Internal Revenue Service

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
April 16, 1999

X =

A =

B =

C =

x =

y =

D1 =

D2 =

D3 =

D4 =

D5 =

D6 =

Year 1 =

Year 2 =

Dear :

This letter responds to a letter dated December 14, 1998, and subsequent correspondence, submitted by X's authorized

representative on behalf of X requesting relief under § 1362(f) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1. X elected to be an S corporation effective D2. X represents that, as of D2, X had subchapter C earnings and profits of $x.

X had subchapter C earnings and profits at the close of each of its first three taxable years as an S corporation, and had gross receipts for each of those years more than 25 percent of which were passive investment income. Neither X's shareholders nor its accountant knew the significance of subchapter C earnings and profits and excess passive income on X's status as an S corporation. X paid the tax under § 1375 for each taxable year after its first taxable year as an S corporation through Year 2.

Until D4, A and B were X's only shareholders. On D5, A became the sole shareholder of X. A died on D6, and A's 100 percent interest in X is now owned by C. C's legal advisors, upon review of X's tax return, discovered that X's subchapter S election had terminated on D3 because X had subchapter C earnings and profits for three consecutive years, and had gross receipts for each of those taxable years more than 25 percent of which were passive investment income. X then applied for relief under § 1362(f).

X represents that the termination of its election to be an S corporation was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

Section 1361(a)(1) of the Code provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1362(d)(3)(A)(i) of the Code provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of such years more than 25 percent of which are passive investment income. Section 1362(d)(3)(A)(ii) provides that any termination under § 1362(d)(3) shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i).

Section 1362(f) of the Code provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated

under paragraph (2) or (3) of § 1362(d), (2) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such 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 such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then notwithstanding the circumstances resulting in such termination, such corporation shall be treated as an S corporation during the period specified by the Secretary.

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 corporation election terminated on D3, under § 1362(d)(3)(A) of the Code, because X had subchapter C earnings and profits at the close of each of three consecutive taxable 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 corporation election was an inadvertent termination within the meaning of § 1362(f) of the Code. Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation beginning D3, and thereafter, provided that X's S corporation election was valid and is not otherwise terminated under § 1362(d), and that the following conditions are met. X must distribute its subchapter C earnings and profits within 30 days from the date of this letter. X must elect, with the consent of its affected shareholder, to have its accumulated earnings and profits distributed first under § 1368(e)(3) and § 1.1368-1(f) of the Income Tax Regulations. C must report this distribution on its 1999 federal tax return as a dividend. If X files an amended return for Year 1 or Year 2 to request refunds of the amounts it paid as taxes under § 1375, X's shareholders must amend their federal tax returns for Year 1 or Year 2 to return the benefit received from any reduction in income under § 1366(f)(3). In addition, as an adjustment under § 1362(f)(4), X must send a payment of $y attached to a copy of this letter to the following address: Internal Revenue Service, 310 Lowell Street, Andover, MA 01812. X must send this payment no later than 30 days from the date of this letter. 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 corporation election was filed that the election was terminated.

Except as specifically ruled upon above, no opinion is expressed concerning the federal income tax consequences of the above-described facts under any other provision of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 is being forwarded to X's authorized representative.

Sincerely yours,

H. GRACE KIM
Assistant to the Chief
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes