Notice of Proposed Rulemaking

S Corporation Subsidiaries

REG–251698–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the treatment of corporate subsidiaries of S corporations. The proposed regulations interpret the rules added to the Internal Revenue Code by section 1308 of the Small Business Job Protection Act of 1996. The proposed regulations affect S corporations and their subsidiaries.

DATES: Written comments must be received by July 21, 1998.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–251698–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–251698–96), Courier's Desk, In-

ternal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Deanna L. Walton, (202) 622-3050 (Subchapter S) or Lee A. Dean, (202) 622-7540 (Subchapter C); concerning submissions, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the **Office of Management and Budget** for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collections of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collections of information should be received by June 22, 1998. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the collections will have a practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in these proposed regulations are in §§1.1361–3(a)(1), 1.1361–3(b)(1), 1.1361–5(a)(2), and 1.1362–8. The collections of information are required to determine the manner in which a corporate subsidiary of an S corporation will be treated under the Internal Revenue Code.

These collections of information are required to obtain a benefit. The likely respondents and/or recordkeepers are small businesses or organizations, businesses or other for-profit institutions, and farms.

Estimated total annual reporting/recordkeeping burden: 10,110 hours

Estimated average annual burden per respondent/recordkeeper: 57 minutes

Estimated number of respondents/recordkeepers: 10,660

Estimated annual frequency of responses: On occasion

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) relating to S corporations and their subsidiaries under sections 1361 and 1362 of the Internal Revenue Code (Code). Section 1308 of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1755 (the Act), modified section 1361 of the 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 treat a wholly owned subsidiary as a qualified subchapter S subsidiary (QSSS). In Notice 97–4 (1997–2 I.R.B. 24), the IRS announced its intention to issue regulations under section 1308 of the Act and requested comments on certain issues. Section 1601 of the Taxpayer Relief Act of 1997, Public Law 105–34, 111 Stat. 788 (the 1997 Act), made a technical correction to section 1361 to provide regulatory authority regarding the consequences of an election to be a QSSS.

Explanation of Provisions

Overview

Prior law prohibited an S corporation from owning 80 percent or more of the stock of another corporation. The Act repealed section 1362(b)(2)(A) of the Internal Revenue Code (Code), thereby allowing an S corporation to own 80 percent or more of the stock of a C corporation. The Act also added section 1504(b)(8) to the Code to prevent an S corporation from joining in the filing of a consolidated return with its affiliated C corporations. A C corporation subsidiary of an S corporation, however, may file a consolidated return with its affiliated C corporations. See H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 224 (1996).

New section 1361(b)(3)(B) defines the term qualified subchapter S subsidiary as any 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. Except as otherwise provided in regulations, a corporation for which a QSSS election is made 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 legislative history accompanying section 1361(b)(3) indicates that, when the parent corporation makes the election, the subsidiary is deemed to have liquidated under sections 332 and 337 immediately before the election is effective. See S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89 (1996). However, the legislative history accompanying the technical correction made by the 1997 Act indicates that regulations may provide exceptions to that general rule. See S. Rep. No. 33, 105th Cong., 1st Sess. 320 (1997).

Section 1361(b)(3)(C) provides that any QSSS that ceases to meet the requirements of section 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 exchange

for the subsidiary's stock. Section 1361(b)(3)(D) provides that a QSSS whose election has terminated (or a successor corporation) may not make an S election or have a QSSS election made with respect to it 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.

Under current and prior law, the S election of a corporation with subchapter C corporation earnings and profits terminated if that S corporation received passive investment income, including dividends, in excess of 25 percent of gross receipts for three consecutive years. Section 1362(d)(3)(E) 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. Neither the Act nor the legislative history provides rules for determining the attribution of dividends to an active trade or business.

QSSS Formation

Under the proposed regulations, an S corporation makes a QSSS election with respect to an eligible subsidiary by filing a form to be developed by the IRS prior to the time these regulations become final. This proposes to change the temporary election procedure provided in Notice 97–4, which provides that a parent S corporation files a completed Form 966, Corporate Dissolution and Liquidation (with some modifications), to make a QSSS election. Until these proposed regulations are finalized, taxpayers should continue to use the temporary election procedure in Notice 97–4 to make QSSS elections.

The proposed regulations also provide that the effective date of a QSSS election may be up to 2 months and 15 days prior to the day the QSSS election is made. This is a slight change from the 75 day retroactive period provided in Notice 97–4, but is consistent with the general time period for making S elections. Unlike the S election, however, a QSSS election does not need to be made within 2 months and 15 days of the beginning of a taxable year. A similar retroactive period is provided for revocations of QSSS status. In addition, a taxpayer may choose a prospective effective date for a QSSS election or revocation, so long as the date selected is not more than 12 months after the date the election or revocation is made.

The proposed regulations provide that, when an S corporation makes a valid QSSS election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the parent. The tax treatment of this liquidation, alone or in the context of any larger transaction (for example, a transaction that also includes the acquisition of the subsidiary's stock), is generally determined under all relevant provisions of the Code and general principles of tax law, including the step transaction doctrine. However, a special transition rule applies to certain elections effective prior to the date that is 60 days after publication of final regulations in the **Federal Register.** The transition rule indicates the recognition of special concerns that may have arisen as a result of transactions entered into by taxpayers relying on the legislative history to the Act and without applying the step transaction doctrine to the acquisition of the subsidiary's stock followed by a QSSS election. The IRS requests comments concerning other transactions occurring during the transitional period for which relief from the effect of application of the step transaction doctrine may be warranted.

