

shareholders may apply this § 1.1361-1(1) to prior taxable years.

[T.D. 8419, 57 FR 22649, May 29, 1992; 57 FR 28613, June 26, 1992, as amended by T.D. 8600, 60 FR 37581, July 21, 1995; 60 FR 49976, Sept. 27, 1995; 60 FR 58234, Nov. 27, 1995; 61 FR 2869, Jan. 29, 1996; T.D. 8869, 65 FR 3849, Jan. 25, 2000; T.D. 8940, 66 FR 9929, 9957, Feb. 13, 2001]

### § 1.1361-2 Definitions relating to S corporation subsidiaries.

(a) *In general.* The term *qualified subchapter S subsidiary* (QSub) 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 QSub 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—

(1) 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; and

(2) Any outstanding instruments, obligations, or arrangements of the corporation which would not be considered stock for purposes of section 1361(b)(1)(D) if the corporation were an S corporation are not treated as outstanding stock of the QSub.

(c) *Straight debt safe harbor.* Section 1.1361-1(1)(5)(iv) and (v) apply to an obligation of a corporation for which a QSub election is made if that obligation would satisfy the definition of straight debt in § 1.1361-1(1)(5) if issued by the S corporation.

(d) *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 QSub election is in effect for the taxable year. Y owns 100 percent of Z, a corporation otherwise eligible for QSub status. X may elect to treat Z as a QSub 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 QSub.

*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 QSub.

*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 QSub, no QSub 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 QSub.

*Example 5.* Individuals A and B own 100 percent of the stock of corporation X, an S corporation, and, except for C's interest (described below), X owns 100 percent of corporation Y, a C corporation. Individual C holds an instrument issued by Y that is considered to be equity under general principles of tax law but would satisfy the definition of straight debt under § 1.1361-1(1)(5) if Y were an S corporation. In determining whether X owns 100 percent of Y for purposes of making the QSub election, the instrument held by C is not considered outstanding stock. In addition, under § 1.1361-1(1)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and § 1.1361-1(1)(5)(iv) applies to determine the tax treatment of payments on the instrument while Y's QSub election is in effect.

[T.D. 8869, 65 FR 3849, Jan. 25, 2000]

### § 1.1361-3 QSub election.

(a) *Time and manner of making election—(1) In general.* The corporation for which the QSub 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.

(2) *Manner of making election.* Except as provided in section 1361(b)(3)(D) and § 1.1361-5(c) (five-year prohibition on reelection), an S corporation may elect to treat an eligible subsidiary as a QSub by filing a completed form to be prescribed by the IRS. The election form must be signed by a person authorized to sign the S corporation's return required to be filed under section 6037. Unless the election form provides otherwise, the election must be submitted to the service center where the subsidiary filed its most recent tax return (if applicable), and, if an S corporation forms a subsidiary and makes a valid QSub election (effective upon the date of the subsidiary's formation) for the subsidiary, the election should