Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3 PLR-115853-98
Date:
December 9, 1998

Company:

State:

Business:

Partnerships:

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Dear

This letter responds to a letter from your authorized representative dated July 29, 1998, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling under § 1362(f) of the Internal Revenue Code that the termination of Company's S corporation election was inadvertent. Company represents the following facts.

Company was incorporated under the laws of State on a to engage in Business. It elected under § 1362(a) to be an S corporation, effective b. It has accumulated subchapter C earnings and profits.

In c, Company sold substantially all of its operating assets and stopped conducting Business, leaving Company with mostly marketable securities and other investment assets. In d, Company began investing in certain publicly traded partnerships (PTPs), including Partnerships.

The accountant assigned by Company's accounting firm to monitor Company's passive investment income was Company's primary contact with the PTPs for estimating the level of passive gross receipts for a given fiscal year. Attempting to increase nonpassive gross receipts for e, the accountant, without the knowledge or consent of Company, directed that Company's entire interest in one of the PTPs be sold. However, as the result of erroneous projections and a computational error, the sale of these units actually increased Company's passive investment income for the year.

Before the error was discovered, the accountant left Company's accounting firm for employment elsewhere. In f, a new accountant from the same firm, upon review of the situation, concluded that Company owed tax under § 1375 (Company paid the § 1375 tax for g also). The accountant assumed that this was Company's second consecutive year of excess passive investment income.

In h, the matter was referred to Company's attorney for planning to avoid termination of Company's S corporation election under § 1362(d)(3). Upon further review, it was determined that Company's S election had already terminated because it had had excess passive investment income for i. This fact was overlooked initially because Company had incurred no tax liability under § 1375 for this year because of a net operating loss. After researching the issue, Company filed this request for inadvertent

termination relief.

Company represents that it is now increasing its investments in PTPs generating nonpassive gross receipts so as to avoid any excess passive investment income in the future.

Except as provided in § 1362(g), § 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) terminates whenever the corporation (I) has accumulated earnings and profits at the close of each of three consecutive tax years, and (II) has gross receipts for each of such tax years more than 25 percent of which are passive investment income.

Except as otherwise provided in subparagraph § 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)(B) 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)(A) 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 might 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 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.

After applying the applicable law and regulations to the facts and representations of this ruling request, we conclude that the termination of Company's S corporation election due to excess passive investment income was inadvertent within the meaning of § 1362(f).

Consequently, we rule that Company will be treated as continuing to be an S corporation from j to the present, unless Company's S election otherwise is terminated under § 1362(d).

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 the propriety of Company's use of a fiscal year for tax reporting.

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

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

JEFF ERICKSON
Assistant to the Chief,
Branch 3
Office of Assistant
Chief Counsel
(Passthroughs and
Special Industries)

enclosure: copy for § 6110 purposes