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CaseStudy

C Corporations as S Corporation Subsidiaries

An S corporation can elect to treat a 100% owned subsidiary as a qualified subchapter S subsidiary (QSub) (Sec. 1361(b)(3)). A QSub election causes the subsidiary to be disregarded for most federal tax purposes. Accordingly, the QSub's items of income, deduction, and credit, as well as its assets and liabilities, are normally treated as those of its parent. As a prerequisite for the election, the subsidiary must be a corporation that would be eligible to be an S corporation if the shareholders of its parent S corporation held its stock directly.

Observation: Before the creation of the QSub alternative, an individual who owned multiple activities conducted as S corporations was required to hold them in a "brother-sister" format (the individual owner holds the stock of several S corporations). Under this arrangement, the individual owner had to ensure that there was adequate stock basis to receive a passthrough loss from any S corporation that may have a loss year. Conversely, in QSub format, all income and losses are combined at the S level, and the owner's tax basis in stock needs to be monitored for only one entity.

As a practical matter, the biggest benefit of establishing one or more QSubs is to limit the parent company's legal liability (i.e., to prevent problems in one business or location from affecting other businesses or locations).

> ***Example 1:*** *E*, Inc., is an S corporation that operates a vegetarian restaurant. The owners are interested in expanding but are worried about the liability of opening new restaurants. To prevent problems in one restaurant from spilling over into other restaurants, *E* forms three new corporations, each operating a new restaurant in a different location, and elects to treat them as QSubs. The assets and liabilities of each restaurant are treated as if they are owned by *E*. Only one S corporation return is filed, the three subsidiaries are disregarded for federal tax purposes, and each provides limited liability protection for *E* and its shareholder(s).

This case study has been adapted from *PPC's Tax Planning Guide—Closely Held Corporations*, 22d Edition, by Albert L. Grasso, Joan Wilson Gray, R. Barry Johnson, Lewis A. Siegel, Richard L. Burris, Mary C. Danylak, Timothy Fontenot, James A. Keller, Michael E. Mares, and Brian B. Martin, published by Thomson Tax & Accounting, Ft. Worth, TX, 2009 ((800) 323-8724; ppc.thomson.com).

Operating a Subsidiary as a C Corporation

S corporations are permitted to hold up to 100% of the stock of a corporation. Ownership of more than 50% of a corporation's stock gives the owner the right to control the subsidiary corporation. Ownership of 80% or more establishes an affiliated group relationship (Sec. 1504(a)(1)). However, the S corporation parent cannot be included as a member of the

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affiliated group for federal tax purposes (Sec. 1504(b)(8)). Thus, only the S corporation's subsidiary C corporations can be included in the group; the S corporation and its QSubs, if any, cannot be included.

Because S corporations cannot be included in an affiliated group, an S corporation cannot join in the filing of a consolidated return. However, a C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporations.

Dividends received by an S corporation from a C corporation are not eligible for the dividends-received deduction (Secs. 1363(b) and 243). Thus, dividends received by an S corporation are fully taxable passthrough items of income.

The Sec. 1374 built-in gains (BIG) tax applies only to S corporations (Sec. 1374(a)). Thus, it does not apply to assets held by a subsidiary C corporation. (BIG tax does apply when the parent S corporation elects QSub status for a C corporation or an S corporation that is subject to the BIG tax.)

In general, there are no carryforwards and no carrybacks between C and S tax years (Sec. 1371(b)). However, net operating losses, capital losses, business credits, and minimum tax credits carried over from C corporation tax years can be used to reduce the BIG tax (Sec. 1374(b)(2)). Therefore, it may be preferable to continue operating the subsidiary as a C corporation rather than making a QSub election when the subsidiary C corporation can use such carryovers.

Operating a Subsidiary as a QSub

A QSub is a subsidiary corporation that is 100% owned by an S corporation that has made a QSub election for that subsidiary (Sec. 1361(b)(3); Regs. Sec. 1.1361-2(a)). (An S corporation can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.) A QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes).

A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation (Sec. 1361(b)(3)). Therefore, transactions between the S corporation parent and the QSub are not taken into account, and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, and debt basis) are considered items of the parent. (See the committee report on Section 1308 of the Small Business Job Protection Act of 1996, P.L. 104-188, H.R. Conf. Rep't No. 104-737, 104th Cong., 2d Sess. 224 (1996).)

The biggest benefit of establishing a QSub is to limit the parent company's legal liability.

Example 2: *E*, Inc., is a calendar-year S corporation that plans to purchase 100% of the stock of *R* Corp., a C corporation. *R* Corp. can be operated as either a C corporation or a QSub. To operate the subsidiary as a QSub, it must be 100% owned by the parent S corporation, and the parent S corporation must make a QSub election. But making a QSub election for a subsidiary that was a C corporation can subject the S corporation to the BIG tax and the LIFO recapture tax (Secs. 1374 and 1375).

Changing Existing Subsidiary into a QSub

When a parent S corporation makes a QSub election for an existing corporation (whether or not its stock was acquired from another person or previously held by the S corporation), the subsidiary is generally deemed to have engaged in a tax-free liquidation under Secs. 332 and 337 immediately before the election is effective (Regs. Sec. 1.1361-4(a)(2)). Filing a QSub election is treated as the adoption of a plan of liquidation for purposes of Sec. 332. If the deemed liquidation does not qualify under Secs. 332 and 337 as a tax-free parent/subsidiary liquidation, the subsidiary must recognize gain on the transaction. Losses are generally not recognized due to the loss limitation on transactions between related parties imposed by Sec. 267.

Under Sec. 337, the subsidiary corporation recognizes no gain or loss on the deemed liquidating distribution of its property (Sec. 337(a)). Under Sec. 332, the parent S corporation recognizes no gain or loss on the deemed receipt of the subsidiary's property (Sec. 332(a)). The parent S corporation takes a transferred basis in the subsidiary's property (Sec. 334(b)).

Example 3: Assume the same facts as Example 2, except *R* Corp. is an S corporation. An S corporation can own stock in another corporation; however, a corporation (other than a Sec. 501(c)(3) charitable organization) is not an eligible S shareholder. Thus, *R*'s S election will terminate on the day before *E* acquires its shares. *E* can then operate *R* as a subsidiary C corporation or as a QSub.

The tax treatment of the deemed liquidation (or of a larger transaction that includes the deemed liquidation) must be determined under the general principles of federal tax law, including the step transaction doctrine (Regs. Sec. 1.1361-4(a)(2)). According to that doctrine, the steps of a corporate reorganization, if related, will be treated as one transaction. Thus, the tax consequences of the transaction (e.g., whether the transferors are in control of the transferee) will be determined after all the steps are completed rather than at each step of the transaction.

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EditorNotes

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