

discretionary distributions of principal to the living descendants of *M* and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, each then-living descendant of *M*, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

*Example 9. Power to distribute to a class of named charitable organizations not pursuant to a power of appointment.* *M* creates Trust from which *A* has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not *A* or a descendant of *M*, has the power to make discretionary distributions of principal to the living descendants of *M* and to *X*, *Y*, and *Z*, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be *A*, *X*, *Y*, *Z*, and each living descendant of *M*.

(9) *Effective date.* This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002. Paragraphs (m)(2)(ii)(A), (m)(4)(iii) and (vi), and (m)(8), *Example 2, Example 5, Example 7, Example 8, and Example 9* of this section are effective on August 14, 2008.

[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; T.D. 9422, 73 FR 47527, Aug. 14, 2008]

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

(a) *In general.* The term *qualified 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]