Special rules may apply when a QSSS election is made following the transfer of one S corporation's stock to another S corporation. For example, if an S corporation acquires the stock of another S corporation in a transaction in which the acquiring S corporation's basis in the stock received is determined by reference to the transferor's basis and makes a QSSS election with respect to the other corporation effective on the day of acquisition, any losses disallowed under section 1366(d) with respect to a former shareholder of the QSSS will be available to that shareholder as a shareholder of the acquiring S corporation. Furthermore, when stock in an S corporation is transferred to another S corporation and a QSSS election is made with respect to the subsidiary effective on the day of acquisition, the S election of the former corporation terminates at the same moment as the QSSS election becomes effective. This rule ensures that the former S corporation is not treated as a C corporation for any period solely because of the transfer.

Generally, the proposed regulations treat the liquidation as occurring at the close of the day before the QSSS election is effective. Under this rule, if a parent corporation makes an S election effective on the same date as a QSSS election with respect to a subsidiary, the deemed liquidation occurs at a time when the parent corporation is still a C corporation. A QSSS election satisfies the requirement of adopting a plan of liquidation under section 332.

Following the deemed liquidation, the QSSS is not treated as a separate corporation (except as otherwise provided in the regulations), and all assets, liabilities, and items of income, deduction, and credit are treated as those of the S corporation. Accordingly, all such items must be reported on the S corporation's return required to be filed under section 6037. A special rule applies for the calculation of these items where either an S corporation or its QSSS is a bank (as defined in section 581). This special rule was first announced in Notice 97–5 (1997–2 I.R.B. 25). Until these proposed regulations are finalized, taxpayers should continue to follow Notice 97–5.

QSSS Termination

The QSSS status of a corporation continues until it terminates. The regulations specify the date of termination for specific terminating events. Section 1361(b)(3)(D) provides that, if a QSSS election terminates, the corporation is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) from the S corporation in exchange for stock of the new corporation immediately before the termination. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Code and general principles of tax law, including the step transaction doctrine. Examples are provided to illustrate situations in which the formation of the new corporation will qualify as a nonrecognition transaction under section 351. The proposed regulations also provide that, under certain circumstances, relief may be available under the standards established under section 1362(f) for the inadvertent termination of an S election.

Section 1361(b)(3)(D) provides that a corporation whose QSSS election has terminated (or a successor corporation) may not make an S election or have a QSSS election made with respect to it for five taxable years following the termination without the consent of the Secretary. The proposed regulations provide that, without requesting the Secretary's consent, a corporation may make an election to be treated as an S corporation or may have a QSSS election made with respect to it before the expiration of the five-year period under certain circumstances. Consent is not required if an otherwise valid S election or QSSS election is made for the former QSSS (or its successor corporation) effective immediately following the disposition of its stock. Thus, the proposed regulations allow corporations to move freely between QSSS and S corporation status, provided there is no intervening period for which the corporation is treated as a C corporation.

C Corporation Subsidiaries

The proposed regulations also provide rules relating to certain C corporation subsidiaries held by S corporations. Under section 1362(d)(3)(E), dividends received by an S corporation from a C corporation in which the S corporation has an 80 percent or greater ownership interest are not treated as passive investment income for purposes of sections 1362 and 1375 to the extent the dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business. The proposed regulations provide guidance for attributing dividends to the active conduct of a trade or business. Special rules apply to dividends distributed by the common parent of a consolidated group.

Under the proposed regulations, earnings and profits of a C corporation derived from the active conduct of a trade or business are the earnings and profits of the corporation derived from activities that would not produce passive investment income under section 1362(d)(3) if the C corporation were an S corporation. The proposed regulations provide a safe harbor under which the corporation may determine the amount of the active earnings and profits by comparing the corporation's gross receipts derived from nonpassive investment income-producing activities with the corporation's total gross receipts in the year the earnings and profits are produced. If less than 10 percent of the C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income, all earnings and profits produced by the corporation during the taxable year are considered active earnings and profits.

The proposed regulations also provide that a C corporation may treat all earnings and profits accumulated by the corporation prior to the time an S corporation held stock meeting the requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bear to the C corporation's total earnings and profits for those three taxable years. Provisions also address the allocation of distributions from current or accumulated earnings and profits.

Proposed Effective Date

The regulations are proposed to be effective on the date that final regulations are published in the **Federal Register.** However, the IRS is considering whether certain provisions should be made retroactive. The IRS requests comments concerning whether certain provisions should be made effective for taxable years beginning on or after January 1, 1997.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. It is hereby certified that the collections of information contained in these regulations will not have a significant economic impact on a substantial number of small businesses. This certification is based on the fact that the economic burden imposed on taxpayers by the collections of information and recordkeeping requirements of these regulations is insignificant. For example, the estimated average annual burden per respondent is less than one hour. Furthermore, most taxpayers will only have to respond to the requests for information contained in §§1.1361–3(b)(1) and 1.1361–5(a)(2) one time in the life of the corporation. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing will be scheduled in the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. The IRS recognizes that persons outside the Washington, DC, area also may wish to testify at the public hearing through teleconferencing. Requests to include teleconferencing sites must be received by June 22, 1998. If the IRS receives sufficient indications of interest to warrant teleconferencing to a particular city, and if the IRS has teleconferencing facilities available in that city on the date the public hearing is to be scheduled, the IRS will try to accommodate the requests.

The IRS will publish the time and date of the public hearing and the locations of any teleconferencing sites in an announcement in the **Federal Register.**

Drafting Information

The principal authors of these proposed regulations are Deanna L. Walton, Office of the Assistant Chief Counsel (Passthroughs and Special Industries); and Lee A. Dean, Office of the Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Amend §1.1361–0 as follows:

1. Revise the introductory text.

2. Remove the entry for §1.1361–1(d)(3).

3. Add entries for §§1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6.

The revisions and additions read as follows:

§1.1361–0 Table of contents.

