Treas. Reg. § 1.1361-4(b)(1).
[118] *Id.*
[119] *Id.*

election with respect to its subsidiary effective on the same date, the subsidiary's assets do not become subject to Code § 1374(d)(8) as a result of the deemed liquidation of the subsidiary because the liquidation is deemed to have occurred immediately before the S election becomes effective (i.e., while the parent was a C Corporation).[120] However, the subsidiary's assets become subject to Code § 1374(a) when the parent converts to an S corporation immediately after the deemed liquidation.[121] Thus, Code § 1374(d)(8) does **not** apply to the subsidiary's assets.

If the parent corporation is an S corporation and makes a QSub election for its wholly-owned C corporation subsidiary, the deemed liquidation occurred the day before the effective date of the QSub election. Consequently, the assets of the subsidiary become subject to Code § 1374 as a result of the parent acquiring the subsidiary's assets in a carryover-basis transaction described in Code § 1374(d)(8) (rather than as a result of the parent's conversion to an S corporation). This treatment can be significant because, as discussed above, the Code § 1374 attributes from the subsidiary's assets (e.g., a loss carryforward) cannot be used in determining the built-in gains tax with respect to the parent's other assets.[122]

The Treasury Regulations require separate pools be created and maintained for purposes of calculating the tax imposed by Code § 1374 for each transaction under Code § 1374(d)(8).[123] In connection with maintaining these separate built-in gains tax pools for an S corporation and each QSub, each entity's Code § 1374 attributes, such as loss carry forwards and credit carryforwards, may be used only to reduce the Code § 1374 tax imposed on the disposition of assets held by that entity. Further, Code § 1374 attributes acquired in one transaction may be used only to reduce tax on the disposition of assets acquired in that transaction.[124] In addition, the taxable income limitation of Code § 1374(d)(2)(i) is allocated among the separate pools pursuant to a formula set forth in the Treasury Regulations.[125] Thus, the rules are rather rigid to prevent manipulation of the built-in gain tax.

As discussed above, an S corporation's net recognized built-in gain for a taxable year is the lesser of:

[120] *See* Treas. Reg. § 1.1361-4(b)(1); *see also* I.R.S. Tech. Adv. Mem. 200247002 (November 22, 2002).
[121] *Id.*
[122] Treas. Reg. §§ 1.1374-1(c) & 8(b).
[123] Treas. Reg. §§ 1.1361-8(c).
[124] Treas. Reg. §§ 1.1361-4(b)(2).
[125] Treas. Reg. §§ 1.1361-8(d).

- Its taxable income determined by using all rules applying to C corporations and considering only its recognized built-in gain, recognized built-in loss, and any built-in gain carryover. This is called the "pre-limitation amount";[126]

- Its taxable income determined by using all rules applying to C corporations as modified by Code § 1375(b)(1)(B).[127] This is called the "taxable income limitation amount";[128] and

- The amount by which its net unrealized built-in gain exceeds its net recognized built-in gain for all prior taxable years. This is called the "net unrealized built-in gain limitation."[129]

If IRC § 1374(d)(8) applies, the determination of tax and the determination of the "taxable income limitation" are determined separately for the assets held by the S corporation when its S election became effective and the assets acquired in an IRC § 1374(d)(8) transaction.[130] Also, the "taxable income limitation" is specially allocated among the groups or pools of assets as prescribed in the Treasury Regulations.[131]

Example 1: X, a C corporation, elected to become an S corporation, effective January 1, 2000. X has a net operating loss carryforward from 2014 of $200,000. On January 1, 2015, Y, an unrelated C corporation, merges into X in a transaction under IRC § 368(a)(1)(A). Y has no loss carryforwards, credit, or credit carryforwards from C years. Y's assets are subject to IRC § 1374. IRC § 1374(d)(8) applies. The net unrealized built-in gain is $1,500,000.

In 2015, X disposes of some of the assets it received from Y. Its pre-limitation amount is $500,000 and its taxable income limitation amount is $1,000,000. Since there is only one (1) pool of built-in gain assets, no allocation of the taxable income is needed. Consequently, X has net recognized built-in gain of $500,000, reducing the net unrealized built-in gain limitation for X to $1,000,000 ($1,500,000 - $500,000). X cannot use its loss carryforward to offset the gain

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[126] Treas. Reg. § 1.1374-2(a)(1).
[127] Pursuant to I.R.C. § 1375(b)(1)(B), for this purpose, deductions allowed under Part VIII of Subchapter B of the Code (other than I.R.C. § 248 deductions) and I.R.C. § 172 are ignored.
[128] Treas. Reg. § 1.1374-2(a)(2).
[129] Treas. Reg. § 1.1374-2(a)(3).
[130] Treas. Reg. § 1.1374-8(c).
[131] Treas. Reg. § 1.1374-8(d).

because the tax is determined separately since the assets of Y were obtained is a basis carryover transaction under IRC § 1374(d)(8).[132]

Example 2: X, a C corporation, makes an S election, effective January 1, 2015. At that time, it has $50,000 of net unrealized built-in gain in its assets. Y has no loss carryforwards, credits, or credit carryforwards. On January 1, 2016, X merges with Y, an unrelated C corporation, in a transaction under IRC § 368(a)(1)(A). Y has no loss carryforwards, credits, or credit carryforwards. Y's assets have $800,000 of net unrealized built-in gain.

In 2016, X has a "pre-limitation amount" of $150,000 on its pre-S corporation assets and a pre-limitation amount of $150,000 on the assets acquired in the merger with Y. X's taxable income limitation amount is $100,000.

X's assets have a net unrealized built-in gain of $50,000; so, its net recognized built-in gain on those assets cannot exceed $50,000 before considering the "taxable income limitation." X's "taxable income limitation" of $100,000 gets allocated between the two pools: (1) the assets X has on the effective date of its S election, and (2) the assets X acquired in the merger with Y for purposes of computing the net recognized built-in gain from each pool.

Consequently, X's net recognized built-in gain from its assets held on the effective date of its S election is $25,000 ($100,000 x $50,000/$200,000). X's net recognized built-in gain on Y's assets is $75,000 ($100,000 x $150,000/$200,000).[133]

As stated above, the Treasury Regulations provide, however, that a single IRC § 1374 pool may exist when the parent corporation's S election is made effective at the same time as its QSub's election.[134] In addition, a separate built-in gains tax exposure does not exist when an S corporation is deemed to acquire the assets of another S corporation under the step-transaction doctrine (or in an actual asset acquisition) if the acquired S corporation has no prior C corporation history.

If an S corporation has tiered subsidiaries for which it will make QSub elections effective on the same date, the general rule is that the subsidiaries liquidate in a bottom-up fashion in order to

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[132] Treas. Reg. § 1.1374-8(e) Example 1.
[133] Treas. Reg. § 1.1374(8)(e) Example 2.
[134] Treas. Reg. § 1.1361-8(c).

avoid multiple groups of Code § 1374(d)(8) assets that cannot be netted for purposes of the built-in gains tax.[135] The S corporation parent, however, may specify the order of the liquidations.[136]

The overlap of the built-in gains tax and QSubs is complex. Careful analysis of any transaction involving assets of a C corporation or an S corporation with C corporation history is warranted.

[d] Potential Planning under IRC § 1375.

In accordance with IRC § 1375, S corporations which have C corporation earnings and profits ("E&P") at the close of the taxable year and "passive investment income" totaling over twenty-five percent (25%) of gross receipts will be subject to a tax imposed at the highest corporate income tax rate under IRC § 11.[137] S corporations without any C corporation E&P, however, are excluded from the application of IRC § 1375.

The purpose of IRC § 1375 is to prevent shareholders from accomplishing through the use of an S corporation what they cannot accomplish in a C corporation because of the personal holding company tax rules. Absent IRC § 1375, shareholders of a C corporation could phase out the corporation's business, sell the corporation's assets, and continue to operate as an investment corporation. At a time when the highest corporate income tax rate is less than the highest individual income tax rate, gain on the sale would be taxed at the lower (corporate) tax rate. By not liquidating the corporation, the after-tax gain on the sale would avoid individual taxation. An S election made following the sale would avoid the personal holding company tax problems applicable to C corporations and permit passive investment of corporate assets. IRC § 1375 is designed to prohibit this type of manipulation.

The passive investment tax of an S corporation (with C corporation E&P at the close of the taxable year) for years when "passive investment income" exceeds twenty-five percent (25%) of gross receipts is based upon the lessor of:

- The "excess net passive income" (IRC § 1375(b)(1)); or
- The corporation's taxable income determined as if were a regular corporation, but without regard to the NOL deduction or the dividends received deduction (IRC § 1375(b)).

This amount is subject to the highest corporate tax rate in effect.

The IRC § 1375 tax cannot exceed the corporation's taxable income for the year (determined if the corporation were a C corporation and ignoring NOLs and dividend received deductions).

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[135] Treas. Reg. §§ 1.1361-4(b)(2) & 1.1374-8(b).
[136] *Id.*
[137] The 1996 Act eliminates C E&P existing before 1983 in certain circumstances.

Corporations may not use any credits other than gasoline and special fuel credits to offset or reduce the tax.[138]

Passive investment income" is defined in IRC § 1362(d) to include gross receipts derived from royalties, rents, dividends,[139] interest, annuities, and gains from sales and exchanges of stocks or securities.

Interest derived from sales of inventory is excluded from the definition of "passive investment income."[140]

Interest income of lending and finance companies generated in the course of loan transactions is excluded from the definition of "passive investment income."[141]

Treasury takes the position that tax-exempt interest income is "passive investment income" subject to the IRC § 1375 tax.[142] The theory is that IRC § 103 only excludes tax-exempt income from "gross income," not "passive investment income" tax imposed by IRC § 1375.

Royalty income received in the ordinary course of business from the licensing or franchising of corporate property is excluded from the definition of "passive investment income."[143] Royalty income is received in the ordinary course of business if the corporation created the underlying property or performed significant services or incurred significant costs with respect to the development or marketing of the property.

Copyrights, mineral, oil and gas royalties, and active business computer software royalties are also excluded from the definition of "passive investment income." Provided, however, in order for copyrights, mineral, oil and gas royalties, and active business computer software royalties to be exempt, the personal holding company tax exclusions under IRC §§ 543(a)(3), 543(a)(4) and 543(d) (ignoring (d)(5)) respectively must be met.[144]

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[138] I.R.C. § 1375(c).

[139] Note the exclusion for certain dividends received from C corporation subsidiaries. I.R.C. § 1362(d)(3)(F).

[140] Treas. Reg. § 1.1362-2(c)(5)(iii)(B).

[141] Treas. Reg. § 1.1362-2(c)(5)(iii)(B).

[142] Treas. Reg. § 1.1362-2(c)(5)(ii)(D).

[143] Treas. Reg. § 1.1362-2(c)(5)(A).

[144] I.R.C. § 543(a)(4) applies to copyrights. It provides that income is excluded from the personal holding company tax if:

- Such income (except royalties received for works created in whole or in part by any shareholder) constitutes at least 50% of ordinary gross income; and
- The personal holding company income for the taxable year (ignoring royalties received for work created in whole or part by any shareholder owning more than 10% of the stock, and dividends received from corporations 50% or more of which the corporation owns, but including mineral, oil and gas royalties) is not more than 10% of ordinary gross income; and

“Rents" mean any amounts received for the "use of, or right to use, property" of the corporation.[145] Specifically excluded are:

- Produced film rentals (defined in IRC § 543(a)(5) as payments for use of or right to use a film, provided the interest being rented was acquired by the corporation before the film was substantially completed, and any payments to a producer for actively participating in the film production). [146]

- Rents derived in the active trade or business of renting property.[147] To qualify as a trade or business, significant services must be rendered or substantial costs must be incurred relative to the rental business. A fact and circumstance analysis is required—look at the number of employees in the rental business, and types of expenses (non-depreciation) incurred.[148]

Net passive income is simply "passive investment income" less allowable deductions directly allocable to such production of income.[149]

Excess net passive income is computed as follows:

- The total deductions (under I.R.C. § 162 only) which are allocable to such royalties (other than personal service compensation paid to shareholders and royalties paid to others) are 25% or more of the amount which equals ordinary gross income less royalties paid or accrued and I.R.C. § 167 depreciation deductions allowable with the respect to the copyright royalties.

I.R.C. § 543(a)(3) applies to mineral, oil and gas royalties. It provides that income is excluded from the personal holding company tax if:

- Such income constitutes at least 50% of ordinary gross income;
- The personal holding company income for the taxable year is not more than 10% of the ordinary gross income; and
- The total deductions (under I.R.C. § 162 only) which are allocable to such royalties (other than personal service compensation paid to shareholders) are at least 15% of ordinary income adjusted in accordance with I.R.C. § 543(b)(2) (subtracting depreciation, property taxes, interest, rent, etc.).

I.R.C. § 543(d) applies to active business computer software royalties. It provides that income is excluded from the personal holding company tax if:

- Such income constitutes at least 50% of ordinary gross income.
- The deductions allowable under I.R.C. §§ 162, 174 and 195 allocable to such royalties are at least 25% of ordinary gross income for the taxable year.

[145] Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2).
[146] Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(3).
[147] Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2).
[148] *Id.*
[149] I.R.C. § 1375(b)(2).

[Passive investment income for taxable year
less 25% of gross receipts for taxable year]
[divided by]
[Passive investment income for taxable year]
[multiplied by]
[Net passive investment income for taxable year]

Example: During a tax year, Corporation has gross receipts of $5,000,000, passive investment income of $2,000,000, IRC § 162 expenses directly allocable to the passive income of $200,000, and taxable income of $1,500,000. Corporation has "excess net passive income" of $675,000:

Passive Investment Income	$2,000,000
Less 25% of gross receipts	($1,250,000)
	$750,000

Passive Investment Income	$2,000,000
Directly Allocable Expenses	($ 200,000)
Net Passive Income	$1,800,000

$ 750,000 / $ 2,000,000 x $1,800,000 equals $675,000

Corporation will owe IRC § 1375 tax on the lessor of its "taxable income" or the "excess net passive investment income." Since "excess net passive income" ($675,000) is less than corporation's taxable income ($1,500,000), it will pay IRC § 1375 tax on the "excess net passive income." The highest corporate income tax rate will be utilized.

