

Internal Revenue Service

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Washington, DC 20224

Person to Contact:

Telephone Number:

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Date:

August 7, 2001

Legend

X =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

D7 =

\$a =

This responds to the February 3, 2001 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under State law on D1, and elected to be treated as an S corporation for its taxable year beginning D2.

In D4, X discovered that it had received passive investment income in excess of 25% of its gross receipts for three consecutive taxable years, commencing with X's D5 taxable year. Further, at the close of each of these three taxable years, X had \$a of subchapter C earnings and profits. As a result, X's S election terminated on D3.

X represents that the termination of its S election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X and its shareholders were unaware that the receipt of a portion of its income was passive investment income and that it could terminate X's S election.

X and its shareholders have consistently treated X as an S corporation since D2,

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and agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary. Shortly after filing its letter ruling request, X filed amended income tax returns for the D5, D6 and D7 taxable years reflecting additional taxes owed pursuant to section 1375. The liabilities shown on the amended returns were paid upon their filing.

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).

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.

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)(iii) 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)(iii) 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 D3, under § 1362(d)(3)(A)(ii), because X had subchapter C earnings and profits at the close of each of three consecutive tax years beginning D2, and had gross receipts for each of those tax years more than 25 percent of which were passive investment income.

We further conclude that the termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation on and after D3, 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 a second amended return for the D7 taxable year, electing pursuant to § 1.1368-1(f)(3) to make a deemed dividend distribution of \$a. Also within 60 days, X's shareholders shall amend their respective D7 income tax return(s) to reflect the changes made to X's D7 return. No amendments shall be made to X's D5 and D6 income tax returns with respect to the tax imposed pursuant to section 1375.

If all of the above conditions are not met, then this ruling is null and void. Furthermore, if this condition is not met, X must notify the service center with which X's S election was filed that the election has terminated

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 who requested it. Section 6110(k)(3) 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,
Dianna K. Miosi
Chief, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

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