This section lists captions contained in §§1.1361–1, 1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6.

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§1.1361–2 Definitions relating to S corporation subsidiaries.

(a) In general.
(b) Stock treated as held by S corporation.
(c) Examples.

§1.1361–3 QSSS election.

(a) Time and manner of making election.
(1) In general.
(2) Time of making election.
(3) Effective date of election.
(4) Example.
(5) Extension of time for making a QSSS election.
(b) Revocation of QSSS election.
(1) Manner of revoking QSSS election.
(2) Effective date of revocation.
(3) Revocation after termination.

§1.1361–4 Effect of QSSS election.

(a) Separate existence ignored.
(1) In general.
(2) Liquidation of subsidiary.
(3) Treatment of banks.
(i) In general.
(ii) Examples.
(4) Treatment of stock of QSSS.
(5) Transitional relief.
(i) General rule.
(ii) Examples.
(b) Timing of the liquidation.
(1) In general.
(2) Acquisitions.
(3) Coordination with section 338 election.
(c) Carryover of disallowed losses and deductions.
(d) Examples.

§1.1361–5 Termination of QSSS election.

(a) In general.
(1) Effective date.
(2) Information to be provided upon termination of QSSS election by failure to qualify as a QSSS.
(3) Examples.
(b) Effect of termination of QSSS election.
(1) Formation of new corporation.
(2) Carryover of disallowed losses and deductions.
(3) Examples.
(c) Inadvertent terminations.
(d) Election after QSSS termination.
(1) In general.
(2) Exception.
(3) Examples.

§1.1361–6 Effective date.

Par. 3. Amend §1.1361–1 as follows:

1. Revise paragraph (b)(1)(i).

2. Remove paragraph (d)(1)(i).

3. Redesignate paragraphs (d)(1)(ii), (d)(1)(iii), (d)(1)(iv), and (d)(1)(v) as paragraphs (d)(1)(i), (d)(1)(ii), (d)(1)(iii), and (d)(1)(iv), respectively.

4. Revise newly designated paragraph (d)(1)(i).

5. Remove paragraph (d)(3).

6. Revise the first sentence of paragraph (e)(1).

The revisions read as follows:

§1.1361–1 S corporation defined.

* * * * *

(b) * * *

(1) * * *

(i) More than 75 shareholders (35 for taxable years beginning before January 1, 1997);

* * * * *

(d) * * *

(1) * * *

(i) For taxable years beginning on or after January 1, 1997, a financial institution that uses the reserve method of accounting for bad debts described in section 585 (for taxable years beginning prior to January 1, 1997, a financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies);

* * * * *

(e) * * *

(1) *General rule.* A corporation does not qualify as a small business corporation if it has more than 75 shareholders (35 for taxable years beginning prior to January 1, 1997). * * *

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Par. 4. Add §§ 1.1361–2, 1.1361–3, 1.1361–4, 1.1361–5, and 1.1361–6 to read as follows:

§1.1361–2 Definitions relating to S corporation subsidiaries.

(a) *In general.* The term *qualified subchapter S subsidiary* (QSSS) means any domestic corporation that is not an ineligible corporation (as defined in section 1361(b)(2) and the regulations thereunder), if—

(1) 100 percent of the stock of such corporation is held by an S corporation; and

(2) The S corporation properly elects to treat the subsidiary as a QSSS under §1.1361–3.

(b) *Stock treated as held by S corporation.* For purposes of satisfying the 100 percent stock ownership requirement in section 1361(b)(3)(B)(i) and paragraph (a)(1) of this section, stock of a corporation is treated as held by an S corporation if the S corporation is the owner of that stock for federal income tax purposes.

(c) *Examples.* The following examples illustrate the application of this section:

Example 1. *X*, an S corporation, owns 100 percent of *Y*, a corporation for which a valid QSSS election is in effect for the taxable year. *Y* owns 100 percent of *Z*, a corporation otherwise eligible for QSSS status. *X* may elect to treat *Z* as a QSSS under section 1361(b)(3)(B)(ii).

Example 2. Assume the same facts as in *Example 1*, except that *Y* is a business entity that is disregarded as an entity separate from its owner under §301.7701–2(c)(2) of this chapter. *X* may elect to treat *Z* as a QSSS.

Example 3. Assume the same facts as in *Example 1*, except that *Y* owns 50 percent of *Z*, and *X* owns the other 50 percent. *X* may elect to treat *Z* as a QSSS.

Example 4. Assume the same facts as in *Example 1*, except that *Y* is a C corporation. Although *Y* is a domestic corporation that is otherwise eligible to be a QSSS, no QSSS election has been made for *Y*. Thus, *X* is not treated as holding the stock of *Z*. Consequently, *X* may not elect to treat *Z* as a QSSS.

§1.1361–3 QSSS election.

(a) *Time and manner of making election*—(1) *In general.* Except as provided

in section 1361(b)(3)(D) and §1.1361–5(d) (five-year prohibition on re-election), an S corporation may elect to treat an eligible subsidiary as a QSSS by filing a completed form to be prescribed by the Internal Revenue Service. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037 and must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable). If an S corporation forms a subsidiary and makes a valid QSSS election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should be submitted to the service center where the S corporation filed its most recent return.

(2) *Time of making election.* A QSSS election may be made by the S corporation parent at any time during the taxable year.

