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Internal Revenue Service

Department of the Treasury

Index Number: 1362.04-00

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3 PLR-100235-99

Date:
July 2, 1999

Company:

M:

N:

P:

Q:

Properties:

State:

a:

b:

c:

d:

e:

f:

g:

h:

2/2

i:

j:

k:

Dear

This letter responds to a letter dated December 28, 1998, and subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code. Company represents the following facts.

Company was incorporated in State on a and elected under § 1362(a) to be an S corporation effective b. Company's shareholders are M, N, and P (P having received its interest in Company after Q's death on c).

Company is in the business of operating Properties. In e, Company sold one of the Properties, taking back an installment note. This sale was negotiated by Company's accountant/attorney. For each of its tax years f, g, and h, Company's interest income from this note exceeded 25 percent of its gross receipts, resulting in the termination of Company's S election effective i. Company had $d of accumulated earnings and profits (E&P) at that time.

It was not until j, upon reviewing information to prepare Company's income tax return (which was on extension) and investigating the tax impact of a contemplated sale of Company's remaining Property, that Company's accountant realized that there might be a problem with passive investment income. Company subsequently contacted another legal advisor who determined that Company's S election had indeed terminated on i.

Company represents that it was not the intention of its officers, directors, or shareholders to terminate Company's election or to permit its termination, and that the terminating event occurred without Company's knowledge. Company and its shareholders (M, N, and P) have agreed to make any adjustments the Service might require, consistent with treating Company as an S corporation. Company has filed as an S corporation since the effective date of its election.

Section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has subchapter C earnings and profits at the close of each of 3 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 any termination under this paragraph 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 § 1362(d)(3)(C), § 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.

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) of the Income Tax Regulations provides that, for purposes of § 1.1362-4(a), the determination of whether a termination was inadvertent is made by the Commissioner. The corporation has the burden of establishing that under the relevant facts and circumstances the Commissioner should determine that the termination was inadvertent. The fact that the terminating event was not reasonably within the control of the corporation and was not part of a plan to terminate the election, or the fact that the event took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event, tends to establish that the termination was inadvertent.

According to the legislative history of § 1362(f)--

> If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently

terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test for three consecutive years because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

S. Rep. No. 640, 97th Cong., 2d Sess. 12 (1982); 1982-2 C.B. 718, 723.

Based solely on the facts presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the termination of Company's S corporation election on i due to excess passive investment income was inadvertent within the meaning of § 1362(f). Consequently, upon the condition that the § 1362(f)(4) adjustment prescribed below is made, and upon the condition that Company's E&P of $d is distributed or deemed distributed in the current tax year (and that the shareholders include this dividend in income for the current year), we rule that Company will be treated as continuing to be an S corporation beginning i, and thereafter, unless Company's S election is otherwise terminated under § 1362(d).

As an adjustment under § 1362(f)(4), Company must send a payment of $k attached to a copy of this letter to the Internal Revenue Service, 310 Lowell St., Andover, MA 01810. This payment must be made no later than 30 days from the date of this ruling letter.

If the conditions above are not met, the ruling is void, and Company must notify the Service Center with which it filed its S election that the election has terminated.

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding the validity of Company's election under § 1362(a) to be an S corporation or whether Company otherwise is eligible to be an S corporation.

In accordance with the power of attorney on file at this office, we are sending the original of this letter to you and a copy to your authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that a private letter ruling may not be used or cited as precedent.

Sincerely,

Donna M. Young

Donna M. Young
Senior Technician Reviewer,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

enclosures (2):
copy of this letter
copy for § 6110 purposes

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