Section 1361.—S Corporation Defined

26 CFR 1.1361–5: Termination of QSub election. (Also §§ 368, 1361, 7701, 1.1361–3, 1.1361–4, 1.1361–5, 301.7701–3.)

Effect of mergers on qualified subchapter S subsidiary (QSub) elections. This ruling discusses the effect certain interest transfers have on QSub and entity classification elections.

Rev. Rul. 2004–85

ISSUES

(1) Does an election to treat a wholly owned subsidiary of an S corporation as a qualified subchapter S subsidiary (QSub), as described in § 1361(b)(3)(B) of the Internal Revenue Code, terminate solely because the S corporation engages in a transaction that qualifies as a reorganization under § 368(a)(1)(F)?

(2) Does an election to treat a subsidiary as a QSub terminate if the S corporation (whether by sale or reorganization under § 368(a)(1)(A), (C), or (D)) transfers 100 percent of the QSub stock to another S corporation in a transaction that does not qualify as a reorganization under §368(a)(1)(F)?

(3) Does an entity classification election of an eligible entity, as described in § 301.7701–3(b) of the Procedure and Administration Regulations, terminate solely because the owner transfers (whether by sale, reorganization under § 368(a)(1)(A), (C), (D), or (F), or otherwise) all of the membership interest in the eligible entity to another person?

FACTS

Situation 1. *X* is a State *A* S corporation that owns 100 percent of the stock of *Sub 1*, a corporation that *X* has elected to treat as a QSub. The shareholders of *X* form *U*, a *State B* corporation. *X* merges with and into *U* in a transaction qualifying as a reorganization under § 368(a)(1)(F). The shareholders of *X* own 100 percent of the stock of *U* and *U* is eligible to be an S corporation under § 1361(b)(1).

Situation 2. *Y* is an *S* corporation that owns 100 percent of the stock of *Sub 2*, a corporation that *Y* has elected to treat as a QSub. *Y* (whether by sale or reorganization under § 368(a)(1)(A), (C), or (D)) transfers *Y*'s assets, including 100 percent of *Sub 2* stock, to *M*, an S corporation, in a transaction that is not a reorganization under § 368(a)(1)(F).

Situation 3. *Z* is a corporation that owns 100 percent of the membership interests in *LLC1*, an eligible entity that elected to be classified for federal tax purposes as an association, contrary to its default classification. *Z* (whether by sale, reorganization under § 368(a)(1)(A), (C), (D), or (F), or otherwise) transfers all of the membership interests in *LLC1* to *N*, another person.

LAW AND ANALYSIS

Situations 1 and 2

Section 1361(a)(1) provides that the term "S corporation" means, with respect to a taxable year, a small business corporation (as defined in § 1361(b)(1)) for which an election under § 1362(a) is in effect for the year.

Section 1361(b)(3)(B) allows an S corporation to elect to treat any domestic corporation that is not an ineligible corporation (as defined in § 1361(b)(2)) as a QSub if 100 percent of the stock of the corporation is held by the S corporation. Section 1.1361–3(a) of the Income Tax Regulations provides the time and manner of making a QSub election.

Under § 1361(b)(3)(A), a corporation that is a QSub is not treated as a separate corporation. Instead, all assets, liabilities, and items of income, deduction and credit

of a QSub are treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1.1361–4(a)(2) provides that, if an S corporation makes a valid QSub election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Under § 1.1361–4(b), this liquidation is generally deemed to occur at the close of the day before the QSub election is effective.

Under § 1.1361–5(a)(1)(ii), if a QSub election terminates as a result of the termination of its parent's S corporation election, then the termination of the QSub election is effective at the close of the last day of the parent's last taxable year as an S corporation. Under § 1.1361–5(a)(1)(iii), if a QSub election terminates as the result of any other event, then the termination of a QSub election is effective at the close of the day on which the event causing the termination occurs.

Sections 1361(b)(3)(C) and 1.1361–5(b)(1) provide that if a QSub election terminates, the former QSub is treated as a new corporation that, immediately before the termination, acquires all of its assets (and assumes all of its liabilities) from the S corporation in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction is determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

Section 1.1361–5(b)(3), *Example 9*, describes the tax consequences of a transfer by an S corporation (*X*) of 100 percent of the stock of a QSub (*Y*) to a C corporation (*Z*). The example provides that the deemed formation of *Y* by *X* (as a consequence of the termination of *Y*'s QSub election) is disregarded for federal income tax purposes. The transaction is treated as a transfer of the assets of *Y* to *Z*, followed by *Z*'s transfer of those assets to the capital of *Y* in exchange for *Y* stock. If, instead, *Z* is an S corporation, and *Z* makes a QSub election for *Y* effective as of the date of *Z*'s acquisition of *Y*, then *Z*'s transfer of the assets of *Y* in exchange for *Y* stock, followed by the immediate liquidation of *Y* as a consequence of the QSub election are disregarded for federal income tax purposes.

Sections 1361(b)(3)(D) and 1.1361–5(c)(1) provide that, absent the consent of the Commissioner, a corporation whose QSub status terminates (and any successor corporation as defined in § 1.1362–5(b)) may not make an S election or have a QSub election made with respect to it before its fifth taxable year which begins after the first taxable year for which the termination was effective.