(3) *Effective date of election.* A QSSS election will be effective on the date specified on the election form or on the date the election form is filed if no date is specified. The effective date specified on the form can not be more than 2 months and 15 days prior to the date of filing and can not be more than 12 months after the date of filing. For this purpose, the definition of the term "month" found in §1.1362–6(a)(2)(ii)(C) applies. If an election form specifies an effective date more than 2 months and 15 days prior to the date on which the election form is filed, it will be effective 2 months and 15 days prior to the date it is filed. If an election form specifies an effective date more than 12 months after the date on which the election is filed, it will be effective 12 months after the date it is filed. The corporation for which the QSSS election is made must meet all the requirements of section 1361(b)(3)(B) at the time the election is made and for all periods for which the election is to be effective.

(4) *Example.* The following example illustrates the application of paragraph (a)(3) of this section:

Example. *X* has been a calendar year S corporation engaged in a trade or business for several years. *X* acquires the stock of *Y*, a calendar year C corporation, on April 1, 1998. On August 10, 1998, *X* makes an election to treat *Y* as a QSSS. Unless otherwise specified on the election form, the election will be effective as of August 10, 1998. If specified on the election form, the election may be effective on some other date that is not more than 2 months and 15 days prior to August 10, 1998, and not more than 12 months after August 10, 1998.

(5) *Extension of time for making a QSSS election.* An extension of time to make a QSSS election may be available under the procedures applicable under §§301.9100–1 and 301.9100–3 of this chapter.

(b) *Revocation of QSSS election*—(1) *Manner of revoking QSSS election.* An S corporation may revoke a QSSS election under section 1361 by filing a statement with the service center where the S corporation's most recent tax return was properly filed. The revocation statement must include the names, addresses, and taxpayer identification numbers of both the parent S corporation and the QSSS. The statement must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037.

(2) *Effective date of revocation.* The revocation of a QSSS election is effective on the date specified on the revocation statement or on the date the revocation statement is filed if no date is specified. The effective date specified on the revocation statement can not be more than 2 months and 15 days prior to the date on which the revocation statement is filed and can not be more than 12 months after the date on which the revocation statement is filed. If a revocation statement specifies an effective date more than 2 months and 15 days prior to the date on which the statement is filed, it will be effective 2 months and 15 days prior to the date it is filed. If a revocation statement specifies an effective date more than 12 months after the date on which the statement is filed, it will be effective 12 months after the date it is filed.

(3) *Revocation after termination.* A revocation may not be made after the occurrence of an event that renders the subsidiary ineligible for QSSS status under section 1361(b)(3)(B).

§1.1361–4 Effect of QSSS election.

(a) *Separate existence ignored*—(1) *In general.* Except as otherwise provided in paragraph (a)(3) of this section, for federal tax purposes—

(i) A corporation which is a QSSS shall not be treated as a separate corporation; and

(ii) All assets, liabilities, and items of income, deduction, and credit of a QSSS shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

(2) *Liquidation of subsidiary.* If an S corporation makes a valid QSSS election with respect to a subsidiary, the subsidiary is deemed to have liquidated into the S corporation. Except as provided in paragraph (a)(5) of this section, the tax treatment of the liquidation or of a larger transaction that includes the liquidation will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. Thus, for example, if an S corporation forms a subsidiary and makes a valid QSSS election (effective upon the date of the subsidiary's formation) for the subsidiary, there will be no deemed liquidation of the new subsidiary. Instead, the corporation will be deemed to be a QSSS from its inception. For purposes of section 332, the making of a QSSS election satisfies the requirement of adopting a plan of liquidation.

(3) *Treatment of banks*—(i) *In general.* If an S corporation is a bank, or if an S corporation makes a valid QSSS election for a subsidiary that is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to the bank parent or bank subsidiary as if the deemed liquidation of any QSSS under paragraph (a)(2) of this section had not occurred. For any QSSS that is a bank, however, all assets, liabilities, and items of income, deduction, and credit of the QSSS, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation. For purposes of this paragraph (a)(3)(i), the term "bank" has the same meaning as in section 581.

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(3):

Example 1. *X*, an S corporation, is a bank as defined in section 581. *X* owns 100 percent of *Y* and *Z*, corporations for which valid QSSS elections are in effect. *Y* is a bank as defined in section 581, and *Z* is not a financial institution. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to *X* and *Y* and do not apply to *Z*. Thus, for example, section 265(b), which provides special rules for interest expense deductions of banks, applies separately to *X* and *Y*. That is, *X* and *Y* each must make a separate determination under section 265(b) of interest expense allocable to tax-

exempt interest, and no deduction is allowed for that interest expense.

Example 2. *X*, an S corporation, is a bank holding company and thus is not a bank as defined in section 581. *X* owns 100 percent of *Y*, a corporation for which a valid QSSS election is in effect. *Y* is a bank as defined in section 581. Pursuant to paragraph (a)(3)(i) of this section, any special rules applicable to banks under the Internal Revenue Code continue to apply to Y and do not apply to *X*. However, all of *Y*'s assets, liabilities, and items of income, deduction, and credit, as determined in accordance with the special bank rules, are treated as those of *X*. Thus, for example, section 582(c), which provides special rules for sales and exchanges of debt by banks, applies only to sales and exchanges by Y. However, any gain or loss on such a transaction by Y that is considered ordinary income or ordinary loss pursuant to section 582(c) is treated as ordinary income or ordinary loss of *X*.

(4) *Treatment of stock of QSSS.* Except for purposes of section 1361(b)-(3)(B)(i) and §1.1361–2(a)(1), the stock of a QSSS shall be disregarded for all federal tax purposes.

