Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Refer Reply To:
CC:PSI:Br.1-PLR-149639-02
Date:
May 5 2003

X =

Shareholder =

State =

D1 =

Year 1 =

Year 2 =

Dear :

This responds to a letter dated August 14, 2002, submitted on behalf of X, requesting relief under section 1362(b)(5) of the Internal Revenue Code.

FACTS

X was incorporated on D1 under the laws of State. Shareholder, the sole shareholder of X, desired that X elect S corporation treatment effective on D1, 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 D1.

X filed a Form 1120S for Year 1 and reported a loss. X issued a Form K-1 to Shareholder allocating the entire Year 1 loss to him. Shareholder reported the loss on his individual tax return for Year 1. The Service audited the returns and disallowed the loss on Shareholder's return because X had not filed an S election (Form 2553). A deficiency has been assessed due to the disallowed loss, but it has not yet been

collected. X filed a Form 1120 for Year 2 and carried forward the loss disallowed on Shareholder's Year 1 return. X's taxable income for Year 2 was reduced by the full amount of the loss carried forward. The statute of limitations on assessment for Year 2 has expired.

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 section 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 section 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 section 1362(b)(3) shall not apply.

The legislative history to section 1362(b)(5) indicates that Congress intended the Service to be reasonable in exercise this authority and to apply standards that are similar to those applied under then present law to inadvertent subchapter S terminations and other late or invalid elections. H. Rep. 104-586, reprinted at 1996-3 C.B. 423. The standards for late or invalid elections referred to in the legislative history were provided by Rev. Proc. 92-85, 1992-2 C.B. 490, and Temp. Treas. Reg. section 301.9100-3T (promulgated by T.D. 8680, 1996-2 C.B. 194, 197), both of which required an analysis of whether the government's interests were prejudiced (similar to current section 301.9100-3(c)). Generally, the interests of the government are prejudiced if granting relief would result in a taxpayer having a lower tax liability in the aggregate for all years to which the regulatory election applies than the taxpayer would have had if the election had been timely made (taking into account the time value of money).

The Service will not ordinarily issue a private letter ruling under section 1362(b)(5) if the period of limitations on assessment under section 6501(a) has lapsed for any taxable year in which an election should have been made or any taxable year that would have been affected by the election had it been timely made. See section 3 of Rev. Proc. 97-48, 1997-2 C.B. 488; section 3.05 of Rev. Proc. 98-55, 1998-2 C.B. 643. As the legislative history to section 1362(b)(5) suggests, the Service may provide relief if the government's interests are not prejudiced.

In the present case, X generated a loss in Year 1 and a gain in Year 2. Shareholder claimed the loss in Year 1, which reduced his reported tax liability, but because X claimed the same loss as a carryforward in Year 2, its tax liability was also reduced. If the relief is granted, the loss claimed on Shareholder's Year 1 return would be validated. In addition, if relief is granted, Shareholder should be required to take into account his distributive share of X's Year 2 income calculated without regard to the inappropriate carryforward loss. However, because the statute of limitations on assessment has expired, Shareholder's Year 2 return cannot be adjusted. Thus, if the relief is granted, Shareholder will have a lower aggregate tax liability than if the election had been timely made.

CONCLUSION

Although X has established reasonable cause for not making a timely S election, the interests of the government would be prejudiced by the granting of the requested relief. Accordingly, relief under section 1362(b)(5) is denied.

Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your representative.

Sincerely,

Dan Carmody
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (1)
Copy of this letter for section 6110 purposes