The Secretary may waive the IRC § 1375 tax if:

- In good faith the corporation believed it had no C corporation E&P at the close of the taxable year; and
- During a reasonable time after it determined that it actually had C corporation E&P, such was distributed to shareholders.[150]

A request for waiver must be made in writing with the district director. The request, which is filed in the same format as a ruling request, must contain all relevant facts to establish the

[150] IRC § 1375(d).

aforementioned waiver criteria; a description of how and when it determined it originally had no C corporation E&P and how and when it discovered that it actually had C corporation E&P; steps taken to distribute the E&P; and time table for distributions if not made yet. On the date the waiver is approved, all E&P must be distributed.

IRC § 1362(d)(3) works in tandem with IRC § 1375. If "passive investment income" for an S corporation that has retained E&P is over twenty-five percent (25%) of gross receipts for three (3) consecutive tax years, the S election is terminated at the beginning of the fourth (4th) taxable year.[151]

Planning Opportunity: The non-passive income of one or more QSubs may help an S corporation parent with E&P avoid a termination under IRC § 1362(d)(3). To accomplish this goal, since the income of the S corporation parent and its QSubs are combined, the aggregate net passive income must be kept below the twenty-five percent (25%) threshold of the aggregate gross receipts of the combined entities in one out of every three (3) consecutive taxable years. Likewise, to avoid or minimize the application of IRC § 1375, the QSubs gross receipts are combined with the gross receipts of the S corporation parent.

[e] Minimize Some of the Intercompany Loan and Transactions Issues.

A common problem encountered by taxpayers is establishing basis in loans the taxpayer made to his or her S corporation in order to deduct the losses generated by the corporation. A controversy often arises when the loans are made by one entity controlled by the taxpayer to another such similarly situated entity and mere journal entries are made to memorialize the transaction. These types of transactions have been the subject of litigation with the IRS in recent years.

[i] *Maguire v. Commissioner*.

In this case,[152] the taxpayers, the Maguires, husband and wife, owned two S corporations. The businesses of the corporations were related. One corporation operated an automobile dealership. The other corporation operated a finance company that purchased customer notes from the dealership. The finance company operated at a profit while the automobile dealership operated at a loss. The Maguires did not have sufficient basis in the dealership to deduct the losses. They had substantial basis, however, in the finance company.

[151] I.R.C. § 1362(d)(3)(A)(ii).
[152] T.C.M. 2012-160 (2012).

At the end of each tax year, the finance company owned substantial accounts receivable due from the dealership. At that time, the Maguires received distributions of the accounts receivable from the finance company. In turn, they contributed the receivables to the dealership in order to increase basis and deduct the losses.

The Service disallowed the losses, arguing the actions between the related entities and the Maguires lacked any economic outlay. Although the transactions were documented by journal entries and corporate resolutions, the parties' economic positions were not altered.

Losses deductible by a shareholder are limited to his or her basis in the corporation under IRC § 1366(d). A shareholder's basis in the corporation is increased by capital contributions. To qualify as a capital contribution, the shareholder must make an actual economic outlay.

The Tax Court disagreed with the IRS. Judge Ruwe found the "distributions and contributions did have real consequences that altered the positions of petitioners individually and those of their businesses." He concluded that there was an economic outlay in this case.

The court's decision hinged on several key facts, including:

- The transactions were properly memorialized in minutes of both corporations;
- The transactions were properly recorded in the books of both corporations;
- The underlying customer notes were real; and
- The accounts receivable were legally enforceable, and thus had value.

One clear takeaway from Judge Ruwe's ruling in this case is that contemporaneous documentation that reasonably memorializes transactions between a taxpayer and his or her wholly-owned corporation(s) may save the day if the Service asserts lack of economic outlay. Failure to maintain contemporaneous, complete and accurate corporate records may lead to a disastrous outcome in a future tax controversy.

[ii] *Kerzner v. Commissioner*.

In this case,[153] the Service beat the taxpayers in this case by a nose. Mr. and Mrs. Kerzner were equal partners in a partnership that owned a building. The partnership leased the building to an S corporation which was owned equally by two shareholders, Mr. and Mrs. Kerzner. Over the years, the partnership loaned the Kerzners money. In turn, they loaned the money to their S corporation, which used the money to pay rent to the partnership.

[153] T.C.M. 2009-76. (2009).

At the end of each year (or after the audit commenced), promissory notes were drafted to document the loans; some of the notes stated an interest rate, some did not. Even though the notes required payment of principal, virtually no payments were ever made because the notes each year were replaced with new notes before any payment was due.

The S corporation had large losses. The Kerzners claimed basis in the loans to the corporation and took the losses on their individual tax returns. Upon audit, the Service claimed the loans lacked economic substance and did not give the Kerzners basis to absorb the losses.

Two points of law need to be understood:

- First, IRC § 1366(d)(1) tells us the losses taken by the Kerzners cannot exceed their adjusted basis in the stock, plus their adjusted basis in any loans from them to the corporation; and

- Second, basis is only obtained in loans if (i) the corporation owes the debt directly to the shareholders; and (ii) the shareholders really made an economic outlay that rendered them poorer. There must be economic substance—the loans must be real.

In *Kerzner*, the money started with the partnership and ended with the partnership. Because it is likely no cash ever actually exchanged hands and only a mere after-the-fact paper trail was created, there was no economic substance. Consequently, the Tax Court disallowed the pass-through losses. **The taxpayers lost the battle.**

The Kerzners could have changed the result:

- They could have taken a real distribution from the partnership and loaned it to the S corporation and required the corporation to make regular payments of principal and interest;

- They could have borrowed money from a bank and loaned it to the S corporation and required it to make regular payments of principal and interest; or

- They could have used their own resources and loaned money to the S corporation and required it to make regular payments of principal and interest.

[iii] Treasury Regulation § 1.1366-2.

On June 12, 2012, Treasury, likely in response to judicial decisions, including *Maguire* and *Kerzner*, issued proposed regulations.[154] The regulations provide guidance as to whether an S corporation shareholder obtains basis under IRC § 1366 for the corporation's indebtedness to the shareholder. On July 23, 2014, with virtually no modifications, the regulations were finalized.[155]

The final regulations are rather narrow in coverage. They provide general guidance in two (2) areas:

- When S corporation indebtedness to a shareholder, including back-to-back loans,[156] creates shareholder basis;[157] and
- When a shareholder obtains basis arising from the shareholder's guarantee of the S corporation's debt.[158]

To determine if an S corporation shareholder obtains basis for indebtedness of the corporation to the shareholder, the courts have historically focused on whether economic outlay exists (i.e., whether the shareholder was poorer after the loan was made). The regulations, however, changed the required focus and abandoned the economic outlay requirement.[159] The new focus, pursuant to the regulations, is whether under principles of federal tax law, looking at all of the facts and circumstances, the debt is bona fide.[160]

With respect to shareholder guarantees of S corporation debt, the final regulations adopt the same theory enunciated by the Tax Court in *Montgomery v. Commissioner*.[161] Consequently, as clearly stated by the Tax Court in *Montgomery* and as now clearly memorialized by Treasury in

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[154] Treas. Reg. § 1.1366-2.
[155] *Id.*
[156] Treas. Reg. § 1.1366-2(a)(iii) Example 2 illustrates a back-to-back loan. "A" owns 100% of two (2) S corporations, "S1" and "S2." "S1" lends money to "A." "A" then lends the money to "S2." Whether the loan to "S2" creates basis for "A" is a question of facts and circumstances. It hinges on whether, under principles of federal tax law, the loan is bona fide. In other words, the loan must be real. Whether there is actual economic outlay no longer is determinative.
[157] Treas. Reg. § 1.1366-2(a)(2)(i).
[158] Treas. Reg. § 1.1366-2(a)(2)(ii).
[159] In 2013, the ABA, as part of its lobby for tax reform, asked Congress to abolish the economic outlay concept in the case of back-to-back loans. *Supra* note 84.
[160] Treas. Reg. § 1.1361-2(a)(2).
[161] *Infra* note 170.

the regulations, a shareholder does not obtain basis merely by guaranteeing the S corporation's debt.[162]

The shareholder does, however, obtain basis to the extent the shareholder actually pays the S corporation's debt. At that time, the S corporation becomes indebted to the shareholder. So, the shareholder obtains basis equal to the amount of the payment.[163]

The final regulations are effective for all transactions occurring on or after July 23, 2014.[164] Taxpayers may, however, rely on the regulations with respect to transactions which occurred prior to that date (assuming the statute of limitations for assessment is still open).[165]

The final regulations are clearly an improvement over the judicially-created requirement that, in order for an S corporation shareholder to obtain basis from the corporation's indebtedness to the shareholder, there must be actual economic outlay, rendering the shareholder poorer. That said, whether indebtedness is bona fide, the new standard, is a question of facts and circumstances. Consequently, there will surely continue to be disputes over this remaining issue unless the regulations are further amended, or Congress amends IRC § 1366, adopting an objective standard.

The only real difference between *Maguire*[166] and *Kerzner*,[167] other than the outcomes, is the adequacy of the taxpayer's recordkeeping. The taxpayer in *Maguire* [168] appeared to have kept accurate and reasonable records that adequately memorialized the loan transactions. The records seem to have been created at or near the time of the actual loan transactions. Whereas, in *Kerzner*,[169] it appeared the loan transactions, if memorialized in writing at all, were done well after the fact (possibly after the audit commenced).

Today, if Treasury Regulation § 1.1366-2(a)(2) could apply to the Kerzners, the Tax Court's focus would be on whether the loan between the Kerzners and the corporation constituted bona fide indebtedness under federal income tax principles. To make that determination, the Tax Court would look at all of the facts and circumstances surrounding the loan. The Kerzners likely would still lose the battle under Treasury Regulation § 1.1366-2(a)(2). The indebtedness was not clearly and reliably documented, and virtually no payments were ever made. Instead, the Kerzners replaced existing promissory notes with the new promissory notes when payments were

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[162] Treas. Reg. § 1.1361-2(a)(2)(ii).
[163] *Id.*
[164] Treas. Reg. § 1.1366-5(b) and (c).
[165] *Id.*
[166] *Supra* note 152.
[167] S*upra* note 153.
[168] *Supra* note 152.
[169] *Supra* note 153.

due. Arguably, the government would prevail, arguing the debt was not real; it was not bona fide debt.

[iv] Debt Basis Resulting From Guarantees.

In *Montgomery v. Commissioner*,[170] the taxpayers, Patrick and Patricia Montgomery, claimed a net operating loss on their 2007 federal joint income tax return, which they carried back to 2005 and 2006. In the calculation of their net operating loss, they included: losses UDI Underground, LLC ("UDI") incurred in 2007 that were passed through to Patricia Montgomery as a forty percent (40%) member of UDI; and losses Utility Design, Inc., an S corporation ("Utility Design") incurred in 2007 that were passed through to Patrick and Patricia Montgomery as shareholders.

The IRS challenged the amount of the net operating loss for 2007 on two grounds. First, the IRS asserted Patricia Montgomery did not materially participate in UDI during 2007. Second, the IRS asserted portions of the losses from Utility Design were disallowed under IRC § 1366(d)(1).

The IRS asserted Patricia Montgomery's share of the 2007 losses from UDI were losses from a passive activity. Specifically, the IRS argued Patricia Montgomery did not materially participate in UDI.

The Tax Court disagreed, holding Patricia Montgomery did materially participate in UDI. In 2007, Patricia Montgomery handled all of the office functions, managed payroll, prepared documents, met with members of the company and attended business meetings. Additionally, she continuously worked on company matters and daily discussed the company's business with Patrick Montgomery. The court ultimately concluded Patricia Montgomery participated in UDI for more than 500 hours during 2007 and her participation was regular, continuous, and substantial. Thus, Patricia Montgomery's UDI activity was a non-passive activity. Not terribly surprising, reliable taxpayer records evidencing material participation appear to have been significant in the Tax Court's holding on this issue.

Next, the Tax Court considered whether the taxpayers' portion of their net operating loss attributable to Utility Design was limited by IRC § 1366(a). IRC § 1366(a) requires an S corporation shareholder, when calculating his or her taxable income for the year, to take into account his or her pro rata share of the S corporation's items of income, loss, deduction, or credit for the S corporation's tax year that ends in the tax year of the shareholder. However, the S corporation's loss taken into account by a shareholder cannot exceed the limitation amount calculated under IRC § 1366(d)(1), which is equal to the shareholder's adjusted basis in the S

[170] T.C.M. 2013-151 (2013).

corporation stock increased by the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder.

The Tax Court concluded Patrick Montgomery's basis in the Utility Design stock was zero at the beginning of 2007. It then considered basis adjustments. In 2006 and 2007, Utility Design borrowed the following amounts: $1 million from SunTrust Bank on August 25, 2006, (which was personally guaranteed by the taxpayers); $60,000 from Patrick Montgomery on September 26, 2007; $30,000 from Patrick Montgomery on October 5, 2007; and $15,000 from Patrick Montgomery on November 13, 2007.

In 2008, Utility Design defaulted on the $1 million loan which the taxpayers were personally liable for as a result of their personal guarantees. Nevertheless, despite repeated demands from Sun Trust Bank, the taxpayers refused to pay the debt. In November 2009, a judgment was entered in favor of the bank against the taxpayers for the amount remaining unpaid on the loan, which at that time amounted to $425,169.54. The taxpayers took the position that their basis in the Utility Design shares was automatically increased by the amount of the judgment (i.e., $425,169.54).

The IRS contended the judgment amount did not increase the taxpayers' stock basis. When an S corporation shareholder guarantees a loan of the corporation, no debt has been created between the S corporation and the shareholder.[171] However, once the shareholder pays the bank pursuant to the guarantee, the S corporation becomes indebted to the shareholder and the shareholder obtains debt basis. *Id.* Quoting the court in *Underwood v. Commissioner*,[172] the court further explained:

> It is the *payment* by the guarantor of the guaranteed obligation that gives rise to indebtedness on the part of the debtor to the guarantor. The mere fact that the debtor defaults and thereby renders the guarantor liable is not sufficient.

Accordingly, the Tax Court held that, because the taxpayers, Patrick and Patricia Montgomery, did not actually make any payments under the guarantee, their guarantee did not increase stock basis.

To add salt to the wound, the Tax Court upheld the Service's imposition of an IRC § 6651(a)(1) penalty against the taxpayers for late filing.