(5) *Transitional relief*—(i) *General rule.* If an S corporation and another corporation (the related corporation) are persons specified in section 267(b) prior to an acquisition by the S corporation of some or all of the stock of the related corporation followed by a QSSS election for the related corporation, the step transaction doctrine will not apply to determine the tax consequences of the acquisition. This paragraph (a)(5) shall apply to QSSS elections effective prior to the date that is 60 days after publication of final regulations in the **Federal Register.**

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(5):

Example 1. Individual *A* owns 100 percent of the stock of *X*, an S corporation. *X* owns 79 percent of the stock of *Y*, a solvent corporation, and *A* owns the remaining 21 percent. On May 4, 1998, *A* contributes its *Y* stock to *X* in exchange for *X* stock. *X* makes a QSSS election with respect to *Y* effective immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by *A* of the *Y* stock qualifies under section 351, and no gain or loss is recognized by *A*, *X*, or *Y*.

Example 2. Individual *A* owns 100 percent of the stock of two solvent S corporations, *X* and *Y*. On May 4, 1998, *A* contributes the stock of *Y* to *X*. *X* makes a QSSS election with respect to *Y* immediately following the transfer. The liquidation described in paragraph (a)(2) of this section is respected as an independent step separate from the stock acquisition, and the tax consequences of the liquidation are determined under sections 332 and 337. The contribution by *A* of the *Y* stock to *X* qualifies under section 351, and no gain or loss is recognized by *A*, *X*, or *Y*. *Y* is not treated as a C corporation for any period solely because of the transfer of its stock to *X*, an ineligible shareholder. See §1.1362–2(b)(4).

(b) *Timing of the liquidation*—(1) *In general.* Except as otherwise provided in paragraphs (b)(2) or (b)(3) of this section, the liquidation described in paragraph (a)(2) of this section occurs at the close of the day before the QSSS election is effective. Thus, for example, if a C corporation elects to be treated as an S corporation and makes a QSSS election (effective the same date as the S election) with respect to a subsidiary, the liquidation occurs immediately before the S election becomes effective, while the S electing parent is still a C corporation.

(2) *Acquisitions.* If an S corporation does not own 100 percent of the stock of the subsidiary on the day before the QSSS election is effective, the liquidation described in paragraph (a)(2) of this section occurs immediately after the time at which the S corporation first owns 100 percent of the stock.

(3) *Coordination with section 338 election.* An S corporation that makes a qualified stock purchase of a target may make an election under section 338 with respect to the acquisition if it meets the requirements for the election, and may make a QSSS election with respect to the target. If an S corporation makes an election under section 338 with respect to a subsidiary acquired in a qualified stock purchase, a QSSS election made with respect to that subsidiary is not effective before the day after the acquisition date (within the meaning of section 338(h)(2)). If the QSSS election is effective on the day after the acquisition date, the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new target corporation under section 338. If an S corporation makes an election under section 338 (without a section 338(h)(10) election) with respect to a target, the target must file a final or deemed sale return as a C corporation reflecting the deemed sale. See §1.338–1(e).

(c) *Carryover of disallowed losses and deductions.* If an S corporation (S1) acquires the stock of another S corporation (S2) in a transaction in which the basis of the S2 stock is determined in whole or in part by reference to the transferor's basis, and S1 makes a QSSS election with respect to S2 effective on the day of the acquisition, any loss or deduction disallowed under section 1366(d) with respect to a former shareholder of S2 is available to that shareholder as a shareholder of S1. Thus, a loss or deduction of a shareholder of S2 disallowed prior to or during the taxable year of the transaction is treated as incurred by S1 with respect to that shareholder if the shareholder is a shareholder of S1 after the transaction.

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. *X*, an S corporation, owns 100 percent of the stock of *Y*, a C corporation. On June 2, 1998, *X* makes a valid QSSS election for *Y*, effective June 2, 1998. Assume that, under general principles of tax law, including the step transaction doctrine, *X*'s acquisition of the *Y* stock and the subsequent QSSS election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of the day on June 1, 1998, the day before the QSSS election is effective, and the plan of liquidation is considered adopted on that date. *Y*'s taxable year and separate existence for federal tax purposes end at the close of June 1, 1998.

Example 2. *X*, a C corporation, owns 100 percent of the stock of *Y*, another C corporation. On December 31, 1998, *X* makes an election under section 1362 to be treated as an S corporation and a valid QSSS election for *Y*, both effective January 1, 1999. Assume that, under general principles of tax law, including the step transaction doctrine, *X*'s acquisition of the *Y* stock and the subsequent QSSS election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of December 31, 1998, the day before the QSSS election is effective. The QSSS election for *Y* is effective on the same day that *X*'s S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when *X* is still a C corporation. *Y*'s taxable year ends at the close of December 31, 1998. See §1.381(b)–1.

Example 3. On June 1, 1998, *X*, an S corporation, acquires 100 percent of the stock of *Y*, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under section 338. *X* immediately makes a QSSS election for *Y* effective June 2, 1998, and also makes a joint election under section 338(h)(10) with the shareholder of *Y*. Under section 338(a) and §1.338(h)(10)–1, *Y* is treated as having sold all of its assets at the close of the acquisition date, June 1, 1998. *Y* is treated as a new corporation which purchased all of those assets as of the beginning of June 2, 1998, the day after the acquisition date. Section 338(a)(2). The QSSS election is effective on June 2, 1998, and the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new corporation.

Example 4. *X*, an S corporation, owns 100 percent of *Y*, a corporation for which a QSSS election is in effect. On May 12, 1998, a date on which the QSSS election is in effect, *X* issues *Y* a $10,000 note under state law that matures in ten years with a market rate of interest. *Y* is not treated as a separate corporation, and *X*'s issuance of the note to *Y* on May 12, 1998, is disregarded for federal tax purposes.

Example 5. *X*, an S corporation, owns 100 percent of the stock of *Y*, a C corporation. At a time when *Y* is indebted to *X* in an amount which exceeds the fair market value of *Y*'s assets, *X* makes a QSSS election effective on the date it is filed with respect to *Y*. The liquidation described in paragraph (a)(2) of this section does not qualify under sections 332 and 337 and, thus, *Y* recognizes gain or loss on the assets distributed, subject to the limitations of section 267.

§1.1361-5 Termination of QSSS election.

(a) *In general*—(1) *Effective date.* The termination of a QSSS election is effective —

(i) On the effective date contained in the revocation statement if a QSSS election is revoked under §1.1361–3(b);

(ii) At the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under §1.1362–2; or

(iii) At the close of the day on which an event (other than an event described in paragraph (a)(1)(ii) of this section) occurs that renders the subsidiary ineligible for QSSS status under section 1361(b)(3)(B).

(2) *Information to be provided upon termination of QSSS election by failure to qualify as a QSSS.* If a QSSS election terminates because an event renders the subsidiary ineligible for QSSS status, the S corporation must attach to its return for the taxable year in which the termination occurs a notification that a QSSS election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSSS.

(3) *Examples.* The following examples illustrate the application of this paragraph (a):

Example 1. Termination because parent's S election terminates. *X*, an S corporation, owns 100 percent of *Y*. A QSSS election is in effect with respect to *Y* for 1998. Effective on January 1, 1999, *X* revokes its S election. Because *X* is no longer an S corporation, *Y* no longer qualifies as a QSSS at the close of December 31, 1998.

Example 2. Termination due to transfer of QSSS stock. *X*, an S corporation, owns 100 percent of *Y*. A QSSS election is in effect with respect to *Y* for 1998. On December 10, 1998, *X* sells one share of *Y* stock to A, an individual. Because *X* no longer owns 100 percent of the stock of *Y*, *Y* no longer qualifies as a QSSS. Accordingly, the QSSS election made with respect to *Y* terminates at the close of December 10, 1998.

Example 3. No termination on stock transfer between QSSS and parent. *X*, an S corporation, owns 100 percent of the stock of *Y* and *Y* owns 100 percent of the stock of *Z*. QSSS elections are in effect with respect to both *Y* and *Z*. *Y* transfers all of its *Z* stock to *X*. Because *X* is treated as owning the stock of *Z* both before and after the transfer of stock solely for purposes of determining whether the requirements of section 1361(b)(3)(B)(i) and §1.1361–2(a)(1) have been satisfied, the transfer of *Z* stock does not terminate *Z*'s QSSS election. Because the stock of *Z* is disregarded for all other federal tax purposes, no gain is recognized under section 311.

(b) *Effect of termination of QSSS election*—(1) *Formation of new corporation.* If a QSSS election terminates under paragraph (a) of this section, the former QSSS is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(2) *Carryover of disallowed losses and deductions.* If a QSSS terminates because the S corporation distributes the QSSS stock to some or all of the S corporation's shareholders in a transaction to which section 368(a)(1)(D) applies by reason of section 355 (or so much of section 356 as relates to section 355), any loss or deduction disallowed under section 1366(d) with respect to a shareholder of the S corporation immediately before the distribution is allocated between the S corporation and the former QSSS with respect to the shareholder. The amount of the disallowed loss or deduction allocated to the S corporation is an amount that bears the same ratio to each item of disallowed loss or deduction as the value of the shareholder's stock in the S corporation bears to the total value of the shareholder's stock in both the S corporation and the former QSSS, in each case as determined immediately after the distribution.

(3) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. *X*, an S corporation, owns 100 percent of the stock of *Y*, a corporation for which a QSSS election is in effect. *X* sells 21 percent of the *Y* stock to *Z*, an unrelated corporation, for cash, thereby terminating the QSSS election. *Y* is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for *Y* stock immediately before the termination from the S corporation. The deemed exchange by *X* of assets for *Y* stock does not qualify under section 351 because *X* is not in control of *Y* within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to *Z*. Therefore, *X* must recognize gain, if any, on the assets transferred to *Y* in exchange for its stock. *X*'s losses, if any, on the assets transferred are subject to the limitations of section 267.

Example 2. Assume the same facts as in *Example 1*, except that, instead of purchasing *Y* stock, *Z* contributes to *Y* an operating asset in exchange for 21 percent of the *Y* stock. *Y* is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for *Y* stock immediately before the termination. Because *X* and *Z* are co-transferors that control the transferee immediately after the transfer, the transaction qualifies under section 351.

Example 3. *X*, an S corporation, owns 100 percent of the stock of *Y*, a corporation for which a QSSS election is in effect. *X* distributes all of the *Y* stock pro rata to its shareholders, and the distribution terminates the QSSS election. The transaction can qualify as a distribution to which sections 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Example 4. *X*, an S corporation, owns 100 percent of the stock of *Y*, a corporation for which a QSSS election is in effect. *X* subsequently revokes the QSSS election. *Y* is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for *Y* stock. On a subsequent date, *X* sells 21 percent of the stock of *Y* to *Z*, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether *X* is in control of *Y* immediately after the deemed exchange of assets for stock. The deemed exchange by *X* of assets for *Y* stock and the deemed assumption by *Y* of its liabilities qualify under section 351 because, for purposes of that section, *X* is in control of *Y* within the meaning of section 368(c) immediately after the transfer.

(c) *Inadvertent terminations.* Relief from the consequences of an inadvertent termination of a QSSS election may be available under the standards established by the Commissioner for the inadvertent termination of an S election under §1.1362–4.

(d) *Election after QSSS termination*—(1) *In general.* Absent the Commissioner's consent, and except as provided in paragraph (d)(2) of this section, a corporation whose QSSS election has terminated under paragraph (a) of this section (or a successor corporation as defined in

§1.1362–5(b)) may not make an S election under section 1362 or have a QSSS election under section 1361(b)(3)(B)(ii) made with respect to it for five taxable years (as described in section 1361(b)-(3)(D)). The Commissioner may permit an S election by the corporation or a new QSSS election with respect to the corporation before the 5-year period expires. The corporation requesting consent to make the election has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election.

