Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:03
PLR-128089-19

Date:
June 15, 2020

X =

State =

Shareholders =

=

=

=

a =

b =

c =

d =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Year 1 =

Year 2 =

Year 3 =

Dear :

This letter responds to a letter dated November 14, 2019, and subsequent correspondence, submitted on behalf of X, requesting relief under §1362(f) of the Internal Revenue Code (Code).

Facts

According to the information submitted and representations made, X was incorporated under the laws of State on Date1. In Year 1, X converted from a State corporation to a State limited partnership and filed a Form 8832, Entity Classification Election, to be classified as an association taxable as a corporation effective Date 2. Also, in Year 1, X elected to be an S corporation effective Date 2.

In Year 2, X learned that its S corporation election may have been invalid because X was a State limited partnership when it elected to be an S corporation. As a State limited partnership, X may have had more than one class of stock in violation of the one class of stock requirement under § 1361(b)(1)(D). To remedy this potential issue, X converted to a State limited liability company in Year 2. X represents that the conversions in Year 1 and Year 2 qualify as reorganizations under § 368(a)(1)(F).

In Year 3, X discovered that its S corporation election would have terminated on Date 6 if its S corporation election was valid because at the close of three consecutive taxable years ending Date 5, X had accumulated earnings and profits of $a. Moreover, for each taxable year ending Date 3, Date 4, and Date 5, X had passive investment income (within the meaning of § 1362(d)(3)) in excess of 25 percent of its gross receipts. As a result, X began to take remedial actions. X represents that it will amend its returns for taxable years ended Date 3 and Date 4 and pay $b and $c, respectively,

under § 1375. In addition, X will elect pursuant to § 1.1368-1(f)(3) of the Income Tax Regulations to distribute all of its accumulated earnings and profits, $a, to its shareholders through a deemed dividend on Date 7.

X represents that the circumstances resulting in the potential ineffectiveness of its S corporation election, as well as the termination on Date 6, were inadvertent, unintended, and not the result of tax avoidance or retroactive tax planning. X and its Shareholders have consistently treated X as an S corporation since Date 2 and agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.

Law and Analysis

Section 1361(a)(1) 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 such year.

Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (b) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than one class of stock.

Section 1.1361-1(l)(1) provides, in part, that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates 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 taxable 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) is 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).

Except as otherwise provided in § 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, and annuities.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation 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 was terminated under § 1362(d)(2) or (3); (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 so that the corporation for which the election was made or the termination occurred is a small business corporation; and (4) the corporation for which the election was made or the termination occurred, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agree to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary regarding this period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1.1362-4(b) provides, in part, 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, in the case of a termination, was not part of a plan to terminate the election, or the fact that the terminating event or circumstance took place without the knowledge of the corporation, notwithstanding its due diligence to safeguard itself against such an event or circumstance, tends to establish that the termination of the election was inadvertent.

Section 1.1362-4(d) provides that the Commissioner may require any adjustments that are appropriate. In general, the adjustments required should be consistent with the treatment of the corporation as an S corporation during the period specified by the Commissioner.

Section 1.1368-1(f)(3) provides that an S corporation may elect under § 1.1368-1(f)(3) to distribute all or part of its subchapter C accumulated earnings and profits through a deemed dividend. If an S corporation makes the election provided in § 1.1368-1(f)(3), the S corporation will be considered to have made the election under § 1.1368-1(f)(2) (to distribute earnings and profits first).

Section 1.1368-1(f)(5)(iii) provides that a corporation makes an election for a taxable year under § 1.1368-1(f) by attaching a statement to a timely filed (including extensions) original or amended return required to be filed under § 6037 for that taxable year. In the statement, the corporation must identify the election it is making under § 1.1368-1(f) and must state that each shareholder consents to the election. In the case of elections for taxable years beginning after December 31, 2002, the statement described in § 1.1368-1(f)(5)(iii) shall be verified by signing the return. A statement of election to make a deemed dividend under § 1.1368-1(f) must include the amount of the deemed dividend that is distributed to each shareholder.

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross

receipts more than 25 percent of which are passive investment income (within the meaning of § 1362(d)(3)).

Section 1375(b)(1)(B) provides that the amount of the excess net passive investment income for any taxable year shall not exceed the amount of the corporation's taxable income for such year as determined under § 63(a)—(i) without regard to the deductions allowed by part VIII of subchapter B (other than the deduction allowed by § 248, relating to organizational expenditures), and (ii) without regard to the deduction under § 172.

Conclusion

Based solely on the representations made and the information submitted, we conclude that X's S corporation election may have been ineffective on Date 2 because X was a State limited partnership at the time of its election. In addition, we conclude that X's S corporation election, if valid, terminated on Date 6 under §1362(d)(3)(A) because X had accumulated earnings and profits at the close of each of three consecutive taxable years beginning on Date 8, and had gross receipts for each of those taxable years more than 25 percent of which were passive investment income. We conclude, however, that the potential ineffectiveness and termination described in this paragraph were inadvertent within the meaning of §1362(f).

Pursuant to the provisions of § 1362(f), X will be treated as an S corporation from Date 2, and thereafter, including on and after Date 6, provided that X's S corporation election was otherwise valid and was not otherwise terminated under § 1362(d). This ruling is subject to the following conditions: (1) X must distribute all of its accumulated earnings and profits no later than Date 7 and make an election under § 1.1368-1(f)(3) to treat the distribution as a deemed dividend on its Year 3 return, (2) within 120 days from the date of this letter, X must file amended returns for its taxable years ended Date 3 and Date 4 and pay the tax due under § 1375, and (3) no later than 45 days from the date of this letter, X must send a payment of $d with a copy of this letter to the following address: Internal Revenue Service, Kansas City Submission Processing Campus, 333 W. Pershing Road, Kansas City, MO 64108, Stop 7777, Attn: Manual Deposit.

If all the above 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 it filed its S corporation election that its election terminated on Date 6.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion regarding X's eligibility to be an S corporation.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed

by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

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.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

Sincerely,

Mary Beth Carchia
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for §6110 purposes

cc: