

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B02-PLR-133879-02
Date:
August 16, 2002

X =

State =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

\$a =

\$b =

Dear :

This letter responds to a letter dated June 17, 2002, together with subsequent correspondence, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

PLR-133879-02

Facts

X was incorporated under State law on Date 1, and elected to be treated as an S corporation for its taxable year beginning Date 2. In the consecutive taxable years of Year 1, Year 2, and Year 3, X received passive investment income (within the meaning of § 1362(d)(3)) in excess of 25% of its gross receipts. Furthermore, X had accumulated earnings and profits remaining in each of these years, which amounted to \$a at the close of Year 3. As a result, X's S election terminated on Date 3. X represents that it filed its federal income tax return as a C corporation for Year 4 and requested this ruling soon after discovering that its S election terminated.

X represents that the termination of its S election was inadvertent and not the result of tax avoidance or retroactive tax planning. X and its sole shareholder agree to make any adjustments consistent with the treatment of X as an S corporation that may be required by the Secretary.

Law and Analysis

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of the taxable years more than 25% of which are passive investment income. The termination is effective on and after the first date of the first tax year beginning after the third consecutive tax year referred to in § 1362(d)(3)(A)(i). Section 1362(d)(3)(A)(ii).

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1362(f) provides, in relevant part, that if: (1) an election under § 1362(a) by any corporation was terminated under paragraph § 1362(d)(3); (2) the Secretary determines that the circumstances resulting in the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

PLR-133879-02

Section 1368(c) provides rules for determining the source of distributions made by an S corporation having accumulated earnings and profits with respect to its stock. Section 1368(e)(3) and § 1.1368-1(f)(2) provide that an S corporation may, with the consent of all of its affected shareholders, elect, to distribute earnings and profits first.

Section 1.1368-1(f)(3) provides that an S corporation may elect to distribute all or part of its accumulated earnings and profits through a deemed dividend. If an S corporation makes the election provided in § 1.1368-1(f)(3), the S corporation will be considered to have made the election under § 1368(e)(3) and § 1.1368-1(f)(2) to distribute earnings and profits first.

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25 percent of which are passive investment income (within the meaning of § 1362(d)(3)).

Conclusions

Based solely on the representations made and the information submitted, we conclude that X's S election terminated on Date 3, under § 1362(d)(3)(A)(ii), because X had accumulated earnings and profits at the close of each of three consecutive tax years beginning Year 1, and had gross receipts for each of those tax years more than 25% of which were passive investment income.

We further conclude that the termination of X's S election was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation beginning on Date 3 and thereafter, unless X's S election is otherwise terminated under § 1362(d), provided that the following conditions are met. Within 60 days from the date of this letter, X shall file an amended return for the Year 3 taxable year, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend distribution of \$a. Also within 60 days, X's sole shareholder will amend his respective Year 3 income tax return to reflect the changes made to X's Year 3 return. No amendments shall be made to X's Year 1 and Year 2 income tax returns with respect to the tax imposed pursuant to § 1375. However, as an adjustment under § 1362(f)(4), X must send a payment of \$b with a copy of this letter to the following address: Internal Revenue Service, Philadelphia Service Center, Attn: Accounting Branch, Philadelphia, PA 19255. X must send this payment no later than 30 days from the date of this letter.

If all of the above conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must notify the Ogden Service Center that the election has terminated.

PLR-133879-02

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X's S corporation election was a valid election under § 1362.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,

Matthew Lay
Acting Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes