Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

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Telephone Number:

Refer Reply To:
CC:DOM:P&SI:1-PLR-121822-98
Date:
January 25, 1999

Legend

X =

Y =

Z =

A =

B =

C =

D =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

d7 =

d8 =

d9 =

d10 =

d11 =

m =

$x =

$y =

This responds to a letter dated November 25, 1998, together with subsequent correspondence, written on behalf of X, requesting relief under § 1362(f) of the Internal Revenue Code, with respect to the termination of X's S corporation election.

Facts

X was incorporated in State on d1, and elected to be treated as an S corporation effective on d3. A, B, and C were the sole shareholders in X during the period d2 through d5. X's assets consisted of a m business, certain securities, and one commercial real estate property.

On d4, X ceased to operate its m business, and the business assets were transferred to Y and Z (two other corporations also owned by A, B, and C) for use in their m businesses. X received no income from m operations after d4. On d5, A began to explore the possibility of liquidating X. However, A, B, and C were unable to reach an agreement regarding the liquidation of X during the period d5 through d7. On d7, C died and C's stock in X passed to Estate. X's commercial real estate property was sold on d9. By unanimous consent dated d10, the shareholders of X directed X's advisors to distribute all remaining assets not required to pay various corporate expenses and to liquidate the corporation.

X received passive investment income in excess of 25% of its gross receipts for three consecutive taxable years, commencing with X's d4 taxable year, and that, as a result, X's S election terminated on d8.

To eliminate X's accumulated earnings and profits, X has paid and will elect under § 1368(e)(3), with the shareholders' consent, to report as a distribution X's entire

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accumulated earnings and profits in X's taxable year ending on d11. X represents that the entire amount of X's C corporation earnings and profits prior to this distribution was $x. X represents that the termination of its S election was inadvertent, and not the result of tax avoidance.

Law and Analysis

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).

Under § 1362(f), if an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3), the corporation will be treated as continuing to be an S corporation during the period specified by the Secretary if (1) the Secretary determines that the termination was inadvertent, (2) no later than a reasonable period of time after discovery of the event resulting in the termination, steps were taken so that the corporation is once more a small business corporation, and (3) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to the subsection, agrees to make any adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding the period.

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

Conclusions

Based solely on the representations made and the information submitted, including the information that was submitted and used to calculate the adjustment described below, we conclude that X's S election terminated on d8 under § 1362(d)(3), because X had accumulated earnings and profits at the close of three consecutive tax years, and had gross receipts for each of those taxable years more than 25 percent 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 d8, and thereafter, unless X's S election is otherwise terminated under § 1362(d), provided that the following conditions are satisfied. As an adjustment under § 1362(f)(4), X must send a payment of $y with a copy of this letter to the following address: Internal Revenue Service; 310 Lowell Street; Andover, MA 05501. X must send this payment no later than 30 days from the date of this letter. In addition, the shareholders must properly report on their individual tax returns their respective shares of X's accumulated earnings and profits distributed to them by X during X's tax year ending on d11. If these conditions are not met, then this ruling is null and void. Furthermore, if these conditions are 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 on whether the original election made by X to be an S corporation 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 a power of attorney on file with this office, a copy of this letter will be sent to your authorized representative.

Sincerely yours,

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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