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Susan Kalinka

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## Lack of Legislation Gives Broad Discretion to the Louisiana Department of Revenue Concerning the Taxation of a Qualified Subchapter S Subsidiary in Louisiana

Susan Kalinka\*

In 1996, Congress enacted legislation permitting a subchapter S corporation to form a qualified subchapter S subsidiary ("QSUB").<sup>1</sup> A corporation is a QSUB if the following requirements are met: (1) the corporation is a domestic corporation; (2) the corporation is not an "ineligible corporation" (*i.e.*, a financial institution that uses the reserve method for accounting for bad debts, an insurance company, a corporation for which a possessions tax credit has been elected, or a DISC or a former DISC); (3) 100% of the corporation's stock is held by an S corporation; and (4) the S corporation (sometimes referred to as the "S corporation parent") elects to treat the corporation as a QSUB.<sup>2</sup> Section 1361(b)(3)(A) of the Internal Revenue Code provides that a corporation that is a QSUB is not treated as a separate entity, and all of its assets, liabilities, and items of income, deduction, and credit ("tax items") are treated as assets, liabilities, and tax items of the S corporation. Thus, for federal tax purposes, a QSUB is disregarded as a separate entity from its S corporation parent (a "disregarded entity") and all of the QSUB's tax items are reported on the S corporation's informational income tax return (Form 1120S).

A QSUB is not an S corporation because all of its stock is owned by another corporation (the S corporation parent). An S corporation may not have a corporation as a shareholder.<sup>3</sup>

The QSUB provisions offer significant benefits to taxpayers. An S corporation may place all of the assets and liabilities of one of its divisions into a wholly-owned subsidiary, shielding those assets from liabilities arising out of the operation of another of the corporation's divisions. The liability shield may make it easier for an S corporation to obtain financing for its more profitable divisions. An S corporation also may own chains of QSUBs, for example, where one QSUB owns all of the stock of another QSUB.<sup>4</sup> For federal tax purposes, the losses incurred by one QSUB may offset other income of the S corporation, including income attributable to another QSUB owned by the same S corporation.<sup>5</sup>

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\* Harriet S. Daggett-Frances Leggio Landry Professor of Law. This article is a sequel to Susan Kalinka, *Louisiana State Taxation of Qualified Subchapter S Subsidiaries: A Proposal*, 58 La. L. Rev. 815 (1998).

1. Small Business Job Protection Act of 1996 § 1308(b), Pub. L. No. 104-188, 104th Cong., 2d Sess. (1996), enacting I.R.C. § 1361(b)(3) (West 1998).
2. I.R.C. § 1361(b)(3)(B) (West 1998).
3. I.R.C. § 1361(b)(1)(B) (West 1998).
4. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 104th Congress (JCS-12-96), Rep. No. 244, 104th Cong., 2d Sess. 120 (1996).
5. I.R.C. § 1361(b)(3)(A) (West 1998).

The federal QSUB provisions, however, create a problem under the Louisiana Corporation Income Tax Act. The Louisiana Legislature has not adopted legislation recognizing a QSUB for Louisiana tax purposes. The lack of statutory authority creates uncertainty with respect to the proper treatment of a QSUB's income under the Louisiana Corporation Income Tax Act. It seems that there are three possible ways of treating a QSUB for purposes of Louisiana state income tax. On the one hand, a QSUB could be treated as a C corporation for Louisiana tax purposes.<sup>6</sup> Alternatively, a QSUB could be treated as a tax-exempt entity. Finally, state taxation of a QSUB could parallel the federal rule by disregarding the QSUB as a separate entity from its S corporation parent. In that case, a QSUB's income would be included on the S corporation parent's income tax return.

