INTERNAL REVENUE SERVICE
UIL 1362.00-00
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CC:DOM:P&SI:7--PLR-121646-97

OCT. 19, 1998

Re:

Legend:

X:

w:

y:

z:

date 1:

date 2:

date 3:

date 4:

date 5:

date 6:

date 7:

date 8:

date 9:

j:

k:

l:

m:

Dear :

We received your representative's letter, dated , , submitted on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code. This letter responds to that request.

The represented facts are as follows: X is a corporation that elected to be treated as an S corporation under § 1362 effective for its taxable year beginning on date 1. X's sole shareholder is z, a qualified subchapter S trust. The beneficiaries of z are w and y, husband and wife. On the date X elected S corporation status, X had $j of accumulated C corporation earnings and profits (E&P). X is on the cash method of accounting with a taxable year ending December 31st.

X hired a new accountant on date 7. When the new accountant prepared X's income tax return for the year ending date 4, she discovered that X had excess passive investment income for that year. Over the next few months, the new accountant reviewed X's income tax returns for the years ending date 2 and date 3, and discovered that X also had excess passive investment income for those years. X's new accountant determined that because X did not have taxable income for the years ending date 2 and date 3, X was not liable for excessive passive investment income taxes for those years. On date 8, X paid excess passive investment income tax in the amount of $k for the year ending date 4. X also paid excess passive investment income tax in the amount of $l for date 5 and made a partial cash distribution of the C corporation E&P during the year ending date 5.

On date 9, X's new accountant informed X that X's S corporation election inadvertently terminated on date 6. The new accountant promptly filed with the Service a request for inadvertent termination relief under § 1362(f). In the request for relief, X represents that X's prior accountant was unaware that excess passive investment income for 3 consecutive years would terminate the S election of a corporation with undistributed C corporation E&P.

Before date 9, X believed that its S corporation election was still in effect. X and z, the sole shareholder of X, and w and y, the beneficiaries of z, filed their income tax returns in a manner consistent with the treatment of X as an S corporation. In the request for relief, X, z, w and y agreed to make any adjustments necessary, consistent with the treatment of X as an S corporation, as may be required. In addition, X, z, w, and y represented that during the period for which X requested relief under § 1362(f), z, w, and y, in determining federal income tax

liabilities, included the proper amounts of the separately and nonseparately computed items of X as provided in § 1366, made adjustments to stock basis as provided in § 1367, and took into account any distributions X made as provided in § 1368.

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

Section 1362(d)(3)(A) provides that an election under § 1362(a) is terminated whenever the corporation has subchapter C 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 percent of which are passive investment income. The termination is effective on and after the first day of the first taxable year beginning after the third consecutive taxable year.

Section 1375(a) provides that if an S Corporation has (1) accumulated E&P at the close of the taxable year, and (2) gross receipts more than 25 percent of which are passive investment income, then there is hereby imposed a tax on the income of such corporation for such taxable year. Such tax shall be computed by multiplying the excess net passive income by the highest rate of tax specified in § 11(b).

S corporation regulation § 1.1361-1(j) sets forth the requirements of a Qualified Subchapter S Trust (QSST). Section 1.1361-1(j)(i) provides the requirement that all of the income of the trust is distributed currently to one individual who is a citizen or resident of the United States. Section 1.1361-1(j)(2) provides that if a husband and wife are income beneficiaries of the same trust, the husband and wife can file a joint return and if each is a U.S. citizen or resident, the husband and wife are treated by the preceding sentence as one beneficiary for the purposes of § 1.1361-1(j).

Section 1362(f) provides that if (1) an election under §1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of § 1362(d); (2) the Secretary determines that the circumstances resulting in the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, 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 with respect to the period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation is treated as continuing to be an S corporation during the period specified by the Secretary.

The committee reports accompanying the Subchapter S Revision Act of 1982, in discussing § 1362(f) as it relates to inadvertent terminations, state, in part, as follows:

> 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 revenue without undue hardship to taxpayers. . . . 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. 12-13 (1982), 1982-2 C.B. 718, 723-24. H.R. Rep. No. 826, 97th Cong., 2nd Sess. 12 (1982), 1982-2 C.B. 730, 735.

X represents that tax avoidance was not a motive in any of the actions or events described above; that the terminating event occurred without the knowledge of X; that X would distribute or make a deemed distribution of any remaining of $j the C corporation E&P; that the $j E&P will be reported as dividends on w and y's joint income tax return; and that X, z, w and y agree to make any adjustments, consistent with the treatment of X as an S corporation, as might be required.

Based on the facts submitted and the representations made, we conclude that: X's S corporation election inadvertently terminated on date 6 because X had subchapter C E&P at the close of each of three consecutive tax years ending on dates 2, 3 and

4, and had gross receipts for each of these tax years, more than 25 percent of which was passive investment income. We also conclude that the termination of X's S corporation election was an inadvertent termination within the meaning of § 1362(f). Accordingly, pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation beginning on date 6, and thereafter, provided that X's S corporation election is not otherwise terminated under § 1362(d), and provided that the following conditions are met:

1. For the year ending date 5, X must make an actual or deemed distribution of the total remaining amount of X's C corporation E&P. Further, X must amend X's federal income tax return for the year ending date 5 to reflect the distribution of X's C corporation E&P to z, X's sole shareholder, and to adjust X's items of income, loss and deduction to show that the items of income have not been reduced for any excess passive investment income tax paid under § 1375.

2. z, the shareholder of X, and w and y, the beneficiaries of z, also must amend their federal income tax returns for the year ending date 5 to report the distribution from X of the total amount of X's C corporation E&P dividend income (actual dividends and deemed dividends) received during the year ending date 5, and to reflect the adjusted items of income, loss and deduction that X reports on its amended return for the year ending date 5, as required above.

3. X must send a payment of $m attached to a copy of this letter and copies of the amended federal income tax returns for X, z, w and y for the year ending date 5 to the Internal Revenue Service, Attn: Mona Langmaid, 310 Lowell Street-Entity, Stop 614, Andover, MA 05501.

On X's timely filed original federal income tax return for the year ending date 5, X reported that it had made a partial cash distribution of X's C corporation E&P to shareholder z. For the years ending date 4 and date 5, X properly paid the § 1375 sting tax that X owed. In the current year, the Service refunded the § 1375 tax that X paid for the year ending date 5. The payment of $m that X must send to Andover attached to a copy of this letter properly accounts for the § 1375 tax paid for the years ending date 4 and date 5, and properly accounts for the refund of the § 1375 tax in the current year. The payment of $m also properly accounts for the § 1366 passthrough amount of items of income, loss and deduction, for X's payment of the § 1375 tax for the excess passive investment income for years ending date 4 and date 5, and the current year refund of the § 1375 tax paid for the year ending date 5. Further, the payment of $m properly accounts for the tax and interest (from date 4, the date X's total amount of C corporation E&P should have been

distributed, to the present) that X owed on the distribution (actual and deemed distributions) of the previously undistributed C corporation E&P. X must submit the payment of $m and X, z, w and y, must submit the amended returns no later than 60 days from the date of this ruling letter. No additional payment is due. This ruling shall be null and void if the requirements of this letter are not met.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the above-described facts under any other provision of the Code. Specifically we express or imply no opinion as to z's status as QSST.

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.

Sincerely yours,

Christine E. Ellison
Branch Chief,
Branch 7
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

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