

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:1-PLR-113615-99

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Dec 09, 1999

### Legend

X =

D1 =

D2 =

D3 =

D4 =

D5 =

State =

\$x =

This responds to a letter dated June 14, 1999, together with subsequent correspondence, submitted on behalf of X, requesting relief under §1362(b)(5) of the Internal Revenue Code.

### Facts

X is a corporation that was incorporated in State on D1. The shareholders of X (Shareholders) desired that X elect S corporation treatment for X, effective on D2, but the election to be treated as an S corporation was not timely filed. Accordingly, X requests a ruling that it will be treated as an S corporation effective D2.

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X received passive investment income (as defined in §1362(d)(3) and the regulations thereunder) in excess of 25% of its gross receipts for three consecutive taxable years, commencing with X's D3 taxable year. X represents that the entire amount of X's accumulated earnings and profits on D4, the last day of the third year, reduced by any actual distributions of X's accumulated earnings and profits made during that year, was \$x.

In order to avoid a termination of X's S status effective D5 under §1362(d)(3), X plans to eliminate X's accumulated earnings and profits by electing under §1.1368-1(f)(3) to make a deemed dividend of \$x for X's taxable year ending on D4. X represents that all of the Shareholders are willing to consent to the deemed dividend election.

### Law and Analysis

Section 1362(a) provides that a small business corporation may elect to be an S corporation.

Section 1362(b) provides the rule on when an S election will be effective. Section 1362(b)(2) provides in relevant part that if an S election is made within the first two and one-half months of a corporation's taxable year, then the corporation will be treated as an S corporation for the year in which the election is made. Under § 1362(b)(3), however, if an S election is made after the first two and one-half months of a corporation's taxable year, then that corporation will not be treated as an S corporation until the taxable year after the year in which the S election is filed.

Section 1362(b)(5) provides that if: (1) no § 1362(a) election is made for any taxable year, and (2) the Secretary determines that there was reasonable cause for the failure to timely make such election, then the Secretary may treat such an election as timely made for such taxable year and §1362(b)(3) shall not apply.

Section 1361(a)(1) defines an S corporation as a small business corporation for which an election under §1362(a) is in effect.

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 three consecutive tax years, and has gross receipts for each of such tax years more than 25 percent of which are passive investment income. Section 1362(d)(3)(A)(ii) provides that the termination shall be effective on and after the first day of the first tax year beginning after the third consecutive tax year referred to in §1362(d)(3)(A)(i). Except as otherwise provided in subparagraph (C), section 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.

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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

X did not file an election to be treated as an S corporation under §1362(a) effective D2. X has, however, established reasonable cause for not making a timely S election and is entitled to relief under § 1362(b)(5).

Based solely on the facts submitted and the representations made, and provided that X otherwise qualifies as an S corporation, we conclude that X will be treated as an S corporation effective D2. An original Form 2553 along with a copy of this letter must be forwarded to the relevant Service Center within the earlier of 60 days from the date of this letter or the expiration of the statute of limitations for any affected income tax returns. X and the shareholders of X must file all amended returns required as a result of the treatment of X as an S corporation effective D2, prior to the expiration of the applicable statute of limitations periods. For the taxable year beginning on D2 and the following year, X must report and pay the tax on passive investment income imposed by §1375. This ruling shall be null and void should X or any of the Shareholders fail to comply with the requirements of this paragraph.

Moreover, based on the representations made by X, and provided that X eliminates X's accumulated earnings and profits by electing under §1.1368-1(f)(3) to make a deemed dividend of \$x for X's taxable year ending on D4, X's S status will not terminate effective D5 under §1362(d)(3).

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.

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.

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Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

**Signed/David R. Haglund**

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
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