

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Contact Person:

199901019

Telephone Number:

In Reference to:

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Date:

October 7, 1998

LEGEND

X =

A =

B =

C =

D =

E =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

d6 =

\$x =

\$y =

This responds to a letter dated July 28, 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. The initial shareholders of X were A and B, who were both individuals. Beginning on d1, X employed A to write books. X owned the copyrights for the books and collected royalties from sales of the books. After d2, A ceased to work for X; however, X continued to own copyrights for, and collect royalties attributable to, books completed before d2.

On d3, C, D, and E (Shareholders) became the shareholders of X. X elected to be treated as an S corporation, effective on d3. On d5, X received a letter from its accountant stating that as a result of the royalties paid to X, X had received passive investment income in excess of 25% of its gross receipts for three consecutive taxable years, commencing with X's first taxable year, and that, as a result, X's S election terminated on d4.

To eliminate X's subchapter C 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 subchapter C earnings and profits in X's d6 taxable year. 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 subchapter C 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 subchapter 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 subchapter C 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 d4 under § 1362(d)(3), because X had subchapter C earnings and profits at the close of three consecutive tax years, commencing with X's first taxable year, 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 d4, 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 subchapter C earnings and profits distributed to them by X during X's d6 tax year. 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.

199901019

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(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,



DANIEL J. COBURN
Assistant to the Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
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