The moral to this story is simple. Shareholders of S corporations do not obtain stock basis merely by guaranteeing the corporation's debt. In addition, unless the shareholder actually pays the debt, a demand by the lender for payment of the debt or even a judgment against the

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[171] *See Underwood v. Commissioner*, 63 T.C. 468, 475-476 (1975), *aff'd* 535 F.2d 309, 311-312 (5th Cir. 1976).
[172] *Id.* at 476 (*emphasis added*).

shareholder in favor of the lender for the debt will not create stock basis. Last, but certainly not least, failure to abide by these clear rules of the road could result in the assessment of penalties.

The Tax Court's ruling is consistent with Treasury Regulation § 1.1366-2(a) which was finalized on July 23, 2014. In accordance with this final regulation, a guarantee of the S corporation's debt, in and of itself, does not give the shareholder basis. Basis is only obtained when and to the extent the shareholder actually pays the debt.[173]

A structure using QSubs would have eliminated part of the controversy in *Kerzner*. Since the QSub is ignored for federal income tax purposes, there is no need to actually transfer funds between the entities. Economic outlay, which was the focus of the Tax Court in *Kerzner*, should not apply. However, following the Tax Court's ruling in *Maguire* and Treasury Regulation § 1.1366-2, to be honored, the debt must be, under principles of federal tax law, looking at all of the facts and circumstances, bona fide. If the debt is between the QSub and its S corporation parent, whether the debt is bona fide should be irrelevant for income tax purposes since the QSub's assets, liabilities and items of income, deduction and credit are treated as those of the parent S corporation. If the debt runs to or from the shareholders of the parent S corporation and the QSub, as was the case in *Kerzner*, the debt will have to be bona fide or it will not be respected.

[f] Satisfaction of Lender Requirements.

Often lenders require that debtors hold collateral for a loan in a bankruptcy remote entity, creating more lender protection. The separate entity is generally not subject to the liabilities of the borrower's other activities. A QSub, which constitutes a separate legal entity, can be used by the debtor for this purpose. As already stated, the QSub is not a separate entity for income tax purposes.

In the context of transactions conducted by an S corporation that otherwise qualify for income tax deferral under IRC §§ 1031 or 1033, the use of a QSub to hold the replacement property of an S corporation should not disqualify the transaction for federal income tax purposes. A review of applicable state and local law, however, is necessary.

[g] State and Local Transfer Taxes.

Many states and local governments impose a transfer or excise tax upon the disposition of certain assets (e.g., real property). If property that an S corporation desires to sell or exchange is subject to such taxes, dropping the property into a QSub and transferring the stock of the QSub may avoid the imposition of the taxes. A careful analysis of the applicable state and local law is

[173] Treas. Reg. § 1.1366-2(a)(2)(ii).

required. Many states and local governments have amended their statutory schemes to include within the purview of such tax regimes the sale or exchange of the property itself or the sale or exchange of a controlling interest in the entity that holds the property.[174] Consequently, caution is required.

[h] Other Planning Opportunities.

Other situations may arise where it is advantageous to have more than one activity under the same taxable roof, including where the at risk limitations of IRC § 465 are in play or the passive activity loss limitations of IRC § 469 are being bumped up against by the shareholder(s). Adding business activities to the S corporation so that the shareholder(s) will meet the at-risk and/or active precipitation requirements may be a viable solution. At the same time, the corporation may not want the added risks or liabilities associated with having the additional business activities within the same corporate entity. A potential solution may be for the shareholder(s) to contribute their stock of the corporation holding the additional business activity to the S corporation and have it make a QSub election or by merging the entities, and making a QSub election. In either case, the shareholders participation in the combined activities may allow them to get over the IRC §§ 465 and/or 469 obstacles.

[i] At Risk Limitations.

A taxpayer's loss deductions are limited to amounts "at risk" in a trade or business or income-producing activity under IRC § 465.

An S corporation shareholder's at-risk basis is generally derived from:

- Capital contributions;
- Unencumbered funds loaned by the shareholder to the corporation or funds borrowed by the shareholder for use in the corporation's activities. IRC § 465(b)(2) provides that a shareholder is at risk with respect to borrowed amounts only if the shareholder is personally liable for repayment of the loan;
- Funds borrowed by the shareholder and then loaned to the corporation for use in the corporation's activities, where the shareholder has borrowed the funds on a nonrecourse

[174] Washington State adopted legislation that brings a sale or exchange of a "controlling interest" within the purview of its real property transfer tax regime. *See* WAC 458-61A-101.

basis, as long as the shareholder has pledged property not otherwise used in the business of the corporation as security for the loan;[175]

- Loans secured by real property used in the activity of holding real property;[176] and
- The fair market value of S corporation stock received as compensation.[177]

An S corporation shareholder does not obtain at risk basis for debts of the corporation for which he or she provides a guaranty. Likewise, amounts borrowed by an S corporation shareholder from a person who has an interest (other than as a creditor) in the business are not considered at risk.[178] Provided, however, an S corporation shareholder may obtain at risk basis for amounts borrowed from a family member, as long as the debt is recourse and the family member is not a shareholder of the S corporation.[179]

Generally, each trade or business conducted by an S corporation is treated as a separate activity for purposes of the at risk rules. However, other than the activities specifically enumerated in IRC § 465(c)(2)(A),[180] activities of an S corporation may be aggregated at the shareholder level when the shareholder actively participates in the activities. IRC § 465(c)(3)(B) allows activities constituting a trade or business to be treated as a single activity when (1) the taxpayer actively participates in the management of the trade or business, or (2) the trade or business is carried on by an S corporation and 65% or more of the losses for the year are allocable to persons who actively participate in the management of the trade or business. This is aggregation rule is best illustrated by following example:

Example: Corporation X is an S corporation. One hundred percent (100%) of X's stock is owned by A. X owns and operates a construction business. X also owns and operates an automobile dealership. While these two (2) businesses are clearly separate lines of activity, provided A actively participates in both the construction and the automobile dealership businesses, they may be aggregated for determining the amount that he or she is at risk for purposes of IRC § 465.

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[175] If the loan secured by property is non-recourse, the at-risk amount is limited to the net fair market value of the taxpayer's interest in the property. S corporation stock is considered to be "property used in the activity," meaning that a shareholder is *not* considered at risk for amounts contributed or loaned to an S corporation when the amounts were obtained by nonrecourse borrowings secured by his or her stock. H.R. 10612, Public Law 94-455.

[176] Treas. Reg. § 1.465-27.

[177] *See* I.R.S. Priv. Ltr. Rul. 8752006 (September 3, 1987).

[178] I.R.C. § 465(b)(3).

[179] Treas. Reg. § 1.465-8(a)(1).

[180] Film or videotape, I.R.C. § 1245 property (subject to recapture of depreciation as ordinary income upon disposition) that is leased or held for leasing, farm property, oil and gas property, and geothermal property.

Active participation for purposes of IRC § 465 does not have the same meaning as the term is used in IRC § 469. According to the legislative history that accompanied the adoption of IRC § 465,[181] facts and circumstances indicative of active participation include:

- Participation or involvement in the decisions revolving around the operations and/or management of the trade or business;
- Providing services to the trade or business; or
- Hiring and firing employees (other than the ultimate person in charge of the trade or business).

The legislative history also provides that certain facts and circumstances may indicate the absence of active participation,[182] including:

- The absence of control over the management and operations of the trade or business;
- The authority to only discharge the manager of the trade or business; and
- The manager of the trade or business is an independent contractor rather than an employee.

Careful planning may allow aggregation for purposes of applying the at risk rules under IRC § 465 for shareholders of an S corporation. In addition, consideration should be given to using the QSub in order to combine one S corporation with at risk availability with another S corporation in which the shareholder has no at risk availability. This potential planning technique may be useful when the shareholder may have suspended losses from one (1) of the S corporations due to at risk rules.

Example: A is the sole shareholder of two (2) S corporations, X and Y. A has suspended losses from Y due to the at risk rules. X is a profitable corporation. X owns and operates a construction business. Y owns and operates an automobile dealership. A actively participates in both of these businesses for purposes of the at risk rules.

A could contribute the shares of Y to the capital of X, followed by X making an immediate QSub election. The result should be the tax attributes of Y are carried over to the activities passed through to A by X, and A should have access to the suspended losses to the extent he

[181] H.R. 10612, Public Law 94-455.
[182] *Id.*

or she had at risk amounts in X to offset the aggregated income generated by X and Y.

[ii] Passive Activity Loss Limitations.

The passive loss rules of IRC § 469 do not apply to partnerships and S Corporations.[183] Provided, however, the rules apply to the owners of these entities at the owner level.

A passive activity means any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate.[184] In general, material participation means "regular," "continuous" and substantial involvement in the activity.[185]

In the case of S corporations, the level of participation of the shareholders generally determines whether material participation exists. Absent material participation, losses will be passive and nondeductible absent passive income.

Treasury Regulations contain rules allowing a taxpayer to aggregate or group trade or business activities and rental activities for purposes of applying Code Section 469.[186] Activities may generally be grouped together and treated as a single activity for measuring gain or loss if the activities constitute an appropriate economic unit.[187] Whether activities constitute an appropriate economic unit is a facts and circumstances test, and taxpayers may use any reasonable method in applying the facts and circumstances in grouping activities.[188] The following factors are generally given the greatest weight in determining whether activities constitute an appropriate economic unit:

- Similarities and differences in the types of trades or businesses;
- The extent of common control;
- The extent of common ownership;
- Geographical location; and
- Interdependencies between and among the activities.[189]

183 I.R.C. § 469(a)(2).
184 I.R.C. § 469(c)(1).
185 I.R.C. § 469(h)(1).
186 Treas. Reg. § 1.469-4.
187 Treas. Reg. § 1.469-4(c)(1).
188 Treas. Reg. § 1.469-4(c)(2).
189 *Id.*

Rental activities may not be grouped with trade or business activities unless the activities constitute an appropriate economic unit and:

- The rental activity is insubstantial in relation to the trade or business activity; or
- The trade or business activity is insubstantial in relation to the rental activity; or
- Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.[190]

Additionally, C corporations, S corporations, and partnerships subject to IRC § 469 (each a "469 Entity") must also group their activities under the foregoing rules.[191] Once a 469 Entity groups its activities, a shareholder or partner may group those same activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 Entities.[192] A shareholder or partner may not, however, treat activities grouped by a 469 Entity as separate activities.[193] Under the foregoing rules, activities may be grouped at both the entity level and again at the taxpayer level.

The IRS addressed the grouping of QSubs for purposes of IRC § 469 in a Technical Advice Memorandum.[194] In the matter presented to the IRS, the taxpayer owned one hundred percent (100%) of the stock of an S corporation ("S1"), which in turn owned QSubs (including "Q1" and "Q2"). Q1 and Q2 operate out of the same location, and maintain separate books and records. Q1 is in the business of leasing trucks and trailers under standard leases with a term of two and one half (2 ½) to five (5) years. Upon termination of the leases, the leased property is returned to Q1. Q2 is in the business of selling trucks and trailers. In fact, it sells trucks and trailers to Q1 at the same pricing that it offers unrelated customers. For the tax years at issue, S1 grouped the activities of Q1 and Q2 for purposes of IRC § 469 and the taxpayer reported the activities in a manner consistent with S1's reported grouping.

The taxpayer argued that the activity of Q1 is a financing trade or business rather than a rental activity. In support of this position the taxpayer made many arguments, including asserting that the leases were "finance leases" under Generally Accepted Accounting Principles. Concluding the activity of Q1 was a rental activity, the Service stated that a rental activity may only be grouped with a non-rental activity if the requirements of Treasury Regulation § 1.469-4(d) are met.

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[190] Treas. Reg. § 1.469-4(d)(1).
[191] Treas. Reg. § 1.469-4(d)(5)(i).
[192] *Id.*
[193] *Id.*
[194] I.R.S. Tech. Adv. Mem. 200737018 (July 18, 2008).

In accordance with the Treasury Regulations,[195] a rental activity may only be grouped with a non-rental activity if the activities together constitute an appropriate economic unit and: the rental activity is insubstantial in relation to the non-rental activity; the other activity is insubstantial in relation to the rental activity; or each owner of the non-rental activity have the same proportionate ownership interest in the rental activity. Once an S corporation groups its activities, the shareholder(s) must group the activities in the same manner. Referencing the legislative history to IRC § 469, the Service stated that the determination as to what constitutes a separate activity is to be made in "a realistic sense."[196]

The Service issued Revenue Procedure 2010-13[197] which requires taxpayers to:

- File a written statement with their original income tax return in the first tax year in which the taxpayer groups two or more activities as a single activity for IRC § 469 purposes;

- File a written statement with their original income tax return in any taxable year in which the taxpayer adds a new activity to an existing grouping; and

- File a written statement with their original income tax return in any taxable year in which the taxpayer regroups their activities under Treasury Regulation Section 1.469-4(e)(2).

If a shareholder of multiple S corporations failed to group the activities of the S corporations pursuant to Revenue Procedure 2010-13, the use a QSub could be considered.

Example: A is the sole shareholder of two (2) S corporations, X and Y. X owns and operates a construction business located in Oregon. Y owns and operates a real estate sales business located in Oregon. X is currently generating losses and Y is generating substantial income. A failed to group the activities of X and Y under Revenue Procedure 2010-13. A's participation in the activities of Y alone does not constitute material participation. A materially participates in the activities of X.

Under the current predicament, A is subject to the net investment income tax under IRC § 1411 on his distributive share of the passive income generated from Y. Likewise, the losses generated by X (as such losses are not passive losses) may not be used to offset the income generated by Y.

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[195] Treas. Reg. § 1.469-4(d).
[196] S. Rep. No. 99-313 at 740 (1986).
[197] Rev. Proc. 2010-13, 2010-4 I.R.B. 329.

A could consider contributing the shares of Y to the capital of X, followed by X making an immediate QSub election. An argument may be made that the activities of X and Y are now in one corporate solution for income tax purposes so that X could possibly group the activities of X and Y under Revenue Procedure 2010-13. Assuming X could group the activities of X and Y, A could arguably group the activities at the shareholder level. The result would be that A could escape the application of IRC § 1411 and would be able to deduct the losses generated by X against the income generated by Y.

Practice Alert: The IRS would likely, however, contend that grouped activities do not constitute an appropriate economic unit, or that the principal purpose of a grouping was to circumvent IRC § 469's prohibition against the use of passive losses to offset non-passive income. In such event, the IRS would attack the grouping and attempt to separate or regroup the activities.

[2] Basic Statutory Requirements.

IRC § 1361(b)(3)(B) is the starting point for any discussion about QSubs. It defines a QSub as:

- A domestic corporation;[198]
- A corporation that is not an ineligible corporation (i.e., a corporation that is a bank that uses the reserve method of accounting under IRC § 585, an insurance company subject to tax under Subchapter L, a corporation electing the possessions tax credit under IRC § 936 or a DISC or former DISC);[199]
- One hundred percent (100%) of the stock is owned by an S corporation;[200] and
- The S corporation parent makes a separate election to treat the subsidiary as a QSub.[201]

The key requirements of a QSub are simple in concept. The entity must be a domestic corporation that is otherwise an eligible corporation. Its stock must be solely owned by an S

[198] I.R.C. § 1361b)(3)(B).
[199] I.R.C. §§ 1361(b)(3)(B) & 1361(b)(2).
[200] I.R.C. § 1361(b)(3)(B)(i). For purposes of satisfying the one hundred percent (100%) ownership requirement, stock of a corporation is treated as held by an S corporation if it is the owner of the stock for federal income tax purposes. Treas. Reg. § 1.1361-2(b)(1). The straight debt safe harbor contained in Treas. Reg. § 1.1361-1(l)(5)(iv) and (v) apply to the analysis. Treas. Reg. § 1.1361-2(d).
[201] I.R.C. § 1361(b)(3)(B)(ii).

corporation. The S corporation parent must prepare and file with the Service a separate election for its subsidiary to be treated as a QSub.

S corporations cannot have more than one (1) class of stock.[202] Interestingly, QSubs are not expressly prohibited from having greater than one (1) class of stock. So, as long as the parent owns one hundred percent (100%) of the QSubs stock, the QSub could theoretically have more than one (1) class of stock.

Practice Alert: Having a QSub with more than one (1) class of stock may be imprudent. For example, if business reasons dictate spinning off the QSub, making the parent - subsidiary corporate structure a brother-sister corporate structure, the result is that the old QSub is now an ineligible corporation because it has more than one (1) class of stock. Consequently, the former QSub is now a C corporation. This is likely an unwanted result.

[3] A Domestic Corporation Requirement.

To determine if a corporation is a domestic corporation, IRC § 1361 takes us to Treasury Regulation § 301.7701-5.[203] The regulations tell us that a domestic corporation is an entity classified as a corporation and which was created or organized in the United States or under the laws of the United States or any state therein.[204] An entity classified as a corporation existing under the laws of a foreign jurisdiction alone will not qualify, even though it owns property or does business in the United States. An entity classified as a corporation that is created or organized in both the United States and a foreign jurisdiction, however, will be treated as a domestic corporation.[205] The term "corporation" includes unincorporated entities which are otherwise treated as corporations under federal income tax laws.[206] Under Treasury Regulation § 301.7701, a domestic entity that "checked-the-box" to be classified as a corporation will be treated as a corporation for federal tax purposes.

[4] Cannot Be An Ineligible Corporation Requirement.

An ineligible corporation[207] is any corporation that is:

- A financial institution which uses the reserve method of accounting for bad debts as describe in IRC § 585;

[202] I.R.C. § 1361(b)(1)(D).
[203] Treas. Reg. § 1361-1(c).
[204] Treas. Reg. § 301.7701-5(a).
[205] Treas. Reg. § 301.7701-5; *see also*, I.R.S. Priv. Ltr. Rul. 9512001 (September 30, 1994).
[206] Treas. Reg. § 301.7701.
[207] I.R.C. § 1361(b)(2)(A), (B), (C) & (D).

- An insurance company subject to tax under Subchapter L of the Code;
- A corporation to which an election under IRC § 936 (the Puerto Rico and possessions tax credit); or
- A DISC or a former DISC.

[5] One Hundred Percent Requirement.

The one hundred percent (100%) requirement seems straightforward, but it is not always simple in application. The proper inquiry is whether the S corporation parent owns all of the stock of the subsidiary. To make this determination, we must look to the principles of federal tax law.[208]

[a] Disregarded Entities.

In the case where shares of a QSub are owned by a disregarded entity, the shares, for purposes of federal income tax, are owned by the owner of the disregarded entity.[209] The Treasury Regulations provide examples that illustrate the impact of disregarded entities on the one hundred percent (100%) requirement.[210]

Example 1: **Tiered QSubs.** X, an S corporation, owns all of the outstanding stock of Y, a QSub. In turn, Y owns all of the outstanding stock of Z, a corporation meeting the QSub eligibility requirements. X may elect to treat Z as a QSub as Y is ignored for federal income tax purposes.[211]

Example 2: **Single-Member LLC.** Same facts as Example 1, except that Y is a limited liability company that is disregarded for federal income tax purposes under Treasury Regulation § 301.7701-2(C)(2). X may elect to treat Z as a QSub.[212]

Example 3: **S Corporation and Two QSubs.** Same facts as Example 1, except that X and Y own fifty percent (50%) of Z. Because Y is disregarded, Z is owned solely by X for income tax purposes. Consequently, X may elect to treat Z as a QSub.[213]

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[208] Treas. Reg. § 1361-2(b)(1).
[209] Treas. Reg. § 301.7701-2(a).
[210] Treas. Reg. § 1.1361-2(d).
[211] *Id.*
[212] *Id.*
[213] *Id.*

[b] Nominal Ownership.

In general, a nominee with no beneficial ownership will be ignored for purposes of determining the owner of the shares of the QSub for federal income tax purposes. So, stock owned by an agent, nominee, or custodian is ignored. Instead, we look to whomever the stock is held for to determine the owner for purposes of federal income tax law.[214] Consequently, in the case of a corporation, if the stock of a subsidiary is held by a receiver of the parent corporation, the parent corporation would be the owner of the stock of the subsidiary for federal income tax purposes. Likewise, the beneficiary of a voting trust is the owner of the stock held by the trust for federal income tax purposes.[215]

[c] Stock That Is Ignored.

For purposes of the one hundred percent (100%) ownership requirement, any outstanding instruments, obligations or arrangements that constitute outstanding equity (i.e., stock) in the QSub must be owned by the S corporation parent. If instruments, obligations or arrangements are owned by any person or entity other than the S corporation parent and such constitute outstanding stock of the QSub, the QSub election will be deemed invalid or otherwise terminated.[216] Instruments, obligations and arrangements that are not considered stock of an S corporation for purposes of the single class of stock rule contained in IRC § 1361(b)(1)(D) are not considered to be outstanding for purposes of applying this rule.[217]

Example: **Stock subject to a substantial risk of forfeiture.** X owns all of the outstanding stock of Y. X wants to incentivize its CEO to remain with X. So, it bonuses the CEO ten percent (10%) of the stock of Y. Except for the stock of Y owned by the CEO, all of the requirements of IRC § 1361(b)(3) are met. Provided the stock bonus is subject to a substantial risk of forfeiture and the CEO has not made an election in accordance with IRC § 83(b) with respect to the stock, the stock is not outstanding. X may elect to treat Y as a QSub.[218] If the risk of forfeiture expires or the CEO makes an IRC § 83(b) election, however, the one hundred percent (100%) rule would be violated, preventing or terminating Y's QSub status.

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[214] Treas. Reg. § 1.1361-1(e)(1).
[215] I.R.C. § 1361(c)(2)(iv).
[216] Treas. Reg. § 1.1361-2(b)(2).
[217] Treas. Reg. § 1.1361-2(b)(1).
[218] Treas. Reg. § 1.1361-1(l)(3).

[d] Debt Versus Equity.

The Treasury Regulations provide that, for purposes of the one hundred percent (100%) ownership requirement, any arrangement that meets the straight debt safe harbor under IRC § 1361(c)(5) will not be considered outstanding stock.[219] So, if a QSub issues a debt instrument to a person or entity other than its parent that otherwise meets the straight debt safe harbor, it will not be considered outstanding stock. Consequently, its QSub election will not be endangered for violating the one hundred percent (100%) ownership requirement.

Pursuant to the straight debt safe harbor, debt is not treated as a second class of stock if four (4) requirements are met, namely:

- There is a written unconditional promise to pay on demand or on a specified date a sum certain in money;
- The interest rate and interest payment dates are not contingent upon profits, the borrower's discretion or like factors;
- The debt is not convertible into stock or other equity interest in the QSub; and
- The creditor is an individual, estate or trust which is otherwise an eligible S corporation shareholder, or a person actively and regularly engaged in the lending business.

If the safe harbor, however, is not met, the debt of a subsidiary, if it is held by any person other than the parent, would allow the Service to assert that it is equity, thus causing the one hundred percent (100%) requirement to be failed. In such instance, the parent would be prohibited from making a QSub election for the subsidiary.[220]

[e] Restricted Bank Director Stock.

In accordance with IRC § 1361(f), "restricted bank director stock" is <u>not</u> considered outstanding for purposes of Subchapter S.[221] Restricted bank director stock is defined as:

- Stock in a bank as defined in IRC § 581; or
- Stock in a depository institution holding company as defined in § 3(w)(1) of 12 USC 1813(w)(1),

[219] Treas. Reg. § 1.1361-2(c).
[220] Treas. Reg. 1.136-2(d) Example 5.
[221] I.R.C. § 1361(f)(1).

provided: (i) such stock is either required by federal or state law to be held by the holder in order for him or her to serve as a director of the bank or depository institution; **and** (ii) such stock is subject to an agreement with the bank or depository institution (or a corporation which controls such entity) whereby the holder must sell the stock back (at the same price as the acquisition price) upon ceasing to be a director.

1.03 THE QUALIFIED SUBCHAPTER S SUBSIDIARY ELECTION

As discussed above,[222] in order for a corporation to be treated as a QSub for federal income tax purposes, in addition to satisfying the requirements set forth in IRC § 1361(b)(3)(B)(i),[223] the parent corporation must prepare and file an election with the Service on IRS Form 8869.[224] Although the parent corporation may include more than one (1) QSub on an IRS Form 8869, an election must be made by the parent corporation for each subsidiary it desires to be treated as a QSub.

Practice Alert: Although it is beyond the scope of this article, state law relative to S corporations and QSubs cannot be ignored. For example, the states of New Hampshire, Tennessee, Texas, and Louisiana, and the District of Columbia do not recognize S corporations. In addition, the states of Arkansas,[225] New Jersey,[226] New York[227] and Pennsylvania[228] require a separate state law election for corporations desiring to be treated as S corporations. Relative to QSubs, the states of Arkansas,[229] New Jersey,[230] and New York[231] all require separate state law QSub elections. A careful review of state law relative to the recognition and treatment of S corporations and QSubs, and the election requirements for S corporations and QSubs is warranted well before a taxpayer subjects its business to taxation within a state.

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[222] *Supra* note 199.

[223] The requirements under I.R.C. § 1361(b)(3)(B) include: (i) the subsidiary is a domestic corporation; (ii) the subsidiary is not an ineligible corporation; (iii) one hundred percent (100%) of the subsidiary is owned by the S corporation parent; and (iv) an election is in effect for which the parent elects to treat the subsidiary as a QSub.

[224] I.R.C. § 1361(b)(3)(B)(ii).

[225] Form AR 1103.

[226] Form CBT-2553.

[227] Form CT-6.

[228] Form Rev-1640CT.

[229] *Supra* note 225.

[230] *Supra* note 226.

[231] Form CT-60-QSSS.

[1] Election Mechanics.

As stated above, the parent corporation is required to make the election on behalf of a subsidiary which it desires to be treated as a QSub. The requirements of IRC § 1361(b)(3)(B) must be satisfied at the time the election is effective and for all periods for which the election is to be effective thereafter.[232] The election form must be signed by a person authorized to sign the parent's IRS Form 1120S.[233] The IRS Form 8869 is filed:

- To the IRS Service Center where the parent corporation filed its most recent IRS Form 1120S in the case where the parent corporation formed the subsidiary and is making the QSub election to be effective upon formation;[234] or

- To the IRS Service Center where the subsidiary filed its most recent tax return in the case where the subsidiary was a pre-existing entity.[235]

As suggested by the IRS in the instructions that accompany Form 8869, the election should be filed by United States mail, certified or registered mail, return receipt, or by a one of the private delivery services approved by the government in IRS Notice 2004-83.[236] The instructions also state that the corporation will be notified of acceptance or non-acceptance of the election generally within sixty (60) days after Form 8869 was filed. If such notification is not received, taxpayers are advised to contact the Service by calling 1-800-829-4933.

[2] Election Timing.

A QSub election may be made by the parent corporation at any time during the taxable year.[237] A QSub election will be effective on the specific date set forth in the election form, provided such date is:

- No more than two (2) months and fifteen (15) days prior to the date of filing; and

- No more than twelve (12) months after the date of filing.[238]

If the specified effective date is more than two (2) months and fifteen (15) days prior to the date of filing, the election is effective two (2) months and fifteen (15) days prior to the date of

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[232] Treas. Reg. §1.1361-3(a)(1).
[233] Treas. Reg. §1.1361-3(a)(2).
[234] *Id.*
[235] *Id.*
[236] I.R.S. Notice 2004-83, 2004-2 CB 1030 (December 23, 2004). DHL, Federal Express and United Parcel Service Express.
[237] Treas. Reg. §1.1361-3(a)(3).
[238] Treas. Reg. §1.1361-3(a)(4).

filing.[239] Likewise, if the specified effective date is more than twelve (12) months after the date of filing, the election is effective twelve (12) months after the date of filing.[240] Last, if the election contains no specific effective date, the effective date is the date of filing.[241]

With retroactive and deferred QSub filing effective dates, additional rules come into play. For a retroactive effective date, the eligibility requirements must be met on the date of filing and all periods of time for which the election is to apply (i.e., from the effective date forward). For a deferred effective date, the eligibility requirements must be met on the effective date of filing and all future periods for which the election is to apply (i.e., from the effective date forward).

[3] Filing An Extension.