(2) *Exception.* If a corporation's QSSS election terminates by reason of a disposition of the corporation's stock, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSSS election made with respect to it before the expiration of the five-year period described in section 1361(b)(3)(D) and paragraph (d)(1) of this section, provided that —

(i) Immediately following the disposition of its stock, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSSS election made for it; and

(ii) The relevant election is made effective immediately following the disposition of the stock of the corporation.

(3) *Examples.* The following examples illustrate the application of this paragraph (d):

Example 1. Termination upon distribution of QSSS stock to shareholders of parent. X, an S corporation, owns *Y*, a QSSS. *X* distributes all of its *Y* stock to *X*'s shareholders. The distribution terminates the QSSS election because *Y* no longer satisfies the requirements of a QSSS. Assuming *Y* is otherwise eligible to be treated as an S corporation, *Y*'s shareholders may elect to treat *Y* as an S corporation effective on the date of the stock distribution without requesting the Commissioner's consent.

Example 2. Sale of 100 percent of QSSS stock. X, an S corporation, owns *Y*, a QSSS. *X* sells 100 percent of the stock of *Y* to *Z*, an unrelated S corporation. *Z* may elect to treat *Y* as a QSSS effective on the date of purchase without requesting the Commissioner's consent.

§1.1361–6 Effective date.

Except as provided in §1.1361–4(a)-(5)(i), the provisions of §§1.1361–2 through 1.1361–5 apply to taxable years beginning on or after the date that final regulations are published in the **Federal Register.**

Par. 5. Amend §1.1362–0 as follows:

1. Add an entry for §1.1362–2(b)(4).
2. Add entries for §1.1362–8.

The additions read as follows:

§1.1362–0 Table of contents.

* * * * *

§1.13622 Termination of election.

* * * * *

(b) * * *

(4) Termination when stock transferred to another S corporation.

* * * * *

§1.1362–8 Dividends received from affiliated subsidiaries.

(a) In general.
(b) Determination of active or passive earnings and profits.
(1) In general.
(2) Lower tier subsidiaries.
(3) *De minimis* exception.
(4) Special rules for earnings and profits accumulated by a C corporation prior to 80 percent acquisition.
(5) Gross receipts safe harbor.
(c) Allocating distributions to active or passive earnings and profits.
(1) Distributions from current earnings and profits.
(2) Distributions from accumulated earnings and profits.
(3) Adjustments to active earnings and profits.
(4) Special rules for consolidated groups.
(d) Examples.
(e) Effective date.

Par. 6. Amend §1.1362–2 as follows:

1. Amend paragraph (b)(1) by adding a sentence to the end of the paragraph.
2. Add paragraph (b)(4).
3. Amend paragraph (c)(5)(ii)(C) by adding a sentence to the end of the paragraph.

The additions read as follows:

§1.1362–2 Termination of election.

* * * * *

(b) * * *

(1) * * * See paragraph (b)(4) of this section for a special rule applying to the termination of an S election caused by the transfer of the corporation's stock to another S corporation.

* * * * *

(4) *Termination when stock transferred to another S corporation.* If all of the stock of an S corporation (S1) is transferred to another S corporation (S2) and a QSSS election for S1 is made effective as of the day of the transfer, S1's S election terminates at the same time as the deemed liquidation under §1.1361–4(a)(2). Accordingly, S1 is not treated as a C corporation for any period solely because of the transfer of S1 stock to S2, an ineligible S corporation shareholder. See, however, §1.338–1(e)(3) if an election under section 338 (without an election under section 338(h)(10)) is made. This paragraph (b)(4) is effective on the date final regulations are published in the **Federal Register.**

(c) * * *

(5) * * *

(ii) * * *

(C) * * * See §1.1362–8 for special rules regarding the treatment of dividends received by an S corporation from a C corporation in which the S corporation holds stock meeting the requirements of section 1504(a)(2).

* * * * *

Par. 7. Add §1.1362–8 to read as follows:

§1.1362–8 Dividends received from affiliated subsidiaries.

(a) *In general.* For purposes of section 1362(d)(3), if an S corporation holds stock in a C corporation meeting the requirements of section 1504(a)(2), the term "passive investment income" does not include dividends from the C corporation to the extent those dividends are attributable to the earnings and profits of the C corporation derived from the active conduct of a trade or business ("active earnings and profits"). For purposes of applying section 1362(d)(3), earnings and profits of a C corporation are active earnings and profits to the extent that the earnings and profits are derived from activities that would not produce passive investment income (as defined in section 1362(d)(3)) if the C corporation were an S corporation.

(b) *Determination of active or passive earnings and profits*—(1) *In general.* An S corporation may use any reasonable method to determine the amount of dividends that are not treated as passive in-

vestment income under section 1362(d)-(3)(E). Paragraph (b)(5) of this section describes a method of determining the amount of dividends that are not treated as passive investment income under section 1362(d)(3)(E) that is deemed to be reasonable under all circumstances.

(2) *Lower tier subsidiaries.* If a C corporation subsidiary (upper tier corporation) holds stock in another C corporation (lower tier subsidiary) meeting the requirements of section 1504(a)(2), the upper tier corporation's gross receipts attributable to a dividend from the lower tier subsidiary are considered to be derived from the active conduct of a trade or business to the extent the lower tier subsidiary's earnings and profits are attributable to the active conduct of a trade or business by the subsidiary under paragraph (b)(1), (b)(3), (b)(4), or (b)(5) of this section. For purposes of this section, distributions by the lower tier subsidiary will be considered attributable to active earnings and profits according to the rule in paragraph (c) of this section. This paragraph (b)(2) does not apply to any member of a consolidated group (as defined in §1.1502–1(h)).