Section 1.1361–5(c)(2) provides that in the case of S and QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may make an S election or have a QSub election made with respect to it before the expiration of the five-year period described in § 1361(b)(3)(D) provided that (i) immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and (ii) the relevant election is made effective immediately following the termination of the QSub election.

Section 368(a)(1)(F) provides that the term "reorganization" means, among other things, a mere change in identity, form, or place of organization of one corporation, however effected.

Section 1.381(b)–1(a)(2) provides that, in the case of a reorganization qualifying under § 368(a)(1)(F) (whether or not such reorganization also qualifies under any other provision of § 368(a)(1)), the acquiring corporation shall be treated (for purposes of § 381) just as the transferor corporation would have been treated if there had been no reorganization.

Rev. Rul. 64–250, 1964–2 C.B. 333, concludes that when an S corporation merges into a newly formed corporation in a transaction qualifying as a reorganization under § 368(a)(1)(F), and the newly formed surviving corporation also meets the requirements of an S corporation, the reorganization does not terminate the S election. Thus, the S election remains in effect for the new corporation.

In *Situation 1*, *X* (an S corporation) merges into *U* (a corporation that meets the requirements to be a small business corporation under § 1361(b)(1)) in a transaction qualifying as a reorganization under § 368(a)(1)(F). Under Rev. Rul. 64–250, *U* will be treated as a continuation of *X*. *U*, therefore, will be an S corporation immediately after the merger. Because *U* is treated as a continuation of *X*, the reorganization does not terminate *X*'s election to treat *Sub 1* as a QSub.

In *Situation 2*, *Y* (an S corporation) transfers its assets, including 100 percent of the stock of *Sub 2* (a QSub), to *M* (an S corporation). Because the transaction does not qualify as a reorganization under § 368(a)(1)(F), *M* will not be treated just as *Y* would have been treated if there had been no reorganization. After the transaction, *Y* no longer owns *Sub 2*, and *Y*'s QSub election for *Sub 2* does not carry over to *M*. Therefore, the QSub election of *Sub 2* terminates at the close of the day on which *Y* transfers its assets, including 100 percent of the *Sub 2* stock to *M*, unless *M* makes a QSub election for *Sub 2*, effective immediately following the termination. See § 1.1361–5(a)(1)(iii) and 1.1361–5(c)(2).

If *M* makes a QSub election for *Sub 2*, effective immediately following the termination of *Sub 2*'s QSub election, then *M*'s deemed transfer of the assets of *Sub 2* in exchange for the stock of *Sub 2* and the immediate liquidation of *Sub 2* as a consequence of the QSub election are disregarded for federal income tax purposes. *See* §§ 1.1361–4(b)(3)(ii) and 1361–5(b)(3), *Example 9*. There will be no period between the termination of *Sub 2*'s QSub election and the deemed liquidation of *Sub 2* during which *Sub 2* is a C corporation.

If *M* does not make a QSub election for *Sub 2*, effective immediately following the termination, then the transaction will be treated as a transfer of the assets of *Sub 2* to *M*, followed by *M*'s contribution of *Sub 2*'s assets to *Sub 2* in exchange for *Sub 2* stock. *See* § 1.1361–5(b)(3), *Example 9*. *Sub 2* will not be eligible to be treated as a QSub or an S corporation before the expiration of the period described in § 1361(b)(3)(D).

Situation 3

Section 301.7701–3(a) of the Procedure and Administration Regulations provides that a business entity that is not classified as a corporation under § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes.

Section 301.7701–3(b) provides default classifications for eligible entities. Under § 301.7701–3(b)(1), unless a domestic eligible entity elects otherwise, it is disregarded as an entity separate from its owner if it has a single owner and is a partner-

ship if it has more than one owner. Under § 301.7701–3(b)(2)(i), unless a foreign eligible entity elects otherwise, it is: (A) a partnership if it has two or more owners and at least one owner does not have limited liability, (B) an association if all owners have limited liability, or (C) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

Section 301.7701–3(c)(1)(i) provides that an eligible entity may elect to be classified other than as provided under § 301.7701–3(b) by filing Form 8832, *Entity Classification Election,* with the applicable service center.

In *Situation 3*, *Z* transfers to *N* 100 percent of the membership interests in *LLC1*, an eligible entity that has elected to be classified as an association. Under § 301.7701–3(c)(1), *LLC1* elects its own classification. *LLC1*'s classification continues until *LLC1* elects otherwise or no longer remains eligible for that classification. Therefore, the sale or transfer of the *LLC1* membership interests to *N* does not affect *LLC1*'s election to be classified as an association.

HOLDINGS

(1) An election to treat a wholly owned subsidiary of an S corporation as a QSub, as described in § 1361(b)(3)(B), does not terminate solely because the S corporation engages in a transaction that qualifies as a reorganization under § 368(a)(1)(F).

(2) An election to treat a subsidiary as a QSub terminates if the S corporation transfers 100 percent of the QSub stock (whether by sale or reorganization under § 368(a)(1)(A), (C), or (D)), to another S corporation in a transaction that does not qualify as a reorganization under §368(a)(1)(F).

(3) An entity classification election of an eligible entity, as described in § 301.7701–3(b), does not terminate solely because the owner (whether by sale, reorganization under §368(a)(1)(A), (C), (D), or (F), or otherwise) transfers all of the membership interest in the eligible entity to another person.

DRAFTING INFORMATION

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