

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

July 26, 2000

Legend

X =

State =

D1 =

D2 =

D3 =

D4 =

D5 =

\$a =

\$b =

\$c =

:

This responds to the March 24, 2000 letter, submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code.

FACTS

X was incorporated under State law on D1, and elected to be treated as an S corporation for its taxable year beginning D2.

In D3, X's attorneys discovered that 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 as an S corporation. Further, at the close of each of these three taxable years, X had \$a of subchapter C earnings and profits. As a result, X's S election terminated on D4.

X represents that the termination of its S election was inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X and its shareholders were unaware that the receipt of passive investment income could terminate their S election.

X and its shareholders have consistently treated X as an S corporation since D2, and agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary. To eliminate its subchapter C earnings and profits, X distributed \$b to its shareholders on D5.

LAW AND ANALYSIS

Section 1361(a)(1) defines an "S corporation", with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

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 each of three consecutive taxable years, and has gross receipts for each of the taxable years more than 25% of which are passive investment income. The termination is effective on and after the first date of the first tax year beginning after the third consecutive tax year referred to in § 1362(d)(3)(A)(i). Section 1362(d)(3)(A)(ii).

Section 1362(f) provides, in relevant part, that if: (1) an election under § 1362(a) by any corporation was terminated under paragraph § 1362(d)(3); (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 the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, 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 the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

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 each of three consecutive tax years beginning D2, and had gross receipts for each of those tax years more than 25 percent of which were passive investment income.

We further conclude that the termination of X's S election was an inadvertent termination 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 met. As an adjustment under § 1362(f)(4), X must send a payment of \$c with a copy of this letter to the following address: Internal Revenue Service, P.O. Box 145500 -- Stop 533, Cincinnati, OH 45250. X must send this payment no later than 30 days from the date of this letter. If this condition is not met, then this ruling is null and void. Furthermore, if this condition is 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 concerning whether X's S corporation election 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 the power of attorney on file with this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,
David R. Haglund
Senior Technician Reviewer, Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
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