On the one hand, it seems that a QSUB should be treated as a C corporation under the Louisiana Corporation Income Tax Act. A QSUB is not treated as an S corporation under state law because the Louisiana Corporation Income Tax Act treats a corporation as an S corporation for state income tax purposes only if the corporation is "classified under Subchapter S of the Internal Revenue Code as an S corporation."<sup>7</sup> As was explained earlier, a QSUB is not classified as an S corporation under subchapter S of the Internal Revenue Code because the shareholder of a QSUB is a corporation. Accordingly, for state tax purposes, it could be argued that the income of a QSUB should not flow through to its S corporation parent or any of the S corporation's shareholders.

However, the Louisiana Corporation Income Tax Act may be interpreted to treat the income of a QSUB as exempt from Louisiana income tax. There are two alternative ways that the income of a QSUB may be subject to Louisiana income tax: (1) the income of a QSUB could flow through to its S corporation parent, as it does under federal tax law or (2) the QSUB could be subject to Louisiana corporate tax as a separate taxpaying entity. Neither of these alternatives seems to be possible under the Louisiana Corporation Income Tax Act.

The tax items of a QSUB cannot flow through to its S corporation parent. Section 47:287.732(A) of the Revised statutes provides that the provisions of the Louisiana Corporation Income Tax Act apply to an S corporation as if the S corporation had been required to file an income tax return with the Internal Revenue Service as a C corporation, in accordance with federal law. Under federal law, a C corporation may not own a QSUB. Where a C corporation owns 100% of the stock of another corporation (the "subsidiary") and does not file a consolidated return with its subsidiary, none of the subsidiary's tax items flow through to the C corporation parent. For state income tax purposes, even

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6. Actually, the Louisiana Corporation Income Tax Act never uses the term "C corporation." However, the act distinguishes between "S corporations" and "corporations." For convenience, this memorandum sometimes refers to a corporation that is not an S corporation as a "C corporation."

7. La. R.S. 47:287.732 (1990).

if a corporation files a federal consolidated return with its subsidiary, the subsidiary's income is not included on the parent's Louisiana state income tax return.<sup>8</sup> Under Section 47:287.732(A), an S corporation should not report any of the QSUB's tax items on its Louisiana state income tax return.

On the other hand, it seems that a QSUB will not report or pay Louisiana corporate income tax with respect to any of its tax items for Louisiana income tax purposes. Because a QSUB is not an S corporation, it should be treated as a C corporation for state income tax purposes. Under the Louisiana Corporation Income Tax Act, a C corporation reports its income in the same manner as it does for federal tax purposes.<sup>9</sup> A QSUB does not report any of its income for federal tax purposes. Instead, the QSUB's income is reported on the S corporation parent's federal informational tax return<sup>10</sup> and by the shareholders of the S corporation parent on their federal income tax returns.<sup>11</sup> Since a corporation that is a QSUB does not report any of its income for federal tax purposes, it should not report any of its income for Louisiana state income tax purposes.

A QSUB does not have gross income or taxable income for federal tax purposes because a QSUB's income is treated as the income of the QSUB's S corporation parent. Thus, even if a QSUB were required to file a federal income tax return, it would report no gross income and no net income. Instead, the QSUB's S corporation parent must include on its federal income tax return all of the tax items earned or incurred by the QSUB. Since the Louisiana Corporation Income Tax Act defines a corporation's income by reference to reporting requirements under federal income tax law, it would seem that a QSUB would not report any tax items for Louisiana income tax purposes.

The foregoing conclusion, however, is not absolutely certain. It is unlikely that the Louisiana Legislature intended for a QSUB's Louisiana income to escape

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8. La. R.S. 47:287.733 (1990 and Supp. 1998).

