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§ 1.1362-1 Election to be an S corporation.

(a) *In general.* Except as provided in § 1.1362-5, a small business corporation as defined in section 1361 may elect to be an S corporation under section 1362(a). An election may be made only with the consent of all of the shareholders of the corporation at the time of the election. See § 1.1362-6(a) for rules concerning the time and manner of making this election.

(b) *Years for which election is effective.* An election under section 1362(a) is effective for the entire taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until the election is terminated.

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§ 1.1362-2 Termination of election.

(a) *Termination by revocation—(1) In general.* An election made under section 1362(a) is terminated if the corporation revokes the election for any taxable year of the corporation for which the election is effective, including the first taxable year. A revocation may be made only with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation. See § 1.1362-6(a) for rules concerning the time and

manner of revoking an election made under section 1362(a).

(2) *When effective—(i) In general.* Except as provided in paragraph (a)(2)(ii) of this section, a revocation made during the taxable year and before the 16th day of the third month of the taxable year is effective on the first day of the taxable year and a revocation made after the 15th day of the third month of the taxable year is effective for the following taxable year. If a corporation makes an election to be an S corporation that is to be effective beginning with the next taxable year and revokes its election on or before the first day of the next taxable year, the corporation is deemed to have revoked its election on the first day of the next taxable year.

(ii) *Revocations specifying a prospective revocation date.* If a corporation specifies a date for revocation and the date is expressed in terms of a stated day, month, and year that is on or after the date the revocation is filed, the revocation is effective on and after the date so specified.

(3) *Effect on taxable year of corporation.* In the case of a corporation that revokes its election to be an S corporation effective on the first day of the first taxable year for which its election is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(4) *Rescission of a revocation.* A corporation may rescind a revocation made under paragraph (a)(2) of this section at any time before the revocation becomes effective. A rescission may be made only with the consent of each person who consented to the revocation and by each person who became a shareholder of the corporation within the period beginning on the first day after the date the revocation was made and ending on the date on which the rescission is made. See § 1.1362-6(a) for rules concerning the time and manner of rescinding a revocation.

(b) *Termination by reason of corporation ceasing to be a small business corporation—(1) In general.* If a corporation ceases to be a small business corporation, as defined in section 1361(b), at any time on or after the first day of the first taxable year for which its

election under section 1362(a) is effective, the election terminates. In the event of a termination under this paragraph (b)(1), the corporation should attach to its return for the taxable year in which the termination occurs a notification that a termination has occurred and the date of the termination.

(2) *When effective.* If an election terminates because of a specific event that causes the corporation to fail to meet the definition of a small business corporation, the termination is effective as of the date on which the event occurs. If a corporation makes an election to be an S corporation that is effective beginning with the following taxable year and is not a small business corporation on the first day of that following taxable year, the election is treated as having terminated on that first day. If a corporation is a small business corporation on the first day of the taxable year for which its election is effective, its election does not terminate even if the corporation was not a small business corporation during all or part of the period beginning after the date the election was made and ending before the first day of the taxable year for which the election is effective.

(3) *Effect on taxable year of corporation.* In the case of a corporation that fails to meet the definition of a small business corporation on the first day of the first taxable year for which its election to be an S corporation is to be effective, any statement made with the election regarding a change in the corporation's taxable year has no effect.

(c) *Termination by reason of excess passive investment income—(1) In general.* A corporation's election under section 1362(a) terminates if the corporation has subchapter C earnings and profits at the close of each of three consecutive taxable years and, for each of those taxable years, has passive investment income in excess of 25 percent of gross receipts. See section 1375 for the tax imposed on excess passive investment income.

(2) *When effective.* A termination under this paragraph (c) is effective on the first day of the first taxable year beginning after the third consecutive year in which the S corporation had excess passive investment income.

(3) *Subchapter C earnings and profits.* For purposes of this paragraph (c), *subchapter C earnings and profits* of a corporation are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under section 1362(a) (or under section 1372 of prior law) was not in effect. The subchapter C earnings and profits of an S corporation are modified as required by section 1371(c).

(4) *Gross receipts—(i) In general.* For purposes of this paragraph (c), *gross receipts* generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions.

(ii) *Special rules for sales of capital assets, stock and securities—(A) Sales of capital assets.* For purposes of this paragraph (c), gross receipts from the sales or exchanges of capital assets (as defined in section 1221), other than stock and securities, are taken into account only to the extent of capital gain net income (as defined in section 1222).

(B) *Sales of stock or securities—(1) In general.* For purposes of this paragraph (c), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. In addition, for purposes of computing gross receipts from sales or exchanges of stock or securities, losses do not offset gains.

(2) *Treatment of certain liquidations.* Gross receipts from the sales or exchanges of stock or securities do not include amounts described in section 1362(d)(3)(D)(iv), relating to the treatment of certain liquidations. For purposes of section 1362(d)(3)(D)(iv), stock of the liquidating corporation owned by an S corporation shareholder is not treated as owned by the S corporation.

(3) *Definition of stock or securities.* For purposes of this paragraph (c), *stock or securities* includes shares or certificates of stock, stock rights or warrants, or an interest in any corporation (including any joint stock company, insurance company, association, or other organization classified as a corporation under section 7701); an interest as a limited

partner in a partnership; certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease; collateral trust certificates; voting trust certificates; bonds; debentures; certificates of indebtedness; notes; car trust certificates; bills of exchange; or obligations issued by or on behalf of a State, Territory, or political subdivision thereof.

(4) *General partner interests*—(i) *In general.* Except as provided in paragraph (c)(4)(ii)(B)(4)(ii) of this section, if an S corporation disposes of a general partner interest, the gain on the disposition is treated as gain from the sale of stock or securities to the extent of the amount the S corporation would have received as a distributive share of gain from the sale of stock or securities held by the partnership if all of the stock and securities held by the partnership had been sold by the partnership at fair market value at the time the S corporation disposes of the general partner interest. In applying this rule, the S corporation's distributive share of gain from the sale of stock or securities held by the partnership is not reduced to reflect any loss that would be recognized from the sale of stock or securities held by the partnership. In the case of tiered partnerships, the rules of this section apply by looking through each tier.

(ii) *Exception.* An S corporation that disposes of a general partner interest may treat the disposition, for purposes of this paragraph (c), in the same manner as the disposition of an interest as a limited partner.

(iii) *Other exclusions from gross receipts.* For purposes of this paragraph (c), gross receipts do not include—

(A) Amounts received in nontaxable sales or exchanges except to the extent that gain is recognized by the corporation on the sale or exchange; or

(B) Amounts received as a loan, as a repayment of a loan, as a contribution to capital, or on the issuance by the corporation of its own stock.

(5) *Passive investment income*—(i) *In general.* In general, *passive investment income* means gross receipts (as defined in paragraph (c)(4) of this section) derived from royalties, rents, dividends, interest, annuities, and gains from the

sales or exchanges of stock or securities.

(ii) *Definitions.* For purposes of this paragraph (c)(5), the following definitions apply:

(A) *Royalties*—(1) *In general.* *Royalties* means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income.

(2) *Royalties derived in the ordinary course of a trade or business.* *Royalties* does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation—

(i) Created the property; or

(ii) Performed significant services or incurred substantial costs with respect to the development or marketing of the property.

(3) *Copyright, mineral, oil and gas, and active business computer software royalties.* *Royalties* does not include copyright royalties, nor mineral, oil and gas royalties if the income from those royalties would not be treated as personal holding company income under sections 543 (a)(3) and (a)(4) if the corporation were a C corporation; amounts received upon disposal of timber, coal, or domestic iron ore with respect to which the special rules of sections 631 (b) and (c) apply; and active business computer software royalties as defined under section 543(d) (without regard to paragraph (d)(5) of section 543).

(B) *Rents*—(1) *In general.* *Rents* means amounts received for the use of, or right to use, property (whether real or personal) of the corporation.

(2) *Rents derived in the active trade or business of renting property.* *Rents* does not include rents derived in the active trade or business of renting property.

Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

(3) *Produced film rents.* Rents does not include produced film rents as defined under section 543(a)(5).

(4) *Income from leasing self-produced tangible property.* Rents does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

(C) *Dividends.* Dividends includes dividends as defined in section 316, amounts to be included in gross income under section 551 (relating to foreign personal holding company income taxed to U.S. shareholders), and consent dividends as provided in section 565. See paragraphs (c)(5)(iii) (B) and (C) of this section for special rules for the treatment of certain dividends and certain payments to a patron of a cooperative. See § 1.1362-8 for special rules regarding the treatment of dividends received by an S corporation from a C corporation in which the S corporation holds stock meeting the requirements of section 1504(a)(2).

(D) *Interest—(1) In general.* Interest means any amount received for the use of money (including tax-exempt interest and amounts treated as interest under section 483, 1272, 1274, or 7872). See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of interest derived in certain businesses.

(2) *Interest on obligations acquired in the ordinary course of a trade or business.* Interest does not include interest on any obligation acquired from the sale of property described in section 1221(1) or the performance of services in the ordinary course of a trade or business of selling the property or performing the services.

(E) *Annuities.* Annuities means the entire amount received as an annuity under an annuity, endowment, or life insurance contract, if any part of the amount would be includible in gross income under section 72.

(F) *Gross receipts from the sale of stock or securities.* Gross receipts from the sales or exchanges of stock or securities, as described in paragraph (c)(4)(ii)(B) of this section, are passive investment income to the extent of gains therefrom. See paragraph (c)(5)(iii)(B) of this section for a special rule for the treatment of gains derived in certain businesses.

(G) *Identified income.* Passive investment income does not include income identified by the Commissioner by regulations, revenue ruling, or revenue procedure as income derived in the ordinary course of a trade or business for purposes of this section.

(iii) *Special rules.* For purposes of this paragraph (c)(5), the following special rules apply:

(A) *Options or commodities dealers.* In the case of an options dealer or commodities dealer, passive investment income does not include any gain or loss (in the normal course of the taxpayer's activity of dealing in or trading section 1256 contracts) from any section 1256 contract or property related to the contract. *Options dealer, commodities dealer, and section 1256 contract* have the same meaning as in section 1362(d)(3)(E)(ii).

(B) *Treatment of certain lending, financing and other business—(1) In general.* Passive investment income does not include gross receipts that are directly derived in the ordinary course of a trade or business of—

- (i) Lending or financing;
- (ii) Dealing in property;
- (iii) Purchasing or discounting accounts receivable, notes, or installment obligations; or
- (iv) Servicing mortgages.

(2) *Directly derived.* For purposes of this paragraph (c)(5)(iii)(B), gross receipts directly derived in the ordinary course of business includes gain (as well as interest income) with respect to loans originated in a lending business, or interest income (as well as gain) from debt obligations of a dealer in such obligations. However, interest earned from the investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business. Similarly, a dealer's income or gain from an item of property is not directly derived in the ordinary course of its trade or business if the dealer held the property for investment at any time before the income or gain is recognized.

(C) *Payment to a patron of a cooperative.* Passive investment income does not include amounts included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2) (A) or (C) of section 1381(a)) by reason of any payment or allocation to the patron based on patronage occurring in the case of a trade or business of the patron.

(6) *Examples.* The principles of paragraphs (c)(4) and (c)(5) of this section are illustrated by the following examples. Unless otherwise provided in an example, S is an S corporation with subchapter C earnings and profits, and S's gross receipts from operations are gross receipts not derived from royalties, rents, dividends, interest, annuities, or gains from the sales or exchanges of stock or securities. S is a calendar year taxpayer and its first taxable year as an S corporation is 1993.

Example 1. Sales of capital assets, stock and securities. (i) S uses an accrual method of accounting and sells:

(1) A depreciable asset, held for more than 6 months, which is used in the corporation's business;

(2) A capital asset (other than stock or securities) for a gain;

(3) A capital asset (other than stock or securities) for a loss; and

(4) Securities.

S receives payment for each asset partly in money and partly in the form of a note payable at a future time, and elects not to report the sales on the installment method.

(ii) The amount of money and the face amount (or issue price if different) of the note received for the business asset are considered gross receipts in the taxable year of sale and are not reduced by the adjusted basis of the property, costs of sale, or any other amount. With respect to the sales of the capital assets, gross receipts include the cash down payment and face amount (or issue price if different) of any notes, but only to the extent of S's capital gain net income. In the case of the sale of the securities, gross receipts include the cash down payment and face amount (or issue price if different) of the notes, but only to the extent of gain on the sale. In determining gross receipts from sales of securities, losses are not netted against gains.

Example 2. Long-term contract reported on percentage-of-completion method. S has a long-term contract as defined in §1.451-3(b) with respect to which it reports income according to the percentage-of-completion method as described in §1.451-3(c)(1). The portion of the gross contract price which corresponds to the percentage of the entire contract which has been completed during the taxable year is included in S's gross receipts for the year.

Example 3. Income reported on installment sale method. For its 1993 taxable year, S sells personal property on the installment plan and elects to report its taxable income from the sale of the property (other than property qualifying as a capital asset or stock or securities) on the installment method in accordance with section 453. The installment payment actually received in a given taxable year of S is included in gross receipts for the year.

Example 4. Partnership interests. In 1993, S and two of its shareholders contribute cash to form a general partnership, PRS. S receives a 50 percent interest in the capital and profits of PRS. S formed PRS to indirectly invest in marketable stocks and securities. The only assets of PRS are the stock and securities, and certain real and tangible personal property. In 1994, S needs cash in its business and sells its partnership interest at a gain rather than having PRS sell the marketable stock or securities that have appreciated. Under paragraph (c)(4)(ii)(B)(4) of this section, the gain on S's disposition of its interest in PRS is treated as gain from the sale or exchange of stock or securities to the extent of the amount the distributive share of gain S would have received from the sale of stock or securities held by PRS if PRS had sold all of its stock or securities at fair market value at the time S disposed of its interest in PRS.

Example 5. Royalties derived in ordinary course of trade or business. (i) In 1993, S has gross receipts of \$75,000. Of this amount, \$5,000 is from royalty payments with respect to Trademark A, \$8,000 is from royalty payments with respect to Trademark B, and

\$62,000 is gross receipts from operations. S created Trademark A, but S did not create Trademark B or perform significant services or incur substantial costs with respect to the development or marketing of Trademark B.

(ii) Because S created Trademark A, the royalty payments with respect to Trademark A are derived in the ordinary course of S's business and are not included within the definition of *royalties* for purposes of determining S's passive investment income. However, the royalty payments with respect to Trademark B are included within the definition of *royalties* for purposes of determining S's passive investment income. See paragraph (c)(5)(ii)(A) of this section. S's passive investment income for the year is \$8,000, and S's passive investment income percentage for the taxable year is 10.67% (\$8,000/\$75,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 6. Dividends; gain on sale of stock derived in the ordinary course of trade or business. (i) In 1993, S receives dividends of \$10,000 on stock of corporations P and O, recognizes a gain of \$25,000 on sale of the P stock, and recognizes a loss of \$12,000 on sale of the O stock. S held the P and O stock for investment, rather than for sale in the ordinary course of a trade or business. S has gross receipts from operations and from gain on the sale of stock in the ordinary course of its trade or business of \$110,000.

(ii) S's gross receipts are calculated as follows:

| | |
|-----------|---|
| \$110,000 | Gross receipts from operations and from gain on the sale of stock in the ordinary course of a trade or business |
| 10,000 | Gross dividend receipts |
| 25,000 | Gain on sale of P stock (Loss on O stock not taken into account) |
| <hr/> | |
| 145,000 | Total gross receipts |

(iii) S's passive investment income is determined as follows:

| | |
|----------|--|
| \$10,000 | Gross dividend receipts |
| 25,000 | Gain on sale of P stock (Loss on O stock not taken into account) |
| <hr/> | |
| 35,000 | Total passive investment income |

(iv) S's passive investment income percentage for its first year as an S corporation is 24.1% (\$35,000/\$145,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 7. Interest on accounts receivable; netting of gain on sale of real property investments. (i) In 1993, S receives \$6,000 of interest on accounts receivable arising from S's sales of inventory property. S also received dividends with respect to stock held for invest-

ment of \$1,500. In addition, S sells two parcels of real property (Property J and Property K) that S had purchased and held for investment. S sells Property J, in which S has a basis of \$5,000, for \$10,000 (a gain of \$5,000). S sells Property K, in which S has a basis of \$12,000, for \$9,000 (a loss of \$3,000). S has gross receipts from operations of \$90,000.

(ii) S's gross receipts are calculated as follows:

| | |
|----------|---|
| \$90,000 | Gross receipts from operations |
| 6,000 | Gross interest receipts |
| 1,500 | Gross dividend receipts |
| 2,000 | Net gain on sale of real property investments |
| <hr/> | |
| \$99,500 | Total gross receipts |

(iii) Under paragraph (c)(5)(ii)(D) of this section, S's gross interest receipts are not passive investment income. In addition, gain on the sale of real property (\$2,000) is not passive investment income. S's passive investment income includes only the \$1,500 of gross dividend receipts. Accordingly, S's passive investment income percentage for its first year as an S corporation is 1.51% (\$1,500/\$99,500). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

Example 8. Interest received in the ordinary course of a lending business. (i) In 1993, S has gross receipts of \$100,000 from loans and investments made in the ordinary course of S's mortgage banking business. This includes, for example, mortgage servicing fees, interest earned on mortgages prior to sale of the mortgages, and gain on sale of mortgages. In addition, S receives, from the investment of idle funds in short-term securities, \$15,000 of gross interest income and \$5,000 of gain.

(ii) S's gross receipts are calculated as follows:

| | |
|-----------|--------------------------------|
| \$100,000 | Gross receipts from operations |
| 15,000 | Gross interest receipts |
| 5,000 | Gain on sale of securities |
| <hr/> | |
| 120,000 | Total gross receipts |

(iii) S's passive investment income is determined as follows:

| | |
|----------|---------------------------------|
| \$15,000 | Gross interest receipts |
| 5,000 | Gain on sale of securities, |
| <hr/> | |
| 20,000 | Total passive investment income |

(iv) S's passive investment income percentage for its first year as an S corporation is 16.67% (\$20,000/\$120,000). This does not exceed 25 percent of S's gross receipts and consequently the three-year period described in section 1362(d)(3) does not begin to run.

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