The Treasury Regulations accompanying Code § 1361(b)(3)(B) provide that the Service has authority to grant the parent corporation, upon request, an extension under Treasury Regulation §§ 301.9100-1 and 301.9100-3. A request, however, must be presented to the IRS in the form of a formal private letter ruling request. Consequently, the taxpayer will incur the costs of preparing the formal request and the corresponding user fee.[242] Currently, the user fee for obtaining relief under Treasury Regulation § 301.9100-3 is $9,800.[243]

The Service has granted several filing extensions under these regulations. As an example, on June 1, 2015, the Service issued Private Letter Ruling 201536015.[244] In this ruling, the Service explained that, under Treasury Regulation § 301.9100-3, an extension of not more than six (6) months (except in the case of a taxpayer who is abroad) will be granted when the taxpayer presents evidence that it acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government. In the case presented in the ruling, X, an S corporation, acquired the stock of Y, an S corporation. X failed to make a timely QSub election. Without any discussion, the Service granted X one hundred twenty (120) days to file the QSub election.

[4] Simplified Late Filing Relief.

Revenue Procedure 2013-30,[245] offers a simplified method of obtaining relief without the need to obtain a formal ruling. In accordance with the revenue procedure, a parent S corporation that

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239 *Id.*
240 *Id.*
241 *Id.*
242 *See* Rev. Proc. 2015-1, 2015-1 I.R.B. 1.
243 *Id.* at Appendix A.
244 I.R.S. Priv. Ltr. Rul. 201536015 (June 1, 2015).
245 *Supra* note 48.

failed to make a timely QSub election may qualify for automatic relief if the following requirements are met:

- The parent S corporation intended to treat the subsidiary as a QSub as of the intended effective date;

- Less than three (3) years and seventy five (75) days have passed since the intended effective date of the election;

- The only failure to qualify as a QSub as of the intended effective date is the late filing;

- The parent S corporation has reasonable cause for its failure to timely file the election and has acted with diligence to correct the error since discovery; and

- The QSub satisfies the requirements of Code § 1361(b)(3)(B), all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation on all affected income tax returns consistent with the QSub election being in place from the intended effective date forward.

While most of the requirements are objective in nature, the S corporation parent must demonstrate reasonable cause as to why a timely QSub election was not filed. This is a subjective inquiry.

Historically, the IRS has placed a fairly low threshold on the reasonable cause requirement. Examples of situations where the IRS has found reasonable cause include: the corporation's responsible person failed to file the election; the corporation's tax professional failed to file the election; and the corporation did not know it needed to affirmatively file an election. Consequently, it appears most reasonable explanations for a late filing will suffice.

To apply for relief under Revenue Procedure 2013-30, the parent S corporation is required to complete and file IRS Form 8869 with the Service Center where the election would have been filed if it had been filed on a timely basis. At the top of the form, it must state **"FILED PURSUANT TO REV. PROC. 2013-30."** The parent corporation must attach to the Form 8869, the following:

- A written statement of an officer of the parent corporation explaining that the subsidiary, during the period at issue, satisfies the requirements of Code § 1361(b)(3)(B), all assets, liabilities, and items of income, deduction, and credit of the QSub have been treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation on all affected income tax returns consistent with the QSub election being in place from the intended effective date forward; and

- A written statement explaining why reasonable cause exists for the late filing of the election and the due diligence the parent corporation has adopted to correct the error following discovery.

Depending upon the circumstances presented, the IRS Form 8869 may be filed by the S corporation parent with its IRS Form 1120S for the current tax year; filed with its late IRS Form 1120S for the taxable year in which the election was supposed to take effect; or filed standing alone.

Example 1: X, an S corporation, formed corporation Y at the beginning of Year One (1). X owns one hundred percent (100%) of Y. All of the QSub requirements under Code § 1361(b)(B)(3) were met at the beginning of Year One (1) and continued to be met thereafter. X forgot to make a QSub election. It filed its Year One (1) IRS Form 1120S consistent with having made a QSub election. On March 15 of Year Three (3), as it was about to file its IRS Form 1120S for Year Two (2), it discovered the error. Including with the IRS Form 1120S a fully completed IRS Form 8869 clearly marked at the top **"FILED PURSUANT TO REV. PROC. 2013-30"** with the required statements attached is appropriate.

Example 2: Same facts as Example 1 above, except the error was discovered when X was preparing its IRS Form 1120S for Year One (1), but the return was being filed with extension on September 15 of Year Two (2). Given the QSub election was to be effective on the first day of Year One (1), late filing relief is required. In this case, X can file the late IRS Form 8869 as described above with its IRS Form 1120S for Year One (1).

Example 3: Same facts as Example 1 above, except the error was discovered a month after X's IRS Form 1120S was filed with the Service. X can file the late IRS Form 8869 as described above (as a standalone document) with the IRS Service Center where it files its IRS Form 1120S.

If the requirements for simplified relief are not met, a formal ruling request will be necessary to obtain relief.

[5] Invalid QSub Election Relief.

A QSub election may be filed on a timely basis, but otherwise be invalid for numerous reasons, including:

- One hundred percent (100%) of the stock of the QSub was not owned by the S corporation parent;[246]

- The QSub was not a domestic corporation;[247] and

- The QSub was an ineligible corporation.[248]

As discussed above, in accordance with IRC § 1362(f)(1)(A), amended by the AJCA to apply to QSubs,[249] if a QSub election made by an S corporation parent was not effective for the intended tax year due to a failure to meet the requirements of IRC § 1361(b) or to obtain shareholder consent, relief may be obtained, provided the following requirements are satisfied:

- The S corporation parent, within a reasonable time after discovery of the inadvertent failure, takes steps to remedy the failure;

- The Service determines the error was inadvertent; and

- The S corporation parent agrees to make any adjustments the Secretary deems necessary and consistent with the treatment of the subsidiary as a QSub.

Unfortunately, relief under Code § 1362(f) requires that the S corporation parent obtain a private letter ruling from the Service. Relief under IRC § 1362(f) is routinely granted by the Service.[250] Unfortunately, like other ruling requests, the attorney costs, the filing fees and the consumption of time are required.

Example: X, an S corporation, formed Y. X caused Y to issue some shares to its CEO. Years later, X decided to elect to have Y treated as a QSub. As part of its preparation for the election, X thought Y had completed a redemption of all stock owned by the CEO, leaving it owning all of the stock of Y. After filing a QSub election for Y on March 15 of Year Five (5), to be effective on January 1 of Year Five (5), X learned that the redemption had not been completed (despite the parties' intent that it was completed). Relief under IRC § 1362(f) is likely available. To obtain it, a private letter ruling is required.

[246] *Supra* note 200.
[247] *Supra* note 198.
[248] *Supra* note 199.
[249] *Supra* note 25.
[250] *See* e.g., I.R.S. Priv. Ltr. Rul. 201340001 (October 18, 2013).

[6] The Result of Not Obtaining Late Filing Relief or Inadvertent Invalid Election Relief.

If an S corporation fails to prepare and file a QSub election for its wholly-owned subsidiary, or it cannot obtain relief from a late or invalid QSub filing, the subsidiary will be taxed under Subchapter C of the Code. As a result of the 1996 Act, an S corporation is allowed to own eighty percent (80%) or more of the shares of another corporation.[251] Consequently, the C corporation subsidiary will be separately taxed from its S corporation parent. The S corporation parent is prohibited from filing a consolidated return with its C corporation subsidiary.[252] Of course, if the C corporation subsidiary issues a dividend to its S corporation parent, it will be classified as a taxable dividend, thereby creating a double tax on the earnings of the subsidiary.[253] For these reasons alone, in most cases, it is important to ensure a QSub election is timely and property filed for an S corporation's wholly-owned subsidiary.

[7] Impact of a QSub Election.

The result of a QSub election are generally two-fold, namely:

- The QSub is not treated as separate and apart from its S corporation parent; and
- All assets and liabilities, and items of income, deduction and credit are treated as assets and liabilities, and items of income, deduction and credit of the S corporation parent.[254]

In other words, for most purposes, a QSub's existence is ignored for federal income tax purposes. Like most general rules, however, there are exceptions.

[a] Certain Income Tax Liabilities.

A QSub is treated as a separate corporation from is S corporation parent with respect to:

- Federal tax liabilities of the QSub for any tax period when it was not a QSub of the S corporation parent;[255]

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[251] *Supra* note 10.
[252] I.R.C. § 1504(b)(8).
[253] Another possible consequence of an S corporation owning all of the stock of a C corporation is the application of IRC § 362(e)(2). If built in loss property is contributed by the S corporation parent to the C corporation subsidiary, a basis adjustment in the loss property to fair market value may be required; alternatively, the S corporation may elect to reduce its stock basis in the subsidiary and the stock of the S corporation shareholders.
[254] Treas. Reg. § 1.1361-4(a)(1).
[255] Treas. Reg. § 1.1361-4(a)(6)(i)(A).

- Federal tax liabilities of another entity for which the QSub is otherwise liable; [256] and
- Federal tax refunds and credits.[257]

In these instances, the QSub is required to report and pay the tax liabilities separate and apart from its S corporation parent.

[b] Employment Taxes.

A QSub is treated as a separate corporation from its S corporation parent with respect to employment taxes contained in Chapters 21, 22, 23, 23A, 24 and 25 of Subtitle C of the Code.[258] Consequently, a QSub is separately responsible for reporting, withholding and paying employment taxes on the wages of its employees, and complying with the other employment tax related obligations, including making employment tax deposits, filing employment tax returns, issuing IRS Forms W-2 to its employees, and back up withholding.

[c] Certain Excise Taxes.

A QSub is treated as a separate corporation from its S corporation parent with respect to certain excise taxes imposed under the Code. Specifically, these taxes include:

- Taxes imposed by Chapters 31 (retail), 32 (manufacturers), 33 (facilities and services), 34 foreign insurers), 35(wagering), 36 (harbor maintenance), 38 (environmental) and 49 (indoor tanning) (other than §§ 4181 and 4461 of the Code and any floor stock taxes related thereto) or claims for credit, refund and payment relating to these taxes or under Code §§ 6426 or 6427;[259]
- Collection of tax imposed by Chapters 33 and 49 of the Code;[260]
- Registration under Code §§ 4101, 4222 and 4412 of the Code;[261] and
- Assessment and collection of amounts under § 4980H of the Code and any reporting required under § 6056 of the Code.[262]

Consequently, a QSub is required to separately report and pay these excise taxes.

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[256] Treas. Reg. § 1.1361-4(a)(6)(i)(B).
[257] Treas. Reg. § 1.1361-4(a)(1)(i)(C).
[258] Treas. Reg. § 1.1361-4(a)(7).
[259] Treas. Reg. § 1.1361-4(a)(8)(A) and (D).
[260] Treas. Reg. § 1.1361-4(a)(8)(B).
[261] Treas. Reg. § 1.1361-4(a)(8)(C).
[262] Treas. Reg. § 1.1361-4(a)(8)(E).

[d] Employer Identification Number.

In accordance with Treasury Regulation § 301.6109-1, a QSub will have and use its own employer identification number in two (2) situations:

- When a QSub election is made for an existing corporation that has its own employer identification number;[263] and
- When a QSub election of the entity described above is terminated.[264]

In all instances, following termination of a QSub election, the subsidiary uses its own employer identification number rather than its S corporation parent's employer identification number. If it did not have its own employer identification number prior to the termination of the QSub election, it will be required to apply for and obtain its own identification number.

Unless otherwise provided in the Treasury Regulations or other published guidance, and except as described above, a QSub must use the employer identification number of its S corporation parent for all federal tax purposes.[265]

1.04 THE TAX IMPLICATIONS OF THE QSUB ELECTION

[1] General Rules.

In general, when a parent S corporation elects to treat its wholly-owned subsidiary as a QSub, a liquidation of the subsidiary into the S corporation parent is deemed to occur for income tax purposes under Code § 332.[266] Except as provided in the applicable Treasury Regulations, assuming the requirements of Code §§ 332 and 337 are satisfied, the deemed liquidation should be tax-free. Consequently, the basis of the assets should carryover from the QSub to the parent S corporate under Code § 334(b).

Even if the election and the deemed liquidation qualifies for tax-free treatment, other traps for the unwary may exist. These traps may bring unintended tax consequences.

[a] Passive Activity.

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[263] Treas. Reg. § 301-6109-1(i)(1) and (3).
[264] *Id.*
[265] Treas. Reg. § 301-6109-1(i)(2).
[266] H.R. Rep. No. 104-188, at 89 (1996).

One of these traps arises when the subsidiary pre-existed the QSub election and has C corporation retained earnings.

Practice Alert: If the subsidiary was previously a C corporation with earnings and profits from its C corporation years, those earnings and profits could cause the application of the passive investment tax under Code § 1375 to apply to the parent S corporation. Even worse, it could cause a revocation of the parent's S election under Code § 1362(d)(3). If the parent's S election is terminated, under Code § 1361(b)(3)(B)(i), the subsidiary can no longer be a QSub as the parent is not an S corporation.

[b] Built-In Gains Tax.

Another trap also arises when the subsidiary pre-existed the QSub election and has appreciated assets from its C corporation tax years (or appreciated assets it obtained from a C corporation in a tax-free or tax-deferred carryover-basis transaction) or has cash basis accounts receivable attributable to its C corporation years.

Practice Alert: If the subsidiary was previously a C corporation with appreciated assets, obtained appreciated assets from a C corporation (or an S corporation subject to the built-in gains tax under Code § 1374) in a tax-free or tax-deferred transaction, and the assets are disposed of within the recognition period as defined in Code § 1374(d)(7), the S corporation parent is exposed to the taxed imposed under Code § 1374. This is a tax that the S corporation parent may have otherwise been immune from had it not made the QSub election.

[c] LIFO Recapture.

A trap arises when the subsidiary pre-existed the QSub election, was a C corporation immediately preceding the election and maintained its inventory under the LIFO method of accounting.

Practice Alert: If the subsidiary was a C corporation immediately prior to the QSub election and maintained its inventory using the LIFO method of accounting for its last taxable year prior to the QSub election, the S corporation parent may be subject to a LIFO recapture tax under Code § 1363(d).

If the deemed liquidation of the QSub up into the S corporation parent is tax free and the carry-over basis rules apply, the story is fairly mundane. Taxpayers, have tried, however, to add drama to the story.

In *Ball v. Commissioner*,[267] the taxpayers owned shares of an S corporation. The corporation owned one hundred percent (100%) of the shares of a subsidiary for which it caused a QSub election to be timely made.