9. Under the Louisiana Corporation Income Tax Act, a corporation generally is taxed on its Louisiana taxable income. La. R.S. 47:287.11(B) (1990). For this purpose, the term "Louisiana taxable income" is defined as Louisiana net income, after the application of a net operating loss adjustment, less a deduction for federal income tax. La. R.S. 47:287.69 (1990). "Louisiana net income" means net income which is earned or derived from sources within the state of Louisiana. La. R.S. 47:287.67 (1990). The "net income" of a corporation is defined as the taxable income of the corporation computed in accordance with federal law for the accounting period and under the same method of accounting (subject to modifications under the Louisiana Corporation Income Tax Act). La. R.S. 47:287.65 (1990). The net income of a corporation is computed by subtracting allowable deductions from the corporation's gross income. Under the Louisiana Corporation Income Tax Act, the "gross income" of a corporation is defined as the same items and same dollar amount required by federal law to be reported as gross income on the corporation's federal income tax return for the same taxable year (subject to modifications under the Louisiana Corporation Income Tax Act). La. R.S. 47:287.61 (1990). The "allowable deductions" of a corporation under the Louisiana Corporation Income Tax Act also are defined by reference to deductions allowed under federal tax law. La. R.S. 47:287.63 (1990).

10. I.R.C. § 1361(b)(3)(A) (West 1998).

11. I.R.C. § 1366(a) (West 1998).

taxation under the Louisiana income tax law. Under Section 47:287.61 of the Revised Statutes, a corporation's gross income is defined by reference to the items and dollar amounts that are required to be reported on the corporation's federal income tax return "whether or not a federal income tax return is actually filed." A court could interpret this language to mean that a QSUB, which should be treated as a C corporation for Louisiana state income tax purposes, must report its Louisiana income in the same manner that it would be required to report income on a federal income tax return if it were a C corporation and were required to file a federal income tax return. Similarly, Section 47:287.65, which defines the "net income" of a corporation as the corporation's taxable income computed in accordance with federal law, and Section 47:287.63, defining the "allowable deductions" of a corporation as the deductions from federal gross income allowed under federal law in the computation of the corporation's taxable income, could be interpreted to mean that the net income and the deductions of a QSUB are computed in accordance with federal law applicable to a C corporation. In that case, a QSUB would be required to report and pay income tax to Louisiana on its Louisiana income as a corporation.

Alternatively, a court could determine that a QSUB is an agent or an alter ego of its parent S corporation. In that case, all of the QSUB's tax items would be treated as items of the parent S corporation for state income tax purposes, as they are under federal tax law.

The uncertainty under the current law creates obvious problems, not only for the Louisiana Department of Revenue and Taxation, but also for Louisiana taxpayers. Without guidance from the Louisiana Legislature, it seems that the best way to tax the income of a QSUB is to include the QSUB's income in the income of its S corporation parent. Under Section 47:287.480(2) of the Revised Statutes, the Secretary of the Department of Revenue and Taxation is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses, whether or not incorporated, if the Secretary determines that the distribution, apportionment, or allocation is necessary to prevent evasion of taxes or to clearly reflect the income of such organizations, trades, or businesses. Inasmuch as a QSUB's income is included on the federal informational income tax return of its S corporation parent, it would seem appropriate to require the S corporation to report the QSUB's income for state income tax purposes.

Section 47:287.480(4) provides that the foregoing provision is operative whether or not a federal income tax return for the taxable year is actually filed by the taxpayer and whether or not such adjustments have been made at the federal level. Thus, even though a QSUB is not required to file a federal income tax return, the Secretary is authorized to allocate the QSUB's income to its S corporation parent.

The statute does not require the Secretary to determine that a QSUB is an alter ego of its S corporation parent in order to require the S corporation to report the QSUB's income. The standard established by the statute is that the apportionment or allocation of the QSUB's income to the S corporation parent

must be necessary "in order to prevent evasion of taxes or clearly to reflect the income" of the S corporation parent and its QSUB.<sup>12</sup> Unless the Secretary allocates a QSUB's income to its S corporation parent, shareholders of an S corporation doing business in Louisiana may evade taxes on Louisiana income by forming one or more QSUBs to operate the S corporation's Louisiana business and claim that the QSUB is exempt from Louisiana state income tax.

It also could be argued that the allocation of a QSUB's income to its S corporation parent clearly reflects the income of the two corporations. As the sole shareholder of the QSUB, the S corporation parent has complete control over the disposition of the QSUB's income. Thus, it is not inappropriate for the S corporation parent to report the QSUB's income as its own.

Section 47:287.480(3) of the Louisiana Revised Statutes also provides special rules that apply in the case of affiliated corporations. In general, consolidated or combined returns are not allowed, except as required by the Secretary pursuant to Section 47:287.480(3).<sup>13</sup> However, Section 47:287.480(3)(b) provides that whenever a corporation that is required to file an income tax return is affiliated with or related to any other corporation through stock ownership by the same interests or as parent or subsidiary corporations, or whose income is regulated through contract or other arrangement, the Secretary may require such consolidated statements as, in his opinion, are necessary, to determine the taxable income received by any one of the affiliated or related corporations. An S corporation is required to file an income tax return.<sup>14</sup> Accordingly, Section 47:287.480(3)(b) authorizes the Secretary to require a consolidated statement including the income of a subsidiary, such as a QSUB, on the S corporation's income tax return if it is necessary to determine the taxable income received by the QSUB.

A QSUB does not report its income for federal income tax purposes. Therefore, it may be impossible for the Louisiana Department of Revenue of Taxation to determine the QSUB's income unless the Secretary requires the S corporation parent to report the QSUB's income for state income tax purposes. Inasmuch as the S corporation parent reports the QSUB's income for federal income tax purposes, it would be easier to determine the QSUB's income for state tax purposes by requiring the S corporation parent to include the QSUB's income on its state income tax return.

The statute does not prescribe the type of consolidated statement that is required. It seems that it is within the Secretary's discretion to determine the type of consolidated statement that must be made. Thus, the Secretary should have the authority to require an S corporation parent to report the income of its QSUB as if the income had been earned by the S corporation parent and then

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12. La. R.S. 47:287.480(2) (1990).

13. La. R.S. 47:287.480(3)(a) (1990).

14. See La. R.S. 47:287.732(A) (1990) (an S corporation is taxed and required to comply with the Louisiana Corporation Tax Act the same as any other corporation). See also 47:287.612 (1990) (requiring a corporation to file an income tax return).

claim an exclusion for any of the QSUB's income that is reported by the S corporation's shareholders.

On the other hand, it also is within the Secretary's discretion to require a QSUB to report its own income on a separate income tax return. Section 47:287.480 of the Revised Statutes authorizes the Secretary to apportion or allocate income between two or more affiliated corporations regardless of whether a federal income tax return for the taxable year is actually filed and regardless of whether the adjustments are made under federal law.<sup>15</sup> Inasmuch as a QSUB is a C corporation for Louisiana state income tax purposes, the Secretary may determine that an allocation of the QSUB's income to the QSUB more clearly reflects income.

Moreover, the Secretary may determine that it is necessary to allocate a QSUB's income to the QSUB and to tax the QSUB as a C corporation to prevent the evasion of income taxes, especially if the QSUB is owned by a nonresident S corporation. There is some question as to whether a state has the authority under the United States Constitution to tax nonresident shareholders on the undistributed income of a corporation doing business in the state.<sup>16</sup>

#### CONCLUSION

The lack of statutory authority creates uncertainty with respect to the proper treatment of a QSUB's income for Louisiana state income tax purposes. Section 47:287.480 of the Revised Statutes, however, gives the Secretary of the Department of Revenue and Taxation broad discretion to allocate the income of a QSUB either to the QSUB or to the QSUB's S corporation parent. The Secretary may prefer to allocate a QSUB's income to its S corporation parent in order to maintain consistency between state and federal taxation of a QSUB's income. Regardless of whether the Secretary chooses to require a QSUB to report its own income or to require the S corporation parent to report the QSUB's income on a Louisiana state income tax return, it would be helpful to taxpayers if the Secretary issued published guidance with respect to the proper reporting of a QSUB's income for Louisiana income tax purposes.

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15. La. R.S. 47:287.480(2), (4) (1990).

16. See Susan Kalinka, *Louisiana State Taxation of Qualified Subchapter S Subsidiaries: A Proposal*, 58 La. L. Rev. 815, 821-26 (1998).