(3) *De minimis exception.* If less than 10 percent of a C corporation's earnings and profits for a taxable year are derived from activities that would produce passive investment income if the C corporation were an S corporation, all earnings and profits produced by the corporation during that taxable year are considered active earnings and profits.

(4) *Special rules for earnings and profits accumulated by a C corporation prior to 80 percent acquisition.* A C corporation may treat all earnings and profits accumulated by the corporation in all taxable years ending before the S corporation held stock meeting the requirements of section 1504(a)(2) as active earnings and profits in the same proportion as the C corporation's active earnings and profits for the three taxable years ending prior to the time when the S corporation acquired 80 percent of the C corporation bears to the C corporation's total earnings and profits for those three taxable years.

(5) *Gross receipts safe harbor.* A corporation may treat its earnings and profits for a year as active earnings and profits in the same proportion as the corporation's gross receipts (as defined in §1.1362–2(c)(4)) derived from activities that would not produce passive investment income (if the C corporation were an S corporation), including those that do not produce passive investment income under paragraphs (b)(2) through (b)(4) of this section, bear to the corporation's total gross receipts for the year in which the earnings and profits are produced.

(c) *Allocating distributions to active or passive earnings and profits*—(1) *Distributions from current earnings and profits.* Dividends distributed by a C corporation from current earnings and profits are attributable to active earnings and profits in the same proportion as current active earnings and profits bear to total current earnings and profits of the C corporation.

(2) *Distributions from accumulated earnings and profits.* Dividends distributed by a C corporation out of accumulated earnings and profits for a taxable year are attributable to active earnings and profits in the same proportion as accumulated active earnings and profits for that taxable year bear to total accumulated earnings and profits for that taxable year immediately prior to the distribution.

(3) *Adjustments to active earnings and profits.* For purposes of applying paragraph (c)(1) or (c)(2) of this section to a distribution, the active earnings and profits of a corporation shall be reduced by the amount of any prior distribution properly treated as attributable to active earnings and profits from the same taxable year.

(4) *Special rules for consolidated groups.* For purposes of applying section 1362(d)(3) and this section to dividends received by an S corporation from the common parent of a consolidated group (as defined in §1.1502–1(h)), the following rules apply—

(i) The current earnings and profits, accumulated earnings and profits, and active earnings and profits of the common parent shall be determined under the principles of §1.1502–33 (relating to earnings and profits of any member of a consolidated group owning stock of another member); and

(ii) The gross receipts of the common parent shall be the sum of the gross receipts of each member of the consolidated group (including the common parent), adjusted to eliminate gross receipts from intercompany transactions (as defined in §1.1502-13(b)(1)(i)).

(d) *Examples.* The following examples illustrate the principles of this section:

Example 1. (i) *X*, an S corporation, owns 85 percent of the one class of stock of *Y*. On December 31, 1998, *Y* declares a dividend of $100 ($85 to *X*), which is equal to *Y*'s current earnings and profits. In 1998, *Y* has total gross receipts of $1,000, $200 of which would be passive investment income if *Y* were an S corporation.

(ii) One-fifth ($200/$1,000) of *Y*'s gross receipts for 1998 is attributable to activities that would produce passive investment income. Accordingly, one-fifth of the $100 of earnings and profits is passive, and $17 (1/5 of $85) of the dividend from *Y* to *X* is passive investment income.

Example 2. (i) The facts are the same as in *Example 1*, except that *Y* owns 90 percent of the stock of *Z*. *Y* and *Z* do not join in the filing of a consolidated return. In 1998, *Z* has gross receipts of $15,000, $12,000 of which are derived from activities that would produce passive investment income. On December 31, 1998, *Z* declares a dividend of $1,000 ($900 to Y) from current earnings and profits.

(ii) Four-fifths ($12,000/15,000) of the dividend from *Z* to *Y* are attributable to passive earnings and profits. Accordingly, $720 (4/5 of $900) of the dividend from *Z* to *Y* is considered gross receipts from an activity that would produce passive investment income. The $900 dividend to *Y* gives *Y* a total of $1,900 ($1,000 + $900) in gross receipts, $920 ($200 + $720) of which is attributable to passive investment income-producing activities. Under these facts, $41 ($920/1,900 of $85) of *Y*'s distribution to *X* is passive investment income to *X*.

(e) *Effective date.* This section applies to dividends received in taxable years beginning on or after the date that final regulations are published in the **Federal Register.**

§1.1368–0 [Amended]

Par. 8. Amend §1.1368–0 in the entry for §1.1368–2(d)(2) by revising "Reorganizations" to read "Liquidations and reorganizations".

§1.1368–2 [Amended]

Par. 9. Amend §1.1368–2 in paragraph (d)(2) by revising "Reorganizations" to read "Liquidations and reorganizations" in the heading and by revising "section 381(a)(2)" to read "section 381(a)" in the first sentence.

Par. 10. Amend §1.1374–8 by adding two sentences to the end of paragraph (b) to read as follows:

§1.1374–8 Section 1374(d)(8) transactions.

* * * * *

(b) *Separate determination of tax.* * * * If a C corporation elects to be treated as an S corporation, and also makes a QSSS election under section 1361(b)(3) (effective on the same date as the S election) with respect to a subsidiary, the assets held by the QSSS at the time of the QSSS election will be treated as assets held by the parent when it became an S corporation. The preceding sentence applies to QSSS elections made after the date final regulations are published in the **Federal Register.**

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Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

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