The taxpayers took the position on their individual income tax returns that the basis in their shares was increased by the amount of built-in gain on the shares of the QSub that went unrecognized pursuant to IRC § 332 as a result of the QSub election. This basis increase allowed the taxpayers to claim a loss passed through from the S corporation parent.

The Service denied the loss on the grounds the taxpayers had inadequate basis in the S corporation. The taxpayers timely filed a petition in the U.S. Tax Court.

The taxpayers, asserting an argument which did not work in *Nathel v. Commissioner*[268] and only temporarily worked in *Gitlitz v. Commissioner*,[269] argued that the unrecognized gain on the upstream liquidation into the S corporation parent was akin to tax-exempt income which results in a basis increase under the IRC § 1367(a)(1)(A).

The argument sounded like magic. Unfortunately for the taxpayers, Judge Kerrigan was not too impressed with the razzle dazzle of the argument and was quick to dismiss it. The Tax Court held that unrecognized gain resulting from a QSub election does not create an item of income, nor does it create tax-exempt income under IRC §1367(a)(1)(A). The non-recognition rules do not exempt income from taxation; they merely defer recognition through the substituted basis rules.

The Service's position was upheld. The taxpayers lost the battle. The carry-over basis rules apply in a tax-free liquidation of the QSub up into its S corporation parent.

The taxpayers in *Ball* were not the first taxpayers to put forth this magical basis increase argument. Chief Counsel of the IRS was presented with a similar argument.[270]

In the facts presented in a Chief Counsel Advice,[271] the shareholders of an S corporation contributed all their appreciated stock of a C corporation to their S corporation. They then caused the S corporation to make a QSub election for the C corporation which was now wholly-owned by the S corporation parent.

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[267] T.C.M. 2013-39 (February 6, 2013).
[268] 105 AFTR2d 2010-2699 (2nd Cir 2010), *aff'g* 131 TC 262 (2008), *cert. denied*, 131 S Ct 2151 (2011).
[269] 531 US 206 (2001).
[270] *Id.*
[271] I.R.S. Chief Counsel Advice 201114017 (2011).

One day after the QSub election was made, the S corporation and the shareholders signed a letter of intent to sell the S corporation's stock. They proceeded and consummated the sale of stock.

Relying on *Gitlitz,*[272] the shareholders took the position that the QSub election increased their basis in the S corporation under Code § 1367(a)(1)(A) by the amount of the S corporation's built-in gain in the stock as a result of the QSub's deemed liquidation under Code § 332. The shareholders argued Code §§ 61(a)(3) and 331(a) applied to the QSub's deemed liquidation to produce an "item of income" within the meaning of Code § 1366(a)(1)(A), and that the income (i.e. gain) was tax-exempt by application of Code § 332. By taking this position, the shareholders were able to recognize a loss instead of a gain on the sale of their S corporation's stock. It would be a wonderful result if it works.

The Chief Counsel's office disagreed with the shareholders' position. It reasoned that Code § 332 generally results in no gain or loss recognition by a parent corporation on property distributed in complete liquidation of a wholly-owned subsidiary. When a parent corporation liquidates its subsidiary, the parent essentially switches from owning the subsidiary's stock to owning the subsidiary's assets. This mere change in form produces no accession to wealth—it does not produce an "item of income." Instead, Code § 332 generates *unrecognized* gain which is later triggered when the assets are disposed of by the parent outside the affiliated group.

The Chief Counsel's office noted the shareholders' position would allow an S corporation to create phantom basis by forming a subsidiary and later liquidating it or making a QSub election. Consequently, a QSub election and the resulting deemed Code § 332 liquidation do not give rise to an item of income under Code § 1366(a)(1)(A), and, therefore, do not increase the electing S corporation shareholders' stock bases under Code § 1367(a)(1)(A).

After *Ball* and CCA 201114017, the law seems quite clear. A QSub election, and the consequential liquidation up into the S corporation parent, in and of itself, do not create a step up in the basis of the QSub shares. Again, the carry-over basis rules apply in a tax-free liquidation of the QSub up into its S corporation parent.

The Treasury Regulations provide that the tax consequences of the deemed liquidation that arises from a QSub election are to be determined under general tax principles.[273] These principles specifically include the step transaction doctrine.[274] Consequently, if an S corporation forms a wholly-owned subsidiary and thereafter makes a valid QSub election for its subsidiary, effective from the date the subsidiary was formed, the transfer of assets to the subsidiary and the deemed liquidation are ignored, and the subsidiary is deemed a QSub form inception.[275] The Treasury

[272] *Supra* note 30.
[273] Treas. Reg. § 1.1361-4(a)(2)(i).
[274] *Id.*
[275] *Id.*

Regulations specifically provide that, unless a plan of liquidation is adopted on an earlier date, the making of the QSub election is the adoption of a plan of liquidation for purposes of Code § 332.[276]

Example: X, a C corporation acquires all of the stock of Y, a C corporation, from an unrelated individual for cash and a note. As part of a plan, X immediately makes a valid S corporation election and a QSub election for Y. Since X acquired all of the stock of Y in a qualified purchase under Code § 338(d)(3), the deemed liquidation resulting from the QSub election is respected as an independent step separate from the stock acquisition and the liquidation under Code §§ 337 and 332.[277]

Example: X, pursuant to a plan, acquires all of the stock of Y from Y's shareholders (unrelated to X) in exchange for ten percent (10%) of X's voting stock. Pursuant to the plan, X makes an S corporation election and a QSub election for Y. The transaction constitutes a reorganization under Code § 368(a)(1)(C) provided the other requirements for a C reorganization (e.g. continuity of business enterprise) are met.[278]

Example: An individual, A, pursuant to a plan, contributes all of the stock of Y to his wholly-owned S corporation, X, and immediately causes X to make a QSub election for Y. The transaction constitutes a Code § 368(a)(1)(D) reorganization provided the other requirements for a D reorganization (e.g. continuity of business enterprise) are met. If the liabilities of Y treated as assumed by X exceed the adjusted basis of the assets of Y, Code § 357(c) would apply, causing the excess liabilities to be gain from the sale or exchange of property (capital gain or ordinary income).[279]

[d] Disappearing Basis.

A tax trap that exists for the unwary resulting from a QSub election is what has been termed by commentators as the "disappearing basis" phenomena. A QSub election causes a deemed liquidation of the subsidiary up into the S corporation parent. As a consequence, any stock in the subsidiary, for income tax purposes, held by the S corporation parent is treated as if it was

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[276] Treas. Reg. § 1.1361-4(a)(2)(iii).
[277] Treas. Reg. § 1.1361-4(a)(2)(ii) Example 1.
[278] Treas. Reg. § 1.1361-4(a)(2)(ii) Example 2.
[279] Treas. Reg. § 1.1361-4(a)(2)(ii) Example 3.

surrendered and cancelled in the liquidation. Hence, the S corporation's basis in its subsidiary's stock disappears.

Example 1: X, an S corporation, acquires from an unrelated seller, Z, all of the stock of Y, an S corporation. X paid Z $1,000,000 for the stock. X makes a QSub election for Y, effective on the date of acquisition. No election under Code § 338 is made in the acquisition. Y's basis in its assets is $500,000. If X decides to sell the stock of Y a few years following the acquisition, it has no basis in its stock of Y. So, if X sells the Y stock for $1,200,000, it will recognize gain on the sale equal to $700,000 ($1,200,000 - $500,000).

Example 2: Same facts as Example 1, except that X does not make a QSub election. In this scenario, there would have been no deemed liquidation. Consequently, on the sale, X would have gain on the sale equal to $200,000 ($1,200,000 - $1,000,000).

Example 3: Same facts as Example 1, except that X joined Z in making an election under Code § 338(h)(10) to treat its original acquisition as an asset acquisition. The result is the same as in Example 2 as the effect of the Code § 338(h)(10) election is to give the target a fair market basis in its assets. The problem with the election is that there is an income tax cost to get the basis step up which either X paid in a negotiated increased purchase price to cover the tax cost (which is likely the case) or Z ate all or part of the tax cost in order to consummate the sale.

[2] Tiered Situations.

When QSub elections are effective on the same date for a tiered group of corporations, the S corporation parent may specify the order of the deemed liquidations resulting from the QSub elections. If no order is specified, however, the liquidations are deemed to occur first for the lowest tier entity and then successively upward until all of the liquidations have occurred.[280] The deemed liquidations are made on the same date.[281]

Example: X, an S corporation, owns one hundred percent (100%) of Y. Y owns one hundred percent (100%) of A, and A owns one hundred percent (100%) of the stock of B, and B owns one hundred percent (100%) of the stock of C. X makes a valid QSub election for each Y, A, B and C.

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[280] Treas. Reg. § 1.1361-4(b)(2).
[281] *Id.*

> If no order is specified for the elections, the result is: C is treated as liquidating into B; then, B is treated as liquidating into A; then, A is treated as liquidating into Y; and last, Y is treated as liquidating into X. The series of liquidations are deemed to have occurred on the same day.[282]

Whether to allow the default rule (upward liquidations from lowest tier up) to occur should be carefully considered. There may be a non-tax business reason that dictates the order of the liquidations.

For example, in a Private Letter Ruling issued by the Service in 2010,[283] a valid business reason for avoiding the default ordering rule existed. In the scenario presented to the Service, X, an S corporation, had two (2) wholly-owned QSubs, namely Y and Z.

X and Y wished to combine their assets and operations into one corporation to take advantage of planned efficiencies and to reduce expenses and operational redundancies. Certain legal agreements under which Y was bound prohibited Y from merging upstream into X. The agreements did not, however, prohibit X from merging downstream into Y.

Consequently, X proposed to merge downstream into Y, with Y surviving the merger. The outstanding shares of X would be exchanged solely for common stock of Y, such that after the merger, the existing shareholders of X would have an identical ownership interest in Y. Y would end up owning one hundred percent (100%) of Z.

The Service ruled the downstream merger of X into Y constituted a valid "F" reorganization. Example 8 to Treasury Regulation § 1.1361-5(b)(3) provides that where an S corporation, that owns one hundred percent (100%) of a QSub, merges into said QSub under state law, causing the QSub election to terminate, and the QSub survives the merger, the formation of the new corporation (the merger of the S corporation into the QSub) can qualify as a "F" reorganization if the transaction otherwise satisfies the requirements of that section.

The Service also ruled the "F" reorganization did not adversely affect X's status as an S corporation. Accordingly, X's S corporation election continued with respect to Y after the merger.[284] Moreover, Z's status as a QSub did not terminate as a result of the reorganization pursuant to Revenue Ruling 2004-85 (an election to treat a wholly-owned subsidiary of an S

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[282] *Id.*
[283] I.R.S. Priv. Ltr. Rul. 201007043 (February 19, 2010).
[284] *See* Rev. Rul. 64-250, 1964-2 C.B. 333.

corporation as a QSub does not terminate solely because the S corporation engaged is a transaction that qualifies as an “F” reorganization).[285]

A tax purpose may exist, however, that dictates the order of the liquidations. One possible reason for desiring a top-down series of liquidations would be to ensure qualifying for tax-free treatment under Code § 332.

Example: X, a C corporation, owns one hundred percent (100%) of Y and Z. Y and Z each own fifty percent (50%) of W. X wants to make an S election for itself and make QSub elections for each Y, Z and W. If the liquidation occurred under the default rule (bottom-up liquidations), tax-free treatment under Code § 332 would not be attained. In accordance with Code §§ 332(d) and 1504(a), Y and Z would have to own eighty percent (80%) or more of the stock of W for the liquidation to be tax free. In the bottom-up format, Y and Z cause the transaction to fail this requirement. In a top-down liquidation approach, this result changes. Once the upper tier subsidiaries, Y and Z, are liquidated into X, followed by W liquidating into X, the problem disappears.

A tiered group of corporations that file consolidated income tax returns may encounter adverse tax consequences from making QSub elections. Depending upon the ordering of the liquidations, the excess loss account rules under Code § 1509 and the corresponding Treasury Regulations may trigger unwanted taxable gain.

Many domestic corporations having eighty percent (80%) or more common ownership through a common parent corporation can qualify to file consolidated income tax returns. The major advantages of consolidated filings are twofold. The consolidated group has the ability to offset a member's income against another member's loss. Also, there is generally non-recognition treatment for most transactions between members of the consolidated group.

There are, however, significant disadvantages to filing on a consolidated basis. For one, the consolidated return rules are extremely complex. In addition, significant tax traps exist for the unwary.

One of those traps arises from the excess loss account. In its basic essence, the excess loss account is the score card that keeps record of the consolidated parent corporation's investment in its subsidiaries. This account may become negative in numerous situations. For example, if a

[285] *See* Rev. Rul. 2004-85, 2004--2 C.B. 189.

subsidiary loses more money than the parent's equity investment (e.g., by borrowing money and losing it) and the consolidated group derives a tax benefit from the loss, the parent's investment can dip below zero. So, if the parent later disposes of the subsidiary's stock, even for no consideration, the parent will recognize gain. In fact, that is exactly the way it works: if the subsidiary becomes worthless, which is essentially a disposition for zero consideration, the excess loss account, to the extent it is negative, causes the parent to recognize gain.

The default ordering rule for the deemed liquidations in a tier-entity scenario should be favorable to the parent S corporation. In accordance with Treasury Regulations § 1.1361-4(b)(1), the deemed liquidations occur on the day before the QSub elections are effective. Consequently, where the parent makes an S election for itself and QSub elections for the lower-tier corporations, the resulting deemed liquidations occur prior to the termination of the consolidated group. Thus, in accordance with Code § 1502 and Treasury Regulation § 1.1502-19(b)(2)(i), gain from the excess loss account should not be triggered. Caution is advised.

The consolidated group rules are numerous and complex. The excess loss account is just one (1) of many tax traps that exist for the unwary when considering making S and QSub elections. Careful review and analysis of each situation is necessary, especially in the case of tiered entities.

[3] Acquisitions.

Several rules come into play when dealing with acquisitions and QSubs. For one, if the S corporation parent does not own one hundred percent (100%) of the subsidiary on the day before the QSub election is effective, the deemed liquidation will occur immediately after the time the S corporation parent owns one hundred percent (100%) of the QSub's stock.[286]

Except in the case where there is an election under Code § 338, if an S corporation acquires the stock of another S corporation, and a QSub election is made, effective on the day the target S corporation is acquired, the target S corporation is deemed to liquidate up into the acquiring S corporation at the beginning of the day that the termination of the target corporation's S election is effective.[287] If a C corporation acquires the stock of an S corporation, and makes an S election for itself and a QSub election for the target corporation effective on the day of the acquisition, the target corporation is deemed to have liquidated up into the acquiring corporation at the beginning of the day in which the acquiring corporation's S election is effective.

Example 1: X, an S corporation, acquires one hundred percent (100%) of the stock of Y, an S corporation. X makes a QSub election for Y effective on

[286] Treas. Reg. § 1.1361-4(b)(3)(i).
[287] Treas. Reg. § 1.1361-4(b)(3)(ii).

the date of acquisition. Y is deemed to liquidate up into X at the beginning of the day when the termination of its S election is effective. Consequently, there is no period of time between the termination of Y's S election and the deemed liquidation of Y during which Y was a C corporation.

Example 2: X, a C corporation, acquires one hundred percent (100%) of the stock of Y, an S corporation. X makes an S election for itself and a QSub election for Y effective on the date of acquisition. Y is deemed to liquidate up into X at the beginning of the day when X's S election is effective. Consequently, there is no period of time between the termination of Y's S election and the deemed liquidation of Y during which Y was a C corporation.

[a] Code § 338 Elections.

The Treasury Regulations specifically consider the impact of an election under Code § 338 in an acquisition where it is contemplated that a QSub election will be made for the acquired corporation.[288] In an acquisition of the stock of a target corporation, provided the requirements of Code § 338 are satisfied, and the requirements of Code § 1361(b)(3)(B) are also satisfied:

- The acquiring corporation may make an election under Code § 338 to treat the acquisition as an asset purchase; and

- The acquiring corporation may make a QSub election with respect to the target corporation.

In the event the election under Code § 338 is made to treat the stock acquisition as an asset acquisition, a QSub election made with respect to the target corporation will not be treated as effective prior to the day after the acquisition is made (within the meaning set forth in Code § 338(h)(2)).[289]

If the QSub election is effective on the day after the acquisition date, the deemed liquidation up into the S corporation parent (the acquiring corporation) occurs immediately after the deemed asset purchase by the new target corporation under Code § 338.[290]

[288] Treas. Reg. § 1.1361-4(b)(4).
[289] *Id.*
[290] *Id.*

If an S corporation makes an election under Code § 338 (without a Code § 338(h)(10) election) with respect to its target, the target must file a final income tax return as a C corporation reflecting the deemed sale.[291]

If the target corporation was an S corporation on the day before the acquisition date, the final income tax return as a C corporation must reflect the activities of the target for the acquisition date, including the deemed sale.[292]

If an S corporation acquires all of the stock of another S corporation, the acquiring corporation may elect under Code § 338, may join in an election under Code § 338(h)(10), and may elect to have the target corporation treated as a QSub.

Example: X, an S corporation, buys one hundred percent (100%) of the stock of Y, an existing S corporation on day one (1). X joins the former shareholder of Y in making an election under Code § 338(h)(10). X elects to treat Y as a QSub. In accordance with Code § 338, the transaction is treated for income tax purposes as if Y sold its assets to X at the close of the acquisition date (day one (1)), and Y became a new corporation that purchased the assets at the beginning of day two (2). Because of the QSub election, the new Y is deemed to have liquidated up into X immediately after the fictitious asset acquisition on day two (2).

[b] Carryover of Suspended Losses.

If an S corporation acquires the stock of another S corporation and makes a QSub election for the new subsidiary, effective on the date of acquisition, Treasury Regulation § 1.1366-2(c)1) governs the availability of existing suspended losses from the target corporation at the time of the acquisition.[293] In accordance with these regulations, when an S corporation is acquired by another S corporation which makes a QSub election for the target S corporation effective on the date of acquisition, provided the basis of the stock of the target is determined in whole or part by reference to the transferor's basis, any suspended losses under Code § 1366(d) with respect to the former shareholder of the target will be available to that shareholder as a shareholder of the acquirer. In other words, a loss or deduction of a shareholder of the target corporation disallowed prior to the acquisition will be available to the shareholder provided he or she is a shareholder of the acquirer after the transaction.

[291] *Id*.
[292] Id. *See also*, Treas. Reg. § 1.338-10(a)(3).
[293] Treas. Reg. § 1.1361-4(c).

Example 1: A owns one hundred percent (100%) of the shares of X and Y, both of which are S corporations. X is a very profitable automobile repair business. Y is an automobile dealership. A is actively involved in the operations of both X and Y. While Y has been historically extremely profitable, it started experiencing some financial setbacks in recent years, resulting from product quality issues. A has significant losses in Y that are suspended in accordance with Code § 1366(d) due to lack of basis in her Y stock. Y has no debt owing to A. A is confident that Y will become profitable again, but it will take a few more years. A contributes her stock of both Y and X to a newly formed corporation, Holdco. Holdco immediately makes an S election and makes QSub elections for X and Y. A's suspended losses from Y will be available to her to offset income flowing through to her from Holdco, provided she has adequate basis in her Holdco stock (which will be the combination of her basis in X and Y, plus any additional capital contributions or amounts she lends to Holdco).

Example 2: Same facts as above, except that A contributes her stock of Y to X and X immediately makes a QSub election for Y. The result should be the same. To the extent A has basis in her stock of X (which should be the combination of her basis in X and Y), she will be able to use the suspended losses that arose from pre-QSub operations of Y.

[c] Code § 355 Distributions.

A parent S corporation should be able to distribute the stock of its QSub to its shareholders in a transaction that qualifies for tax-free treatment under Code § 355 provided the rigorous requirements of Code § 355 and the corresponding Treasury Regulations are satisfied. In the context of Code § 355, a pivotal issue is whether a QSub will be treated as a separate corporation from its S corporation parent at the time of the distribution of its stock.

Neither the Code nor the provisions contained in the applicable Treasury Regulations directly address this issue. Interestingly, Treasury Regulation § 1.1361-5(b)(3) indicates that the QSub will indeed be treated as a separate corporation for purposes of a distribution of the stock of the QSub under Code § 355. The fact that the S corporation parent is distributing the stock of a QSub should not prevent Code § 355 from applying.

Example: X, an S corporation, owns one hundred percent (100%) of the stock of Y, a corporation for which a QSub election is in effect. X distributes all of the Y stock on a pro rata basis to its shareholders. The distribution, in and of itself, terminates Y's QSub election as X no longer owns one hundred percent (100%) of its stock as required under

Code § 1361(b)(3)(B)(i). The transaction can qualify as a distribution to which Code §§ 368(a)(1)(D) and 355 apply, provided the requirements of these sections are satisfied.[294]

[4] Sale or Transfer of QSub Stock.

As discussed above, in order to qualify as a QSub, one hundred percent (100%) of the subsidiary's stock must be owned by the S corporation parent.[295] If the S corporation parent disposes of any of the stock of the QSub, the QSub election will terminate because the wholly-owned requirement will be violated.[296] In accordance with Code § 1361(b)(3)(C), in this event, the result of which is a termination of the QSub election, it will be treated for income tax purposes as a deemed transfer of assets to the former QSub in a transaction which Code § 351 applies.

Practice Alert: If the basis of the assets is less than the liabilities, the termination may result in a taxable event under Code § 357. **Caution is advised**.

Example: A owns one hundred percent (100%) of X, an S corporation. X in turn owns one hundred percent (100%) of Y for which a valid QSub election is in place. For good business reasons, X caused Y to bonus twenty percent (20%) of the stock of Y to Y's CEO. The rationale for the bonus was to share the profits of Y with the CEO and to create golden handcuffs to keep the CEO working for Y. The stock is subject to a ten (10) year cliff vesting. Consequently, if the CEO leaves the employment of Y for any reason within then (10) years of the bonus, the stock will be forfeited. C considered adopting a phantom plan, but the CEO would not accept it; he wanted real stock of Y. After conferring with his tax advisors, the CEO made an election under Code § 83(b). As a consequence, despite the substantial risk of forfeiture, the stock owned by the CEO is outstanding. The QSub election is terminated upon the transfer of the Y stock to the CEO. Immediately before that point, a deemed transfer of assets and assumption of liabilities from X to a new Y occurred to which Code § 351 applies. In accordance with Code § 1361(b)(3)(C)(i) and Treasury Regulation § 1.1361-5(b), immediately before the termination caused by a transfer to the QSub's stock, a deemed transfer of its assets and liabilities from the S corporation parent to a

[294] Treas. Reg. § 1.1361-5(b)(3) Example 4.

[295] I.R.C. § 1361(b)(3)(b)(i).

[296] An exception to this consequence may occur if the stock of the QSub is transferred to a disregarded entity owned by the S corporation parent.

newly formed Y in exchange for the stock of the newly formed Y occurred to which the general principles of federal tax law apply, including Code § 351. For this purpose, instruments, obligations and other arrangements that are not considered as stock under Treasury Regulation § 1.1361-2(b) are ignored. If the adjusted basis of the assets (in X's hands) exceeds the liabilities deemed to be transferred to Y, the termination should be tax free.

1.05 REVOCATION AND TERMINATION OF QSUB ELECTIONS

A QSub election may be intentionally revoked by the S corporation parent. Also, it may be terminated, intentionally or unintentionally, for failing to continue to satisfy the requirements of Code § 1361(b)(3)(B).

[1] Revocation of a QSub Election.

A QSub election may be revoked by the S corporation parent.[297] The revocation procedure is fairly straightforward. The S corporation parent is required to prepare and file a statement with the IRS Service Center where its most recent IRS Form 1120S was properly filed.[298] The statement must be signed by a person authorized to sign the parent S corporation's return under Code § 6037.[299] It must contain the following:

- The name, address, and taxpayer identification number of the S corporation parent; and
- The name, address, and taxpayer identification number, if any, of the QSub.

While not required, the statement should clearly state the effective date of the intended revocation. If no effective date is stated, the effective date of the revocation will be the date of filing (e.g., the date it is hand delivered to the Service, placed in the United States mail or placed in the hands of one of the private delivery services approved in IRS Notice 2004-83).[300] If a revocation is mailed, it is always warranted to mail it by certified or registered mail, return receipt requested.

For obvious reasons, the statement should clearly indicate the intent to revoke the QSub election of the subsidiary corporation.

At least four (4) rules relative to revocation exist, namely:

[297] Treas. Reg. § 1.1361-3(b)(1).
[298] *Id.*
[299] *Id.*
[300] *Supra* note 15.

- If an effective date is specified in the statement, it cannot be more than twelve (12) months after the date of filing;[301]

- If an effective date is specified in the statement, it cannot be more than two (2) months and fifteen (15) days prior to the date of filing;[302]

- If the specified effective in the statement is more than twelve (12) months after the date of filing, the actual effective date will be twelve (12) months after the date of filing;[303] and

- If the specified effective in the statement is more than two (2) months and fifteen (15) days prior to the date of filing, the actual effective date will be two (2) months and fifteen (15) days after the date of filing.[304]

Practice Alert: A revocation cannot be made after the occurrence of a QSub disqualifying event (i.e., an event that causes the QSub to fail one or more of the requirements set forth in Code § 1361(b)(3)(B)).[305]

An extension of time in which to file a revocation statement for a QSub may be obtained in limited situations, namely when the necessary approval of the S corporation parent's shareholders is delayed because:

- One (1) or more of the shareholders is serving in the armed forces in a combat zone or in a contingency operation as defined under Code § 7508; or

- The S corporation parent or one (1) or more of the shareholders is affected by a presidentially declared disaster or a terrorist or military action as defined under Code § 7508A.[306]

Example 1: X, an S corporation, owns one hundred percent (100%) of the stock of Y, a corporation for which a QSub election is in effect. X revokes Y's QSub election by filing a revocation statement with the IRS Service Center where it files its IRS Form 1120S. The revocation statement contains no effective date. Consequently, the revocation will be effective on the date of filing.

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[301] Treas. Reg. § 1.1361-3(b)(2).
[302] *Id.*
[303] *Id.*
[304] *Id.*
[305] Treas. Reg. § 1.1361-3(b)(3).
[306] Rev. Proc. 2005-27, 2005-20 I.R.B. 1050.

Example 2: Same facts as Example 1, except the revocation statement specifies an effective date that is sixty (60) days prior to the date of filing. Consequently, the revocation will be effective on the date set forth in the statement.

Example 3: Same facts as Example 1, except the revocation statement specifies an effective date that is one hundred twenty (120) days prior to the date of filing. Consequently, the revocation will be effective on the date which is two (2) months and fifteen (15) days prior to the date of filing.

Example 4: Same facts as Example 1, except the revocation statement specifies an effective date that is one (1) year and four (4) months after the date of filing. Consequently, the revocation will be effective on the date which is one (1) year after the date of filing.

Example 5: Same facts as Example 1, except the revocation statement specifies an effective date that is eleven (11) months after the date of filing. Consequently, the revocation will be effective eleven (11) months after the date of filing.

Example 6: Same facts as Example 1, except that the revocation statement, which specifies an effective date that is January 1 of the current tax year, could not actually be filed until May 1 of that year because the person authorized to sign the S corporation parent's return under Code § 6037 was serving in the armed forces in a combat zone. In accordance with Revenue Procedure 2005-27,[307] X will be able to obtain an extension of time in which to file the revocation, retroactively effective back to January of the current tax year.

Practice Alert: What if you made a prospective revocation of a QSub election but change your mind prior to the effective date? Can you rescind a QSub revocation?

Code § 1361(b)(3) and the corresponding Treasury Regulations do not specifically address the rescission of a prospective QSub revocation, but by analogy to the regulations dealing with S corporation elections, a good argument exists that you can rescind a prospective revocation of a QSub election, provided the following facts exist:

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[307] *Id.*

- The effective date of the revocation has not yet occurred;

- A statement is filed with the IRS Service Center where the revocation was filed prior to the effective date of the revocation, clearly advising the Service that the S corporation parent is rescinding the prior filed QSub revocation and is doing so prior to its effective date; and

- The statement is signed by a person authorized to sign the parent S corporation's return under Code § 6037.[308]

[2] Termination of a QSub Election.

