Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to *A* directly or to any trust created for the benefit of *A*. On January 1, 2003, *M* creates Trust-2 for the benefit of *A*. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. *A*, as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the 75-shareholder limit of section 1361(b)(1)(A). Additionally, because *A* is already counted as an S corporation shareholder because of *A*'s status as a potential current income beneficiary of Trust-1, *A* is not counted again by reason of *A*'s status as the deemed owner of Trust-2.

Example 6. Potential current beneficiaries and distributee trust not holding S corporation stock. (i) *Distributee trust that would itself qualify as an ESBT.* Trust-1 holds stock in *X*, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to *A*, *B*, and Trust-2, a trust for the benefit of *C*, *D*, and *E*. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, *A*, *B*, *C*, *D*, and *E* are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(ii) *Distributee trust that would not qualify as an ESBT or a QSST.* Assume the same facts as in paragraph (i) of this *Example 6* except that *D* is a nonresident alien. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, *X*'s S corporation election terminates.

(iii) *Distributee trust that is a section 1361(c)(2)(A)(ii) trust.* Assume the same facts as in paragraph (i) of this *Example 6* except that Trust-2 is a trust treated as owned by *A* under section 676 because *A* has the power to revoke Trust-2 at any time prior to *A*'s death. On January 1, 2003, *A* dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of *A*'s death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), *A*'s estate. Thus, *B* and *A*'s estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

Example 7. Potential current beneficiaries and powers of appointment. *M* creates Trust for the benefit of *A*. *A* also has a currently exercisable power to appoint income or principal to anyone except *A*, *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. The potential current beneficiaries of Trust will be *A* and all other persons except for *A*'s creditors, *A*'s estate, and the creditors of *A*'s estate. This number will exceed the 75-shareholder limit of section 1361(b)(1)(A). If Trust holds S corporation stock, the corporation's S election will terminate.

(9) *Effective date.* This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002.

[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; T.D. 8994, 67 FR 34397, May 14, 2002; T.D. 9078, 68 FR 42252, July 17, 2003]

§ 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(l)(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(l)(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(l)(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(l)(5)(v), the QSub election is not treated as an exchange of debt for stock with respect to such instrument, and §1.1361–1(l)(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 re-election), 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 be submitted to the service center where the S corporation filed its most recent return.

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

(4) *Effective date of election.* A QSub 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 cannot be more than two months and 15 days prior to the date of filing and cannot 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 two months and 15 days prior to the date on which the election form is filed, it will be effective two 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.

(5) *Example.* The following example illustrates the application of paragraph (a)(4) 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, 2002. On August 10, 2002, X makes an election to treat Y as a QSub. Unless otherwise specified on the election form, the election will be effective as of August 10, 2002. If specified on the election form, the election may be effective on some other date that is not more than two months and 15 days prior to August