



Code to permit an S corporation (1) to own 80 percent or more of the stock of a C corporation, and (2) to elect to own a qualified subchapter S subsidiary (QSSS).

To help taxpayers comply with the law, the Department of the Treasury and the Internal Revenue Service intend to issue regulations interpreting § 1308 of the Act. This notice solicits comments from taxpayers and practitioners regarding the issues listed below. However, any other comments concerning the changes made by § 1308 of the Act will be considered in developing regulatory guidance. This notice also provides temporary guidance on the manner in which a QSSS election must be made and the effective date of the election.

BACKGROUND

Prior law prohibited a subchapter S corporation from owning 80 percent or more of the stock of another corporation. Furthermore, an S corporation could not have a corporation as a shareholder. Congress modified these constraints by enacting § 1308 of the Act, effective for taxable years beginning after December 31, 1996. The Act added new §§ 1361(b)(3), 1362(d)(3)(F), and 1504(b)(8) to the Code, while removing § 1361(b)(2)(A) and 1361(c)(6).

By removing § 1361(b)(2)(A), the Act permits an S corporation to own 80 percent or more of a C corporation. At the same time, new § 1504(b)(8) prevents an S corporation from joining in the filing of a consolidated return with its affiliated C corporations, but does not prevent the C corporation subsidiary from filing a consolidated return with its affiliated C corporations. *See* H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 224 (1996).

Under prior law, the S election of a corporation with C earnings and profits terminated if that S corporation received passive income, including dividends, in excess of 25 percent of gross receipts for 3 consecutive years. Section 1363(d)(3)(F) modifies that general rule by excluding dividends from passive investment income to the extent that the dividends are attributable to the active conduct of a trade or business of a C corporation in which the S corporation has an 80 percent or greater ownership interest. However, neither the Act nor the legislative history provides rules for determining the attribution of dividends to an active trade or business.

New § 1361(b)(3)(B) defines the term “qualified subchapter S subsidiary” as a domestic corporation that is not an ineligible corporation, if (1) an S corporation holds 100 percent of the stock of the corporation, and (2) that S corporation elects to treat the subsidiary as a QSSS. Section 1361(b)(3)(A) provides that a corporation that is a QSSS is not treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of the QSSS are treated as assets, liabilities, and items of income, deduction, and credit of the parent S corporation.

The statutory provisions do not provide guidance on how the corporation makes the election, the effective date of the election, or how the commingling of assets, liabilities, and other items occurs after the election is made. The legislative history, however, indicates that when the parent corporation makes the election, the subsidiary will be deemed to have liquidated under §§ 332 and 337 immediately before the election is effective. *See* S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996)(Senate Report); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89 (1996)(House Report). Where the S corporation acquires the stock of the subsidiary in a qualified stock purchase, the corporation may make an election under § 338 with respect to the subsidiary.

Section 1361(b)(3)(C) provides that any QSSS that ceases to meet the requirements of § 1361(b)(3)(B) will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the cessation from its S corporation parent in a deemed exchange for the subsidiary’s stock. Upon the termination, § 1361(b)(3)(D) provides that the former QSSS (and any successor corporation) is not eligible to make either a QSSS election or an election to be treated as an S corporation before its fifth taxable year that begins after the first taxable year for which the termination is effective, unless the Secretary consents to the election.

REQUEST FOR COMMENTS

The Service and Treasury invite comments from the public on issues that should be addressed in proposed regulations implementing § 1308 of the Act. The Service is particularly interested in receiving comments on the following:

- 1) The attribution of dividends received by an S corporation from an 80

Subchapter S Corporation Subsidiaries

Notice 97-4

PURPOSE

Section 1308 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (the Act) modified § 1361 of the Internal Revenue

percent or greater owned C corporation between earnings and profits attributable to the active conduct of a trade or business or to passive investments of the C corporation, particularly in situations where the C corporation is a member of an affiliated group that files a consolidated return;

2) Issues arising upon the formation of a QSSS, including those arising from the operation of §§ 332 and 337 or § 338;

3) Issues arising upon the termination of a QSSS; and

4) Issues arising when a QSSS election is made for a subsidiary that is a member of a consolidated group. Written comments should be sent to the following address:

Internal Revenue Service

CC:DOM:CORP (NT 97-4;

CC:DOM:P&SI:1)

P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

In the alternative, comments may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to the courier's desk at 1111 Constitution Avenue, NW., Washington, DC, or submitted electronically via the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

TEMPORARY QSSS ELECTION PROCEDURE

The legislative history supporting § 1308 of the Act indicates that when a parent corporation makes an election to treat a subsidiary as a QSSS, the subsidiary will be deemed to have liquidated under §§ 332 and 337 immediately before the election is effective. *See* Senate Report at 53; House Report at 89. When a corporation liquidates under § 332, that corporation must file a Corporate Dissolution or Liquidation Form 966 within 30 days of the adoption of a liquidating plan or resolution. In addition, that corporation must file a return for the short period ending on the date that it goes out of existence.

The Service and Treasury intend to issue regulations describing the manner in which a QSSS election must be made and the effective date of the election. Until regulations are issued, however, taxpayers should follow the procedures listed in this notice to satisfy the election requirements.

To make the QSSS election, the parent corporation should file a Form 966 with the Service Center. When completing the form, the parent corporation

should follow the instructions applicable to that form with the following modifications:

1. At the top of the Form 966, print "FILED PURSUANT TO NOTICE 97-4."
2. In the box labeled "Employer identification number" (EIN), enter the subsidiary's EIN (if applicable). If the subsidiary was not in existence prior to the time of election and does not have an EIN, there will be no need to obtain a taxpayer identification number for the subsidiary. In this case, insert "QSSS" in the box. (If the parent corporation chooses to obtain an EIN for the newly-formed QSSS, the parent should check "Other" when asked the "Type of entity" on the SS-4, and specify that the entity is a QSSS.)
3. In Box 4 on Form 966, enter the desired effective date for the election. The election may be effective on the date Form 966 is filed or up to 75 days prior to the filing of Form 966, provided that date is not before the effective date of § 1308 of the Act and that the subsidiary otherwise qualified as a QSSS for the entire period for which the retroactive election is in effect. For these purposes, the requirement that Form 966 be filed within 30 days of the date in Box 4 is ignored.
4. In Box 7c on Form 966, enter the name of the parent. The parent's EIN should be included in Box 7d.
5. In Box 10 on Form 966, enter "§ 1361(b)(3)(B)."
6. Form 966 must be signed by a corporate officer authorized to sign the PARENT's tax return.

Banks and bank holding companies should consult Notice 97-5, 1997-2 I.R.B., before filing an election under the procedures listed above.

DRAFTING INFORMATION

The principal author of this notice is Deanna L. Walton of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice contact Ms. Walton at (202) 622-3050 (not a toll-free call).