A QSub election will terminate in the event of any of the following occur:

- The S corporation parent's S election is revoked or otherwise terminated;[309]

- One hundred percent (100%) of the subsidiary is no longer owned by the S corporation parent;[310]

- The subsidiary is no longer a domestic corporation;[311] or

- The subsidiary becomes a corporation described in Code § 1361(b)(2) (a financial institution that uses the reserve method of accounting for bad debts, an insurance company taxed under Subchapter L of the Code, a corporation to which a Code § 936 is in effect, or a current or former DISC).[312]

In accordance with the applicable Treasury Regulations,[313] a termination is effective:

- If the termination is due to the S corporation parent's S election being terminated or revoked, the termination of the QSub election occurs on the last day of the S corporation parent's last year as an S corporation;[314]

- If the termination is due to the occurrence of an event that causes the QSub to fail any of the requirements set forth in Code § 1361(b)(3)(B) (discussed above), the termination of

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[308] Treas. Reg. § 1.1362-6(a)(4) addresses the procedures for rescinding an S election revocation prior to its effective date. Arguably, this regulation applies by analogy to the rescission of a QSub revocation prior to its effective date.
[309] I.R.C. § 1361(b)(3)(B)(i).
[310] *Id.*
[311] *Id.*
[312] *Id.*
[313] Treas. Reg. § 1.1361-5.
[314] Treas. Reg. § 1.1361-5(a)(1)(ii).

the QSub election occurs at the close of the day in which any of such requirements failed to be met;[315] or

- If the termination is due to the S corporation's parent becoming a member of a consolidated group of corporations (and no Code § 338(g) election is made), Treasury Regulation § 1.1502-76(b)(1)(ii)(A)(2) (special rules for S corporations that join a consolidated group) applies to the S corporation parent's QSub that also joins the group at the same time, [316] and the S corporation parent's S election terminates at the close of the day before it joined the consolidated group, and the QSub election is terminated effective that same date.[317]

In the event the termination of the QSub election is due to the failure to satisfy any of the requirements set forth in Code § 1361(b)(3)(B) (discussed above), the S corporation parent has the additional responsibility of attaching to its income tax return for the taxable year in which the termination of the QSub election occurred a statement that clearly indicates:

- The QSub election terminated;
- The date of the termination;
- The name, address and employer identification number of the S corporation parent; and
- The name, address and employer identification number of the subsidiary.

Practice Alert: A transfer of stock of a QSub by another QSub to the S corporation parent will not cause a termination of a QSub election.[318]

Example 1: X, an S corporation, owns one hundred percent (100%) of the stock of Y, a QSub. Y owns one hundred percent (100%) of the stock of Z, also a QSub. Y transfers all of its stock of Z to X. Because X is treated as owning the stock of Z both before and after the stock transfer, the transfer of the stock of Z to X does not terminate Z's QSub election. In addition, because the stock of Z is ignored for all other federal tax purposes, no gain will be recognized under Code § 311 as a result of the stock transfer.[319]

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[315] Treas. Reg. § 1.1361-5(a)(1)(iii).
[316] Treas. Reg. § 1.1361-5(a)(3).
[317] Treas. Reg. § 1.1361-5(a)(3) Example 4.
[318] Treas. Reg. § 1.1361-5(a)(3) Example 3.
[319] *Id.*

Example 2: X, an S corporation, owns one hundred percent (100%) of Y for which a QSub election is in effect. Effective January 1, 2016, X's S election is revoked. Consequently, Y's QSub election is terminated, effective December 31, 2015 (the last day of X was an S corporation).[320]

Example 3: X, an S corporation, owns one hundred percent (100%) of Y for which a QSub election is in effect. Effective January 15, 2016, X sold one (1) share of Y stock to A, an unrelated individual. Consequently, because X no longer owns one hundred percent (100%) of Y, Y's QSub election is terminated, effective at the close of January 15, 2016.[321]

Example 4: X, an S corporation, owns one hundred percent (100%) of Y for which a QSub election is in effect. Effective January 15, 2016, Z, the common parent of a consolidated group of corporations, acquires eighty percent (80%) of the stock of X. Z does not cause an election to be made under Code § 338(g) with respect to the X stock. X's S election terminates as of the close of the day before the transfer (January 14, 2016). Consequently, because X no longer is an S corporation, pursuant to the special rules that apply when stock is transferred to a consolidated group of corporations, Y's QSub election is terminated, effective at the close of January 14, 2016.[322]

Example 5: Same facts as Example 4, except Z acquires eighty percent (80%) of the stock of Y (rather than the stock of X). Consequently, Y's QSub election terminates effective as of the close of January 15, 2016.[323] This is the same result as in Example 3.

[3] Rejoining the Club After Termination or Revocation.

In accordance with Code § 1361(b)(3)(D), as a general rule, if a corporation's QSub status was terminated or revoked, it is not eligible to be treated as a QSub or make an S election for five (5) years. There are exceptions to this rule:

[320] Treas. Reg. § 1.1361-5(a)(3) Example 1.
[321] Treas. Reg. § 1.1361-5(a)(3) Example 2.
[322] Treas. Reg. § 1.1361-5(a)(3) Example 4.
[323] Treas. Reg. § 1.1361-5(a)(3) Example 5.

- If a QSub election was revoked before it was effective, the revocation will be ignored and the S corporation parent will not be required to wait five (5) years to make another QSub election on behalf of its subsidiary;[324]

- With the consent of the Secretary, provided the requesting corporation establishes that, under the facts and circumstances, the Service should allow a re-election before the five (5) years has expired. Assuming the same standards are applied by the Service as it applies to S corporation re-elections, the key is to show no tax abuse or tax avoidance motives exist. A formal ruling is required. In the S election arena, these rulings are commonly granted;[325] and

- If the QSub election terminated by reason of the disposition of the subsidiary's stock by the S corporation parent, it will not be required to wait five (5) years to make another QSub election on behalf of its subsidiary nor will the subsidiary have to wait the five (5) years to make an S election, provided that: (i) immediately following the disposition of the QSub's stock, the subsidiary or its successor is otherwise eligible to make an S election or have a QSub election made on its behalf; and (ii) the relevant election is made effective immediately following the stock transfer.[326]

Example 1: X, an S corporation, owns one hundred percent (100%) of Y. On December 1, 2015, S files a QSub election for Y, effective January 1, 2016. On December 15, 2015, X decides that it does not want Y to be treated as a QSub, so it revokes the election before it becomes effective. X does not have to wait five (5) years to re-elect QSub status for Y.

Example 2: X, an S corporation, owns one hundred percent (100%) of Y. X sells all of the stock of Y to Z, an unrelated S corporation. Z may immediately (effective the date of the stock acquisition) make a QSub election on behalf of Y without waiting five (5) years and without obtaining the Secretary's consent.[327]

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[324] Treas. Reg. § 1.1361-3(b)(4).

[325] *See e.g.* I.R.S. Priv. Ltr. Rul. 8842007, I.R.S. Priv. Ltr. Rul. 8844005, I.R.S. Priv. Ltr. Rul. 8831048, I.R.S. Priv. Ltr. Rul.8828050, and I.R.S. Priv. Ltr. Rul. 200004028.

[326] Treas. Reg. § 1.1361-5(c)(2).

[327] Treas. Reg. § 1.1361-5(c)(3) Example 2.

[4] Waiver of Inadvertent Terminations.

As part of the AJCA, in 2004, Congress amended Code § 1362(f) to specifically give the Service authority to waive inadvertent QSub terminations.[328] As is the case with respect to inadvertent S election terminations, a QSub will continue to be treated as a QSub during a period of inadvertent termination, if four (4) requirements are satisfied:

- The QSub election has been terminated because any of the requirements of Code § 1361(b)(3)(B) have not been met;
- The Service determines that the termination was inadvertent;
- The corporation promptly takes steps to correct the condition; and
- The QSub and the S corporation parent (and its shareholders) agree to treat the QSub election as having been continuously in effect.[329]

Continuation of a QSub election following an inadvertent termination is ultimately within the Secretary's sole discretion. To obtain a determination of inadvertent termination, however, a formal ruling request must be prepared and filed with the IRS.[330] The Service routinely issues rulings in this area.

1.06 BANKS

Amendments made by Congress in 1996 to Code § 1361 allows a parent corporation that owns all of the stock of a subsidiary that is a bank (as defined in Code § 581) to elect to be treated as an S corporation and further allows the parent corporation to elect to treat the bank as a QSub.[331] The Treasury Regulations that pertain to S corporations and QSubs that are banks are brief but complex.[332]

The regulations provide:

- If the S corporation parent and its QSub are banks, any rules applicable to banks under the Code will apply separately to the banks as if the deemed liquidation of the QSub as a result of the QSub election had not occurred (except as provided in other published guidance that applies Code §§ 265(b), 291(a)(3) and 291(e)(1)(B)); and

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[328] § 238 of the AJCA, Public Law 108-357.
[329] Treas. Reg. § 1.1362-4(a).
[330] Treas. Reg. § 1.1362-4(c).
[331] Public Law 104-188, §1315.
[332] Treas. Reg. §1.1361-4(a)(3).

- For any QSub that is a bank, all assets, liabilities, and items of income, deduction, and credit of the QSub, as determined with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation parent.[333]

Example: X, an S corporation owns one hundred percent (100%) of Y and Z. X and Y are banks as defined in Code § 581. Z is not a bank. X made valid QSub elections for both Y and Z. Any special rules that apply to banks under the Code continue to separately apply to X and Y after the effective date of the QSub elections. For example, Code § 265(b), which creates special interest expense deductions for banks, separately applies to X and Y; they do not apply to Z.[334] If only Y was a bank, however, the special banking rules would only apply to it.[335]

In *Vainisi v. Commissioner*,[336] the Seventh Circuit Court of Appeals was presented with the application of the merging of Subchapter S and the banking rules contained in Subchapter L. This case illustrates the complexity of Subchapter L being applied to Subchapter S corporations.

The Seventh Circuit Court of Appeals reversed a decision of the Tax Court when it held that a QSub bank is not subject to Code § 291 after three years. In this case, the Vainisis owned a holding company which, in turn, owned all the stock of First Forest Park National Bank and Trust Co (the "Bank")—a QSub. In 2003 and 2004, the Bank earned tax-free interest from "qualified tax-exempt obligations." The Vainisis deducted from their taxable income the entire interest expense the Bank had incurred in borrowing money with which to buy those obligations. The Tax Court held the Vainisis were entitled to deduct only 80% of that expense.

Interest that a financial institution pays on a loan it uses to purchase tax-exempt bonds or other tax-exempt obligations is generally not deductible from taxable income if the bond had been purchased by a financial institution after August 7, 1986, but is deductible if purchased on or before that date.[337] Interest allocable to "qualified tax-exempt obligations" meeting certain criteria is deductible, however, regardless of when the obligations were purchased (i.e., the bonds are treated as if they had been acquired on August 7, 1986).[338] This allows the taxpayer to deduct the interest on the money borrowed to purchase them—but not all the interest. Code §§ 291(a)(3) and (e)(1)(B) only allow a financial institution to deduct eighty percent (80%) of the interest (the 80% limitation).

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[333] *Id.*
[334] Treas. Reg. § 1.1361-4(a)(3)(ii) Example 1.
[335] Treas. Reg. § 1.1361-4(a)(3)(ii) Example 2.
[336] 105 AFTR 2d 2010-1402 (7th Cir. March 17, 2010).
[337] I.R.C. §§ 265(a), (b)(1), & (2).
[338] I.R.C. § 265(b)(3).

A review of the rules is necessary. Code § 1361 allows certain financial institutions to elect S corporation status, and further allows an S corporation to elect to treat its wholly-owned subsidiary as a QSub. Code § 1361(b)(3)(A) provides that a QSub is not treated as a separate corporation except as provided in the regulations. Treasury Regulation § 1.1361-4(a)(3) provides that 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 Code continue to apply separately to the bank parent or bank subsidiary. Meanwhile, Code § 1363(b)(4) states that "the income of an S corporation shall be computed in the same manner as in the case of an individual, except that Code § 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the three (3) immediately preceding taxable years."

The Tax Court held Code § 291(a)(3) applied to the QSub bank, and thus only allowed the Vainisis to deduct eighty percent (80%) of the interest. The court determined under Code § 1361(b)(3)(A) and Treasury Regulation § 1.1361-4(a)(3), the special bank rules apply separately to each QSub that is a bank and each QSub bank must first determine its income and deductions before its income and deductions can be treated as income and deductions of the S corporation parent. Therefore, Code § 291(a)(3) required the S corporation to reduce its interest expense deductions relating to the bank's qualified tax-exempt obligations.

The Seventh Circuit Court of Appeals subsequently reversed the Tax Court's decision. It held that under Code § 1364(b)(3), the eighty percent (80%) limitation and the rest of Code § 291 did not apply to the Vainisi's S corporation because it had not been a C corporation in one (1) of the immediately preceding three (3) years. The court found that the "except as provided in the regulations" language in Code § 1361(b)(3)(a) did not authorize the Service to apply Code § 291 to S corporations or QSubs that are banks. Instead, Code § 1361(b)(3)(a) and Treasury Regulation § 1.1361-4(a)(3) "merely require the special banking rules be applied to S corporation and QSub banks at the corporate level so that a bank's S corporation *status* will not emasculate the rules." Thus, pursuant to Code § 1364(b)(3), the only corporations to which Code § 291 applies to are those which were C corporations in one (1) of the three (3) immediately preceding years. The Court of Appeals also rejected a number of policy arguments made by the government.

1.07 CONCLUSION

The birth of the QSub in 1997, as a result of the 1996 Act,[339] has made the Subchapter S terrain more challenging. The amendments to Subchapter S and the corresponding Treasury Regulations to accommodate the QSub, as well as the cases and rulings, have added significant complexity to the world of S corporations. The abolishment of the affiliated group prohibition and the creation of the QSub have, however, helped redirect Subchapter S back toward President

[339] *Supra* note 10.

Eisenhower's original goal which he enunciated in 1954 – that legislation be passed that would minimize the influence that federal tax laws have on a small business's selection of a form of business entity. By eliminating the affiliated group prohibition and allowing Subchapter S corporations to have wholly-owned subsidiaries, Subchapter S is more flexible. With that flexibility comes much more complexity and tax traps that exist for the unwary. When working with QSubs a good understanding of the applicable provisions of the Code and Treasury Regulations, as well as the cases and rulings, is absolutely necessary.